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**An Efficiency Based Resolution of
Contentious Issues under the
Convention on International Sale of Goods**

by

Hassan Nizami

**A thesis submitted in partial fulfillment of the requirements for the degree
of Doctorate of Philosophy in Law**

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Declaration

This thesis is submitted to the University of Warwick in support of my application for the degree of PhD in Philosophy of Law. It has been composed by myself and has not been submitted in any previous application for any degree.

Abstract

Given the prominence of international trade in the globalized economy, large undesirable costs arise due to uncertainties in international transactions. The United Nations Convention on Contracts for the International Sales of Goods, Vienna, 1980 identifies some of these costs to be a product of separate legal rules on international trade, and recognizes the solution to lie in a unified statement of norms. Judicial experience with the Convention, however, has demonstrated that the existence of a unified statement of norms does not ensure uniform results.

While the majority of the literature on the Convention takes a black letter law approach without examining the impact of varying interpretations on the end users of the Convention, this thesis argues that the provisions of the Convention, from the perspective of the parties, must operate to achieve the ends of efficiency. Absent the same, parties drafting a contract would opt out of the application of the default rules by including a provision in the contract governing the contingency. Such an outcome would in turn significantly increase transaction costs associated with contractual negotiating and drafting.

This thesis concerns itself with six areas that have raised a great deal of disagreement amongst the scholarly and judicial community namely: The scope and role of the principle of good faith; the issues surrounding the inclusion of standard terms into the contracts of sale; the extent to which the Convention allows for the use of open-price terms; the question of the period within which notice of non-conformity must be provided; the rate at which interest has to be paid on sums in arrears and; the guiding principles for the interpretation of the term ‘foreseeability’ as contained in article 74. Each chapter of this thesis therefore deals with one of these issues and attempts to resolve it in line with the international character of the Convention - and one that promotes the efficiency of the agreement. For the purposes of this thesis, an efficient rule is defined as one that operates to minimize transaction costs, does not allow or de-incentivizes the potential of parties to act in an opportunistic manner and places liability on the best risk avoider. In reaching such an interpretation of the articles under examination, the thesis gives due regard to the travaux préparatoires, scholarly opinion and judicial pronouncements on the matter.

Abbreviations

Convention	The United Nations Convention on Contracts for the International Sales of Goods, Vienna, 1980
SGA	Sale of Goods Act, 1979
AC	Advisory Council
UCC	Uniform Commercial Code
BOF	Battle of Forms
LSR	Last Shot Rule
FSR	First-Shot Rule
CA	Court of Appeals
Restatement	The Restatement (Second) of Contracts
TC	Transaction costs
UCTA	Unfair Contracts Terms Act 1977
Principles	UNIDROIT Principles of International Commercial Contracts, 2010
BSR	Best Shot Rule
ROI	Rate of Interest
travaux	Travaux préparatoires
RASCC	Rate applied to short term commercial credits
PIL	Private International Law
CLT	Coerced Loan Theory
ULIS	Uniform Law on The International Sale of Goods, 1964.
UNCITRAL	United Nations Commission on International Trade Law

Vienna Convention	Vienna Convention on the Law of Treaties, 1969
ULF	Uniform Law on the Formation of Contracts for the International Sale of Goods, 1964
UNIDROIT	International Institute For The Unification of Private Law
CC	French Civil Code
BGB	Bürgerliches Gesetzbuch - German Civil Code
HGB	Handelsgesetzbuch - German Commercial Code
LG	Landgericht
SGA 1893	The Sale of Goods Act 1893
BGH	<u>Bundesgerichtshof</u>
HL	House of Lords
Draft Convention	United Nations Commission on International Trade Law Draft
CLOUT	Case Law on UNCITRAL Texts
UGB	Austrian Commercial Code
GKRF	The Russian Civil Code
SCC	The Spanish Civil Code
UK	United Kingdom
US	United States

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Chapter 1: Introduction

The United Nations Convention on Contracts for the International Sales of Goods, Vienna, 1980 (hereafter referred to as ‘Convention’) was drafted with the aim of harmonizing the law on international sales. This harmonization was motivated by compelling political realities, the interconnectedness of domestic and international economies, and the need for certainty in international sales.¹ Given the prominence of international trade in the globalized economy, large undesirable costs arise due to uncertainties in international transactions.² The Convention identifies some of these costs to be a product of separate legal rules on international trade, and recognizes the solution to lie in a unified statement of norms.³

Judicial experience with the Convention, however, has demonstrated that the existence of a unified statement of norms does not ensure uniform results.⁴ This may partly be attributable to the fact that unlike scientists, lawyers do not have the luxury to write laws in formulas and numbers.⁵ Rather the only tools available to lawyers are words – which have been characterized by Professor Honnold as “mushy, ambiguous things” that constitute “blunt (and) unreliable tools.”⁶ This problem is exacerbated when, in legal drafting, recourse is made to intrinsically vague terms such as foreseeability and good faith.⁷

¹ Arthur Rosett, ‘Critical Reflections on the United Nations Convention on Contracts for the International Sale of Goods’ (1984) 45 Ohio State Law Journal 265

² *ibid*

³ The UNCITRAL states that the purpose of the Convention “is to provide a modern, uniform and fair regime for contracts for the international sale of goods. Thus, the CISG contributes significantly to introducing certainty in commercial exchanges and decreasing transaction costs.”

<http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG.html> accessed: 2 December 2012; The preamble to the United Nations Convention on the International Sale of Goods, 11 April 1980 (hereinafter referred to as ‘Convention’) states: “...that the adoption of uniform rules which govern contracts for the international sale of goods and take into account the different social, economic and legal systems would contribute to the removal of legal barriers in international trade and promote the development of international trade.” See also Kazuaki Sono, ‘Restoration of the Rule of Reason in Contract Formation: Has There Been Civil and Common Law Disparity?’ (1988) 21 Cornell International Law Journal 477.

⁴ Camilla Baasch Andersen, ‘The Uniform International Sales Law and the Global Jurisconsultorium’ (2005) 24 Journal of Law and Commerce 159.

⁵ John Honnold, ‘The Sales Convention in Action – Uniform International Words: Uniform Application?’ (1988) 8 Journal of Law and Commerce 207.

⁶ *ibid*.

⁷ *ibid*.

Conceptual and linguistic problems are further intensified by the pre-disposition of courts and tribunals to interpret international instruments through a domestic lens.⁸ In this regard Professor Honnold advocates the solution to lie in the use of scholarly writing and judicial pronouncements from other legal systems.⁹ An in-depth analysis of the Convention however, reveals the inherent incoherence of the instrument, which limits the possibility of any one legal tradition accepting the ruling of another legal system on certain provisions.¹⁰ One of the reasons for such incoherence, in the words of Professor Ziegel, lies in the fact that “where an acceptable compromise could not be reached the drafters unhappily had to seek refuge in vague or obfuscatory language.”¹¹

The Convention is a result of over 10 years of negotiations for the creation of a unified statement of international commercial law. In fact, it may be argued that the foundation stone of the Convention was actually laid at the Sixth Session of the Hague Conference on Private International Law held in 1928. After a brief hiatus during the Second World War the project resumed in the early part of the 1950s, with delegates representing 20 states.¹² As a result of this effort, the ULIS and the ULF were adopted at the Diplomatic Conference held at The Hague in 1964.¹³ Eric Bergsten notes that even at this stage there were concerns regarding the extent to which states would ratify the uniform law on sales.¹⁴ Indeed even four years after the

⁸ *ibid*; see also James E. Bailey, 'Facing the Truth: Seeing The Convention on Contracts for the International Sale of Goods as an Obstacle to a Uniform Law of International Sales' (1999) 32 *Cornell International Law Journal* 273.

⁹ Honnold (n 5).

¹⁰ There are however instances where courts belonging to one jurisdiction have made reference to judgments emanating from other jurisdictions. See for example District Court, Northern District of Georgia, United States, 17 December 2009; Rechtbank Rotterdam, Netherlands, 25 February 2009; Tribunale di Forlì, Italy, 16 February 2009; CLOUT case No. 867 [Tribunale di Forlì, Italy, 11 December 2008]; Oberlandesgericht Stuttgart, Germany, 31 March 2008; Supreme Court, Poland, 11 May 2007; CLOUT case No. 774 [Bundesgerichtshof, Germany, 2 March 2005]; CLOUT case No. 889 [Handelsgericht Kanton Zürich, Switzerland, 24 October 2003].

¹¹ Jacob S Ziegel, 'The Future of the International Sales Convention from a Common Law Perspective' (2000) 6 *New Zealand Business Law Quarterly* 336, 338.

¹² On the first of July 1964 the ULIS opened for signature. Reprinted in (1964) 13 *American Journal of Comparative Law* 453.

¹³ Convention Relating to a Uniform Law on the International Sale of Goods 1 July 1964 (hereinafter referred to as 'ULIS') reprinted in John O. Honnold, *Uniform Law for International Sales Under The 1980 United Nations Convention* (2nd edn, Kluwer Law International 1991) 667-91; Convention Relating to a Uniform Law on Contracts for the International Sales of Goods, 1964 [hereinafter ULF], reprinted in Honnold at 659-66.

¹⁴ Eric Cohen, 'Methodological Problems in the Drafting of the CISG' in André Janssen and Olaf Meyer (eds), *CISG Methodology* (Sellier European Law Publishers 2009) 11

adoption of the uniform law, it was noted at the First Session of the UNCITRAL that the ULIS had not reached the necessary five ratifications to bring it into force.¹⁵

At the Second Session of the UNCITRAL it became clear that one of the significant barriers in the ratification of the uniform law lay in the fact that it did not adequately address the concerns of developing states. This is hardly surprising given that both the uniform laws were drafted almost exclusively by the representatives of industrialized Western European states.¹⁶ Nations with different legal, social and economic traditions therefore viewed them with a degree of skepticism, at least with regard to the extent to which the model laws represented an attempt at a global unification.¹⁷ As a result, the Session concluded with the decision to set up a Working Group to “ascertain which modification of the existing text might render them capable of wider acceptance by countries of different legal, social and economic systems.”¹⁸ The number of proposals for amendment were so numerous that it became clear that a new convention would have to be drafted.¹⁹

It should be noted that the ULIS and the ULF were neither model laws nor standalone conventions. Rather they were uniform laws attached to conventions.²⁰ Any state that became a member of the convention to which the uniform law was attached automatically undertook the obligation to incorporate the uniform law into their domestic legislation.²¹ As a result, public international law viewed such incorporation as a fulfillment of treaty obligation; from the perspective of domestic law, however, the model laws were simply domestic law statutes once incorporated.²²

¹⁵ By 1972, it had been ratified by a total of only eight nations. Michael P. Van Alstine, ‘Dynamic Treaty Interpretation’ (1998) 146 *University of Pennsylvania Law Review* 687, 696

¹⁶ Elizabeth Hayes Patterson, ‘United Nations Convention on Contracts for the International Sale of Goods: Unification and the Tension Between Compromise and Domination’ (1986) 22 *Stanford Journal of International Law* 263, 267

¹⁷ *ibid.* See also Van Alstine (n 15).

¹⁸ Commission Report Second Session (1969), A/7618 para 38.

¹⁹ Van Alstine (n 15) 687.

²⁰ Bergsten (n 14) 13.

²¹ See Article 1(1) of The Convention Relating to the Uniform Law on The International Sale of Goods (The Hague 1 July 1964); Article 1(1) of the Convention relating to The Uniform Law On The Formation of Contracts for the International Sale of Goods (The Hague 1 July 1964)

²² Bergsten (n 14) 12.

In 1969, when the UNCITRAL restarted the process of unification of law on international sales, the drafting committee was composed of representatives belonging to fourteen countries which were “chosen to represent and ensure the involvement, feedback, and support from the distinct legal systems of this world.”²³ Moreover, when the Convention was adopted at the UN Diplomatic Conference 1980, representatives of sixty-two states participated – belonging to a multitude of legal, social and political traditions.²⁴ The diversity of views that sought recognition during the drafting stages is itself testament to the momentous achievement reached by the UNCITRAL. It is also however testament to the fact that the provisions of the Convention, in various instances, represent diplomatic compromise on the part of the drafters. Unfortunately, such compromise often came at the expense of clarity.

It is essential for the future success of the Convention that its end users – i.e. the mercantile community – are provided a degree of clarity vis-à-vis their respective rights and obligations. In the words of Professor Rosett:

Businesspersons do not place a high value on doctrinal purity nor do they especially value the political capacity to accommodate persistently conflicting views in an acceptable diplomatic text. They do need to set prices and undertake risks; hence, they need legal guidance in responding to particular situations.²⁵

1.1 Interpretative Philosophy Of The Convention

During the drafting stages of the Convention, the subject of interpretation attracted intense interest, specifically with regards to the extent to which the Convention would displace national law.²⁶ During this stage of deliberations, delegates can roughly be divided into two groups. One group completely rejected the idea or even the possibility of framing a comprehensive code of international legal

²³ The UNCITRAL was established through Resolution 2205 (XXII) of the General Assembly. Susanne Cook, ‘The Need for Uniform Interpretation of the 1980 United Nations Convention on Contracts for the International Sale of Goods’ (1988) 50 University of Pittsburgh Law Review 197, 202

²⁴ Ziegel (n 11) 337.

²⁵ Before the creation of the UNCITRAL in 1966, the UNIDROIT was responsible for the unification of commercial law; Rosett (n 1) 269.

²⁶ Article 17 of the ULIS stated that all questions left unsettled were to be resolved in conformity with the general principles on which the Convention is based. Honnold (n 5).

standards and advocated for a skeleton of rules that would be devoid of any unifying principles.²⁷ The other group, advocated for a Convention that would completely preempt and be independent of national laws.²⁸

After prolonged deliberations, Article 7 was incorporated into the text of the Convention.²⁹ By virtue of this article, the Convention is to be interpreted with due regard to its international character, the need to promote uniformity in its application and the observance of good faith in international trade.”³⁰ A perusal of Article 7(1) suggests that it merely specifies the goals an appropriate interpretation is to reach rather than framing a clear methodology of interpretation.³¹ Article 7(2) goes on to state that issues that lie within the scope of the Convention but have not been explicitly settled in it are to be resolved in conformity with the general principles on which it is based.³² Domestic law is only applicable for the resolution of an issue which falls within the scope of the Convention when the text is silent on the matter and no general principle capable of resolving the issue can be identified.

1.1.1 International Character:

According to Article 7, the Convention must be interpreted on the basis of its international character³³ – i.e. independent of domestic legal concepts and interpretative techniques.³⁴ The negative consequences of a nationalistic interpretation of the Convention have been recognized in various recent European judgments. For instance, in the case of *Gerichtspräsident von Laufen*, the court asserted that the independence of the Convention from national interpretative techniques is essential to its goal of uniform application, and concluded that unwarranted recourse to domestic law completely undermines the objectives of the

²⁷ Van Alstine (n 15)793.

²⁸ Ibid.

²⁹ Convention, Article 7.

³⁰ ibid Article 7(1).

³¹ Ulrich Magnus, ‘Tracing Methodology in the CISG: Dogmatic Foundations’ in André Janssen and Olaf Meyer (eds), *CISG Methodology* (Sellier European Law Publishers 2009) 40.

³² Convention, Article 7(2).

³³ Convention, Article 7.

³⁴ See United Nations Conference on Contracts for the International Sale of Goods, Vienna, 10 March-11 April 1980, Official Records, Documents of the Conference and Summary Records of the Plenary Meetings and of the Meetings of the Main Committee, 1981, p. 17.

Convention.³⁵ Great care should therefore be taken to avoid what is known as the homeward trend, i.e. the “temptation for judges and the parties settling disputes ... to look at what is familiar especially as it appears to be so at first glance.”³⁶ The first element of the article therefore serves an elevating function in that the Convention is viewed to lie in the international dimension, distinct and independent of domestic legal regimes.³⁷

1.1.2 Uniformity in Application:

Article 7 goes on to state that while interpreting the Convention, attention must be paid to promoting uniformity in its application. This part of the article seems to address the interpreters of the Convention, rather than focusing on substantive provisions.³⁸ Furthermore, Article 7 uses the term ‘need,’ rather than a more elastic term such as ‘want’. What transpires then is the instruction to interpreters and adjudicators to give due regard to decisions by courts of other member states.³⁹ Such recognition of foreign case law is so important in the interpretative methodology of the Convention that certain commentators have classified it as a legal duty.⁴⁰

It should however be noted that a court charged with interpreting a provision of the Convention is not bound by judgments delivered by a foreign court on the matter. Rather all that is required is that the court considers such judgments where they exist.⁴¹ Consequently, such judgments command persuasive authority only, and may be diverged from.

³⁵ Gerichtspräsident von Laufen, Switzerland, 7 May 1993.

³⁶ Marianne Roth and Richard Happ, ‘Interpretation of the CISG According to Principles of International Law’ (1999) 4 International Trade and Business Law Annual 1, 3

³⁷ Martin Gebauer, ‘Uniform Law, General Principles and Autonomous Interpretation’ [2000] Uniform Law Review 683, 686. This is not to deny the fact that in certain instances the Convention mandates reference to national law, see for example Article 1(1)(b).

³⁸ Bruno Zeller, ‘The UN Convention on Contracts for the International Sale of Goods (CISG) – A Leap Forward Towards Unified International Sales Laws’ (2000) 12 Pace International Law Review 79, 88.

³⁹ *ibid*

⁴⁰ Magnus (n 31) 41.

⁴¹ Professor Di Matteo, however, holds otherwise. See Larry A. DiMatteo, ‘An International Contract Law Formula: The Informality of International Business Transactions Plus the Internationalization of Contract Law Equals Unexpected Contractual Liability’ (1997) 23 Syracuse Journal of International Law and Commerce 67.

1.1.3 The Observance of Good Faith:

The interpretation of what the requirement of observance of good faith entails has occupied scholars and tribunals alike since the formation of the Convention, and the issue is far from being resolved. In particular, there are two issues in this regard that have given rise to controversy. First, the Convention makes absolutely no attempt to define what the principle of good faith actually entails. As a result, academics and courts alike disagree on the definition of the principle.

Unfortunately, most commentators simply equate the principle with other vague terms such as fairness and justice – therefore no concrete guidance is provided vis-à-vis what the principle actually means. Second, it is questionable whether the principle amounts to a general principle upon which the Convention is based. These two issues, in part, form the subject matter of Chapter 2 of this thesis.

1.1.4 General Principles:

The second clause of Article 7 stresses the Convention's independence from national legal systems by stating that even in cases where the Convention does not expressly answer a question which lies in its sphere, such issues should be resolved on the basis of the general principles on which the Convention is based. Certain commentators argue that for the application of the general principles, it is necessary that the gap be one that has unintentionally not been settled in the Convention.⁴² This thesis argues that this view is misguided. Indeed, there were instances during the drafting stages of the Convention where the drafters viewed the issue to fall within the scope of the Convention but were forced to intentionally leave certain gaps as a result of the difficulty faced in formulating a solution acceptable to the majority.⁴³ The fact that such issues fall within the scope of the Convention is reason enough to follow the interpretative methodology contained in Article 7(2) whereby recourse to domestic law for the resolution of issues that lie within the scope of the Convention is only allowed in cases where the general principles are unable to address the issue.

⁴² Magnus (n 31) 44.

⁴³ The issue of the rate at which interest is to be charged under Article 78 is an example of how such gaps have been intentionally left in the Convention.

The Convention therefore “imposes first an intro-interpretation with respect to interpretation issues or gaps”⁴⁴ and the use of domestic law in the interpretation of the Convention is allowed only as a last resort.⁴⁵

Allowing recourse to domestic law as a last resort is understandable since, in certain instances, there was an absence of consensus in the UNICTRAL as to whether a particular rule or set of rules should be incorporated into the Convention.⁴⁶ Since the absence of consensus could have very well resulted in the breakdown of the whole Convention, the drafters opted to promote uniformity as much as possible through the incorporation of as many rules on the international sales of goods as the delegates could agree upon.⁴⁷

Furthermore, the drafters of the Convention were often faced with situations where the participants disagreed on the basis of cultural and ideological norms rather than differing conventional rules. For instance, the use of custom and usage in the interpretation of contracts divided the delegates for a decade.⁴⁸ While countries with a capitalist mode of production gave a very high value to custom and usage that had evolved over centuries,⁴⁹ post-colonial states viewed them as remnants of imperialism that had to be broken out of.⁵⁰ Countries with centrally planned economies had strong ideological concerns with unwritten contracts, the autonomy of parties in private contracts and trade customs that they viewed to be a product of Western trade.⁵¹ Given the diverse nature of conflicting interests that sought recognition during the drafting stages of the Convention, the only course open to the drafters in various

⁴⁴ CLOUT case No. 720 [Netherlands Arbitration Institute, Netherlands, 15 October 2002].

⁴⁵ American Arbitration Association, United States, 23 October 2007

<<http://cisgw3.law.pace.edu/cases/071023a5.html>> accessed: 10 January 2013.

⁴⁶ Mark N. Rosenberg, 'The Vienna Convention: Uniformity in Interpretation for Gap-filling – An Analysis and Application' (1992) 20 Australian Business Law Review 442, 452

⁴⁷ Henning Lutz, 'The CISG and Common Law Courts: Is There Really a Problem?' (2004) 35 Victoria University of Wellington Law Review 711, 724

⁴⁸ Honnold (n 13).

⁴⁹ Stephen Bainbridge, 'Trade Usages in International Sales of Goods: An Analysis of the 1964 and 1980 Sales Conventions' (1984) 24 Virginia Journal of International Law 619.

⁵⁰ Arthur Rosett, 'CISG Laid Bare: A Lucid Guide to a Muddy Code' (1988) 21 Cornell International Law Journal 575, 589.

⁵¹ E. Allan Farnsworth, 'The Vienna Convention: History and Scope' (1984) 18 The International Lawyer 17.

instances was to frame rules in a manner that would achieve diplomatic compromise.⁵²

1.2 Do the Rules of the Convention Benefit the Parties?

It should be noted that subject to the dictates of Article 12, parties are free to derogate via agreement from the provisions of the Convention. In turn, it is only when the contract is incomplete that the rules of the Convention, governing such a contingency, become operative. By way of example, while Article 78 specifically obliges a party to pay interest on sums in arrears, it would be inapplicable if the contract specifically states that the no interest is to be paid on the same. It is in this regard that the Convention operates as a set of default rules.

Default rules, from the perspective of the parties, must operate to achieve the ends of efficiency. Absent the same, parties drafting a contract would opt out of the application of the default rules by including a provision in the contract governing the contingency. Such an outcome would in turn significantly increase transaction costs associated with contractual negotiating and drafting. It is in this context that the utility of the economic analysis of the law becomes apparent.

The economic analysis of contract law generally starts from the admittedly false assumption that parties have made provisions for every possible contingency in their contracts.⁵³ Consequently, there is no role for default rules and in instances of dispute courts should simply enforce the express intention of the parties as contained in the provisions of the contract concluded between them.⁵⁴

Contracts are however seldom, if ever, complete and various reasons have been advanced for the same. For instances, parties may not be able to foresee a

⁵² Volker Behr, 'The Sales Convention in Europe: From Problems in Drafting to Problems in Practice' (1998) 17 Journal of Law and Commerce 263.

⁵³ Oliver Hart and John Moore, 'Incomplete Contracts and Renegotiation' (1988) 56 Econometrica 755.

⁵⁴ Steven Shavell, 'On the Writing and Interpretation of Contracts' (2006) 22 Journal of Law, Economics and Organization 289, 295.

contingency ex-ante and therefore may omit to contract on it.⁵⁵ Moreover, a cost-benefit analysis may lead parties to conclude that the cost of agreeing upon the appropriate course of action upon the materialization of a remote contingency may outweigh the advantages of specificity.⁵⁶ In certain instances, parties may intentionally leave the contract incomplete vis-à-vis certain contentious issues, insistence to negotiate upon which might well blow up the deal.⁵⁷ It may simply be too costly to enforce or monitor certain terms ex-post and resultantly parties may opt not to include them in their contracts.⁵⁸

Concerns surrounding incompleteness of contract are remedied if default rules operate to keep the efficiency of the bargain intact on the materialization of unspecified contingencies.⁵⁹ For the purposes of this thesis, a rule is considered efficient if it:

1.2.1 Operates to minimize transaction costs:

Traditionally economic theorists focused on gains of trade made possible by the division of labor and specialization.⁶⁰ This analysis, however, did not take into account the costliness of the exchange process itself. In his famous article, “The Problem of Social Costs,” Coase argued that the neoclassical paradigm would only achieve the implied allocative results in the absence of transaction costs.⁶¹ In other words, an efficient allocation of resources will result where an agreement has been bargained for, regardless of the initial assignment of rights, so long as transaction

⁵⁵ George M. Cohen, ‘Interpretation and Implied Terms in Contract Law’ in Gerrit De Geest (ed), *Contract Law and Economics* (Volume 6, 2nd edition, Edward Elgar Publishing 2011) 129

⁵⁶ Richard Posner, ‘The Law and Economics of Contract Interpretation’ (2005) 83 *Texas Law Review* 1581, 1583

⁵⁷ George Gies, ‘An Embedded Options Theory of Indefinite Contracts’ (2006) 90 *Minnesota Law Review* 1664, 1680-82. Insisting upon the inclusion of such terms may well lead the other party to believe that the insisting party is untrustworthy. See Claire Hill, ‘Bargaining in the Shadow of the Lawsuit: A Social Norms Theory of Incomplete Contracts’ (2009) 34 *Delaware Journal of Corporate Law* 191, 209-10.

⁵⁸ Karen Eggleston, Eric Posner and Richard Zeckhauser, ‘The Design and Interpretation of Contracts: Why Complexity Matters’ (2000) 95 *Northwestern University Law Review* 91, 109

⁵⁹ Shavell (n 86) 289

⁶⁰ Douglass C. North, ‘Institutions and a Transaction-cost Theory of Exchange’ in James E. Alt and Kenneth A. Shepsle (eds), *Perspectives On Positive Political Economy* (Cambridge University Press 1990) 191.

⁶¹ Ronald Harry Coase, ‘The Problem of Social Cost’ (1960) 3 *The Journal of Law and Economics* 1.

costs are kept at a minimum.⁶² As a result, in instances where the transaction costs are zero, the choice of legal rules does not have an impact on the efficiency of the agreement, whereas if transaction costs were positive, the choice of legal rules would have an impact on the efficiency of the outcome.⁶³

It may therefore be stated that the economic function of contract law is to promote voluntary exchange by keeping transaction costs to a minimum. In the context of the Convention, this statement would simply mean that the rules of the Convention should be interpreted in a manner that minimizes transaction costs. This is in line with the purpose of the Convention, which attempts to limit transaction costs by providing a unified statement of commercial law.

Indeed minimizing transaction costs is necessary since they act as a barrier in the conclusion of mutually beneficial agreements.⁶⁴ Professor Mackaay identifies three types of transaction costs: 1) negotiating costs; 2) costs associated with performance and enforcement; and 3) costs associated with the opportunism of the other party.⁶⁵ Negotiating costs are not simply limited to costs associated with agreeing on the terms of the contract and drafting, but rather include costs associated with discovering the preferences and concerns of the other party. The greater the cost associated with procuring such information, the smaller the pie.⁶⁶

Performance and enforcement costs include costs associated with market uncertainties. Merchants would generally not wish to conclude contracts when they believe that changes in the market would foil their plans.⁶⁷ In such a situation, it is necessary to reduce such uncertainty; where that is not possible, the law should attempt to reduce costs by placing risk on the best risk-avoider.

⁶² *ibid*

⁶³ Efficiency here is used to refer to the relationship between the total benefits of a situation relative to its aggregate costs. See A. Mitchell Polinsky, *An introduction to Law and Economics* (3rd edn, Aspen Publishers 2003) 7

⁶⁴ Ejan Mackaay, *Law and Economics for Civil Law Systems* (Edward Elgar Publishing 2013) 223-225

⁶⁵ *ibid*

⁶⁶ Carl J. Dahlman, 'The Problem of Externality' (1979) *Journal of Law and Economics* 141.

⁶⁷ Mackaay (n 96) 223-224

While transaction costs and opportunism are closely related, certain commentators argue that they should not be grouped together – they represent two different concepts.⁶⁸ To address this, this chapter includes a separate section on the concept of opportunism.

1.2.2 Does not allow or de-incentivizes the potential of parties to act in an opportunistic manner:

According to Judge Posner, deterring opportunistic behavior is “the fundamental function of contract law.”⁶⁹ Opportunism for the purposes of this thesis is defined as the policy of self-interest, whereby a party takes undue advantage of an asymmetry to change the ratio of return between the parties to its advantage, and to the detriment of the other.⁷⁰ In the words of Oliver Williamson, it is the policy of “self-interest with guile.”⁷¹

A party acting opportunistically does not necessarily act in contravention of the literal interpretation of the provisions of the Convention but rather places self-interest before the interests of the other party when the opportunity arises.⁷² As such, creative compliance is but one aspect of opportunistic behavior. While there are no issues with a party acting in a self-interested manner; parties should not be allowed to operate contrary to the reasonable expectations of the other under the contract. As such a party acts opportunistically when it “capitalizes on the mistakes of others: utilizes opportunities created by the errors, weaknesses or distractions of opponents to one's own advantage.”⁷³

Opportunism is most evident during the performance stage of a contract. In instances where parties do not perform their contractual obligations simultaneously but rather

⁶⁸ Robert Cooter, ‘The Cost of Coase’ (1982) 11 *Journal of Legal Studies* 1.

⁶⁹ Richard A. Posner, *Economic Analysis of Law* (6th edn, Aspen Publishers 2003) 93-94

⁷⁰ Ejan Mackaay, ‘Good Faith in Civil Law Systems: A Legal-Economic Analysis’ (2012) 18 *Revista chilena de derecho privado* 149, 162.

⁷¹ Oliver E. Williamson, *Markets and Hierarchies, Analysis and Antitrust Implications: A Study in the Economics of Internal Organization* (Free Press 1975) 26.

⁷² *ibid*

⁷³ Donald L. Luskin, ‘Newt's Bain Opportunism Is Mitt's Opportunity’ *Wall Street Journal* (17 January 2012) <<http://www.wsj.com/articles/SB10001424052970204409004577158741468922050>> accessed 24 August 2014

sequentially, one invests in performance before the other. In various instances, this leads to a condition of asset specificity, which in Williamson's words refers to "durable investments that are undertaken in support of particular transactions, the opportunity cost of which investment is much lower in best alternative uses or by alternative users should the original transaction be prematurely terminated."⁷⁴ Consequently the party that has begun its performance is at the mercy of the other. This means that the sequence of performance makes opportunism profitable from the perspective of the party who has to perform last. It should however be noted that opportunism is not limited to the performance stage of the contract but may occur at any stage. Moreover, while the condition of asset specificity is facilitative of opportunism on the part of the party that has not yet invested in performance, it is definitely not a requirement for it.⁷⁵

In its most simplified form opportunism is simply an un-agreed transfer of wealth that is in contravention of the other parties' reasonable expectations under the contract.⁷⁶ In this sense it also includes exploitation of an unspecified contingency by one party with the view of changing the division of gains from the contract in its favor.

The potential of opportunistic behavior on the part of one of the parties to a contract reveals the importance of interpreting default rules in a manner that bars the same. In the words of Ayres and Gertner, "By changing the default rules of the game, law makers can importantly reduce opportunities for rent seeking, strategic behavior."⁷⁷

Opportunism left unchecked carries great costs. Simply put, the easier it is for one party to affect the return from an asset to the other party without being completely liable for its actions, the lower is the value of the asset itself.⁷⁸ Therefore, default

⁷⁴ Oliver E. Williamson, *The Economic Institutions of Capitalism* (Simon and Schuster 1985) 55

⁷⁵ George M. Cohen, 'The Negligence-Opportunism Tradeoff in Contract Law', (1992) 20 Hofstra Law Review 941, 995

⁷⁶ Timothy J. Muris, 'Opportunistic Behaviour and the Law of Contracts' (1981) 65 Minnesota Law Review 521, 566. He states that "opportunistic behaviour provides a ground upon which to separate good from bad faith"

⁷⁷ Ian Ayres and Robert Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules' (1989) 99 Yale Law Journal 87, 94

⁷⁸ Douglass C. North, *Institutions, Institutional Change and Economic Performance* (Cambridge University Press 1990) 31

rules that make parties liable for the costs incurred as a result of opportunistic behavior would operate to maximize the joint return of the parties.⁷⁹ Moreover, if transaction costs did not exist, parties would be able to identify the potential of opportunism on the part of the other and would have forbidden it by expressly incorporating a clause to that effect in their contract.⁸⁰

1.2.3 Places liability on the best-risk avoider:

The least-cost avoider or the best-risk avoider⁸¹ is a concept that initially took root in tort law.⁸² In a nutshell, the concept was employed to deter negligent behavior by punishing a party for not taking cost-justified precautions.⁸³ In the realm of contract law, the best-risk avoider amongst the parties to a contract is identified as the one who is best able to evaluate, mitigate, prevent, and insure against the risk.⁸⁴ It is argued that if default rules operate to provide an incentive to the best risk-avoider, through the imposition of liability or denial of recovery to take adequate precautions, the joint return of the parties is maximized. It should be noted that wealth maximization as used in this thesis does not concern itself with individual welfare.⁸⁵ Instead, it is simply concerned with the sum of participant utility excluding third party effects.⁸⁶

Applying the Coase theorem to the issue of the best-risk avoider it is argued that if transaction costs do not exist then all legal rules are efficient – provided, of course,

⁷⁹ *ibid*

⁸⁰ Posner (n 100) .

⁸¹ Posner and Rosenfield use the term ‘superior risk bearer’ while Cooter and Cohen employ the term ‘least cost avoider.’ This thesis employs these terms interchangeably. See Richard A. Posner and Andrew M. Rosenfield, ‘Impossibility and Related Doctrines in Contract Law: An Economic Analysis’ (1977) 6 *The Journal of Legal Studies* 83, 90; Cohen (n 107) 941; Robert Cooter, ‘Torts as the Union of Liberty and Efficiency: An Essay on Causation’ (1987) 63 *Chicago-Kent Law Review* 523.

⁸² Cohen (n 106) 942.

⁸³ The term precaution is used in this thesis as “any action that reduces harm.” Robert Cooter, ‘Unity in Tort, Contract, and Property: The Model of Precaution’ (1985) 73 *California Law Review* 1, 3

⁸⁴ Cooter (n 112) 532.

⁸⁵ A. Mitchell Polinsky, ‘Risk Sharing through Breach of Contract Remedies’ (1983) 12 *The Journal of Legal Studies* 427

⁸⁶ Geis uses the term ‘social welfare’ in a similar manner. See George S Geis, ‘Empirically assessing *Hadley v Baxendale*’ (2005) 32 *Florida State University Law Review* 897, 912

that neither party has an advantage comparative to the other in taking precautions.⁸⁷ In other words, in situations where there are no transaction costs, the function of the best-cost avoider principle becomes redundant. In the world of international sale of goods however, transaction costs are ever present, thereby limiting the possibility of parties to contract around costly legal default settings. The way around this issue is for the law to provide default rules that place liability on the best-risk avoider. In the words of Professor Cohen, “efficient legal rules minimize the sum of all precaution costs,” thereby reducing the sum of transaction costs.⁸⁸

The party best able to evaluate the risk however, is not always the one best able to take precautions against it. For instance, if the seller is risk neutral while the buyer is risk averse, then attempts to impose an open price term on the buyer may well have a crowding out effect, regardless of the fact that the buyer may be best suited to evaluate the risk. As a result, one must take into account the categories into which different parties can be grouped – for example, risk averse or risk neutral – when identifying the best risk-avoider.

Moreover, the concept of the best-risk avoider can only achieve its intended goals if opportunistic behavior is constrained.⁸⁹ For instance, if a party possesses private information about its circumstances, and does not reveal the same to the other party for strategic reasons it should be identified as the best risk-avoider in instances where precaution is dependent on information revelation.⁹⁰ In such instances, the fact that the other party would be better able to insure against the risk (for instance due to a smaller premium on insurance) becomes irrelevant. This is because the strategically acting party could have enabled the other to take efficient precaution by revealing the information.⁹¹

⁸⁷ *ibid*

⁸⁸ Cohen (n 106) 946.

⁸⁹ It is in this regard that the concept goes beyond deterring negligent behaviour.

⁹⁰ Ayres and Gertner (n 108) 94.

⁹¹ Provided that the other party is best suited to take the precaution.

1.3 Issues Under Consideration

In particular, this thesis concerns itself with six areas that have raised a great deal of disagreement amongst the scholarly and judicial community. While there are numerous other articles and issues within the Convention which require clarification, these six have been chosen because:

1.3.1 The function of the principle of good faith:

A proper interpretation of the Convention requires adherence to the interpretative methodology contained in Article 7. Unfortunately, the dictates of Article 7 have been interpreted inconsistently by the judicial and academic community. Specifically, there is a great degree of disagreement amongst academic community and judicial pronouncements alike, surrounding the definition and function of the principle of good faith. As such, any thesis attempting to interpret provisions of the Convention must begin by resolving this uncertainty.

1.3.2 The issues surrounding the inclusion of standard terms into the contracts of sale:

Given the prevalent use of standard forms in the context of sale of goods, it is hardly surprising that the issue of Battle of Forms (BOF) has been a subject of extensive debate amongst legal scholars around the world.⁹² Various commentators argue that they “raise some of the trickiest doctrinal issues.”⁹³ Unfortunately the Convention does not expressly settle the question of the manner in which conflicting standard forms are to be incorporated into the agreement. As a result, reference has to be made to the dictates of Article 19, which is generally concerned with the question of what amounts to a valid acceptance. The travaux however reveal that the black letter wording of the article does not adequately remedy the concerns of the drafters on the issue. The resolution of the question is therefore unique in that one must derogate

⁹² Giesela Ruhl, ‘Battle of the Forms: Comparative and Economic Observations’, (2003) 24 University of Pennsylvania Journal of International Economic Law 189.

⁹³ Jonathan Morgan, *Great Debates in Contract Law* (Palgrave Macmillan 2015) 68; See for instance Oberlandesgericht Linz, Austria, 23 March 2005; Bundesgerichtshof, Germany, 9 January 2002; Landgericht Kehl, Germany, 6 October 1995.

from the express wording of the Convention in order to reach a commercially reasonable interpretation which is in line with the intent of the drafters.

1.3.3. The issue of open-price terms:

The interplay between Articles 14 and 55 is unique in that a reading of the two seems to suggest that the two contradict one another. Since every article of the Convention is of equal value, it is impossible for the dictates of one article to take precedence over the other. A review of case law and scholarly opinion however demonstrates that at various instances the dictates of Article 14 have been held to be superior to that of Article 55. For example, Professor Garro argues that Article 55 only comes into operation when parties to the contract belong to a member state that has entered into a reservation vis-à-vis part II of the Convention.⁹⁴

The existence of such seemingly contradictory articles is attributed to a diplomatic compromise reached between delegates who advocated for the adoption rules on price terms that would operate to allow parties flexibility as required by prevailing commercial practice, and those who were concerned such provision of flexibility might operate to impose a price which was never intended by the parties.⁹⁵ Indeed an analysis of the Convention's travaux reveals that the interplay between Articles 14 and 55 is one of the most difficult questions raised by the Convention.⁹⁶

1.3.4 The question of the period within which notice of non-conformity must be provided:

⁹⁴ Alejandro M. Garro, 'Reconciliation of Legal Traditions in the U.N. Convention on Contracts for the International Sale of Goods' (1989) 23 International Lawyer 443, 463; see also Professor Farnsworth's view whereby contracts with open price terms cannot be recognized under the Convention since under Article 55, a price term may be implied "where a contract has been validly concluded" and under Article 14, a contract cannot be validly concluded without a sufficiently definite price term. Farnsworth (n 52); see also *Pratt & Whitney v. Malev Hungarian Airlines*, Legfelsbb Bíróság, Gf. I. 31, 349/1992/9 (Dr. László Szlávnits trans., 1992, reprinted in 13 J. L. & COM. 32 (1993)).

⁹⁵ Compare, for example, the view of the delegate of Korea during the 8th meeting of the first committee with that of the delegate of France in Legislative History, 1980 Vienna Diplomatic Conference, Summary Records of Meetings of the First Committee, 8th Meeting, 17 March 1980 (Vienna Diplomatic Conference) .

<<http://www.cisg.law.pace.edu/cisg/firstcommittee/Meeting8.html>> accessed: 4 January 2013.

⁹⁶ See Vienna Diplomatic Conference (n 126).

Unfortunately, there existed a wide array of views amongst the drafters of the Convention vis-à-vis the importance and preferred impact of the non-provision of a notice of non-conformity.⁹⁷ As a result, the text of the article was a result of an uneasy compromise.⁹⁸ It is therefore hardly surprising that questions concerning the timeframe within which the notice is to be provided have constituted one of the most recurring issues that have been brought before courts for adjudication.⁹⁹

Uncertainty with regards to the timeframe within which notice is to be provided is extremely detrimental to the parties of a contract of sale, since non-compliance with the timeframe operates to bar the invocation of any remedy by the buyer which is otherwise available to the buyer under the Convention. The issue has therefore been chosen as a result of its importance – or to put it the other way around, as a result of the disadvantages that accrue due to uncertainty in this regard.

1.3.5 The rate at which interest has to be paid on sums in arrears:

Unlike various lacunae in the Convention, the issue of ROI was extensively debated during the drafting stages of the Convention. As such, a great degree of guidance is contained in the travaux in the form of policy consideration behind the tabling of alternative approaches on the matter and the respective criticisms levied against the same. Various commentators and courts however completely ignore the travaux whilst discussing the appropriate methodology to be adopted in the ascertainment of

⁹⁷ According to Professor Schlechtriem, the article was “one of the Conference's most difficult problems”. See Peter Schlechtriem, *Uniform Sales Law: The UN-Convention on Contracts for the International Sale of Goods* (Manz 1986) 70.

⁹⁸ Anselmo Martinez Canellas, ‘The Scope of Article 44 CISG’ (2005) 25 *Journal of Law and Commerce* 261, 263

⁹⁹ See Franco Ferrari, ‘Specific Topics of the CISG in the Light of Judicial Application and Scholarly Writing’ (1995) 15 *Journal of Law and Commerce* 1, 99: “One of the most important issues of the CISG . . . appears to be . . . the notice to be given to the seller in case of non-conformity of the goods”. This is hardly surprising since around one-fifth of the cases arising from the predecessors of the Convention, namely ULIS, centered on this issue see Peter Birks (ed), *The Frontiers of Liability* (Vol. 2, Oxford University Press 1994) 43; The AC in Opinion Number 2 similarly notes: “The provisions regarding the notice that should be given by the buyer to the seller of goods in case of their alleged lack of conformity to the contract were among the most disputed matters in the preparation of the CISG. The proper interpretation of those provisions is in turn one of the most controversial matters in its implementation since it involves both fact and law.” CISG-AC Opinion no 2, Examination of the Goods and Notice of Non-Conformity: Articles 38 and 39, 7 June 2004. Rapporteur: Professor Eric E. Bergsten, Emeritus, Pace University School of Law, New York.

the appropriate ROI.¹⁰⁰ As a result, numerous commentators have argued that the issue of ROI is outside the scope of the Convention.¹⁰¹

The issue of ROI has been chosen because it represents an instance where the drafters clearly viewed an issue to fall within the scope of the Convention but despite great effort, were unable to agree on a formulation acceptable to all delegates.

1.3.5 The guiding principles for the interpretation of the term ‘foreseeability’ as contained in Article 74:

The reason for analyzing foreseeability as it is contained in Article 74 lies in the fact that unlike all other issues under analysis, the principle did not attract much debate during the drafting stages of the article and thus the travaux are not of much help in the identification of the philosophical underpinnings of the principle of foreseeability, which would provide the grounds for an efficiency based interpretative methodology. Resultantly, this issue represents an instance where recourse is made to the general principles upon which the Convention is based for the resolution of the issue.

1.4 Approach:

The requirements contained in Article 7 of the Convention – whereby “regard is to be had to the Convention’s international character and to the need to promote uniformity in its application” – rules out the possibility of interpreting the same with reference to the dictates of domestic law. Cognizant of this fact, this thesis adopts the following approach to the resolution of issues under examination.

¹⁰⁰ Professor Honnold is amongst those who believe that the travaux provide ‘little or no guidance’ on the issue. Honnold (n 12) 603.

¹⁰¹ See for example, CLOUT case No. 4 [Landgericht Stuttgart, Germany, 31 August 1990]; CLOUT case No. 6 [Landgericht Frankfurt a.M., Germany, 16 September 1991]; See generally, Christian Thiele, ‘Interest on Damages and Rate of Interest Under Article 78 of the U.N. Convention on Contracts for the International Sale of Goods’ (1998) 2 Vindobona Journal of International Commercial Law and Arbitration 3.

First, in order to appreciate the issues faced during the drafting of the Convention, it is essential to recognize the tension between the stances adopted by different legal traditions on the matter. To this end each chapter carries out an analysis of the manner in which the relevant issue is governed under UK, US and German or French law.¹⁰² The reason for choosing these particular jurisdictions lies specifically in the divergence between them in the manner in which the issues under analysis are governed.

The chapters then move on to identify the theoretical justifications provided by the delegates for the adoption of one methodology over others. To this end, the thesis shall provide a detailed analysis of the travaux of the Convention on the issue under consideration.¹⁰³ Such an analysis shall provide a list of requirements that a methodology for the resolution of the issues must fulfil in order to be acceptable under the Convention. At this stage, the efficiency based detailed above shall be utilized to concretely classify such considerations so that they may be applied in the resolution of the issues under examination. It must be noted that these concepts will only be utilized to the extent that they represent the concerns of the drafters. As a result, the use of the efficiency criterion in the interpretation of the Convention is limited to the extent that the same represents the actual intention of the drafters.

Next, the chapters analyze the existing scholarly opinion and judicial pronouncements on the issue under examination. At this stage of the analysis, the diversity of and inconsistency between such opinions and pronouncements shall be highlighted.

At different stages of the analysis, various chapters shall compare the default rule under analysis with the otherwise most commonly used alternate default in order to ascertain whether the rules of the Convention are capable of reaching the ends of

¹⁰² The chapter on ROI does not carry out such an analysis, since in this instance it would not provide any additional tools for a greater appreciation of the issues confronted during the drafting stages of the article. It does however state why certain delegates supported the inclusion of a fixed rate of interest while other supported the inclusion of a methodology of ROI calculation as opposed to a fixed rate.

¹⁰³ As explained above, the issue of what the term foreseeability means in the context of article 74 did not attract debate during the drafting stages of the Convention, resultantly the chapter on the issue does not carry out such an analysis. Rather the chapter makes reference to the general principles upon which the Convention is based for the identification of such justifications.

efficiency. This analysis shall provide a degree of insight into whether the parties would prefer to contract out of the application of the particular default.¹⁰⁴

Equipped with such analysis, each chapter shall move on to resolve the issue under examination in line with the international character of the Convention – and one that promotes the efficiency of the agreement.

1.5 Limitations:

Before moving into the details of the argument put forward by this thesis, it is important to lay out some of the limitations that inform this work. Three main limitations are listed below.

- 1) Empirical research: While it is argued that the efficiency-based considerations will greatly aid tribunals in interpreting the provisions of the Convention in a manner that does promote efficiency and advances harmonization, this paper is limited by existing empirical research. In other words, there is great need for empirical analysis and the formulation of mathematical techniques to concretely ascertain whether a particular default would promote efficiency relative to other defaults.
- 2) Choice of domestic law for an analysis: in order to highlight the tensions between stances adopted by different legal traditions on the matter, which resulted in the need for compromise solutions, this thesis has limited its analysis to UK, US and German (and or) French Law. While these stances only represent a fraction of the views that sought recognition during the drafting of the Convention, it is argued that the concerns of developing states were largely based upon the socio-economic conditions prevalent in those states rather than being a result of the stance adopted by their respective legal traditions. Moreover, this thesis does not evaluate the stance adopted by the national laws of communist states, as the same have greatly changed since

¹⁰⁴ In Chapter Two (the chapter dedicated to discussing good faith), it is argued that the application of the principle is limited to the interpretation of the Convention and does not extend to that of the underlying contract. Therefore, the chapter will question whether parties should include an express term in their contract whereby the principle applies to it as well. In the case of the chapter on the notice requirement under Article 39, such an analysis is omitted.

the end of the Cold War. Given that the drafting process ended well before the fall of the Iron Curtain, such an analysis would be out of touch with current realities.

- 3) Third party rights: while evaluating the efficiency of a particular rule, this thesis does not take into account the impact of the same on third parties.

Chapter 2 Good Faith

Introduction

“Notwithstanding the extensive literature on the subject, no consensus exists on precisely what the duty of good faith means.”¹

Article 17 of the ULIS, the predecessor of the Convention, defines the interpretative methodology to be adopted by tribunals, called upon to settle disputes that are governed by it but not expressly settled thereunder.² When faced with such issues, the article excludes the use of national legal principles and norms.³ Instead, the resolution of such gaps is limited to the application of the general principles upon which the instrument was based.

The provision, however, became extremely controversial in practice and opponents of this approach to gap-filling questioned the ability of tribunals to identify and apply such principles.⁴ Proponents of the provision, on the other hand, argued that recourse to domestic law would undermine the goal of uniformity. Indeed, the international nature of the instrument demanded that it be interpreted independent of domestic law. Thus, it made sense to subject its interpretation and gap filling to its own general principles.⁵

During deliberation of what became Article 7 of the Convention, the issue of how the international instrument is to be interpreted and applied resurfaced. During this stage of the proceedings the delegates were roughly divided into two camps. The first camp believed that recourse to domestic law was a necessary evil.⁶ They argued

¹ Daniel R. Fischel, ‘The Economics of Lender Liability’ (1989) 99 Yale Law Journal 131, 140.

² Article 17 of the ULIS reads: “Questions concerning matters governed by the present Law which are not expressly settled therein shall be settled in conformity with the general principles on which the present Law is based.”

³ Article 2 of the ULIS read: “Rules of private international law shall be excluded for the purpose of the application of the present Law, subject to any provision to the contrary in the said Law.”

⁴ René David, ‘The International Unification of Private Law’, *International Encyclopedia of Comparative Law: Legal Systems of the World, Their Comparison and Unification, Vol. II*, Chapter 5 (J. C. B. Mohr 1971) 138

⁵ Ibid.

⁶ Michael Joachim Bonell, ‘Article 7’ in C. Massimo Bianca and Michael Joachim Bonell, *Commentary on the International Sales Law: The 1980 Vienna Sales Convention* (Giuffrè 1987) 65; see also Alejandro M. Garro, ‘Reconciliation of Legal Traditions in the UN Convention on Contracts for the International Sale of Goods’ (1989) 23 The International Lawyer 443.

that experience with the methodology of interpretation prescribed by the ULIS had proved that such general principles could not be concretely identified. Thus the incorporation of such an approach under the Convention would rarely provide meaningful guidance in the resolution of issues governed by it but not expressly settled thereunder.⁷ They therefore advocated for the possibility of recourse to domestic law.⁸ In the other camp, and in the majority, were those who believed that allowing recourse to domestic law would severely undermine the ex-ante predictability of the impact of the rules of Convention and operate contrary to its international character.⁹

The issue was resolved through the proposal of the delegate of the German Democratic Republic, which essentially entailed a compromise solution.¹⁰ The first part of Article 7(2) reflected the text of its counterpart in the ULIS and limited the resolution of issues, governed by the Convention but not expressly settled thereunder, to the general principles upon which the instrument is based. The second part, however, allowed for reference to the rules of domestic law as a last recourse.¹¹

While the issue of the methodology to be adopted in ‘gap filling’ was accepted and incorporated into the text, after a great deal of debate and deliberation, it remains far from clear. The most controversial ambiguity is whether the principle of good faith, as contained in Article 7(1), amounts to one of the general principles upon which the Convention is based.

The inclusion of the concept of good faith in Article 7(1) of the Convention itself represented a compromise between delegates that advocated for the inclusion of the requirement of ‘good faith’ and those who opposed the inclusion of the principle in total.¹² The compromise, which incorporated the principle in the provision dealing

⁷ Garro (n 6).

⁸ UNCITRAL Yearbook I, Vol. I (1968-1970) Part II, Chapter II, Para 170; UNCITRAL Yearbook II (1971), 49

⁹ *ibid.* See also Lisa Spagnolo, ‘Opening Pandora’s Box: Good Faith and Precontractual Liability in the CISG’ (2007) 21 *Temple International & Comparative Law Journal* 261.

¹⁰ UNCITRAL Yearbook IX (1978); see also Bonell (n 6) 70.

¹¹ For an analysis of when recourse can be had to domestic law see American Arbitration Association, *United States*, 23 October 2007 <<http://cisgw3.law.pace.edu/cases/071023a5.html>> accessed: 11 June 2013; *Federal Arbitration Court for the Moscow Region, Russia*, 25 June 2001 <<http://cisgw3.law.pace.edu/cases/010625r1.html>> accessed: 11 June 2013.

¹² Michael F. Sturley, ‘International Uniform Laws in National Courts: The Influence of Domestic Law in Conflicts of Interpretation’, (1986) 27 *Virginia Journal of International Law* 729, 731.

with the interpretation of the Convention, coupled with the uncertainty surrounding the definition of the principle itself, has led to disagreement and uncertainty with regards to the concept's exact function vis-à-vis the Convention. In the academic community, for instance, two schools of thought emerged on the issue. The first school includes Professor Farnsworth¹³, Eorsi¹⁴ and Winsip,¹⁵ who advocate that the function of the concept is simply to aid in the interpretation of the Convention by judges. Various courts have adopted this narrow construction of the function of the principle under the Convention and have applied the same¹⁶.

The other school of thought asserts that the duty to act in good faith is directed at the parties to a contract of international sale of goods as well.¹⁷ Various tribunals have adopted this view.¹⁸ For instance, a tribunal required a party to pay damages on the grounds that his actions were “contrary to the principle of good faith in international

¹³ E. Allan Farnsworth, ‘Duties of Good Faith and Fair Dealing under the UNIDROIT Principles, Relevant International Conventions and National Laws’ (1995) 3 *Tulane Journal of International & Comparative Law* 47, 56.

¹⁴ Gyula Eorsi, ‘General Provisions’ in Galston & Smith (eds), *International Sales: The United Nations Convention on Contracts for the International Sale of Goods* (Matthew Bender 1984).

¹⁵ Peter Winship, ‘International Sales Contracts Under the 1980 Vienna Convention’, (1984) 17 *Uniform Commercial Code Law Journal* 65, 67.

¹⁶ See for instance ICC Court of Arbitration Case No. 8611 of 1997, where the court stated that “since the provisions of Art. 7(1) CISG concerns only the interpretation of the Convention, no collateral obligation may be derived from the ‘promotion of good faith’”. Court of Arbitration of the International Chamber of Commerce, ICC, 23 January 1997

<<http://cisgw3.law.pace.edu/cases/978611i1.html>> accessed: 11 June 2013. Note however, that the court proceeded to find an obligation of good faith elsewhere in the CISG.

¹⁷ Peter Schlechtriem, ‘Good Faith in German Law and in International Uniform Laws’ in Bonell (ed), *Centro di studi e ricerche di diritto comparato e straniero* (Saggi, Conferenze e Seminari, Rome, 1997) No. 24; See for example Oberlandesgericht München, Germany, 14 January 2009

<<http://cisgw3.law.pace.edu/cases/090114g1.html>> accessed: 13 June 2013; Audiencia Provincial de Navarra, Spain, 27 December 2007 <http://cisgw3.law.pace.edu/cases/071227s4.html> accessed: 13 June 2013; Oberlandesgericht Köln, Germany, 21 December 2005

<http://cisgw3.law.pace.edu/cases/051221g1.html> accessed: 13 June 2013; Primer Tribunal Colegiado en Materia Civil del Primer Circuito, Mexico, 10 March 2005

<<http://cisgw3.law.pace.edu/cases/050310m1.html>> accessed: 13 June 2013.

¹⁸ See for example CLOUT case No. 154 [Cour d'appel de Grenoble, France, 22 February 1995] <<http://cisgw3.law.pace.edu/cases/950222f1.html>> accessed: 13 June 2013; Audiencia Provincial de Navarra, Spain, 27 December 2007 <<http://cisgw3.law.pace.edu/cases/071227s4.html>> accessed: 13 June 2013.

trade laid down in Article 7 CISG”.¹⁹ Prominent academics from this school of thought include Professors Maskow²⁰ and Bonell.²¹

This chapter is concerned with ascertaining the appropriate function of the principle of good faith vis-à-vis the Convention. The first part of this chapter is an analysis of the definition and functions attached to the concept in the UK, United States and Germany. This is in order to highlight the tensions that are created when one attempts to unify legal terms and redefine their functions, and to attain a better appreciation of the [varying] connotations attached to the concept by delegates of different countries at the UNCITRAL Working Group. The reason for choosing these particular jurisdictions lies specifically in the divergence between them on the importance and function attributed to the principle.

The second part of this chapter then analyses the drafting history of the Convention and the interpretation and application of the principle by courts and tribunals. It concludes, that while the travaux clearly reveal that the intended application of the principle was limited to aid in the interpretation of the Convention, in fact, courts and tribunals have attributed other functions to the principle in addition; for instance, the imposition of substantive obligations on the parties to contract governed by the Convention.

The third part of this chapter identifies the appropriate function to be attributed to the principle. It argues that the principle is intrinsically vague and, as a result, cannot provide meaningful guidance if used as a general principle, under Article 7(2) of the Convention. It recommends that gap filling should be conducted through the

¹⁹ Ibid CLOUT case No. 154.

²⁰ See also Fritz Enderlein and Dietrich Maskow, *International Sales Law: United Nations Convention on Contracts for the International Sale of Goods* (Oceana 1992) 59. Professor Schlechtriem while noting that Article 7(1) limits the role of good faith to the interpretation of the Convention states “the principle that not only the interpretation of the Convention, but also the evaluation of the relations, rights and remedies of the parties, should be subject to the principle of good faith and fair dealing has found its way into the Convention, its understanding by the majority of legal writers and its application by the courts.” Schlechtriem (n 17) 3.

²¹ Bonell takes this a step further by stating that usages and contractual agreements between the parties may also be disregarded if in the particular circumstances, they run contrary to the principle of good faith. The argument rests on the assertions that, since such usages and agreements are allowed by virtue of article 6 and article 9 of the Convention; the respective articles have to be interpreted subject to the requirement of good faith in order to ascertain the relevance and applicability of such usages/ agreements between the parties. Bonell (n 6).

ascertainment of general principles that underlie specific articles of the Convention rather than through reference to vague notions such as good faith.

Since Article 7(1) does not limit recourse to other international instruments to ascertain the meaning of the principle, this chapter also draws support from the dictates of the UNIDROIT Principles (Principles). However, as the Principles, like the Convention, do not concretely define the principle of good faith, reference to provisions that contain specific manifestations of good faith is necessary. The exercise of defining the principle of good faith via recourse to the Principles would appear to add to the uncertainty, by simplifying a greater number of vague rules under the banner of good faith. Instead, attempt is made to define the principle via reference to specific articles of the Convention itself. The identification and analysis of such articles, arguably leads to the conclusion that their common core lies in barring opportunistic behavior.

Finally, this chapter turns to analyze whether parties should opt to include an express term obligating good faith performance in their contracts. To this end the framework of efficiency discussed in chapter 1 is utilized.

2.1 The differentiation between good faith as a tool of interpretation and good faith as a general principle:

Given the ideological fault lines between legal traditions, deliberations about the text of Article 7(2) ended in a compromise and the final text of the article was drafted in general terms so that it would not pose a hindrance in the ratification of the Convention.²² A consequence of this compromise has been uncertainty with regards to the definition and parameters of the general principles upon which the Convention is based. As courts and academics deliberated upon the Convention, many of its textual uncertainties were settled with the passage of time. In this regard Article 7(2) maybe said to provide one of the best examples of how the Convention is an instrument with a life of its own; an ever evolving being. This is not to say that the question of what exactly constitutes the general principles of the Convention has

²² John Honnold and Harry M. Flechtner, *Uniform Law for International Sales under the 1980 United Nations Convention* (Kluwer Law International 2009) 15.

been settled, rather it is simply recognition of the volume of scholarly opinion and case law that this article has generated.

For any meaningful analysis of the role and scope of the doctrine of good faith vis-à-vis the Convention, the distinction between Article 7(1) and 7(2) must be recognized. Article 7(1) is concerned with the interpretation of the Convention and specifically obligates the observance of good faith thereunder. Article 7(2) on the other hand provides the procedure that is to be adopted in cases where the Convention is silent on matters that fall within its scope and does not make specific reference to the principle of good faith. Moreover Article 7(2) limits gap filling to the general principles upon which the Convention itself is based, whereas, Article 7(1) contains no such limitation and, as such, it does not limit the interpretation of the principle to the confines of the Convention.²³ Rather, unlike Article 7(2), Sub-Article 1 allows the interpretation of the principle to be derived from external sources, as long as they belong to the international sphere.²⁴

Nevertheless, various courts and academics have interpreted the term ‘general principles’ to include the obligation to act in ‘good faith’ (including courts from Germany²⁵, Spain²⁶, United States²⁷, Russia²⁸, Greece²⁹, France³⁰, Mexico³¹ and

²³ Recourse to domestic law is allowed only as a last resort.

²⁴ This is a consequence of the ‘international character’ of the Convention. See Article 7(1) of the United Nations Convention on the International Sale of Goods (hereinafter referred to as the ‘Convention’).

²⁵ See Oberlandesgericht Celle, Germany, 24 July 2009

<<http://cisgw3.law.pace.edu/cases/090724g1.html>> accessed: 15 June 2014; Oberlandesgericht München, Germany, 14 January 2009 <<http://cisgw3.law.pace.edu/cases/090114g1.html>> accessed: 15 June 2014; Oberlandesgericht Brandenburg, Germany, 18 November 2008 <<http://cisgw3.law.pace.edu/cases/081118g1.html>> accessed: 15 June 2014.

²⁶ Audiencia Provincial de Navarra, Spain, 27 December 2007

<<http://cisgw3.law.pace.edu/cases/071227s4.html>> accessed: 15 June 2014.

²⁷ International Centre for Dispute Resolution of the American Arbitration Association, United States, 23 October 2007 <<http://cisgw3.law.pace.edu/cases/071023a5.html>> accessed: 15 June 2014.

²⁸ Tribunal of International Commercial Arbitration at the Russian Federation Chamber of Commerce and Industry, Russian Federation, 2 June 2005 <<http://cisgw3.law.pace.edu/cases/050602r1.html>> accessed: 15 June 2014; Tribunal of International Commercial Arbitration at the Russian Federation Chamber of Commerce and Industry, Russian Federation, 27 May 2005 <<http://cisgw3.law.pace.edu/cases/050527r1.html>> accessed: 15 June 2014.

²⁹ Court of First Instance Larissa, Greece, 2005 <<http://cisgw3.law.pace.edu/cases/050165gr.html>> accessed: 17 June 2014.

³⁰ Court of Arbitration of the International Chamber of Commerce, France, 2003 <<http://cisgw3.law.pace.edu/cases/031849i1.html>> accessed: 17 June 2014.

³¹ Primer Tribunal Colegiado en Materia Civil del Primer Circuito, Mexico, 10 March 2005 <<http://cisgw3.law.pace.edu/cases/050310m1.html>> accessed: 17 June 2014.

Serbia³²). As a result of such an interpretation, an adjudicator should refer to the principle of good faith when faced with a question which lies in the scope of the Convention but is not expressly settled in it³³. Such a stance has generated a great deal of confusion with opponents arguing that such a position is in direct contradiction with the deliberations and final compromise achieved by the drafters of the Convention.³⁴

The greatest source of controversy attached to the principle of good faith thus lies in its substantive relationship with the provisions of the Convention, and the lack of a concrete definition of the principle. This paper shall attempt to carry out an analysis of the roles/functions/definition attached to the concept in the UK, United States and Germany. This is in order to appreciate the tension(s) created when one attempts to unify legal terms and redefine their functions, as well as, to attain a better appreciation of the varying connotations attached to the concept by delegates of different countries at the UNCITRAL Working Group.

2.2 Analysis of the definition and scope of the principle of Good Faith

2.2.1 Good faith in English Law:

“There is no general doctrine of good faith in English law of contract. The plaintiffs are free to act as they wish, provided that they do not act in breach of a term of the contract”³⁵

³² Foreign Trade Court of Arbitration attached to the Yugoslav Chamber of Commerce, Serbia, 9 December 2002 <<http://cisgw3.law.pace.edu/cases/021209sb.html>> accessed: 17 June 2014.

³³ For instance, in the *Rechtbank Rotterdam* case, the court stated that in light of the general principle of good faith set forth in the Convention that “it is not sufficient for the applicability of general terms and conditions to refer to the general terms and conditions in the offer to conclude a contract, without providing the text of the general terms and conditions preceding or during the closing of the agreement”; thereby effectively filling in a gap in Convention. *Rb Rotterdam, Netherlands*, 25 February 2009 <http://cisgw3.law.pace.edu/cases/090225n1.html> accessed: 17 June 2014.

³⁴ According to Professor Farnsworth's “[it would be a] perversion of the compromise to let a general principle of good faith in by the back door.” E. Allan Farnsworth, ‘The Eason-Weinmann Colloquium on International and Comparative Law: Duties of Good Faith and Fair Dealing under the UNIDROIT Principles, Relevant International Conventions and National Laws’ (1995) 3 *Tulane Journal of International and Comparative Law* 47, 56.

³⁵ *James Spencer & Co Ltd v. Tame Valley Padding Co Ltd*, unreported, April 8, 1998 (CA) per Potter LJ. It should be noted that in the context of sale of goods this statement is qualified in 1994 see Section 4 of the Sale and Supply of Goods Act 1994, Section 15a of the Sale of Goods Act 1979 (SGA).

Until the mid-eighteenth century, English courts tended not to recognize the existence of contracts concluded as a result of a party's bad faith.³⁶ Certain commentators attribute this approach to the influence of the rules of the law merchant on English law at the time.³⁷ As a result, it is not surprising to come by judgments delivered in the era that state "the general principle is applicable to all contracts and dealings. Good faith forbids either party from concealing what he privately knows, to draw the other into a bargain, from his ignorance of that fact, and his believing the contrary"³⁸

By the early part of the nineteenth century the grounds for invalidation based upon bad faith were governed under the banner of fraud. At the time, however, the concept of fraud was defined in very broad terms. In the words of Joseph Chitty:

great weakness of understanding, although it does not amount to insanity, if coupled with circumstances of fraud, apparent either from the unconscientious bargain, from the exercise of undue influence, from want of adequate motive, or the like is grounds for setting aside an agreement especially in the court of equity.³⁹

A general principle of good faith does not exist in modern English contract or commercial law.⁴⁰ This, however, should not be taken to mean that English contract law in its entirety does not incorporate particular manifestations of the principle of

³⁶ Reinhard Zimmermann, and Simon Whittaker (eds), *Good Faith in European Contract Law* (Cambridge University Press 2000) 41.

³⁷ By the middle of the seventeenth century the law merchant was considered as a part of the law of the state and by the end of the century, common law courts had become so familiar with it that they no longer required evidence of the dictates of mercantile custom. See Edward Coke, *The First Part of the Institutes of the Laws of England: Or A Commentary upon Littleton* (7th edn) cited in Reinhard Zimmermann and Simon Whittaker, *Good Faith in European Contract Law* (Cambridge University Press 2000).

³⁸ Lord Mansfield in *Carter v Boehm* (1766) 3 Burr 1905, 1910.

³⁹ Joseph Chitty, *A Treatise on the Laws of Commerce and Manufactures, and the Contracts relating Thereto: With an Appendix of Treaties, Statutes, and Precedents* (A. Strahan 1824) 159. Chitty similarly states "fraud appears from the intrinsic nature and subject of the bargain itself" at page 158.

⁴⁰ Ewan McKendrick, *Sale of Goods* (LLP 2000) 55. It however seems that aversion of English courts towards the principle is in decline see *Timeload Ltd. v. British Telecommunications PLC* [1995] EMLR 459; *Philips Electronique Grand Public SA v. British Sky Broadcasting Ltd.* [1995] EMLR 472.

good faith.⁴¹ In the case of *Interfoto v Stiletto*, Lord Bingham stated “English law has characteristically committed itself to no such overriding principle of [good faith] but has developed piece meal solutions in response to demonstrated problems of unfairness.”⁴² This stance had previously been adopted by Professor Bridge in 1984, who, while evaluating whether there is a need for the concept of good faith in common law, argued that common law reaches the same result as that which would have been reached, if the concept of good faith had been applied to the facts of the case, through a more detailed level of legal rules⁴³. There are various examples of such rules, ranging from the maxims of equity that operate to strike down unconscionable agreements; the rules of common law on mistake, duress, penalty clauses and misrepresentation; and the exclusion of unfair terms through the use of legislative enactments such as the Unfair Contracts Terms Act 1977 (UCTA).

Similarly, English law seems to be averse to the imposition of a general requirement to act in good faith during the pre-contractual stage.⁴⁴ According to Professors Carter and Harland:

The basic principles of contract law were laid down in an economic, social, political and intellectual context different from today's. They were developed under the influence of the forces of individualism, competitiveness, laissez-faire, an intellectual climate characterized by a high regard for general principle, and economic dominance of a free market economy.⁴⁵

⁴¹ James Holland and Julian Webb, *Learning Legal Rules: A Students' Guide to Legal Method and Reasoning* (Oxford University Press 2013) 356.

⁴² *Interfoto Picture Library Ltd v. Stiletto Visual Programmes Ltd* [1988] 1 All ER 352, 353.

⁴³ See Michael Bridge, ‘Does Anglo-Canadian Law Need a Doctrine of Good Faith?’ (1984) 9 Canadian Business Law Journal 385. In 1992 this argument found support in the case of *Interfoto Picture Library v Stiletto* where Bingham LJ stated “English law has, characteristically, committed itself to no such overriding principle [of fair open dealing] but has developed piecemeal solutions in response to demonstrated problems of unfairness.” *Interfoto Picture Library Ltd v. Stiletto Visual Programmes Ltd*. [1989] QB 433.

⁴⁴ This is partially based upon the rigidity of contract law of the common law world, which has historically stemmed from the objective theory which constitutes one of the general principles/grundnorms of contract law. Grant Gilmore, *The Death of Contract* (Ohio State University Press, 1974) 101.

⁴⁵ John W. Carter, *Contract Law in Australia* (2 edn, Butterworths 1991) 7.

These ‘forces’ have led to the aversion in contract law to recognize notions that could unsettle the certainty of contractually agreed terms. In 1992 for instance, the House of Lords clearly and unequivocally stated that:

The reason why an agreement to negotiate, like an agreement to agree, is unenforceable, is simply because it lacks the necessary certainty... The concept of a duty to carry on negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations.⁴⁶ Each party to the negotiations is entitled to pursue his (or her) own interest, so long as he avoids making misrepresentations.⁴⁷

The aversion in the objective theory of contract law to anything that could risk unsettling the certainty of contractually agreed terms stems from the underlying concept of freedom to contract. This concept assumes “a paradigm situation of one-to-one negotiation of all the terms of the agreement by parties of equal bargaining strength concerned to maximize their individual positions.”⁴⁸ In the context of the Twenty First Century however, contracts are not always concluded between parties with equal bargaining strength - thereby creating a tension between the common law theory of contract and the reality of contract negotiation. This has led to the need to make qualifications and adjustments when applying the objective theory of contract law. It therefore comes as no surprise that the Caveat Emptor rule has been weakened in the context of sale of goods, through the evolution of common law rules.

As such, while modern English law does not adopt a general concept of good faith, it has been able to qualify the classical theory of contract law by solving specific

⁴⁶ Interestingly, in this case the parties had expressly included the requirement to deal in good faith in their contract. The impact of the judgment therefore was to over-ride the express agreement of the parties. In 2005 however, Lord Longmore while delivering the judgment in Lord Longmore in *Petromec v Petroleo* stated in obiter that if the parties have expressly inserted the obligation of good faith in their contract, it should be enforceable. *Petromec Inc v Petroleo Brasileiro SA Petrobras* [2005] EWCA Civ 891. See Ewan McKendrick, *Contract Law* (8th edn, Palgrave Macmillan 2009) 214.

⁴⁷ *Walford and Others v Miles and Another* [1992] 2 AC 128.

⁴⁸ J.W. Carter, *Contract Law in Australia* (2 edn, Butterworths 1991) 7.

problems through the use of general ethical imperatives⁴⁹. In particular, the problems of unfairness have been combated in four ways.

2.2.2 Expectation of the parties:

Lord Steyn once noted that “there is not a word of difference between the objective requirement of good faith and the reasonable expectation of the parties.”⁵⁰ Indeed, English courts do make recourse to the intention of the parties in order to achieve similar results to those which would have been achieved if a general principle of good faith had been applied to the facts of the case. This is done for instance by analyzing express terms as understood by a reasonable bystander or through implication of terms such as the duty to deliver goods of satisfactory quality under s 14(2) of the Sale of Goods Act.⁵¹

2.2.3 Special rules for particular contracts:

Legal rules governing certain ‘types’ of contracts, in certain instances, either specifically or via reference to the implied intentions, require the observation of good faith. For instance, partnership contracts are classified as “contracts of good faith.”⁵² Similarly parties to a contract of insurance and mortgage require good faith performance.⁵³ Moreover, contracts involving fiduciary relationships require that the fiduciary act in a manner that promotes the interest of the principal and must not

⁴⁹ Examples include *Timeload Ltd v British Telecommunications* (n40); *Philips Electronique Grand Public S.A. v. British Sky Broadcasting Ltd* (n 40); *Balfour Beatty Civil Engineering Ltd v Docklands Light Railway Ltd* [1996] 78 Build LR 42, 58; *Re Debtors* (Nos 499 and 49950 of 1998) [1999] 1 All ER (Comm) 149, 157–158. See Michael G. Bridge, ‘Good Faith in Commercial Contracts’ in Roger Brownsword, Norma J. Hird and Geraint G. Howells (eds), *Good Faith in Contract: Concept and Context* (Ashgate and Dartmouth 1999) 139.

⁵⁰ Lord Steyn, ‘Contract Law: Fulfilling the Reasonable Expectations of Honest Men’ (1997) 113 Law Quarterly Review 433, 450.

⁵¹ Unless the buyer is made aware of the defect before the conclusion of the contract see Section 14(2)(c) of the Sale of Goods Act 1979.

⁵² Per Lord Hoffman in *O'Neill v Phillips* [1999] 1 WLR 1092, 1098 quoted in Joseph Chitty, *Chitty on Contracts: General principles* (Hugh Beale (ed), Vol. 1, Sweet & Maxwell 2013) Section 1-045. The impact of such a categorization is to impose on the parties the duty to disclose all material information of which the other party is unaware of.

⁵³ In the context of insurance contracts the requirement of good faith performance requires disclosure. In the words of the High Court of England and Wales, insurance contracts must be performed in the “utmost good faith” *Fujitsu Services Ltd v IBM United Kingdom Ltd* [2014] EWHC 752 (TCC), 153 Con LR 203, 133.

allow his interests to be in conflict with those of the principal.⁵⁴ In the context of sale of goods, English courts have imposed an obligation on the seller to inform the buyer of the defects the goods suffered from in instances where he has been requested to cure the defect. In the case of *J & H Ritchie Ltd v Lloyd Ltd*, for instance, the House of Lords stated that such information should be sufficient to allow the buyer to choose between rejecting the goods and accepting them.⁵⁵

2.2.4 Limitation on contractual freedom in certain instances:

Certain legislative instruments have been enacted to combat unfair contractual terms. Of these instruments the UCTA 1977 and the UTCCR 1999 are of seminal importance for the purposes of this section.⁵⁶ While the UCTA excludes terms from a contract on the basis of the reasonableness test contained in Article 11, the UTCCR applies the test of fairness that is based upon the requirement of fair dealing and good faith. It must be noted at this juncture that the UTCCR is simply the implementation of the Unfair Terms in Consumer Contracts Directive and, as such, the principle has been introduced into UK law through pressures from the EC.⁵⁷ It is on these grounds that the express inclusion of the requirement of good faith in UK law on consumer transactions on standard terms has been labelled as a legal irritant.⁵⁸

While the utility of including the principle of good faith in UK law through the regulation has been greatly criticized, Leggatt J. believes that such an inclusion is not contrary to the structure of common law.⁵⁹ After analyzing how various common law jurisdictions have incorporated the concept, he asserts that UK law has historically

⁵⁴ Chitty (n 52) Section 1-045.

⁵⁵ *J & H Ritchie Limited v. Lloyd Limited* [2007] UKHL 9.

⁵⁶ It is important to note that the UTCCR applies only to consumer contracts and it is in this regard that it should not be compared with the Convention. The UCTA however governs business-to-business transactions as well.

⁵⁷ Council Directive 2011/83/EU of 25 October 2011 on Consumer Rights, amending Council Directive 93/13/EEC and Directive 1999/44/EC of the European Parliament. Several other examples of legislation implementing EU directives, which use the principle of good faith, have been mentioned in Chitty (n 52) Para 1-043.

⁵⁸ Gunther Teubner, 'Legal Irritants: Good Faith in British Law or how Unifying Law Ends Up in new Divergences' (1998) 61 The Modern Law Review 11.

⁵⁹ *Yam Seng Pte Ltd v International Trade Corporation Ltd* [2013] EWHC 111 (QBD) Paras 130-131.

implied the principle by law in certain categories of contract.⁶⁰ While recognizing the fact that UK law does not imply such a duty in all commercial contracts, he states “there seems to me to be no difficulty, following the established methodology of English law for the implication of terms in fact, in implying such a duty in any ordinary commercial contract based on the presumed intention of the parties.”⁶¹ Professor Beale notes that “the implication of an implied term applicable generally (or even widely) to commercial contracts would undermine to an unjustifiable extent English law’s general position rejecting a general legal requirement of good faith.”⁶² It is therefore unsurprising that subsequent case law has treated this statement of Leggatt J. to be specific to the facts of that case rather than a principle of general application.⁶³

2.3 Good faith in US law:

Unlike the piecemeal approach adopted by English courts with regards to the indirect application of the principle of good faith and the rejection of a general principle altogether, American law has been more receptive to the principle. According to Professor Farnsworth, American law has contained a generally accepted doctrine of good faith for centuries.⁶⁴ The application of the doctrine of good faith was first recognized by the legislature in 1952 under Section 1-203 of the UCC, which provides that “Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.” Not only does the UCC explicitly make reference to the principle of good faith in over 50 sections, it also attempts to provide a definition of the same. Under Section 1-201(19) good faith has been defined to mean “honesty in fact in the conduct or transaction concerned.” Furthermore, Section 2-103 (1) (b), with reference to merchants, defines good faith as “honesty in

⁶⁰ *ibid* Para 131.

⁶¹ *ibid*.

⁶² Chitty (n 52) Section1-050.

⁶³ *Compass Group UK and Ireland Limited (t/a Medirest) v Mid Essex Hospital Services NHS Trust* [2012] EWCH 781 (QB); *TSG Building Services Plc v South Anglia Housing Limited* [2013] EWHC 1151 (TCC).

⁶⁴ E. Allan Farnsworth, ‘The Concept of ‘God Faith’ in American Law’ in Bonell (ed), *Centro di studi e ricerche di diritto comparato e straniero* (Saggi Conference e Seminari, Rome, 1993) Paper 10 available at <<http://www.cisg.law.pace.edu/cisg/biblio/farnsworth3.html>>.

fact and the observance of reasonable commercial standards of fair dealing in the trade.”

The Restatement (Second) of Contracts (Restatement) similarly states, “Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”⁶⁵ It is interesting to note that neither the Code nor the Restatement extends the application of the principle to the negotiations stage, but rather, they limit its application solely to performance.⁶⁶ Furthermore, the fact that the Code has provided a definition of the principle does not mean that the same is uniformly interpreted. Instead, three different competing views have emerged in scholarly debate.

Firstly, according to Professor Farnsworth, the extension of the concept of good faith to performance serves to imply terms into the contract.⁶⁷ This view has found support in various judicial decisions that have implied duties not specifically contained in contracts that provides grounds for a party’s dissatisfaction in the contract.⁶⁸

Professor Summers, on the other hand, argues that the principle of good faith acts to exclude certain behaviors that may be regarded as ‘bad faith performance.’⁶⁹ As such, Professor Summers appear to define the concept in negative rather than positive terms.⁷⁰ This seems to be in line with the definition of the concept provided in comments to Section 205 of the Restatement where “good faith performance ... excludes a variety of types of conduct characterized as involving ‘bad faith’ because they violate community standards of decency, fairness or reasonableness.”⁷¹

⁶⁵ Section 205.

⁶⁶ An exception to this, i.e. where a court imposed the duty to negotiate in good faith is found in *Heyer Products Co. v. United States* 135 Ct. Cl. 63, 140 F. Supp. 409 (1956).

⁶⁷ E. Allan Farnsworth, Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code’ (1963) 30 University of Chicago Law Review 666, 679.

⁶⁸ See, e.g., *Fortune v. National Cash Register Co.* 373 Mass. 96, 364 N.E.2d 1251 (Mass. 1977). See also *Tymshare Inc v. Covell* 727 F.2d 1145 (D. C. Cir. 1982), per Scalia J.

⁶⁹ Robert S. Summers, “‘Good Faith’ in General Contract Law and the Sales Provisions of the Uniform Commercial Code’ (1968) 54 Virginia Law Review 195.

⁷⁰ He argues “in cases of doubt, a lawyer will determine more accurately what the judge means by using the term ‘good faith’ if he does not ask what good faith itself means, but rather asks: What...does the judge intend to rule out by his use of this phrase?” Summers (n 69) 200.

⁷¹ Restatement (Second) of Contracts, § 205.

According to this stance, the principle cannot be given a concrete positive meaning, but instead, can only be defined by reference to what it is not. To this end, Professor Summers has provided a list of situations that are excluded by the application of the principle of good faith to include:

evasion of the spirit of the deal, lack of diligence and slacking off, wilful rendering of only substantial performance, abuse of power to specify terms, abuse of a power to determine compliance, and interference with or failure to cooperate in the other party's performance.⁷²

In response to the position adopted by Professor Summers, Professor Burton has argued that the 'excluder' interpretation of the good faith principle renders the terms agreed by the parties unenforceable and imposes obligations contrary to that which was intended by the parties.⁷³ He adopts an interpretation of the principle whereby it is viewed only as limiting the discretion that a party may exercise in the performance of the contract.⁷⁴ While the differences between the different perspectives have generated a debate between the two authors, in most instances, it seems to be more theoretical than practical.

Take, for example, the assertion by Professor Burton that under his interpretation of the concept of good faith, it would amount to bad faith if a party tried to recapture opportunities that had been foregone in contracting⁷⁵. In such a case, it would seem that a judge charged with the duty of ascertaining whether the principle of good faith in performance had been adhered to, would not be applying two different standards while using the two stances. In fact, this led Professor Summers to assert that Burton's 'foregone opportunities' stance is not any more focused than his excluder analyses in such situations.⁷⁶

⁷² Summers (n 69) 232-233.

⁷³ Steven J. Burton, 'More on Good Faith Performance of a Contract: A Reply to Professor Summers' (1984) 69 Iowa Law Review 497, 499.

⁷⁴ Steven J. Burton, 'Breach of Contract and the Common Law Duty to Perform in Good Faith' (1980) 94 Harvard Law Review 369, 372-373.

⁷⁵ *ibid.*

⁷⁶ Robert S. Summers, 'The General Duty of Good Faith - Its Recognition and Conceptualisation', (1982) 67 Cornell Law Review 810.

Regardless of the fine differences between the two approaches, it cannot be denied that Burton's interpretation can potentially result in a narrower application of the principle of good faith than Summers' broader and resultantly vaguer stance. In any event, the disagreement between scholars on the exact function and scope of the principle sheds light on the fact that even though at least two separate instruments have attempted to define the concept of good faith in contractual performance, it is still shrouded by uncertainty.

Rather than clarifying the situation, courts have added to the confusion by upholding all three stances at the same time. Some courts have even used the three interpretations interchangeably or used one to support the other. For example, in the case titled *Tymshare v. Covell*, Justice Scalia upheld Professor Summers' interpretation of good faith as an 'excluder' and applied the same stating:

It [good faith] is a phrase without general meaning of its own and serves to exclude a wide range of heterogeneous forms of bad faith. In a particular context the phrase takes on specific meaning, but usually this is only by way of contrast with the specific form of bad faith actually or hypothetically ruled out.⁷⁷

However, he then goes on to agree with Professor Farnsworth's implied terms stance. As such, the court seems to agree with two (at times) contradictory approaches to the definition of good faith. To make matters more complicated, the court reads the two positions together and asserts that:

When these two insights are combined, it becomes clear that the doctrine of good faith performance is a means of finding within a contract an implied obligation not to engage in the particular form of conduct which, in the case at hand, constitutes bad faith.⁷⁸

Such judgments have subsequently led courts to endorse definitions that are extremely vague and, as a result, incapable of providing any proper standards. Take for instance *Conoco v. Inman Oil Co*, a case that was decided a year after the

⁷⁷ *Tymshare Inc v. Covell* (n 68)

⁷⁸ *ibid.*

Tymshare v. Covell decision.⁷⁹ Here, the court, while defining the principle of good faith performance, stated that it operates to compel parties to a contract “to do nothing destructive of the other party's right to enjoy the fruits of the contract and to do everything that the contract presupposes they will do to accomplish its purpose.”⁸⁰ As such, the court seems to have incorporated both the negative and positive definition into the same test, thereby adding further confusion to the exact parameters of the principle's definition. The impact of such decisions has subsequently led courts to use different standards together (exclusive v. inclusive v. implied terms) as if they are completely consistent with one another.⁸¹

In any case, experimentation by judges on the scope of the function of the principle reveals that American jurists would be far more receptive than their English counterparts to the creation and evolution of the principle in the international domain. This assertion, however, should be qualified with the observation that American jurists are not willing to extend the application of the principle beyond the confines of contractual performance. As such, any proposal for the development of the principle of good faith in international law, which extends to the pre-contractual phase, will be resisted by American jurists.

2.4 Good Faith in German Law

Unlike common law (with the qualified exception of the United States), civil law jurisdictions have been more hospitable to the principle of good faith.⁸² This, however, should not be read to mean that civil law jurisdictions have been able to adopt a standard definition of the principle, or, that the principle is treated similarly in civil law jurisdictions with regards to its scope. Take, for instance, the comparison of the treatment afforded to the principle in France and Germany. While both jurisdictions have adopted a general statutory provision that requires the observance of good faith, the treatment afforded to it varies significantly.⁸³ In France, the

⁷⁹ *Conoco Inc. v. Inman Oil Company Inc.* 774 F.2d 895 (8th Cir. 1985).

⁸⁰ *ibid* 908.

⁸¹ See for example *Foley v. Interactive Data Corp.* 765 P.2d 373 (Cal. 3d 1988) wherein both Summers and Burton are cited together in a manner that suggests that their views are equate-able.

⁸² Hugh Collins, ‘Good Faith in European Contract Law’ (1994) *Oxford Journal of Legal Studies* 229

⁸³ Article 1134 of the French Civil Code and Section 242 of the German Civil Code (BGB).

principle has rarely been invoked to disallow contractual terms or to imply further terms into the contract. In the words of Professor Bridge:

Good faith is enshrined in art. 1134 of the French Civil Code but its practical impact can be described as shallow: it has done nothing to disallow penalty clauses, it has not expanded the narrow categories of lesion and it has not been employed to give relief in what we would now call cases of commercial impossibility.⁸⁴

In German law on the other hand, the principle applies to all cases governed by the Civil Code and has the potential to override special provisions.⁸⁵

Professor Schlechtriem argues that the principle was introduced into German law to allow courts to ‘fill-in’ minor and major gaps in the legislation.⁸⁶ Of course, no code can possibly aspire to address all the situations that may arise within its scope of application and, as such, the creation of a tool to guide judges in the filling of gaps is not surprising.

Interestingly, Professor Schlechtriem views the role of providing guidance in the interpretation of code provisions as a part of this gap filling function. In this regard, however, the principle operates as a tool for judges in the evolution of the law.⁸⁷ In such instances, not only does the principle operate to fill-in gaps in the law, but is also used to address new situations that may arise within the scope of the law’s application.⁸⁸ Moreover, part of the gap filling function of the principle is to imply terms into the contract (in line with Professor Farnsworth’s stance on the application and meaning of good faith). In this sense, the principle is most often invoked to imply and implement obligations that are needed to complete the duties and

⁸⁴ Michael G. Bridge, ‘Does Anglo-Canadian Contract Law Need a Doctrine of Good Faith?’ (1984) 9 *The Canadian Business Law Journal* 385, 414-415.

⁸⁵ Schlechtriem (n 17).

⁸⁶ *ibid* page 6

⁸⁷ *ibid* p.13

⁸⁸ *ibid*. See also Werner F. Ebke and Bettina M. Steinhauer, ‘The Doctrine of Good Faith in German Contract Law’ in J. Beatson and Daniel Friedman, *Good Faith and Fault in Contract Law*, Oxford (Clarendon Press 1995) 171-190.

obligations in a given contract; although such obligations were neither agreed by the parties in their contract nor laid down in the applicable provisions of law.⁸⁹

It is extremely important to note here that the duties so implied, are not simply ones without which performance would become impossible or where there would be a frustration of contract. Rather, such implied duties include contractual duties of care. In other words, German courts have invoked the principle of good faith to imply the duty of care to protect the economic assets of parties and even to establish vicarious liability.

Of these functions attributed to the principle of good faith in German law, it seems that only the role of good faith, as a tool for interpretation (of the Convention as opposed to the underlying contract), is completely compatible with the dictates of Article 7. The ‘gap-filling’ function may also be compatible with Article 7 if ‘good faith’ is in fact one of the general principles upon which the Convention is based. While the principle of good faith plays a central role in the context of German law, it must be noted that, even in the context of this legal system, there does not exist a concrete, unanimously accepted definition. Rather, the meaning of the principle is ascertained with reference to three distinct sources of law within the German legal order.⁹⁰ The first source from which the notion is ascribed meaning is the German Constitution.⁹¹ In the case of the Convention, however, there exists no comparable source. This is because the Convention sits in the international domain so is not subject to any overriding instrument of hard law.

The second source used to ascribe a definition to the principle lies in the provisions of other legislative instruments, including the German Civil Code (BGB). The methodology adopted to derive meaning from these sources is exactly that prescribed by Article 7(2) with regards to the ascertainment of the general principles upon which the Convention is based. As such, in order to ascertain the meaning of good faith as contained in Section 242 of the BGB, a court must turn to the structure and substance of the provisions of the Code. It can then identify the methodology and

⁸⁹ *ibid* page 14.

⁹⁰ Schlechtriem (n 17) 11-13.

⁹¹ *ibid* page 9.

values used by the legislator to solve specific problems and the general principles upon which such a solution is based. These evaluations allow inferences of more general values and standards, which can be used to interpret the doctrine of good faith itself.

It is however extremely important to note that while recourse may be made to any number of legislative instruments in order to identify the definition of good faith under national law, this has explicitly been rejected in the case of Article 7(2) of the Convention. Article 7(2) mandates gaps to be filled on the basis of the general principles upon which the Convention is based and as such allows recourse only to the provisions of the Convention itself.

The final method of ascribing meaning to the notion of good faith in German law is by reference to ‘collective conviction’ or, in other words, by reference to that which would be considered a fair by a reasonable man.⁹² Since the community of the Convention is quite specific, i.e. that of international merchants, it might theoretically be possible to ascertain and express such community standards and, as such, apply this method to the ascertainment of the confines of the principle of good faith as contained in Article 7 (1) of the Convention itself.⁹³ Such a step, however, has the potential of opening the doors for judicial abuse through personal bias. Since the homeward trend has been predominantly prevalent in the interpretation of the Convention by courts, the potential danger of such a methodology to evolve into a tool for the exercise of personal bias cannot be ignored.

The drafters of the Convention fortunately have expressly governed such a methodology through the incorporation of Article 9 (2) into the Convention. By virtue of this article, the vague objective standard of fairness has been replaced by the use of (relatively) more concrete trade usages. Furthermore, even trade usages have been limited to those

⁹² *ibid.*

⁹³ *ibid* page 10.

which the parties knew or ought to have known and which in international trade is widely known to, and regularly observed by, parties to contracts of the type involved in the particular trade concerned⁹⁴.

As such, the role of trade usages, especially with regards to their implications on a contract, have been severely restricted and resultantly precluding potential of using the standard of ‘fairness’ as judged by a reasonable man in ascertaining the meaning of good faith.

The discussion above highlights the diversity with which national legal systems recognize the principle of good faith. While English law takes a piecemeal approach to reach the ends of ‘justice and fairness’, US commercial law recognizes the application of the principle of good faith in contractual performance. In the context of German law, a much broader function is played by the principle. Not only does it apply to the pre-contractual stage, judges enjoy a greater degree of discretion in identifying its definition in any given context. So while US commercial law limits good faith to the observance of “reasonable commercial standards of fair dealing in the trade”, under German law the judge may make recourse to a number of sources.

2.5 Good Faith in the Convention

2.5.1 Drafting History of the Convention

The Working group during its first session in 1970 deliberated upon Article 7 of the ULIS which read “Questions concerning matters governed by the present Law which are not expressly settled therein shall be settled in conformity with the general principles on which the present Law is based.”⁹⁵ While none of the proposals for amendment advanced during this stage were accepted the article was amended at the Second Session of the Working group whereby reference to ‘general principles’ was removed. The reasons for such an amendment lay in the concern of various delegates

⁹⁴ Convention, Article 9.

⁹⁵ ULIS, Article 7.

that reference to ‘general principles’ was too vague to provide any meaningful guidance.⁹⁶

At the seventh session of the working group the following provision was adopted:

1. In the course of the formation of the contract the parties must observe the principles of fair dealing and act in good faith. [Conduct violating these principles is devoid of legal protection.
2. The exclusion of liability for damage caused intentionally or with gross negligence is void.
3. In case a party violates the duties of care customary in the preparation and formation of a contract of sale, the other party may claim compensation for costs borne by it.⁹⁷

Professor Honnald comments that when this provision was initially discussed, the principle of good faith had a lot of support from delegates who believed that the principle had proved its utility in various national legal systems and would prove to be just as useful in the context of international law.⁹⁸ Issues of uniform interpretation of the principle, it was thought, would be settled through judicial interpretation. Opponents of the inclusion of the principle, on the other hand, had concerns about the principle’s vague nature and were not convinced that judicial interpretation would be capable of providing a uniform interpretation. Moreover, there were concerns that national courts interpreting the principle would fall prey to the homeward trend and draw on their own legal and social traditions.⁹⁹

Concerns surrounding the vagueness of the draft article led to the deletion of the second and third sub-articles. It is interesting to note that the exemption clauses were opposed on the grounds that they did not reflect the reality of commercial transactions. It was argued that in international sale contracts, the inclusion of

⁹⁶ UNCITRAL, Yearbook II (1971) 62.

⁹⁷ U.N. Doc. A/CN.9/WG.2/WP, annex, para. 3.

⁹⁸ Professor Honnald notes that “the general concept that the draft Convention should contain provisions relating to good faith and fair dealing was supported by a majority of the representatives” John Honnald, *Documentary History Of The Uniform Law For International Sales: The Studies, Deliberations, And Decisions That Led To The 1980 United Nations Convention With Introductions And Explanations* (Kluwer Law and Taxation 1989) 71

⁹⁹ Bonell (n 6) 66.

exemption clauses placed a cost on the party in whose favor the clause operated. In the words of Professor Honnold, in international sales contracts “exclusion of liability for the seller was frequently compensated by a lower price for the buyer.”¹⁰⁰ It therefore seems that the representatives were not willing to displace the power of the parties to a sales contract to negotiate and enter into contracts which they believed to be in their best interest.

The Eighth Session of the Working Group therefore concluded with the adoption of an amended version of the first sub-article that read, “in the course of the formation of the contract the parties must observe the principles of fair dealing and act in good faith.”¹⁰¹

While the records of the deliberations during the Eighth Session lend credence to the fact that the principle of good faith, which would operate to place substantive requirements on the parties to a sales contract, did garner majoritarian support, an analysis of the later sessions of the Working Group paints the opposite picture. At the Eleventh Session of the Working Group, the provision faced strong opposition from various quarters. Firstly, the common law world was extremely wary of the inclusion of the principle on the grounds of its definitional vagueness. One of the most supported arguments at the session was that the inclusion of the principle would not be useful since it was already implicit in the laws regulating business activity.¹⁰²

Further opposition was from the developing world. They feared that the term ‘fair dealing’ would be interpreted on the basis of the standards of international business practice, which at the time were not considered entirely fair by the developing nations. Furthermore, representatives questioned the value of an article that operated to place substantive requirements on the parties, without incorporating a penalty for its breach.

¹⁰⁰ Honnold (n 98) 298-299, Para 81.

¹⁰¹ Honnold, *ibid*, Para. 87; Yearbook IX (1978) 14.

¹⁰² Honnald *ibid* Paras. 42-60.

Supporters, now in minority, argued that the issue of penalty was not as significant as some delegates had argued it to be. They were of the view that the inclusion of the principle would operate to undermine discriminatory behavior and objectionable practice by the parties. Under such a regime, they argued, the court would be able to prescribe penalties for breach of the principle on a case-by-case basis thereby advancing the standard of behavior expected in international trade.

By way of compromise, Draft Article 6 was formulated, which extended the application of the principle of good faith solely to the interpretation of the Convention.¹⁰³

At the 1980 Vienna Conference, in recognition of the limited role of the principle, i.e. to the interpretation and application of the Convention, it was argued that adjudicators should be provided guidance in the ascertainment of the entitlements of the parties. As such, the inclusion of a separate provision on the interpretation of contracts of sale was suggested.¹⁰⁴ The proposal however failed to garner the requisite support on the grounds that such a construction of the principle would be “derogatory to the terms of the contract.”¹⁰⁵

By this stage of the drafting process, all delegates recognized the fact that under the draft, the principle had absolutely no role in filling in the gaps of the Convention. Take for instance the proposal of the delegate of Bulgaria, whereby gaps would be filled through the application of the law of the seller’s place of business. The delegate of Czechoslovakia recommended that the issue be settled in conformity with the rules of private international law. Interestingly, even the most vocal proponents of the principle did not recommend that its application be extended to what became Article 7(2). Rather they argued that the principle should play a role in the interpretation of the contract as opposed to the Convention itself. Norway, for instance, argued for the extension of the application of the principle to the

¹⁰³ At the time it was article 6 of the draft Convention.

¹⁰⁴ Contracts for the International Sale of Goods, and on Draft Provisions Concerning Implementation, Reservations and Other Final Clauses Prepared by the Secretary-General Document A/CONF.97/9 [Original: English] [21 February 1980]

¹⁰⁵ See the comment of the ICC in Contracts for the International Sale of Goods, and on Draft Provisions Concerning Implementation, Reservations and Other Final Clauses Prepared by the Secretary-General *Document A/CONF.97/9 [Original: English] [21 February 1980]*

interpretation of the contract of sale of goods¹⁰⁶ while Italy argued for its application to formation, performance and interpretation of the contract.¹⁰⁷ Both these proposals were rejected on the grounds that Article 7 reflected a hard won compromise and as such there was no need to reopen the same for debate.¹⁰⁸

An analysis of the travaux therefore reveals that the inclusion of the principle of good faith in Article 7(1) was subject to the rejection of any role that the principle could play in either the interpretation of the contract or in filling the gaps of the Convention. As such, the application of the principle was limited only to the interpretation of the Convention. Various commentators and courts however have been able to broaden the role played by the principle by holding it to be one of the general principles on which the Convention is based under Article 7(2). This conclusion is surprising since such a role for the principle was rejected during the drafting of the article. Rather, it was thought that the principle could operate to play one of three potential roles. To use the words of the delegate of the Republic of Korea:

As far as the principle of the observance of good faith in international trade was concerned...three possible areas of application. The first area was the interpretation and application of the provisions of the Convention, the second (as in the Italian proposal) was the relationship between the parties to a contract of sale, and the third was the determination of the intent of such parties.¹⁰⁹

2.6 The application of the principle of Good faith in practice: an analysis of case law

2.6.1 Good faith viewed solely as a guide to interpretation.

¹⁰⁶ Honnold (n 98) Para 6; Legislative History, 1980 Vienna Diplomatic Conference (A/CONF.97/C.1/L.28).

¹⁰⁷ The relevant part of its proposal reads: "In the formation [interpretation] and performance of a contract of sale the parties shall observe the principles of good faith and international co-operation." (U.N. Doc. A/CONF. 97/C.1/L.59).

¹⁰⁸ Ibid.

¹⁰⁹ Mr. Kim (Republic of Korea), Legislative History, 1980 Vienna Diplomatic Conference, Summary Records of Meetings of the First Committee, 5th Meeting, 13 March 1980, Articles 6 and 7 [became CISG Article 7 and CISG Article 8] (A/CONF.97/C.1/L.5, L.15, L.16, L.22, L.28, L.49, L.52 and L.59).

Various judicial decisions have limited the role of the good faith principle, as contained in Article 7(1), solely as a guide to interpretation. Even in this context, however, no case has been found which attempts to define exactly what the notion entails. This should not be taken to mean, that while recognizing the role the principle plays in the interpretation of the Convention, courts have been unable to achieve equitable results in the performance of that function due to the lack of a concrete definition of the principle. In fact, when faced with such a situation, certain courts have adopted an analogous position to the piecemeal solution adopted by English jurists in achieving equitable results.

In the case titled of *W v. R* for instance, involved several sales contracts between a German seller and a Spanish buyer of industrial machinery produced in Germany.¹¹⁰ Four years after the contracts had been concluded, the buyer initiated arbitration, claiming damages arising out of the sellers refusal to provide spare parts.

The arbitrator while recognizing that German law requires sellers of technical equipment to have spare parts ready for delivery, stated that such an obligation could not be implied via recourse to the principle of good faith as contained in the Convention, since its application was limited to the interpretation of the Convention. While the tribunal did not venture into defining what good faith entailed in the context, it stated, “a prompt delivery of replacement spare parts had become normal practice as defined by Article 9(1) of the CISG.” The court therefore found, in accordance with Article 33(c) and 9(1) read with Article 7(2) of the CISG, that the seller was obliged to deliver the spare parts within a reasonable time.

Two points emerge from an analysis of the judgement. Firstly, the court noted that Article 7(1) was not capable of imposing any substantive obligations on the parties, since its scope is limited to the interpretation of the Convention. Secondly, after this assertion, the court, faced with a gap in the Convention, turned to Article 7(2) and took a piecemeal approach to the principles upon which the Convention is based (in this case reference to Article 9(1) and 33(c)).

¹¹⁰ *W. v. R. (F.R.G. v. Spain)*, ICC Court of Arbitration, UNILEX, No. 8611/HV/JK (Jan. 23, 1997).

2.6.2 Good faith as imposing substantive requirements on the parties

While the drafting history of the Convention reveals that good faith as a general requirement of the Convention was rejected,¹¹¹ it must be recognized that when the principle of good faith is used as an aid in the interpretation of the Convention under Article 7(1), such an application would have an impact on the behavior of parties to a contract of international sale of goods.¹¹² This is not to say that the principle of good faith would directly impose obligations upon the parties, but rather, it would do so indirectly. In other words, since the Convention, as a set of default rules, imposes certain rights and obligations on the parties, the interpretation of the instrument in accordance with the requirement of good faith would in turn require that such good faith requirements are conformed with.¹¹³

Take for instance the ruling in the *Iron Molybdenum case* which involved a contract for sale concluded between a German seller and an English buyer.¹¹⁴ Upon non delivery of goods, the buyer set an additional period of time for deliver which was not complied with. The buyer therefore, at the expiration of the extra time set for delivery, bought the goods from another seller and brought a claim for the difference between the price of substitute goods and the price under the contract.

One of the issues before the court was the impact of the non-provision of notice of avoidance as required under Article 26 of the Convention. The court, while interpreting the Article, stated that the notice requirement is dispensed with in instances where the seller had refused to perform its obligation to deliver the goods “and that to insist on such a declaration would be contrary to the principle of good faith.”¹¹⁵ As such, the use of the principle in the interpretation of the Convention

¹¹¹ Farnsworth emphasizes that this fact proves that the article should be read literally and as such does not impose any obligation to act in good faith upon the parties. See Farnsworth (n 13) 56.

¹¹² Professor Bridge while discussing this view states “parties derive their rights and duties from the contract in accordance with the CISG; The CISG is to be interpreted in accordance with good faith; therefore the parties rights and duties are subject to good faith”. Michael G. Bridge, *The International Sale Of Goods: Law And Practice* (Oxford University Press 2007) 59.

¹¹³ Subject to the dictates of Article 12 of the Convention.

¹¹⁴ *Iron Molybdenum case*, Appellate Court Hamburg, Germany, 28 February 1997

<http://cisgw3.law.pace.edu/cases/970228g1.html#> accessed: 20 June 2014

¹¹⁵ *ibid.*

operates to motivate parties to conform to the requirement of good faith while performing their obligations. This motivation is simply the impact of the risk that a party acting in bad faith may not be able to hide behind a literal interpretation of the provisions of the Convention.

As illustrated below, the court indeed reached the correct conclusion from an efficiency perspective. This is so, because insistence on the requirement of a notice, in instances where the seller would not gain any information that it does not already possess, would simply operate to increase transaction costs and would allow parties in certain instances to act in an opportunistic behavior.

In any case, the ruling should not be confused to impose a general requirement of good faith on the parties to a contract of international sales of goods. Nor should this be interpreted to mean that there is a requirement to interpret the contract between the parties in good faith as suggested by Professor Bonell.¹¹⁶ It is asserted that the distinction between the Convention and the contract being governed under it must be maintained, for ignoring the same flies in the face of the compromise solution that was adopted.¹¹⁷

2.6.3 Good faith as a gap-filler

As discussed above, various courts have interpreted the general principles upon which the Convention is based to include the principle of good faith. Take, for instance, the decision of the German provincial Court of Appeal in Clout case no. 133.¹¹⁸ This case involved the sale of cars between a German seller and an Italian buyer. After the first delivery, the buyer requested subsequent deliveries be deferred as a result of exchange rate fluctuations. The seller, however, proceeded to demand payment of a bank guarantee that had been furnished by the buyer in favour of the seller. While the court ordered the seller to repay the guarantee to the buyer, it

¹¹⁶ Bonell (n 6).

¹¹⁷ Peter Winship, 'Commentary on Professor Kastely's Rhetorical Analysis Symposium: Reflections on the International Unification of Sales Law' (1988) 8 Northwestern Journal of International Law & Business 623.

¹¹⁸ CLOUT case No. 133 [Oberlandesgericht München, Germany, 8 February 1995] <<http://cisgw3.law.pace.edu/cases950208g1.html>> accessed: 20 June 2014.

dismissed the buyers claim for damages on the grounds that it had failed to declare the contract avoided at the time as required by Article 26.¹¹⁹ Furthermore, the court stated that “to allow the buyer to declare the contract void at the time of the trial, two and a half years after the event, would violate the principle of good faith in Article 7(1) of the CISG.”¹²⁰

It is a pity that the court resorted to the vague principle of good faith in this instance. This is because, while Article 26 specifically requires the provision of a notice, it is silent as to the time limit within which the notice has to be provided. As a result, the court should have identified this gap and made reference to Article 7(2) and it should have been resolved on the basis of the general principles on which the Convention is based, in this case via reference to the underlying principle of Article 39, 43 and 49(2). In particular, Article 49(2) specifically requires the buyer to avoid the contract within a reasonable time. Articles 39 and 43 similarly obligate the buyer to furnish a notice within a reasonable time. By way of analogy then, the court should have concluded that the Convention requires a uniform requirement regardless of the type of breach. If such a route had been adopted, then the court could have based its decision on specific provisions rather than having to resort to the vague notion of good faith.

A methodology that requires reference to specific articles of the Convention to ascertain the general principles, upon which it is based, creates limitations. It means that the discretion of judges is limited in the exercise of gap-filling relative to that which they enjoy by making reference to the principle of good faith in such an exercise. Such limiting of discretion, arguably, has two distinct advantages. First, it aids in the evolution of the Convention itself. In other word words, if courts must specifically mention the articles they are employing in deriving specific general principles, courts in future instances will have a clearer frame of reference to employ. Moreover, such judgments would encourage greater debate in the academic community vis-à-vis the merits of the conclusions reached.¹²¹ This would, in turn,

¹¹⁹ Article 26.

¹²⁰ CLOUT case No. 133 (n 118).

¹²¹ Judgments that make reference to good faith in gap filling are difficult to criticize on merits if they do not provide a specific definition of what the principle entails in the given context.

operate to complement and ensure the ‘international’ interpretation of the Convention as required by Article 7(1).¹²²

Second, it provides a greater degree of certainty to parties’, vis-à-vis their rights and obligations, since they may refer to past judgments which provide a degree of reasoning.¹²³ When such a methodology is adopted courts must provide some degree of reasoning for their conclusions, even if the same is limited solely to the identification of articles, for which the general principles have been derived. In future cases of similar nature, therefore, parties would have some degree of certainty as to the likely outcome of their dispute since they would be aware of previous reasoning. As demonstrated, in the case discussed in this sub-part, in instances where principle of good faith is employed, no discussion is necessary and consequently, the parties are not provided with any meaningful insights as to their respective rights and obligations in related disputes.¹²⁴

2.6.4 Good faith general requirement used to impose further obligation upon a party:

Greater confusion is caused by the stance adopted by a few courts and academics, whereby the good faith requirement is used to impose further obligation upon a party or where the good faith requirement is imposed upon the interpretation and performance of contractual terms agreed between the parties.

In the *BRI Production "Bonaventure" v. Pan African Export* case, a French manufacturer and seller of jeans and an American buyer concluded a contract of sale. The contract specifically stated that the jeans were only to be shipped to South America and Africa. Moreover, the seller had reputedly asked for proof of the destination of the jeans. Upon realizing that the goods had been shipped to Spain during the second delivery, the seller refused to make further deliveries. The court, finding in favour of the seller, awarded him damages amounting to 10,000 French

¹²² Albeit to a degree.

¹²³ Even if such reasoning is confined to the mention of specific articles.

¹²⁴ CLOUT case No. 133 (n 118)

Frances for abuse of process, finding that the conduct of the buyer was “contrary to the principle of good faith in international trade laid down in Article 7 CISG, aggravated by the adoption of a judicial stand as plaintiff in the proceedings, constituted abuse of process.”¹²⁵

The court therefore held that the requirement to act in good faith (a) extends to the performance of the contract (b) can result in the imposition of penalties not mentioned in the Convention when the requirement is not conformed with.¹²⁶ As such, the interpretation of the notions applicability under Article 7(2) (i.e. resolution of gaps in the Convention), seems to have been imported into the language of Article 7(1). The end result is that the confines of Article 7(1) are unjustly broadened to impose an obligation upon the parties to act in good faith in the performance of their obligations.

Such a broad interpretation would inevitably result in subjecting the interpretation of the terms agreed between the parties to the test of good faith performance. In other words, while Article 6 expressly allows the parties to “exclude the application of this Convention or, subject to Article 12, derogate from or vary the effect of any of its provisions”, such a broad interpretation of the concept will translate into its applicability in the interpretation of the rights and obligations arising from contract.¹²⁷ If such an application of the good faith principle is, in fact, justified, then this obligation can be extended to all possible cases - a result that was disapproved at the Vienna Conference.¹²⁸ Professor Eorsi, however, does not seem to be opposed to such a reading of the application of the notion.¹²⁹

¹²⁵ Cour d'Appel de Grenoble, Chambre Commerciale, France, 22 February 1995
<http://www.unilex.info/case.cfm?id=83>

¹²⁶ It is interesting to note that the Convention under article 74 which governs the award of damages for breach of contract only speaks of compensatory damages and not punitive ones. This case therefore seems to bring punitive damages into the realm of the Convention through the requirement to observe good faith.

¹²⁷ Convention, Article 6.

¹²⁸ For a similar view though based on different grounds See Winship (n 117) 625.

¹²⁹ In Professor Eorsi's opinion, there is no distinction between the interpretation of the Convention and the contract. He states “interpretation of the two cannot be separated since the Convention is necessarily interpreted by the parties also; after all, the Convention constitutes the law of the parties insofar as they do not make use of Article 6 on freedom of contract” See Eorsi (n 15) Chapter 2, § 2.03.

2.7 The Recommended Approach

Provided that the principle of good faith in international law is still in its incipient stage, coupled with the uncertainty surrounding its scope vis-à-vis the Convention, this paper argues that the best possible solution to this uncertainty, is to view the doctrine of good faith as an interpretative guide in cases of textual ambiguity. With regards to Article 7(2), general principles derived from the Convention should be viewed, at best, as particular manifestations of good faith [rejecting any general requirement of the same]. Flowing from this, is the conclusion that good faith cannot be used to imply any additional rights and obligations into the underlying contract.

The Viennese arbitral award in the Rolled Metal Sheets case is an example of this stance.¹³⁰ This case involved a contract for the sale of rolled metal sheets between an Austrian seller and a German buyer. The buyer commenced arbitral proceedings to recover damages for defects in the goods. The problem was that the buyer had not adhered to the contractual stipulations regarding the examination of the goods and the notice of non-conformity. The buyer had sent the notice to the seller six months after delivery, when he was contractually bound to do so immediately after delivery, or at the latest within two months from the date of delivery.

The buyer argued that the seller was estopped from raising the defence of untimely notice. The arbitral tribunal recognised that the issue of estoppel was not expressly settled by the Convention and that the issue was closely related to the wider problem of the significance of the reference to good faith in Article 7(1) of the Convention. The tribunal, rather than attempting to define the principle, chose to make reference to specific articles, namely Article 16(2) (b) and Article 29(2) and concluded that the principle of estoppel was indeed one of the general principles upon which the Convention is based.

Once again, the tribunal demonstrated that it is possible to arrive at equitable solutions without having to resort to a wider doctrine of good faith. The principle of estoppel, after all, is but one of the general principles of the Convention that is closely associated with the notion of good faith. In this context, the term ‘good faith’

¹³⁰ CLOUT case No. 94 [Internationales Schiedsgericht der Bundeskammer der gewerblichen Wirtschaft, Austria, 15 June 1994] <http://cisgw3.law.pace.edu/cases/940615a4.html> accessed: 20 June 2014.

is used merely as a moral aspiration, not a legal doctrine.¹³¹ At most, it used as a term to describe the value that the doctrine of estoppel tries to promote.

Regardless of the merits of such an approach, the majority of cases and commentators remain in favour of a more substantive role for good faith.

2.7.1 Good Faith is too vague to provide meaningful guidance as a general principle

In order for good faith to amount to a general principle upon which the Convention is based, it is essential to prove that it is manifested in a number of articles. Simple reference to the fact that Article 7(1) expressly contains the term, however, does not suffice in elevating it to a general principle of the Convention.¹³² In response to this assertion, various academics have embarked upon the task of evidencing the fact that the notion of good faith is indeed a general principle upon which the Convention is based by demonstrating that various provisions of the Convention implicitly impose an obligation to act in good faith.¹³³ Professor Schlechtriem, for instance, argues that since several provisions of the Convention employ the standard of the 'reasonable person', good faith must be one of the general principles upon which the Convention is based.¹³⁴

Unfortunately, however, no explanation is given as to how the notion of good faith is equated with the standard of reasonableness. As has been demonstrated above, there is complete lack of agreement on the definition of the term. Even if it were assumed that good faith includes the standard of reasonableness, it (reasonableness) would

¹³¹ Disa Sim, 'The Scope and Application of Good Faith in the Vienna Convention on Contracts for the International Sale of Goods' <<http://www.cisg.law.pace.edu/cisg/biblio/sim1.html>> accessed: 19 June 2014.

¹³² *ibid.*

¹³³ See Amy H. Kastely, 'Unification and Community: A Rhetorical Analysis of the United Nations Sales Convention Symposium: Reflections on the International Unification of Sales Law', (1988) 8 *Northwestern Journal of International Law & Business* 574, 577.

¹³⁴ Peter Schlechtriem, *Uniform Sales Law – The UN-Convention on Contracts for the International Sale of Goods* (Manz 1986) 39.

merely be one of the manifestations of the broader concept.¹³⁵ Indeed, there are various other means employed in the Convention, apart from reasonableness, to achieve the goals of fairness and justice.¹³⁶

The objective here is to demonstrate the problems surrounding the method employed in deriving the principle of good faith as a general principle on which the Convention is based. If all articles, which intrinsically require parties to act in a manner that would ensure fairness and justice, are used to this end, then the notion becomes too general thereby depriving it of the requisite specificity of a legal doctrine.¹³⁷ Attempts to define a concrete definition, however, would fail in capturing the nuances of each rule collapsed under the banner of good faith. In the words of Disa Sim “it is far better to craft sensitive responses to particular problems through a piecemeal approach rather than resort to an amorphous doctrine of good faith with questionable content.”¹³⁸

In other words, for the purposes of Article 7(2), it is a wiser choice to identify the general principles upon which the Convention is based, without equating the same with good faith. In fact, since most such principles are extracted from specific articles, their utility depends upon whether the case at hand satisfies the test for their applicability rather than whether the parties had ascribed to some general standard of good faith.

As such, rather than focusing on the vague notion of good faith, more specific principles such as the principle requiring the mitigation of damage caused as a result of breach by the other party should be developed. Such an exercise would require the ascertainment of specific principles. Thereby, providing a somewhat concrete

¹³⁵ The notion of good faith (as opposed to legal concept) seems to be synonymous with anything that leads to justice and fairness. In this sense, reasonableness is merely one of the many manifestations of the concept.

¹³⁶ For instance, it may be asserted that there is an underlying principle that the solution which preserves the contract should always be preferred in favour of another that would terminate the contract. This is based upon Article 19(2); 25; 26; 34; 37; 48; 49; 51(1); 64; 71 and 72.

¹³⁷ Such article would include but are not limited to; those that impose a standard of reasonableness such as 8 (2), 8 (3), 18, 34, 35, 37, 47-49, 60-65, 77, 79(1), 85-88; those that require cooperation between the parties such as 19 (2), 25, 26, 34, 37, 64, 71, 72, 77 etc.

¹³⁸ Disa Sim (n 131).

definition to what constitutes the general principles on which the Convention is based and allowing adjudicators sufficient flexibility, which is essential for the evolution of the Convention.

4.1 Good Faith as a guide for interpretation

The travaux and the literal wording of Article 7(1) reveal that the only role to be played by the principle of good faith is in the interpretation of the Convention. Both the travaux and the Convention, however, have been unable to provide any meaningful guidance with regards to what exactly the notion of good faith entails in this context. Provided that the forum of adjudication in the case of the Convention are the national courts, the trend of adjudication on the interpretation of the principles vis-à-vis the Convention has been marred by judges drawing on their experience of the principle in domestic contexts, thereby producing contradictory answers. Similarly, scholars have not offered much help in shedding light on the subject, since they usually either seem to assume that the principle is self-defining or that case law will be able to develop the principle in the domain of international law.¹³⁹

Before embarking upon the identification of the appropriate definition of the principle of good faith as used in Article 7(1), it is necessary to analyse what the term ‘interpretation’ implies. Because of the challenges a broad definition is bound to face, especially on the grounds that a term cannot be attributed meanings that run contrary to what the drafters reasonably expected them to mean during and at the conclusion of the drafting stages,¹⁴⁰ this paper shall adopt a narrow definition which may be stated to represent the common core. Such a narrow definition of ‘interpret’

¹³⁹ Keith Highet defines *lex mercatoria* as an autonomous system of transnational commercial law that is “capable of being applied by decision makers (judges or arbitrators) as a source of legal rules, in order to give content to decisions, in much the same way that these decision makers would apply a real legal system such as the *lex fori* or the *lex loci arbitri*” Keith Highet, ‘The Enigma of the Lex Mercatoria’ in Thomas E. Carbonneau (ed), *Lex Mercatoria and Arbitration: A Discussion of the New Law Merchant* (1998). See Isaak I. Dore and James E. DeFranco, ‘A Comparison of the Non-Substantive Provisions of the UNCITRAL Convention on the International Sale of Goods and the Uniform Commercial Code’ (1982) 23 Harvard International Law Journal 49 <<http://www.cisg.law.pace.edu/cisg/biblio/dore.html>> accessed: 19 June 2014.

¹⁴⁰ This is to say that since the Convention is simply a compromise document, member states would be alarmed to see terms interpreted in a manner that either run contrary to the hard won compromise, or breath meanings into them which were not anticipated and would have been opposed had the same been suggested during the drafting stages.

thus would simply be ‘to make clear’.¹⁴¹ As such, good faith is to apply solely to the interpretation of the Convention and its role should be limited to instances of textual ambiguity.¹⁴²

While the express words of the Article and the travaux seem to completely reject the validity of the application of the principle to the underlying contract, certain academics and tribunals have argued in favour of such an application.¹⁴³ For instance, in one case, a Spanish court that held that the terms contained in the contract must conform to the requirement of good faith, “in that the content of a contract should be as anticipated by the parties, in accordance with the principle of reasonable expectation.”¹⁴⁴ Apart from the invalidity of any application of the principle that would impose substantive requirements on the parties as demonstrated by the travaux, Part 4 of this chapter shall argue that any such application of the principle should be rejected since it would produce inefficient results, as far as the end users of the Convention are concerned.

Provided that the only acceptable use of the principle is in the resolution of textual ambiguity of the Convention, there is still the question of what the principle actually entails. Unlike the case for Article 7(2), however, Article 7(1) does not impose any limitation with regards to defining the principle solely through reference to the text of the Convention. As such, adjudicators are free to identify the content of the principle via reference to external sources, so long as they conform to the Convention’s international character. Unfortunately, even in the sphere of international law there does not exist a unanimously accepted definition of the principle.

According to various academics and tribunals, the UNIDROIT principles provide the

¹⁴¹ Michael Agnes (ed), *Webster's New World College Dictionary* (4th edn, 1999) 747.

¹⁴² Textual ambiguity as used here however, is not confined to instances where there are two possible interpretations of the Convention, but also covers instances where simply, clarity as to the dictates of a particular article is sought. Resultantly there is no question as to the extent of ambiguity that must be present for the principle to become applicable as a tool in the interpretation of the Convention.

¹⁴³ Academics in favor of such an interpretation include Franco Ferrari, ‘Uniform Interpretation of The 1980 Uniform Sales Law’ (1994-95) 24 *Georgia Journal of International and Comparative Law* 183; Eorsi (n 15) § 2.03; Bonell (n 7).

¹⁴⁴ CLOUT case No. 547 [[Audiencia Provincial de Navarra, Spain, 22 September 2003](#)]. See also CLOUT case No. 1039 [[Audiencia Provincial de Navarra, Spain, 27 December 2007](#)].

best source in the domain of international law for the interpretation and supplementation of the rules of the Convention.¹⁴⁵ This is based on the fact, that since the drafters of the Principles had access to the discussions held at UNCITRAL, they were able to identify provisions in the Convention that were ambiguous or inconsistent as a result of compromise. This allowed the drafters to make modifications whereby such ambiguities and inconsistencies were removed.¹⁴⁶ Moreover, the drafters of the principles were legal scholars, rather than country representatives; as such, there was no need for diplomatic solutions or crafty drafting to disguise the compromise between conflicting interests.¹⁴⁷ Thus, the drafters of the principles were able to identify and incorporate the most egalitarian and efficient solutions to problems, rather than advocating for the interest of any particular country. The resulting text of the principles, therefore, represents a significant improvement to the rules on international sale of goods whereby the potential of contradictory interpretations is significantly curtailed.

Given the potential of the Principles in aiding in the interpretation of the Convention, it seems to represent the natural choice to make reference to for the identification of the meaning of the term good faith. It should, however, be noted at this point that the Principles do not enjoy the status of a convention and are to be applied where the parties have opted for their application in their contract.¹⁴⁸ Moreover, any attempt to derive the definition of the terms used in the Convention, through the use of the Principles, must ensure that the term, so defined, does not contradict the fabric of the remaining articles of the Convention. For example, a definition that operates to extend the application of the principle to the pre-contractual stage should be ignored since it is directly contradictory to the methodology adopted under the Convention. With this in mind, the next sub-section shall attempt to ascertain whether the Principles can aid in the identification of the definition of the principle of good faith.

¹⁴⁵ See for example Alejandro Miguel Garro, 'The Contribution of the UNIDROIT Principles to the Advancement of International Commercial Arbitration' (1995) 3 *Tulane Journal of International and Comparative Law* 93.

¹⁴⁶ Michael Joachim Bonell, 'The UNIDROIT Principles in Practice -- The Experience of the First Two Years' (1997) *Uniform Law Review* 34-35

¹⁴⁷ *ibid.*

¹⁴⁸ Pilar Perales Viscasillas, 'UNIDROIT Principles of International Commercial Contracts: Sphere of Application and General Provisions' (1996) 13 *Arizona Journal of International and Comparative Law* 381.

2.7.2 The UNIDROIT principles and the Convention

Unfortunately, like the Convention, the UNIDROIT Principles do not define the principle of good faith. This, however, should not be taken to mean that the Principles are incapable of shedding any light on the subject. The Principles contain various provisions that, although not defining the principle of good faith, do attempt to define the parameters of the principle's application. It is asserted, that an analysis between the functions ascribed to the principle by the Convention and the Principles may aid in the identification of certain provisions that may assist in the framing of an appropriate definition.

It must be noted at the onset, that unlike the Convention, the Principles extend the application of 'good faith' to the conduct of the parties.¹⁴⁹ Furthermore, Article 4.8 (2)(c) of the Principles states that regards is to be had to good faith and fair dealing in determining what terms are to be implied into a contract.¹⁵⁰

Similarly, the Principles extend the application of the principle of good faith to the pre-contractual stage and to the validity of the contract, both of which lie outside the scope of the Convention. The only reference to the pre-contractual phase in the Convention is found in Article 16(2)(b) which states that an offer cannot be revoked "if it was reasonable for the offeree to rely on the offer as being irrevocable and the offeree has acted in reliance on the offer." The same text has been adopted in the Principles in Article 2.14 (b). The Principles, however, go a step further and establish a duty not to break off pre-contractual negotiations in bad faith.¹⁵¹

Reference to bad faith in Article 2.15(2) of the Principles, coupled with an attempt in Article 2.1.15 (3) to define an aspect of the term, are rather interesting,¹⁵² The fact that the drafters choose to attempt to define the concept of good faith by reference to what constitutes bad faith (Summer's excluder analysis) and through the concepts

¹⁴⁹ Article 1.7(1) of the Principles states "Each party must act in accordance with good faith and fair dealing in international trade".

¹⁵⁰ For instance, a lot of ink has been spilled on the proposition that general duty to cooperate can be implied under the Convention, with proponents pointing towards similarities between certain articles of the Convention and article 5.1.3 of the Principles. See Bonnell at § 2.3.2.2.; Article 5.1.3 of the Principles states "Each party shall cooperate with the other party when such co-operation may reasonably be expected for the performance of that party's obligations".

¹⁵¹ Art. 2.15 (2) UNIDROIT Principles of International Commercial Contracts 2010 (Principles)

¹⁵² 2.1.15(3) "It is bad faith, in particular, for a party to enter into or continue negotiations when intending not to reach an agreement with the other party".

function in implying terms into the contract (Farnsworth's 'implied terms' analysis) seems to point to the conclusion that they were well aware of the controversial debate on the principle and intentionally decide to draft the provision pertaining to it in vague terms.

In any event, the reference by both instruments to the fact that a party should not be allowed to take advantage of acts and situations that are irreconcilable with his prior conduct, does garner support for the proposition that the prohibition of *venire contra factum proprium* is one of the elements of good faith.¹⁵³ The enunciation, by the Principles, of the requirement to negotiate with a clear view to reach agreement under Article 2.1.15, however, is not supported by the text of the Convention.

In the case of non-performance caused by a creditor, however, the Principles seem to provide substantial help in defining good faith. Both the Convention and the Principles state "a party may not rely on a failure of the other party to perform, to the extent that such failure was caused by the first party's act or omission."¹⁵⁴ The Principles, however, go a step further by adding "or by another event for which the first party bears the risk."¹⁵⁵ Both these provisions seem to be driven from the same source, i.e. no one should be allowed to profit from his unlawful or otherwise forbidden act. Since the underlying principle remains the same, the additional provision in the Principles can aid in the 'good faith' observant interpretation of the Convention.

The discussion above, however, suffers from one fatal flaw. Since the Principles do not provide a definition of the term good faith, one is forced to resort to a similar methodology, as the one contained in Article 7(2), in order to ascertain the term's meaning through analogy. While the use of such a methodology does not give rise to any substantial criticism, those engaged in such an exercise must justify why recourse to the provisions of the Convention itself is not adequate. In other words, reference to the provisions of other instruments would simply add to the uncertainty of the definition of the principle by simplifying a greater number of vague rules

¹⁵³ Apart from under Article 16(2)(b), support for this proposition stems from the text Article 29(2) as well. The same has been reproduced in the Principles in 2.1.18.

¹⁵⁴ Article 80 of the Convention.

¹⁵⁵ Article 7.1.2 Principles (n 151)

under the banner of good faith. The problem, therefore, is that any definition derived from external sources would “spiral into the Charybdis of vacuous generality.”¹⁵⁶

It is asserted that unlike the case of Article 7(2) of the Convention, the definition ascribed to the principle of good faith in Article 7(1) need not encompass all the provisions of the Convention that reflect a duty of good faith. Rather, it is advisable to identify a narrow and concrete definition, which may be said to reflect the ‘common core’, i.e. one that member states would at minimum agree upon. This is not to say that reference should be made to domestic law, for apart from being contrary to the text of the Convention, such a methodology is bound to fail in its objectives given the diversity of meanings ascribed by national laws. Rather reference should be made to the provisions of the Convention itself, with the aim of ascertaining some concrete definition that reflects the standard of behaviour the Convention requires of the parties. The utility of such a definition, it is asserted, would outweigh that of a general definition, since the latter would in most instances undermine the goals of certainty and uniformity. In other words, while a concrete and narrow definition would face criticisms of under-inclusiveness, it would be more in line with the purported objectives of the Convention.

2.7.3 Defining good faith from within

Paul J. Powers, after analysing the underlying norm of each article of the Convention, defines good faith as:

an expectation of each party to a contract that the other will ... perform his duties under the contract in a manner that is acceptable to the trade community. The duty of good faith is an international doctrine that requires parties to an international transaction to act reasonably, as they would expect the other party to act. This definition is international in spirit and captures the best of domestic definitions around the world. Good faith is a lot like the golden rule: treat others as you wish to be treated. Performing contract duties

¹⁵⁶ Summers (n 69) 206.

in a manner which is honest, fair, and reasonable will almost always be considered good faith performance.¹⁵⁷

Since any article that advances the goals of fairness and justice may be said to play a role in the definition of the principle of good faith, it is difficult, if not impossible, to comprehensively identify such articles. This assertion is based on the fact that the definition of the terms ‘fairness’ and ‘justice’ is ambiguous. Indeed, a lot of ink has been spilled in the ascertainment of what these notions actually entail. The literature on this debate simply goes to show that what may be considered fair by one, might well be considered unfair by the other.

Keeping this limitation in mind, this sub-section shall now attempt to identify the conduct that the Convention requires of the parties to the contract. Such an approach has two seminal advantages. Firstly, it tactfully avoids the pitfalls surrounding the definition of the notions of fairness and justice and, secondly, it provides adjudicators with a standard by which they may settle issues of textual ambiguity.

2.8 The standard of conduct that the Convention requires of the parties to the contract

2.8.1 Requirement of honest communication and co-operation

The Commitment of honest communication and co-operation is identified from the following articles:

Article 40 precludes the seller from relying on the fact that notice of non-conformity has not been given by the buyer in accordance with Articles 38 and 39, if the lack of conformity relates to facts of which the seller knew or could not have been unaware and which he did not disclose to the buyer.

Articles 77, 85 to 88 impose on the parties’ obligations to take steps to preserve the goods and mitigate its loss.

¹⁵⁷ Paul J. Powers, ‘Defining the Undefinable: Good Faith and the United Nations Convention on Contracts for the International Sale of Goods’ 18 Journal of Law and Commerce 333, 352.

Articles 32(3), 48(2) and 60(a) and 65, impose the duty to co-operate with the other party in so far as that party requires his co-operation to fulfil his part of the contractual bargain.

Articles 19(2), 25, 26, 34, 37, 48, 49, 51(1), 64, 71 and 72A state that the contract should always be preferred in favor of another that would terminate the contract.

2.8.2 Obligation not to act in a manner contrary to the other party's reasonable expectation

Article 16(2) (b), 21 (2), 16 (2) (b) and 29 (2), operate to bar parties from acting contrary to the reasonable expectations of the other. For example, a late acceptance which was sent in such circumstances that if its transmission had been normal it would have reached the offeror in due time, is considered valid.¹⁵⁸ Similarly a party may not contradict a representation on which the other party has reasonably relied.

2.8.3 Obligation to act in a reasonable manner even where acting otherwise might not be in contravention of the express wording of an article (the rule against creative compliance)

Articles 8(2), 8(3), 18(2), 34, 37, 47-49, 63-65, 72(2), 73(2), 75, 85, 87, 88: are based on the principle that a party's behavior is to be judged according to the standard of reasonableness in the absence of any specific regulation.

Unfortunately, even this analysis suffers from the criticism of translating one general term into another. In other words, even though this analysis attempts to define the principle with reference to specific articles of the Convention, it does little more than inform adjudicators that the Convention is to be interpreted in a manner that promotes reasonableness and co-operation, which seem to be just as vague as other terms that have been employed to define good faith.¹⁵⁹

¹⁵⁸ Subject to the proviso that the offeror without delay "orally informs the offeree that he considers his offer as having lapsed or dispatches a notice to that effect."

¹⁵⁹ Such terms include "fairness, fair conduct, reasonable standards of fair dealing, reasonableness, decent behaviour... and honesty in fact" Troy Keily, 'Good Faith and the Vienna Convention on Contracts for the International Sale of Goods (CISG) (1999) 3 Vindobona Journal of International Commercial Law and Arbitration 15, 17-18.

This is where the utility of the economic analysis of the law becomes apparent, i.e. by allowing the term to be defined in a relatively more concrete manner. It is asserted that the common core of all the articles, discussed above, lies in barring opportunistic behavior and reducing transaction costs.¹⁶⁰ In other words, courts should strive to interpret the Convention in a manner that limits the possibility of parties acting opportunistically and reduces transaction costs. While there are various types of transaction costs, and opportunism can take a variety of forms, these two terms are far more concrete than those usually employed in legal analysis defining good faith. Moreover, since there two ‘objectives’ underlie almost all the article of the Convention, as evidenced by the travaux of individual articles, they are best suited to define the principle of good faith as contained in the Convention.¹⁶¹ Another reason for employing these objectives in the interpretation of the Convention, is that apart from providing the parties with a greater degree of certainty as to the interpretative methodology contained in Article 7, they motivate parties not to derogate from the dictates of the Convention via agreement since they are assured that the Convention will be interpreted in line with the dictates of efficiency.

Before proceeding, it is important to note that the concepts of opportunism and transaction costs are closely related, i.e. a reduction in the probability of opportunism will lead to a decrease in transaction costs. This shall be illustrated in the discussion below.

Opportunism, for the purposes of this thesis, is defined as the policy of self-interest, whereby a party takes undue advantage of an asymmetry to change the ratio of return between the parties to its advantage, and to the detriment of the other.¹⁶² In the words of Oliver Williamson, it is the policy of “self-interest with guile.”¹⁶³ A party acting opportunistically does not necessarily act in contravention of the literal interpretation

¹⁶⁰ Good faith as the opposite of opportunism was first argued by Muris. See Timothy J. Muris, ‘Opportunistic Behavior and the Law of Contracts’ (1980) *Minnesota Law Review* 65, 521.

¹⁶¹ The following chapters, while discussing the travaux of individual articles that constitute their subject matter reach this conclusion.

¹⁶² Ejan Mackaay, ‘Good Faith in Civil Law Systems: A Legal-Economic Analysis’ (2012) 18 *Revista chilena de derecho privado* 149, 162.

¹⁶³ Oliver E. Williamson, ‘Markets and Hierarchies: Analysis and Antitrust Implications’ (Macmillan USA 1983) 26.

of the provisions of the Convention but, rather, places self-interest before the interests of the other party when the opportunity arises.¹⁶⁴ As such, creative compliance is but one aspect of opportunistic behaviour. Moreover, a party acting opportunistically would “capitalize on the mistakes of others: to utilize opportunities created by the errors, weaknesses or distractions of opponents to one's own advantage.”¹⁶⁵

In its most simplified form opportunism is simply an un-agreed transfer of wealth that is in contravention of the other parties' reasonable expectations under the contract.¹⁶⁶ In this sense, it also includes exploitation of an unspecified contingency by one party with the view of changing the division of gains from the contract in its favor.

Opportunism left unchecked carries great costs. This means that the concept of opportunism and transaction costs are associated. Parties, when faced with the probability of opportunism, would attempt to specify as many contingencies in their contract as possible to combat the same. This would in turn drive up transaction costs. Moreover, the possibility of opportunism, if high, would operate to shrink the market by driving risk-averse parties out.¹⁶⁷ These concerns led Judge Posner to argue that the possibility of opportunism carries with it social costs and in this sense it is welfare reducing,¹⁶⁸ i.e. while opportunism operates to benefit the party acting in such a manner it harms merchants as a whole.¹⁶⁹ The existence of a default rule, however, which operates to bar opportunism such as good faith interpretation, would operate to facilitate trust in the contracting environment, thereby, decreasing the motivation of parties to contract on a multitude of contingencies and thus lowering transaction costs.

¹⁶⁴ *ibid.*

¹⁶⁵ Donald L. Luskin, ‘Newt's Bain Opportunism Is Mitt's Opportunity’ *Wall Street Journal* (17 January 2012).

¹⁶⁶ Timothy J. Muris, ‘Opportunistic Behaviour and the Law of Contracts’ (1980) 65 *Minnesota Law Review* 521, 566. He states that, “opportunistic behaviour provides a ground upon which to separate good from bad faith” at 566.

¹⁶⁷ This is especially true in instances where the probability of opportunism is high and transaction costs of specification outweigh the return from the transaction to the innocent party.

¹⁶⁸ Richard A. Posner, *Economic Analysis of the Law* (8th edn, Wolters Kluwer Law & Business 2011) 9.

¹⁶⁹ Avinash K. Dixit, *Lawlessness and Economics: Alternative Modes of Governance* (Princeton University Press 2007) 1. 1

Mackay et al. argue that individuals do not base their decisions on the calculation of probabilities but rather base them on past instances.¹⁷⁰ As a result, if opportunism is left unchecked, parties, especially risk-averse ones would automatically shift gears “into an over-protective mode.”¹⁷¹ Moreover, other parties in the market that become aware of such an incident would react in a similar manner. This means that opportunism left unchecked would operate to erode trust between merchants. The inclusion of a default rule, i.e. good faith, whereby default rules are interpreted in a manner that promotes good faith, would operate to minimize instances of opportunism and add efficiency to the market as a whole. This would mean that a party contemplating to act opportunistically would not be able to take cover under the literal interpretation of the provisions of the Convention.

2.7 Should parties expressly incorporate the principle in their contracts?

The interpretative methodology of Article 7, if interpreted in a manner that operates to bar opportunistic behaviour, would result in limitations on creative compliance of the provisions of the Convention. As discussed above, good faith, as contained Article 7, may only be used in the interpretation of the Convention and does not extend to the underlying contract. Consequently, Article 7 has absolutely no application to instances of creative compliance of the terms of the contract. A way around this problem is for the parties to include a specific provision in their contracts, whereby they must conform to the requirement of good faith in performance. On the basis of the arguments discussed above, such a subjective requirement of good faith would operate to increase the ex-ante value of the contractual relationship.¹⁷²

As such, from an efficiency-based perspective, the application of a substantive requirement of good faith to the Convention or the underlying contract is

¹⁷⁰ Ejan Mackaay and Violette Leblanc, ‘The Law and Economics of Good Faith in the Civil Law of Contract’ (2003) 14.

¹⁷¹ Ibid.

¹⁷² According to Posner “Good faith is a compact reference to an implied undertaking not to take opportunistic advantage in a way that could not have been contemplated at the time of drafting, and which therefore was not resolved explicitly by the parties” *Market Street Associates Limited Partnership and Williamorenstein v. Dale Frey, et al.* 941 F.2d 588, 595 (7th Cir. 1991).

advantageous to the extent that it saves on the costs of contracting on every possible contingency and prevents transactional insecurity by providing a default rule that operates to prevent opportunistic behavior.¹⁷³

It should, however, be noted that the potential of the principle in barring opportunistic behavior on the parties is inversely related to the probability that the court applying the principle will achieve the wrong result. The question, therefore, is whether courts and tribunals are able to correctly interpret the principle of good faith so as to achieve the ‘correct result’, i.e. one that does not allow for opportunistic behavior and maximizes the value of contractual exchanges. In other words, the possibility that courts, when called upon to resolve a dispute arising from a contract that incorporates the requirement of good faith, will not be able to reach the ‘correct answer’ and would operate to motivate parties to act opportunistically where an unspecified contingency arises. This is especially true for cases where a party believes that the benefits of acting in an opportunistic manner would be higher than the costs of the judicial outcome.¹⁷⁴

Moreover, since good faith, as used in the contract, cannot be interpreted with reference to the general principles upon which the Convention is based, courts would have to inquire what the parties meant when they used the term; subsequently, good faith in this context would be a vague principle.

Due to the vague nature of the principle as used in the contract, parties that choose to be governed by it would seldom be able to concretely identify their obligations and entitlements at the occurrence of a particular unspecified contingency. This is simply a result of the fact that what may be considered good faith performance by one party may not be considered so by the other. In such a case, it would be difficult to ascertain whether a party is indeed acting in an opportunistic manner.¹⁷⁵ This leads to the conclusion that from the perspective of a tribunal called upon to resolve a dispute

¹⁷³ Fischel for instance states, “the rationale for imposing a duty of good faith on lenders relates to the impossibility of drafting a contract covering every possible contingency.” At Fischel (n 1) 140.

¹⁷⁴ A. Mitchell Polinsky & Steven Shavell, ‘Legal Error, Litigation, and the Incentive to Obey the Law’ (1989) 5 Journal of Law, Economics, & Organization 99, 99-101.

¹⁷⁵ Since it could be extremely difficult to ascertain exactly what opportunism entails in the given circumstances.

arising from a contract governed by the Convention, the entitlements of the parties are far clearer when an express provision of the Convention or contract provides the same¹⁷⁶, rather than when they are ascertained through the application of vague principles such as good faith.¹⁷⁷

According to Posner, the substantive requirement of good faith is efficient when the costs of negotiating contingencies are too high and the probability of such contingencies materializing is low.¹⁷⁸ This analysis, however, is flawed, in that it does not account for the difference in risks parties bear when they opt for the inclusion of the good faith requirement in comparison to when they opt for specification in contract.¹⁷⁹ This paper therefore asserts that this approach does not concretely prove the efficiency of the principle of good faith.

It may therefore be concluded that the application of the principle of good faith as imposing substantive requirements on the parties is efficient only when the costs saved on negotiating each contingency outweighs the chances of, and the resultant cost of, judicial error. The question of whether the inclusion of a good faith requirement is efficient is therefore dependent upon the extent to which it operates to reduce Transaction Costs (TC). Here TC is equal to the aggregate cost that the parties incur as a result of specifying contingencies, plus the aggregate cost incurred as a result of the incompleteness of contract. The cost of specifying contingences includes the cost of identifying and negotiating on contingencies, coupled with the costs associated with drafting the contract. The aggregate cost of incompleteness, on the other hand, is simply a reflection of the costs of opportunism that parties bear as a result of the possibility of opportunistic behaviour of one party when a contingency, which has not been contracted upon, arises. Interestingly, while the cost of specifying contingencies increases with the number of contingencies negotiated

¹⁷⁶ In a case of a complete contract, the possibility of opportunism does not arise. This is to say that where the contract is complete, the essential prerequisite for opportunism is missing. The risk in such a situation is that the other party may simply breach the contract.

¹⁷⁷ Where parties agree to govern their contract through the use of a substantive requirement of good faith however, the risk of opportunism subsists since the court may not be able to find the 'correct answer' as a result of the contract being indeterminate about the parties' entitlements thereunder and the use of judicial discretion that may result in a redistribution of the parties' entitlements.

¹⁷⁸ Richard Posner, *Economic Analysis of the Law* (6th edn, Aspen Publishers 2002).

¹⁷⁹ Specification of good faith in the contract attracts the risk that courts would not be able to reach the correct result.

and incorporated into the contract (hereinafter referred to as N), the cost of incompleteness, i.e. 'opportunistic cost' seems to decrease with N.

From a law and economics perspective, the substantive application of the doctrine of good faith operates to make the contract more complete thereby reducing N. This would lead to the conclusion that if the same number of contingencies have been incorporated into a contract, the inclusion of a subjective good faith requirement would operate to reduce TC relative to a situation where good faith has not been incorporated. This statement, however, suffers from a fatal flaw; it is premised on the fact that the principle of good faith is capable of substituting specification, which as discussed above, is not always true as a result of the possibility of judicial error in the ascertainment of the entitlements of the parties through the use of the principle.

A greater problem that surfaces, when the principle of good faith is applied substantively, is that it may operate to reallocate the entitlements of the parties from what the contract states to what the court deems 'in good faith'. In other words, a subjective requirement of good faith may operate to allow courts to ascertain whether the express terms of the contract conform to the requirement of the principle and mold the entitlements of the parties accordingly. This operates to displace the argument, made earlier, that the cost of incompleteness decreases with N, since the cost of incompleteness is only partially dependent upon the number of specified contingencies. Given that parties have the most information about their dealings, it is asserted that the parties are better able to define their respective entitlements than courts. In other words, the informational asymmetry between the parties and courts makes the former better suited to ascertain which interpretative methodology is likely to achieve the 'correct result', thereby increasing the value of their contractual relationship ex-ante. As such, where the substantive principle of good faith is applied, costs may increase even if the court specifies the same number of contingencies as the parties themselves would have specified had the principle not applied.

2.8 Conclusions:

The adoption of a substantive good faith requirement promotes efficiency to the extent that it saves on transaction costs that the parties would have to bear as a result of negotiating on various contingencies. There is, however, an additional cost associated with such an interpretative regime, i.e. the cost of judicial error in identifying the 'correct result' through the application of a vague concept. Moreover, the application of a vague concept in the ascertainment of the entitlement of the parties is less preferable in efficiency terms, to contractual specification of entitlements. This is based on the fact that the latter provides more certainty ex-ante. The substantive application of the principle of good faith is less preferable than a strict contractual interpretative regime, since the former allows courts to ascertain what good faith requires, regardless of whether the contingency under scrutiny is specified or otherwise. As such, under such an interpretative regime courts may err by disregarding, or reaching conclusions that contradict the entitlements expressly stated in the contract.

Limiting the application of the principle of good faith to the interpretation of the Convention, in cases of textual ambiguity, restricts the costs that are incurred through the application of a substantive principle of good faith. Under such a methodology, courts and tribunals no longer have the power to displace the express terms of the contract or even judge them on the basis of whether they conform to the requirement of good faith.

The role of good faith, as such, would be limited solely to ensuring that the Convention is not interpreted in a manner that allows for opportunistic behaviour. The resulting decrease in costs associated with judicial error, coupled with the economic advantages of certainty, would result in the labelling of such an approach as the more efficient one.

Such a limited application and function of the principle of good faith carries with it the advantage that parties can ascertain the optimal level of specification, i.e. parties would specify contingencies to the extent that the marginal cost of specification equals the expected cost resulting from the incompleteness of the contract.

Moreover, interpretation of default rules in accordance with the principle of good faith, arguably, provides incentives to parties to act in a co-operative manner. From a law and economics perspective, co-operation is valuable since it results in an exchange of information, reductions in costs and increases the overall efficiency of the transaction.¹⁸⁰

It should be noted that traditional economic law theory questioned the utility of the principle of good faith on the grounds that they limit the rights of parties to enter into efficient exchanges on their own terms.¹⁸¹ Such a criticism, however, does not apply to default rules since the parties are free to negotiate whatever terms they see fit, and, it is only in the case of a gap in the contract that default rules come into play.

¹⁸⁰ Duke, Arlen. "A Universal Duty of Good Faith: An Economic Perspective' (2007)." *Monash University Law Review* 33: 182. At 186

¹⁸¹ Frank H Stephen, *The Economics of Law* (Brighton: Iowa State University Press, 1988), 155 at page 156

Chapter 3 Battle of Forms

“There should be no doubt that ‘chaos’ is an accurate characterization of the state of law in the ‘battle of the forms’ arena.”¹

Introduction

Changes in mercantile practice as a result of the advent of mass production and marketing, coupled with the creation of large and in certain instances market-dominating firms, have led to the prevalent use of standard forms in the context of sale of goods.² The use of such forms is preferred because they provide significant advantages to both sellers and buyers of goods – for instance by reducing transaction costs.³

While empirical evidence suggests that most contracts that suffer from conflicts between clauses contained in standardized forms are performed without incident,⁴ they have been noted to “raise some of the trickiest doctrinal issues.”⁵ It is therefore

¹ Caroline N. Brown, ‘Restoring Peace in the Battle of the Forms: A framework for making Uniform Commercial Code Section 2-207 Work’ (1991) 69 North Carolina Law Review 893, 902.

² Professor Burke notes that “almost ninety-nine percent of written contracts consist of standard forms.” John J. A. Burke, ‘Contracts as a Commodity: A Nonfiction Approach’, (2000) 24 Seton Hall Legislative Journal 285, 290; Daniel T. Ostas and Frank P. Darr, ‘Redrafting UCC section 2-207: An Economic Prescription for the Battle of the Forms’ (1995) 73 Denver University Law Review 403, 405; W. David Slawson, ‘Standard Form Contracts and the Democratic Control of Lawmaking Power’ (1971) 84 Harvard Law Review 529; K. N. Llewellyn, ‘Reviewed Work: The Standardization of Commercial Contracts in English and Continental Law’ (1939) 52 Harvard Law Review 700.

³ For a review on how the use of standard forms benefits the society as a whole see Friedrich Kessler, ‘Contracts of Adhesion—Some Thoughts About Freedom of Contract’ (1943) 43 Columbia Law Review 629, 631-632; for a review on the advantages of cost reduction see Batya Goodman, ‘Honey I Shrink-Wrapped the Consumer: The Shrink-Wrap Agreement as an Adhesion Contract’ (1999) 21 Cardozo Law Review 319, 326.

⁴ A study conducted by Professor Murray concludes that such contracts are performed without incident because: (A) as long as the transaction is proceeding in a manner considered appropriate by both parties, legal clauses do not come into play (B) when conflict does arise, parties try to resolve it in a cordial manner that does not harm the prospects of a future business relationship between them. As such, parties prefer to settle disputes through business tools rather than legal ones. J. E. Murray, ‘The Definitive “Battle of the Forms”: Chaos Revisited’ (2000) 20 Journal of Law and Commerce 1.

⁵ Jonathan Morgan, *Great Debates in Contract Law* (Palgrave Macmillan 2015) 68; See for instance *Oberlandesgericht Linz, Austria*, 23 March 2005 <<http://cisgw3.law.pace.edu/cases/050323a3.html>> accessed 28 December 2014; *Bundesgerichtshof, Germany*, 9 January 2002 <<http://cisgw3.law.pace.edu/cases/020109g1.html>> accessed 28 December 2014; *Amtsgericht Kehl, Germany*, 6 October 1995 <<http://cisgw3.law.pace.edu/cases/951006g1.html>> accessed 28 December 2014.

hardly surprising that the issue of Battle of Forms (BOF) has been a subject of extensive debate amongst legal scholars around the world.

Standard forms contain pre-printed terms, which are rarely discussed during the negotiation stage.⁶ Various commentators therefore question the extent to which the terms contained in such forms represent a “bargained for exchange.”⁷ Most commentators, however, cognizant of this fact, still argue for the enforcement of the terms contained in such forms.⁸ The argument rests on the assertion that parties should read and understand the terms of the contracts they conclude.⁹ As a result, it is argued that contract law rules should be designed in a manner that puts parties on notice that the standard forms they sign will govern the transaction.

Moreover, certain empirical studies indicate that standard forms are generally designed in a manner that promotes the interests of both parties to the transaction.¹⁰ This argument rests on the assumption that competition would drive businesses to draft their standard contracts in a competitive manner.¹¹ For instance, since optimal risk allocation between the parties to contracts would seldom vary within the same industry, sellers of similar goods would draft and use similarly termed standard forms.¹²

⁶ See Morgan (n 5); Professor Rakoff noted back in 1983, “Virtually every scholar who has written about contracts of adhesion has accepted the truth of this assertion [that the contents of pre-printed forms are rarely discussed during negotiations], and the few empirical studies that have been done have agreed.” See Todd D. Rakoff, ‘Contracts of Adhesion: An Essay in Reconstruction’ (1983) 96 Harvard Law Review 1173, 1179.

⁷ See generally Ulrich Magnus, ‘Incorporation of Standard Contract Terms under the CISG’ in Camilla Baasch Andersen and Ulrich G. Schroeter (eds), *Sharing International Commercial Law across National Boundaries: Festschrift for Albert H. Kritzer on the Occasion of his Eightieth Birthday* (Wildy, Simmonds and Hill 2008) 323.

⁸ Robert A. Hillman and Jeffrey J. Rachlinski. ‘Standard-Form Contracting in the Electronic Age’ (2002) 77 New York University Law Review 429, 438.

⁹ *ibid.*

¹⁰ George L. Priest, ‘A Theory of the Consumer Product Warranty’, (1981) 90 The Yale Law Journal 1297, 1307-14.

¹¹ *ibid.* While this article is in the context of consumer sales, the arguments apply equally to business-to-business contracts. Indeed, the bargaining power that businesses possess leads to the inference that standard forms used in business-to-business settings would be more competitive than those used in consumer transactions.

¹² Slawson, for instance, reaches this conclusion with regards to warranties provided in the automobile industry. See Slawson (n 2).

If competition does operate to incentivise the use of standard contracts containing mutually beneficial terms, parties would seldom engage in renegotiation, since particularizing such terms to the individual sale would drastically increase transaction costs – thereby reducing the net joint returns from the transaction.¹³ Schwart and Wilde therefore argue that market intervention should occur only in instances where information asymmetry or lack of competition results in standard forms being drafted in a non-mutually beneficial manner.¹⁴

Empirical evidence, however, reveals that parties to a sales transaction seldom read standard forms.¹⁵ As a consequence, there is not much evidence to support the claim that parties would draft standard forms competitively out of fear of losing business opportunities to competitors. Meyerson, for instance, argues, “Drafters of form contracts [possess] the power to impose their will on unsuspecting and vulnerable [parties].”¹⁶ Even if parties do read standard forms, the majority of current domestic laws operate to motivate the formulation of self-serving terms. As shall be discussed below, national laws adopt either the Last Shot Rule (LSR), the Knock-Out Rule (KOR) or a hybrid of the two in cases where both parties to a transaction exchange their forms (BOF).

In particular, the BOF scenario gives rise to three questions:

- (A) Has a contract come into existence where there is a conflict in the standard terms contained in the forms of the parties?
- (B) If (A) is answered in the affirmative, then what are the terms of the contract?
- (C) If (A) is answered in the negative, does performance create a contract? If so, on what terms?

¹³ Steven R. Salbu, ‘Evolving Contract as a Device for Flexible Coordination and Control’ (1997) 34 American Business Law Journal 329, 376-78; Slawson (n 2) 531.

¹⁴ Alan Schwartz & Louis L. Wilde, ‘Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests’ (1983) 69 Virginia Law Review 1387, 1389-91.

¹⁵ Thomas J. McCarthy, ‘Ending the “Battle of the Forms;” a Symposium on the Revision of Section 2-207 of the Uniform Commercial Code’ (1994) 49 The Business Lawyer 1019, 1063; see also John E. Murray, ‘The Chaos of the “Battle of the Forms”: Solutions’ (1986) 39 Vanderbilt Law Review 1307, 1373; See Brown (n 1).

¹⁶ Michael I. Meyerson, ‘The Reunification of Contract Law: The Objective Theory of Consumer Form Contracts’ (1993) 47 University of Miami Law Review 1263, 1272.

Since all three questions above are linked to the rules on the formation of contracts, these questions have traditionally been answered in view of the procedure of contract formation adopted by the relevant law. For instance, in legal regimes that adopt the traditional approach to contract formation – i.e. the terms of the offer and acceptance must correspond – an acceptance with different or additional terms is viewed as a counter offer.¹⁷ As such, a contract is only said to come into existence when the counter-offer is accepted..

In contrast, regimes that recognize contract formation, even though the acceptance is not a mirror image of the offer, adopt a more flexible approach towards the BOF scenario. Since a contract is recognized in such cases, the question of what terms it entails cannot be answered by giving primacy to the standard terms of one party over the other.¹⁸ As a result, the question must be answered through the application of a methodology that knocks-out conflicting terms.

Diverging opinions held by delegates belonging to common law and socialist countries on the one hand and civil law regimes and the United States on the other, vis-à-vis the method of contract formation, formed the basis of the majority of discussions on the treatment of standard terms during the drafting stages of the Convention.¹⁹ In particular, the delegates of the United Kingdom, Czechoslovakia, USSR and Poland advocated for the adoption of the traditional approach to contract formation, as reflected in their domestic legal systems. Delegates of the Federal Republic of Germany, France and the United States on the other hand advocated for a more flexible approach, similar to the one adopted by their national legal regimes.

A review of the travaux reveals that the delegates at the drafting stages of Article 19 attempted to have their domestic methodology adopted by alluding to the inferior

¹⁷ Rick Rawlings, 'The Battle of Forms' (1979) 42 The Modern Law Review 715.

¹⁸ Giving primacy of the terms of one party over the other would result in undermining party autonomy and the nature of private contracts as a bargain.

¹⁹ UNCITRAL Yearbooks VIII (1977) and IX (1978)

<https://www.uncitral.org/pdf/english/yearbooks/yb-1977-e/yb_1977_e.pdf> and https://www.uncitral.org/pdf/english/yearbooks/yb-1978-e/yb_1978_e.pdf accessed 29 November 2015; United Nations Conference on Contracts for the International Sale of Goods, Official Records, Vienna, 10 March - 11 April 1980 [A/CONF.97/19] <<https://www.uncitral.org/pdf/english/texts/sales/cisg/a-conf-97-19-ocred-e.pdf>> accessed 29 November 2015.

normative value of differing methodologies.²⁰ As a result, in order to appreciate the issues faced during the drafting of Article 19, it is essential to recognize the tension(s) between the stances adopted by different legal traditions on the matter. Such recognition will provide an overview of the options available to the drafters for the settlement of the issue of BOF. To this end, this chapter will attempt to carry out an analysis of the methodology of contract formation and the treatment afforded to BOF scenarios under English, American, and German law. The chapter will then move on to identify the theoretical justifications provided by the delegates for the adoption of one methodology over others. Such an analysis shall provide a list of requirements that a methodology for the resolution of the issues raised by BOF scenarios must fulfil, in order to be acceptable under the Convention. To this end, the chapter will provide a detailed analysis of the travaux of the Convention on the issue of BOF. Equipped with the list of essential requirements of acceptability of a methodology to resolve BOF issues, the chapter will move on to examine the methodology adopted under Article 19 of the Convention. A checklist analysis will be conducted in order to examine the extent to which the current methodology addresses the concerns of the drafters. For this reason, the black letter law of Article 19 will be examined. The chapter will then move on to analyse Opinion No. 13, the only opinion of the Advisory Council pertaining to the issue of BOF. Finally, the chapter will recommend an approach to the resolution of the BOF scenario which fulfils the objectives that the drafters of the Convention intended to achieve.

3.1 Comparative Analysis of Domestic Law Rules on BOF

3.1.1 United Kingdom:

²⁰ The only exception was the delegate of Australia, who opposed any divergence from the Last Shot Rule on the grounds that such a divergence would be contradictory to the stance adopted by Australian domestic law. Legislative History, 1980 Vienna Diplomatic Conference, Summary Records of Meetings of the First Committee, 10th meeting (Tuesday, 18 March 1980, (A/Conf.97/C1/L.60, L.61, L.87, L.91, L.92, L.97, L.98) <<http://www.cisg.law.pace.edu/cisg/firstcommittee/Meeting10.html>> accessed 27 November 2014 (Vienna Diplomatic Conference).

Academic discussion originating from England on the methodology to be adopted in the resolution of BOF issues is extremely sparse. This is surprising since the general rules of contract formation under English law have hardly changed since the nineteenth century,²¹ when these rules were developed in a context where most transactions were concluded face-to-face by the parties.²²

Under common law, a contract is said to come into existence when the terms of the offer are a mirror-image of those contained in the acceptance.²³ Where the two deviate, a counter-offer is said to have been made.²⁴ The corollary of this is that the original offer ceases to exist, as if it had been expressly rejected.²⁵

In this context an acceptance is said to be valid if the party making the offer is expressly notified of it²⁶ – or in the case of unilateral contracts, through conduct.²⁷ It is in the latter case that issues of BOF may arise. Take, for instance, a situation where the buyer sends an order with its standard terms attached. On receipt of the order the seller ships the goods along with a delivery form purporting to incorporate its standard terms. The buyer then accepts delivery of the goods. In such a case, English law will attempt to identify which offer has been accepted without variation.²⁸ Since the seller's reply to the buyer's offer was not a mirror image of the latter's terms, it is viewed as a counter-offer.²⁹ However, as the buyer accepted the goods without objection, the buyer is deemed to have accepted the counter offer

²¹ This is to say that the traditional rules of contract formation have not been displaced by new rules. Instead, a few exceptions have been created. For instance, it was held in *Nicolene Ltd v Simmonds* [1953] 1 QB 543 that a meaningless term is to be ignored and terms that are implied by law will be allowed. Moreover, courts have distinguished between counter-offers and mere inquiries. See for example *Stevenson Jacques & Co. v. McLean* (1880) 5 QBD 346.

²² Linda Mulcahy, and John Tillotson. *Contract Law in Perspective* (4th edn, Cavendish publishing 2004) 165.

²³ *Hyde v Wrench* (1840) 49 ER 132 Chancery Division. It should be noted that for usual conditions to form part of the contract they must satisfy the test of reasonable notice or incorporation by signature. See *L'Estrange v F Graucob Ltd* [1934] 2 KB 394.

²⁴ A mere request for information has been held not to constitute a counter offer. See *Stevenson* (n 21).

²⁵ *Hyde* (n 23).

²⁶ Joseph Chitty, *Chitty on Contracts: General principles* (Hugh Beale ed, Vol. 1, Sweet & Maxwell, 2012), 2-046. The mailbox rule is an exception to this.

²⁷ *ibid* 2-047.

²⁸ See for example *British Road Services Ltd v Arthur V Crutchley & Co Ltd* [1968] 1 All ER 811.

²⁹ *Butler Machine Tool Co Ltd v Ex-Cell-O Corp Ltd* [1977] EWCA Civ 9.

under English law.³⁰ Such a methodology has been labelled as the Last Shot Rule (LSR), since the terms that constitute the contract are the ones contained in the standard terms of the party that “fired the last shot.”³¹

It may therefore be concluded that English courts, when faced with situations where the parties have acted as if they had a validly concluded contract, even though the terms of the offer and acceptance do not correspond, attempt to ascertain which party’s terms control the transaction rather than concluding that the parties have not reached an agreement.³² It would, however, be incorrect to state that English courts will apply the LSR in all instances of BOF.

In *Tekdata Interconnections Ltd v Amphenol Ltd*,³³ the buyer made an offer to purchase on its own terms. The seller responded by sending an acknowledgement containing its own terms and delivered the goods. When the dispute arose, both parties claimed that the contract had been concluded on their own terms. The court of first instance made reference to the judgment delivered by Lord Denning in *Butler*,³⁴ where he stated that the traditional rules on contract formation did not represent the commercial world of today and argued that the “appropriate” resolution of such issues would require an analysis of the documents passing between the parties and their conduct so as to ascertain whether the parties had reached an

³⁰ A relatively recent case from Scotland found otherwise. In this case, the original offer stated that its terms would prevail. Interestingly the court ruled that the contract had been concluded on those terms, even though a counter offer was subsequently made. Consequently, the outcome seems to resemble the First Shot Rule. See *Specialist Insulation Ltd v Pro-Duct (Fife) Ltd* [2012] CSOH 79. A later case from Scotland however clarified that *Specialist* institutions was decided on the facts and does not lay down a rule for general application. In particular, the court concluded that in *Specialist* institutions the counter-offer was never signed as required on the facts of that case. See *Grafton Merchandising Gb Ltd t/a Buildbase v Sundial Properties (Gilmerton) Ltd* Edinburgh Sheriff Court 30 January 2013 (unreported) <http://www.obligations.law.ed.ac.uk/2013/07/09/two-recent-decisions-on-the-battle-of-the-forms-i-e-conflicting-standard-conditions-of-contract/> accessed 2 January 2015.

³¹ *British Road Services* (n 28); Henry D. Gabriel, ‘The Battle of the Forms: A Comparison of the United Nations Convention for the International Sale of Goods and the Uniform Commercial Code: The Common Law and the Uniform Commercial Code’ (1994) 49 *The Business Lawyer* 1053; *Zambia Steel & Building Supplies v James Clark & Eaton Ltd* [1986] 2 *Lloyd's Rep* 225.

³² Unless the facts clearly demonstrate that there was no so-called meeting of the minds.

³³ *Tekdata Interconnections Ltd v Amphenol Ltd* [2009] EWCA Civ 1209.

³⁴ *Butler* (n 29).

agreement on all essential terms.³⁵ On the basis of this reasoning, the court derogated from the LSR and held that the contract was concluded on the buyer's terms.³⁶

On appeal to the Court of Appeal (CA), Longmore LJ held that the ruling of Lord Denning in *Butler* did not displace the traditional rules of contract formation, since the same was accepted by all other members of the court including Lord Denning himself.³⁷ Longmore LJ did, however, state that there were limits to the application of the traditional analysis. In particular the traditional analysis was not applicable where "the documents passing between the parties and their conduct show that their common intention was that some other terms were intended to prevail."³⁸

Dyson LJ, in his judgment, stated that while the LSR was arbitrary and favored the terms of the one who got the last say, it was necessary to the extent that it provided certainty to commercial relationships.³⁹ He was therefore of the opinion that in "simple" BOF cases the traditional rules should be applied, whereas there might be instances where the court must ascertain the objective intention of the parties.⁴⁰ The court, however, did not find the facts of the case as falling in the exception, and applied the traditional analysis.

This judgment resultantly reinforced the application of the LSR in the UK. At the same time, it stated that it would not apply in instances where the circumstances clearly reveal that the parties intended their transaction to be governed by terms other than those contained in the form sent last in the series of communication leading to the conclusion of the contract. Philip Morgan opines that such an intention

³⁵ Lord Denning had adopted this reasoning in the prior case of *Gibson v Manchester City Council* - CA [1978] 1 WLR 520. On appeal to the HL, Lord Diplock stated, "While there may be certain exceptional types of contract which do not fit into the normal analysis, a contract alleged to be concluded by a flow of correspondence is not one of these." Lord Edmund-Davies considered the alternate approach suggested by Lord Denning and without rejecting it, held that it would operate to reach the same conclusion as that reached via the application of the traditional approach to contract formation. *Gibson v Manchester City Council* [1979] 1 WLR. 294.

³⁶ The court argued that the facts demonstrated that the parties had never intended the terms of the seller to apply.

³⁷ *Tekdata Interconnection Ltd* (n 33).

³⁸ *ibid.* [2010] 1 Lloyd's Rep. 357.

³⁹ *ibid.*

⁴⁰ *ibid.*

“would be difficult to show in a Battle of Forms case, unless there is a clear course of dealings between the parties.”⁴¹

As a result, the application of the traditional rules of contract formation continue to justify the application of the LSR in the UK. These rules, however, are displaced in instances where a contrary intention is found; which would usually be only found where the contract is concluded after a series of negotiations.⁴²

3.1.2 United States

“Perhaps more criticism has been levelled against Section 2-207 than any other provision of the Uniform Commercial Code.”⁴³

Unlike UK law, the dictates of US law on the formation of contracts is based upon the assumption that parties to a sales contract generally do not read and understand the contents of the other’s standard forms.⁴⁴ As a result, the dictates of US law on the issue do not allow parties to have the contract set aside on the basis of the incompatibility of standard forms. Rather, what is generally considered as a counter-offer under English law is usually classified as an acceptance under US law.⁴⁵ Such a result is achieved by separating the question of the formation of a contract from the issue of the ascertainment of its terms.

It would be misleading to state that national law as opposed to international law has found a clear solution, or even a well-defined methodology in combating instances of BOF. Professor Williston’s treatise on contract law, for instance, while referring to the solution contained in the Uniform Commercial Code (UCC) states, “After

⁴¹ Phillip Morgan, ‘Battle of the Forms: Restating the Orthodox’ (2010) 69 The Cambridge Law Journal 230, 231.

⁴² In such instances, the court must give consideration to the entire correspondence between the parties. See *Air Studios (Lyndhurst) Ltd v Lombard North Central PLC* [2012] EWHC 3162 (QB), [2013] 1 Lloyd’s Rep. 63.

⁴³ Ostas and Darr (n 2) 403.

⁴⁴ Thomas J. McCarthy, ‘In Ending the “Battle of the Forms”. A Symposium on the Revision of Section 2-207 of the Uniform Commercial Code – An Introduction: The Commercial Irrelevancy of the “Battle of the Forms” (1994) 49 The Business Lawyer 1019. This assumption however does not apply in contracts between merchants. See Uniform Commercial Code, Section 2-207 (2).

⁴⁵ “[T]he current 2-207 creates a perverse incentive to carefully read and consider the fine print on each and every invoice or purchase order received.” Ostas and Darr (n 2) 413.

nearly 40 years of experience with the section, the only thing clear about the section is that it remains unclear . . . a section that raises as many questions as it answers.”⁴⁶

The question of contract formation where the acceptance or conformation contains additional terms to that of the offer is dealt with in Subsection 1 of Section 2-207 of the UCC. The subsection states:

A definite and seasonable expression of acceptance or a written confirmation which is sent within a reasonable time operates as an acceptance even though it states terms additional to or different from those offered or agreed upon, unless acceptance is expressly made conditional on assent to the additional or different terms.⁴⁷

As such, the section operates to classify a reply that accepts the offer but contains additional or conflicting terms, as a valid acceptance of the terms of the offer. The only proviso to this rule is that the reply will be classified as a counter-offer where it expressly states that the acceptance is only operative on the additional or conflicting terms.⁴⁸ As such, unlike the traditional approach to contract formation as adopted under UK law, US domestic law recognizes the existence of a contract where the offer and acceptance are not mirror images of one another. Moreover, unlike the LSR adopted under the common law system, the UCC seems to favour a First-Shot Rule (FSR), according to which the terms of the initial correspondence form the final contract – even though the acceptance to that correspondence contained different terms.⁴⁹

This is not to say that the traditional approach of classifying a reply that contains additional or different terms as a counter-offer has been completely done away with under the methodology adopted by the section. Rather Subsection 1 provides an

⁴⁶ Samuel Williston, *A Treatise On The Law Of Contracts* (4th edn, 1990-date) 141-142.

⁴⁷ Uniform Commercial Code, Section 2-207.

⁴⁸ *ibid.* The reply however, must also be a “definite” and “seasonable expression” of acceptance.

⁴⁹ However, acceptance of the offer will not be found when: (1) the acceptance is “expressly made conditional on assent to the additional or different terms” (2) the reply materially alters the terms of the acceptance and (3) the reply does not fulfil the requirements of S2-204 of the UCC i.e. show the intention to conclude the contract.

exception to the FSR and reverts to the traditional approach in cases where the acceptance expressly states that it is only operative on the terms contained therein.⁵⁰

It must be noted that under the regulatory scheme of the section, the corollary of the LSR, i.e. the idea that the party making the offer is the master of the offer, has also been circumscribed.⁵¹ This, it is asserted, leads to a situation where “oppression and unfair surprise”⁵² are no longer recognized as valid tools in contract formation.

Subsection (2) of Section 2-207 moves on to specifically tackle the issue of additional terms. It states:

The additional terms are to be construed as proposals for addition to the contract. Between merchants such terms become part of the contract unless:

- (a) The offer expressly limits acceptance to the terms of the offer;
- (b) They materially alter it; or
- (c) Notification of objection to them has already been given or is given within a reasonable time after notice of them is received.⁵³

This subsection operates to create a distinction between contracts where both parties are merchants and those where they are not. In the latter case, it is presumed that the parties do not read standard terms and conditions contained in the pre-printed forms but are rather simply concerned with more material terms of the contract⁵⁴. The impact of this presumption on the drafting of Section 2-207 is clear; parties are not to be bound by the additional terms contained in the acceptance unless these terms are

⁵⁰ The exception has been a subject of great debate amongst the legal scholars. In particular, problems arise where the language used in the acceptance is ambiguous vis-à-vis the conditionality of acceptance on its own terms. See for instance, *Roto-lith Ltd v. F P Bartlett & Co* 297 F.2d 497 (1st Cir. 1962). For criticisms of the ruling see Douglas G. Baird and Robert Weisberg, ‘Rules, Standards, and the Battle of the Forms: A Reassessment of § 2-207’ (1982) 68 Virginia Law Review 1217.

⁵¹ The LSR is based upon the presumption that the offeror is the master of the offer, since an acceptance that materially differs from the terms of the offer is characterized as a counter-offer, capable of being accepted through express assent or conduct.

⁵² John Edward Murray, ‘An Essay on the Formation of Contracts and Related Matters Under the United Nations Convention on Contracts for the International Sale of Goods’ (1988) 8 Journal of Law and Commerce.11.

⁵³ UCC, Section 2-207 (2).

⁵⁴ These essential terms, in the case of Section 2-207 are limited to an adequate description of the goods and their quantity. See Ostas and Darr (n 2).

brought to the attention of the other party and their acceptance is negotiated upon.⁵⁵ In the latter case, however, this presumption is displaced in favour of one which assumes that parties meticulously go through each element of the standard terms. While the reasons for the creation of this binary are outside the scope of this chapter, it is clear that the dictates of the UCC are based upon the principle that a party is not allowed to impose non-negotiated terms upon the other. However, as will be discussed below, this methodology does not translate into the fact that the intention of the parties is given paramount importance.

Subsection 2 applies where the dictates of Subsection 1 have been fulfilled and a contract is recognized. As such, for Subsection 2 to be applicable it is necessary that the parties have agreed upon the essential terms of the contract, as categorized under the domestic law.

Subsection (3) of Section 2-207 goes on to address situations of BOF where the contract has not been formed under Subsection 1. It reads:

Conduct by both parties which recognizes the existence of a contract is sufficient to establish a contract for sale although the writings of the parties do not otherwise establish a contract. In such case the terms of the particular contract consist of those terms on which the writings of the parties agree, together with any supplementary terms incorporated under any other provisions of this Act.⁵⁶

As such, Subsection 3 operates to hold parties to an agreement which is evidenced by their conduct. In other words, courts will hold parties to an agreement they have entered into, even if the written documents do not fulfil the requirements of contract formation. The UCC in such instances, mandates the application of the knock-out rule.⁵⁷ The idea here is to incorporate all coinciding clauses of the respective forms into the final contract, since they are acceptable to both parties, and disregarding all

⁵⁵ The term ‘negotiated,’ as used here, simply refers to the fact that both parties are aware of and agree to the applicability of these terms.

⁵⁶ See UCC, Section 2-207(3)

⁵⁷ *ibid.*

conflicting clauses.⁵⁸ Gaps created by the knocking-out of terms are then to be filled by default rules of law.

While the application of the methodology adopted under 2-207 seems rather straightforward, judicial experience has proved otherwise. In particular, the scope and the interrelationship between the dictates of Subsection 2 and 3 have given rise to a great deal of confusion.

Subsection 2 provides that additional terms contained in the reply are to be classified as proposals for additions to the contract, which become part of the final contract between merchants subject to three exceptions. This raises the question as to whether conflicting terms are to be afforded the same treatment. That is to say, if conflicting terms are governed by Subsection 2, then they will be incorporated into the contract so long as they do not materially vary the terms of the offer and the offer does not expressly exclude additional terms.⁵⁹ As such, if BOF scenarios fall within the scope of Subsection 2, mere silence on the part of the party making the offer is sufficient proof of assent. On the other hand, if the treatment afforded to additional terms is distinct from that which is to be afforded to conflicting terms, then the methodology of Subsection 1 will apply, whereby only the terms of the offer will dictate the contract.

Unfortunately, the official commentary has provided further uncertainty to this debate by supporting both positions. Compare for instance official comment 3 with comment 6 on the section.⁶⁰ Case law has adopted both situations, whereby different terms are either viewed as forming part of the contract as a result of being found to

⁵⁸ See e.g. *Daitom, Inc. v. Pennwalt Corp.* 741 F.2d 1569 (10th Cir. 1984); *Southern Idaho Pipe & Steel Co. v. Cal-Cut Pipe & Supply, Inc.* 567 P.2d 1246.

⁵⁹ Provided that the party making the offer does not object.

⁶⁰ UCC, Official Comments. Comment 3 states: "Whether or not additional or different terms will become part of the agreement depends upon the provisions of Subsection (2). If they are such as materially to alter the original bargain, they will not be included unless expressly agreed to by the other party. If, however, there are terms which would not so change the bargain they will be incorporated unless notice of objection to them has already been given or is given within a reasonable time." Comment 6 states: "If no answer is received within a reasonable time after additional terms are proposed, it is both fair and commercially sound to assume that their inclusion has been assented to. Where clauses on confirming forms sent by both parties conflict each party must be assumed to object to a clause of the other conflicting with one on the confirmation sent by himself. As a result the requirement that there be notice of objection which is found in Subsection (2) is satisfied and the conflicting terms do not become a part of the contract. The contract then consists of the terms originally expressly agreed to, terms on which the confirmations agree, and terms supplied by this Act, including Subsection (2)."

be regulated by Subsection 2, or different terms do not fall under the scope of the subsection.

Interestingly, even Professors White and Summers, the authors of the most widely cited treatise on the UCC, disagree with one another on the preferred approach.⁶¹ Professor White, relying on comment 6 of the official commentary, applies the knock-out rule contained in Subsection 3. Professor Summers on the other hand refers to the dictates of Subsection 1, concluding that the different terms in the acceptance are redundant and the contract is formed on the terms of the offer.⁶²

Such disagreement amongst academics and courts alike has led Professors Daniel T. Ostas and Darr to conclude: “Determining which rule will be followed, therefore, seems to depend more on the skill of the advocates and the identity of the judge than on the language of the UCC.”⁶³

In general, courts adopt three predominant approaches adopted by courts in the resolution of BOF scenario: namely, the LSR, the FSR and the KOR. Courts adopting the LSR usually adopt the stance that a reply to the offer which is not a mirror image of the offer constitutes counter offer.⁶⁴ Courts adopting an interpretation of the article whereby the FSR is to be adopted in the BOF scenario, argue that since the UCC does not contain rules whereby an acceptance may operate to modify the terms of an offer, the differing terms contained in the acceptance do not form part of the contract.⁶⁵ Finally, certain courts adopt the view that the existence of differing terms simply proves that agreement on those terms has not been reached between the parties; consequently, such terms should be replaced with default rules of the law.⁶⁶

⁶¹ James J. White and Robert S. Summers, *Uniform Commercial Code* (5th edn, West Group 2000)

⁶² See White and Summers (n 61) 34-35.

⁶³ Ostas and Darr (n 2) 406.

⁶⁴ See for example *Roto-Lith. Ltd.* (n 50). This case is cited by Professors White and Summers while identifying this approach. See White and Summers (n 61) 33.

⁶⁵ *ibid* 34. They cite *Reaction Molding Technologies, v. General Elec. Co.* 588 F. Supp. 1097 (Eastern District of Pennsylvania 1984) as an example of such an approach adopted by courts.

⁶⁶ *ibid.* citing *Daitom* (n 58) as an example of this approach.

3.1.3 German Law:

German law, like the law of the UK, traditionally applied the LSR in the resolution of BOF scenarios. Section 150 (2) of the German Civil Code (BGB), states that a reply to an offer which contains additions or modifications is to be classified as a counter offer.⁶⁷ On the basis of this section, German courts would attempt to ascertain whether either of the parties had unconditionally accepted the terms of the other in order to find a validly concluded contract. Professor Schlechtriem notes that a contract hardly ever failed as result of the application of the section.⁶⁸ Rather, “the party that had last referred to its terms and conditions finally succeeded and the solution was accordingly named theory of the last word.”⁶⁹ As such, until 1970, German courts would strictly apply the LSR in the resolution of BOF scenarios.⁷⁰

The first major departure from the LSR came in 1970 when the Bundesgerichtshof held that Section 154(1) only gave rise to a presumption which would be displaced where the parties had begun to perform the contract.⁷¹ The court further stated that the rule contained in Section 150(2) was subject to the requirements of good faith and fair dealing as mandated by Section 242 of the Code. As a result, a contract would be concluded where the parties intended to be bound by it,⁷² even though the acceptance did not match the terms of the offer.⁷³ The question of what the content of the contract would be in such situations was to be answered by reference to the default rules of law.⁷⁴

⁶⁷ German Civil Code (BGB).

⁶⁸ Peter Schlechtriem, ‘Battle of the Forms in International Contract Law: Evaluation of Approaches in German Law, UNIDROIT Principles, European Principles, CISG; UCC approaches under consideration’ translation of ‘Kollidierende Geschäftsbedingungen im internationalen Vertragsrecht’, in Karl-Heinz Thume (ed), *Festschrift für Rolf Herber zum 70. Geburtstag*, Newied: Luchterhand (1999) 36-49, with an updated reference to a January 9, 2002 ruling by the Supreme Court of Germany added thereto <http://www.cisg.law.pace.edu/cisg/biblio/schlechtriem5.html> accessed 3 January 2015.

⁶⁹ *ibid* 36.

⁷⁰ See for example Bundesgerichtshof (hereinafter referred to as ‘BGH’), BB 882, No. 1624

⁷¹ *ibid*; the section states: “As long as the parties have not yet agreed on all points of a contract on which an agreement was required to be reached according to the declaration even of only one party, the contract is, in case of doubt, not entered into. An agreement on individual points is not legally binding even if they have been recorded.”

⁷² Act on the Regulation of the Law of General Conditions of Contract 1976, Section 6(2); Such intent could be deduced from performance of the contract see for example BGH, 61 BGHZ 282.

⁷³ BGH, 61 BGHZ 282

⁷⁴ Unlike the KOR, the court held that the content of the contract was completely governed by the default rule of law. See e.g. OLG Hamm, BB, (1979) 701, 701.

The reason for the rejection of the LSR was premised upon the newly accepted view that in instances where one party had insisted that its terms would govern the contract, performance by that party would not amount to an acceptance of the other's terms. Rather, in the view of German courts at the time, the dictates of good faith would operate in such instances to bar the parties from relying on the formalism of Section 150(2) of the BGB.⁷⁵ Consequently, courts would hold that a contract had been concluded, the terms of which were provided by default rules.

Thus, while the court wished to give value to the intention of the parties – i.e. finding the existence of a contract where the parties intended to be bound by it, even though the rules on offer and acceptance would reach the opposite conclusion – it was forced to imply default rules into the contract. Such a stance was problematic since default rules do not reflect the intention of the parties in every given case. The methodology of separating the rules on formation from those on content, however, had the advantage of paving the way for future refinement of the rules on BOF resolution.

In 1980, the Court of Appeals in Cologne was called upon to decide the fate of a contract which was formed on the basis of diverging standard forms.⁷⁶ The court made reference to Section 6(2) of the Act on the Regulation of the Law of General Conditions of Contract, which states that any term which does not effectively become part of the contract is to be replaced by the default rules of law, and argued that only those terms are to be replaced which have not effectively become part of the contract; all other terms are not to be so replaced. As such, this decision introduced the concept of the KOR in German law.⁷⁷ In 1985, the BGH affirmed this stance and accepted the application of the KOR in instances where the parties have performed the contract and have explicitly stated that they only wish to contract on their own terms.⁷⁸ In instances where such defensive clauses are not contained in the standard forms, German courts apply the LSR.

⁷⁵ *ibid.*

⁷⁶ Oberlandesgericht, Köln, BB, (1980) 1237, 1240.

⁷⁷ *ibid.*

⁷⁸ BGH, NJW 1838 (1839).

As a result, German law applies both the LSR and the KOR in the resolution of BOF scenarios. It should however be noted that since most standard forms used in Germany contain defensive clauses, courts are seldom faced with disputes that call for the application of the LSR.

3.2 Analysis of the Travaux

Discussions on the text of Article 19 [draft Article 13] began as early as September 1977, when the Working Group established by the UNCITRAL began deliberations on Sub-Article 2 of the Draft Article.⁷⁹ At the time, the Draft Article consisted of two sub-articles; the first constituted the traditional common law rules of contract formation, while the second allowed for a degree of flexibility in the application of the rule by stating, “A reply to an offer which purports to be an acceptance but which contains additional or different terms which do not materially alter the terms of the offer constitutes an acceptance.”⁸⁰

At this stage of the deliberations, amendments were proposed for the deletion of Sub-Article 2 by socialist states, who viewed the dictates of the sub-article as doing nothing more than giving rise to uncertainty as to what amounts to a non-material alteration. Proponents of the proposed amendment, on the other hand, emphasized the importance of the rule that the parties must agree on all terms for the conclusion of a valid contract.⁸¹ The proposal, however, did not garner sufficient support and was rejected.⁸²

At the Eleventh Session of the UNCITRAL, held in spring 1978, the dictates of Sub-Article 2 of Draft Article 13 came under attack once again. Delegates of socialist

⁷⁹ Francois Vergne, ‘The "Battle of the Forms" under the 1980 United Nations Convention on Contracts for the International Sale of Goods’ (1985) *The American Journal of Comparative Law* 233, 235.

⁸⁰ Article 13 of the Draft Convention stated: “(1) A reply to an offer containing 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 which contains additional or different terms which do not materially alter the terms of the offer constitutes an acceptance unless the offeror objects to the discrepancy without delay. If he does not so object, the terms of the contract are the terms of the offer with the modifications contained in the acceptance.”

⁸¹ See Report of the Working Group on the International Sale of Goods on the work of its Ninth Session (Geneva, 19-30 September 1977) A/CN.9/142 at § 224.

⁸² For a review of the deliberations of the Working Group on the 27th of September 1977, see Vergne (n 79) 235-236.

countries including Czechoslovakia, Yugoslavia and the German Democratic Republic argued that the term “materially alter” as contained in Sub-Article 2 was inherently vague and would give rise to uncertainty.⁸³ Moreover, they viewed the article as a whole insufficient in that it did not provide guidelines for the use of standard forms and the resolution of BOF scenarios.

At the 199th meeting of the UNCITRAL, the delegate of the United States responded to these concerns by pointing towards “usual” mercantile practice, arguing, “it was quite a common occurrence for commercial transactions to go ahead without a formal conclusion of a contract by offer and acceptance.”⁸⁴

In order reach a commonly acceptable formulation of the article, a Working Group was set up.⁸⁵ The Working Group, rather than amending the existing text of the article, sought to remedy disagreements by adding a third sub-article, which provided a list of what constituted material alterations.⁸⁶

The amendment was adopted and the Draft Article was renumbered as Draft Article 17. It read:

(1) A reply to an offer which purports to be an acceptance containing 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 which contains additional or different terms which do not materially alter the terms of the offer constitutes an acceptance unless the offeror objects to the discrepancy without undue delay. If he does not so object, the terms of the contract are the terms of the offer with the modification contained in the acceptance.

⁸³ See Analytical compilation of comments by Governments and international organizations on the Draft Convention on the Formation of Contracts for the International Sale of Goods as adopted by the Working Group on the International Sale of Goods and on the draft of a uniform law for the unification of certain rules relating to validity of contracts for the international sale of goods prepared by the International Institute for the Unification of Private Law A/CN.9/146/Add.1-4.

⁸⁴ Summary Record of the 199th Meeting of the UNCITRAL 9th Session UN Doc. A/CN9/SR 199.

⁸⁵ *ibid.*

⁸⁶ Vienna Diplomatic Conference (n 20).

(3) Additional or different terms relating, inter alia, 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, unless the offeree by virtue of the offer or the particular circumstances of the case has reason to believe they are acceptable to the offeror.

Given the divergence of methodologies existing in domestic laws for the resolution of issues raised by BOF scenarios, it is unsurprising that the drafters were not able to unanimously accept any one given methodology for incorporation into the text of the Convention. Interestingly, the debate on Article 19 of the Convention was based upon disagreements amongst the delegates on the method of contract formation rather than the identification of a methodology for the resolution of issues raised by BOF scenarios. This, however, should not be interpreted to mean that the impact of the proposed methods of contract formation on potential BOF scenarios was completely ignored.⁸⁷

A trend that becomes apparent from an analysis of the travaux of the article, is that the delegates favored the adoption of legal principles contained in their own domestic law.⁸⁸ With the exception of a few delegates, however, preference for domestic legal principles was not – or at least was not argued to be – based solely upon partiality to the relevant domestic law. Rather, as shall be explained below, delegates argued for the adoption of the principles contained in their respective domestic laws on considerations that may broadly be categorized into efficiency and

⁸⁷ The issue of BOF was brought up for the first time by Bulgaria during the drafting stages. The delegate was of the opinion that the “Knock-Out Rule should be adopted in cases where ‘general conditions’ of parties are in conflict with one another.” *Legislative History, 1980 Vienna Diplomatic Conference, Report of the First Committee (A/CONF.97/C. 1/L.87)*.

⁸⁸ For instance, as early as the tenth meeting of the First Committee, the delegate of the UK proposed the deletion of paragraphs 2 and 3 of the article, as a result of which the Convention would adopt the traditional rules of offer and acceptance, whereby any reply to an offer which derogates from its terms amounts to a counter-offer, regardless of materiality. This would bring the dictates of the Convention on the matter in line with the stance adopted by UK national law. *Legislative History, 1980 Vienna Diplomatic Conference, Report of the First Committee (A/CONF.97/C.1/L.91)*; *Legislative History, 1980 Vienna Diplomatic Conference, Report of the First Committee (A/CONF.97/C.1/L.61)*.

The proposal was rejected with 20 votes in favor and 22 against. The delegate of the US, however, took a stance more in line with US law and proposed that the list contained in Article 19(3) be considered non-exhaustive **Legislative History, 1980 Vienna Diplomatic Conference, Report of the First Committee (A/CONF.97/C.1/L.97)**: “In paragraph (3), delete the words “*inter alia*” and substitute the words among other matters.”

utility concerns. Moreover, arguments for preferring one approach over another were rarely based upon the merits of a particular approach, but rather were made by demonstrating or alluding to the de-merits of alternative approaches.

The delegate of the UK, for instance, argued for the adoption of the traditional rules of contract formation as contained in UK domestic law on the grounds that any other methodology would result in uncertainty as to whether a contract had actually been concluded.⁸⁹ The delegate of Bulgaria similarly referred to Articles 18(1) and 19(1) to argue that the Convention established a “fundamental rule and a rational principle” – that is, “there could be no contract without agreement by the parties on all points.”⁹⁰ Without referring to how the traditional rules of contract formation and resultantly the LSR would result in a complete meeting of the minds, the delegate went on to assert that the fundamental rule was almost nullified by the exceptions given in paragraphs 2 and 3 which circumscribed the application of the traditional rules and resultantly the LSR. Consequently, a contract could be concluded implicitly when there had been no agreement on the essential elements of sale as stated in the first sentence of paragraph 3.⁹¹ Such an approach, according to the delegate:

...sacrificed the fundamental considerations of international trade relations namely certainty and security, to less important considerations, such as the flexibility of rules and equity in individual cases. It also jeopardized the interests of less experienced enterprises, which might not refuse an offer in good time.⁹²

Other delegates, on the other hand, were of the view that the realities of international trade did not require regulation that furthered the goals of certainty and security as much as they necessitated the existence of a regime that allowed flexibility. Article 19(1) which incorporates the traditional rules of contract formation under English law, was not subjected to any debate and no amendments to it were proposed. As such, it was adopted without opposition. Disagreement existed, however, about the

⁸⁹ Legislative History, 1980 Vienna Diplomatic Conference, *Summary Records of Meetings of the, First Committee*, 6th meeting, Friday, 14 March 1980 (A/CONF.97/8/Add. 3).

⁹⁰ Bulgaria (A/CONF.97/C.1/L.91).

⁹¹ *ibid.*

⁹² *ibid.* The delegate therefore proposed that paragraphs 2 and 3 should be deleted.

extent to which the following sub-articles should circumscribe those rules.

The delegate of Finland, Mr. Sevon, said that he could not agree to the UK proposal –which wanted to see paragraphs 2 and 3 omitted from the text – since trade in his view largely took place in the manner described in those subsections.⁹³ The delegate did not, however, specify as to what certainty and flexibility demanded in the current context.

Strict application of the traditional rules of contract formation was further challenged on the grounds that in trade practice minor changes were often made to the offer and that contracts were nevertheless considered as having been concluded and were performed.⁹⁴ The only effect that the deletion of the paragraphs circumscribing the traditional rules would have would be to make some contracts void, which would nonetheless be executed. Such an eventuality would result in undermining the intent of the parties, who via performance had clearly proved that they recognized the existence of a contract.⁹⁵ Another objection to the incorporation of the traditional rules on contract formation came from the delegate of the United States. Professor Farnsworth was in favor of keeping the existing text of the article since the LSR would operate to motivate parties to act in an opportunistic manner.⁹⁶ This assertion was based on the grounds that parties to a given contract could take refuge behind the so-called mirror-image rule, should one party no longer have an interest in performing the contract for reasons other than those hinging on material alterations; this could be, for example, in the event of a rise or drop in the price of the goods for which the contract was made.⁹⁷

The delegate of France similarly questioned the utility of the LSR on the grounds of its impact on cases of BOF. In particular, it was asserted that the application of LSR would operate to give primacy to international law over the intent of the parties. The delegate argued that merchants involved in international sale of goods seldom negotiated over general conditions relating to the issues of guarantee, liability and

⁹³ Vienna Diplomatic Conference (n 20).

⁹⁴ *ibid.*

⁹⁵ See comments of Mr. Maskow, delegate of the German Democratic Republic in Vienna Diplomatic Conference (n 20).

⁹⁶ *ibid.* The delegate of Norway agreed.

⁹⁷ *ibid.*

jurisdiction.⁹⁸ Rather, they employed standard forms containing terms on these issues which were seldom in harmony. Regardless of such variation in the forms on these issues, the parties did however accept the existence of a contract once agreement was reached on price, quantity and quality. The delegate therefore argued that if the second and third paragraphs of the Draft Article were deleted, parties would be forced to set their general conditions aside which would operate to undermine party autonomy.⁹⁹

The delegate of Japan similarly questioned the utility of LSR in such cases.¹⁰⁰ He stated that in practice performance was usually carried out following an exchange of standard forms which led to numerous additions. In his view, “the Convention could not oblige the parties to reply to all those additions individually,”¹⁰¹ as such a stance would lead to a situation that would drastically increase transaction costs by requiring parties to individually agree to non-material terms. These concerns led the delegate of Denmark to assert that the strict application of the traditional rules of contract formation would increase uncertainties rather than remove them, since parties even after performance could potentially have the contract declared voidable.¹⁰²

As such, the debate on the article simply devolved to the question of the extent to which the traditional rules of contract formation be circumscribed in order to allow for flexibility. Since Article 19(3) attempted to provide a list of terms, variation of which would require adherence to the traditional rules of contract formation, debate simply revolved around the question of what the list should include. Delegates belonging to countries following the common law tradition generally wished for the list to be as detailed as possible, whereas those belonging to the civil law tradition would prefer a short – albeit non-exhaustive – list.¹⁰³

⁹⁸ Legislative History, 1980 Vienna Diplomatic Conference, *Report of the First Committee* (A/CONF.97/C.1/L.60).

⁹⁹ Vienna Diplomatic Conference (n 20).

¹⁰⁰ *ibid.*

¹⁰¹ *ibid.*

¹⁰² *ibid.*

¹⁰³ *ibid.* The delegates of France, Norway and the German Democratic Republic wished the list to be limited to the price, the quantity and the quality, which in their view constituted the particular terms of contracts and affected the very substances of the sale. Interestingly, the delegate of Finland agreed with the delegates belonging to common law jurisdictions, on this issue.

The application of the Knock-Out Rule was put to vote at this stage of drafting, on the basis of an amendment proposed by the delegate of Belgium.¹⁰⁴ The delegate explained that the KOR is best suited to resolve issues raised by BOF scenarios since the commercial staffs of the parties are not legal experts, and therefore would negotiate on material terms of the contract – such as the price and the characteristics of the goods – while employing standard forms in a rather mechanical way. In such a case, the delegate believed that the conflicting clauses should be deemed not to form part of the contract.¹⁰⁵ This proposal was however rejected on two grounds: (1) It was contrary to the rules of common law and consequently, common law countries were not willing to accept a rule for the resolution of BOF scenarios which would have an impact on the rules of contract formation contained in the first paragraph of the draft article¹⁰⁶ and (2) certain delegates viewed the impact of the KOR to operate to undermine the rules of party autonomy as contained in Article 6 of the Convention.

3.2.1 Considerations

During the drafting stages of the article, various concerns were raised vis-à-vis what is considered an appropriate methodology of contract formation and, as a result, what is appropriate for the resolution of issues raised by BOF scenarios. These concerns can be summarized as follows:

- 1) An agreement can only be said to be in existence when all essential terms have been negotiated. As a result, essential terms that have not been negotiated cannot be imposed upon a party simply on the grounds that they were contained in the other's standard form. As such, an appropriate methodology for the resolution of issues raised by BOF scenarios must be one that fosters voluntary exchange by enforcing mutually understood agreements.

¹⁰⁴ Belgium (n 87).

¹⁰⁵ *ibid.*

¹⁰⁶ See for example the comments of the delegate of Ireland at para. 90 and that of the delegate of the UK at para. 92 in Vienna Diplomatic Conference (n 20).

- 2) An appropriate methodology is one that does not operate to increase transaction costs as a result of being disassociated from the realities of international trade.
- 3) A methodology is appropriate only if it operates to minimize the incentive of parties to act in an opportunistic manner.

3.3 Theoretical Framework of Analysis

The economic approach to contract law is based upon the assumption that individuals are rational maximizers of welfare and as a result would only agree to a contract if they believe that doing so would make them better off.¹⁰⁷ Since the parties have knowledge of the details of the transaction that are generally unavailable to the public, it is assumed that an exchange will make both parties better off so long as the terms of the same are negotiated. The existence of such knowledge leads to the conclusion that the parties, in comparison with courts, are better equipped to identify the optimal allocation of risks. As a result, various academics have argued that failure by courts to enforce standard terms of the parties would harm parties to a sales transaction.¹⁰⁸ As such, one of the pillars of the economic approach to contract law is simply that contract law should foster voluntary exchange by enforcing negotiated agreements. It is in this sense that the economic approach satisfies the first consideration detailed above.

A second tenet of the economic approach is that contract law should foster voluntary exchange by keeping transaction costs to a minimum. In other words, contract law should promote an efficient allocation of resources. Based upon the Coase theorem, it is asserted that an efficient allocation of resources will result where an agreement has been bargained for, regardless of the initial assignment of rights, so long as transaction cost is kept at a minimum.¹⁰⁹ It may therefore be stated that the economic

¹⁰⁷ Eric A. Posner, 'Economic Analysis of Contract Law after Three Decades: Success or Failure?' (2003) 112 *The Yale Law Journal* 829; Richard A. Posner and Andrew M. Rosenfield, 'Impossibility and Related Doctrines in Contract Law: An Economic Analysis' (1977) 6 *The Journal of Legal Studies* 83; Robert Cooter and Thomas Ulen, *Law and Economics* (Scott, Foresman, 1988).

¹⁰⁸ In the context of common law courts, see Karl N. Llewellyn, 'Prausnitz: The Standardization of Commercial Contracts in English and Continental Law' (1939) 52 *Harvard Law Review* 700, 704.

¹⁰⁹ Ronald Harry Coase, 'The Problem of Social Cost' (1960) 3 *The Journal of Law and Economics*.
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function of contract law is to promote voluntary exchange by keeping transaction costs to a minimum. It is in this sense that the economic approach to contract law satisfies the second and third considerations detailed above.

Applying these considerations to both the KOR and the LSR, it becomes apparent that neither satisfies the concerns listed above, and consequently neither is a suitable methodology to be incorporated into the Convention.

3.3.1 LSR and Efficiency

3.3.1.1 Enforcing mutually understood agreements:

The LSR does not enforce mutually understood agreements as is required by the first consideration detailed above; instead, it operates in certain instances to motivate the parties to act opportunistically. This assertion is based upon the argument that the LSR leads to the incorporation of terms that have not been negotiated by unjustly favoring the standard terms of the party last to make an offer.¹¹⁰

Consequently, the LSR places the party that exchanges its standard terms first (usually the buyer) in a vulnerable position.¹¹¹ In a typical BOF scenario, the buyer sends the purchase order along with its terms and the seller responds with acceptance along with its terms. In such instances, the fate of the contract is firmly in the hands of the seller. If the seller does not deliver the goods, there is no contract. As a result, the seller is allowed the opportunity to speculate to the detriment of the buyer. The buyer cannot have the contract enforced. If – on the other hand – the seller does deliver the goods, the seller's terms will prevail.

3.3.1.2 Transaction costs

While the LSR does provide certainty vis-à-vis the rules relating to contract formation and the identification of its terms, the same does not translate into a lowering of transaction costs. Various academics have, however, argued that there is

¹¹⁰ Brown (n 1) 902-03.

¹¹¹ Corneill A. Stephens, 'On Ending the Battle of the Forms: Problems with Solutions' (1992) 80 Kentucky Law Journal 815, 819.

a direct correlation between formalism and predictability, which for the purposes of this chapter translates into the argument that the provision of a strict rule in favor of a flexible one reduces transaction costs.¹¹² This argument flows from the fact that strict rules provide users a greater degree of certainty and predictability. As a result, transaction costs are saved to the extent that courts only need to identify the form last sent before the commencement of performance in order to ascertain the terms upon which the contract has been concluded.

This argument, however, does not stand up in the case of the LSR. This is because the application of the rule does not provide the users with an economically efficient methodology through which they may achieve their desired expectations. Instead, it motivates them to have an extensive exchange simply because they know that the terms of the party which fired the last shot will control the transaction. Such a “ping pong effect” translates into increasing the volume of legal documents that flow between the parties, thereby increasing transaction costs, especially in instances where standard forms are vetted.¹¹³ In any case, the ping pong effect of the LSR does not promote economic efficiency to the extent that it gives greater importance to matters of form than to business realities.

One controversial opinion, however, holds that empirical evidence suggests that the LSR promotes the most efficient outcome and does not motivate parties to draft its standard terms in a manner that maximizes its profits.¹¹⁴ This argument is based upon the assertion that market forces will operate to encourage parties to draft terms that advance the joint interests of the parties.¹¹⁵ In other words, parties would shy

¹¹² Gregory M. Travaglio, ‘Clearing the Air After the Battle: Reconciling Fairness and Efficiency in a Formal Approach to U.C.C. Section 2-207’ (1983) 33 Case Western Reserve Law Review 327, 364.

¹¹³ While the majority of empirical evidence suggests that parties usually do not vet standard forms sent by the other, there is empirical evidence to suggest both that parties usually do not enter into an extensive exchange of documents (in order to preserve business relationships) and conversely, that sophisticated parties do indeed pay particular attention to the drafting of their standardized forms. Baird and Weisberg (n 50) 1252; the term “ping pong effect” in the context of the Convention was first used by Professor Viscasillas. See Maria del Pilar Perales Viscasillas, ‘Battle of the Forms under the 1980 United Nations Convention on Contracts for the International Sale of Goods: A Comparison with Section 2-207 UCC and the UNIDROIT Principles’ (1998) 10 Pace International Law Review 97.

¹¹⁴ Baird and Weisburg (n 50) 1253-60.

¹¹⁵ For an opposing view, see Rakoff (n 6) 1225: “The fact that any given firm will seek to do business only on the basis of its own document(s) does not exclude the possibility that other firms will offer different mixes of form terms.”

away from prolonged exchange of forms, fearing the potential of losing a business opportunity albeit on the other party's terms.¹¹⁶ Such fears, according to Professor Leff, would lead to a situation where businesses would draft comparable forms.¹¹⁷ Professor Slawson similarly argues that even a small decline in sales as a result of non-beneficial terms in standard forms would motivate parties to draft their terms in a mutually beneficial manner.¹¹⁸

Indeed, in competitive markets, businesses involved in the trade of goods would be motivated to draft their terms in a mutually beneficial manner for the same reasons that they would price their goods competitively.¹¹⁹ In other words, traders of goods would use mutually beneficial standard forms if omission to do so would result in a decline in sales.¹²⁰ Consequently, traders of goods have a choice between a) identifying and distinguishing between parties who do read and are concerned with the content of standard forms and those who do not; and offering mutually beneficial terms to those parties that are concerned with the content of the forms while using self-serving terms with all others, or (b) drafting and using mutually beneficial standard terms with all contracting parties.

It is argued that parties that are concerned with contents of standard forms are ones who are likely to be affected by those terms i.e. they are likely to face the contingency that is covered by the terms contained in the standard forms.¹²¹ Such parties would consequently reveal this information to the other party in hopes of having the standard form amended.¹²² This in itself is reason enough for traders to draft self-serving standard forms, as they know that rather than losing business as a

¹¹⁶ *ibid.*

¹¹⁷ Arthur Allen Leff, 'The Leff Dictionary of Law: A Fragment' (1985) 94 Yale Law Journal 1855, 1931.

¹¹⁸ Slawson (n 2) 529.

¹¹⁹ Alan Schwartz and Louis L. Wilde, 'Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis' (1979) 127 University of Pennsylvania Law Review 630, 636-638.

¹²⁰ *ibid.* See also Priest (n 10) 1347.

¹²¹ Data relating to preprinted terms in banking transactions collected by Melvin A. Eisenberg shows, for instance, that in cases where the probability of disagreement over a term is low, the costs of deliberation on such terms outweighs its relative advantages. Alex Y. Seita, 'Uncertainty and Contract Law' (1984) 46 University of Pittsburgh Law Review 75, 133-35.

¹²² Hillman and Rachlinski (n 8) 433.

result of such terms, they would usually be requested to amend them in a minority of cases.¹²³

Moreover, if the number of parties who are concerned with the contents of standard forms is relatively low, then the benefits of providing the whole market with beneficial terms would be outweighed by the benefits of using self-serving terms.¹²⁴ In such instances, potential parties to international sale of goods would prefer to identify whether the content of standard forms are of specific importance to the other, rather than drafting and using mutually beneficial standard forms with all potential parties they might deal with.

Such a stance will lead to a situation where parties who do not read standard forms will be subjected to terms that inefficiently impose risks. This is partly a result of the fact that parties involved in the sale of goods are seldom aware of the contents of their standard forms themselves. Rather, the duty of drafting standard forms is usually delegated to lawyers who draft terms with regards to the best interest of their clients.¹²⁵ To use Professor Rakoff's words, "The lawyer drafts to protect the client from every imaginable contingency. The real needs of the business are left behind; the standard applied is the latitude permitted by the law."¹²⁶

It is concluded from the discussion above that even if the party receiving the standard terms decides to read them, there is little evidence that market forces would motivate the drafters to formulate terms that maximize mutual benefit. Goldberg, for instance concludes that the Braid-Weisberg analysis is not a credible reflection of practice.¹²⁷ He argues that parties may be motivated to draft standard terms in a manner which promotes mutual interest, in a legal regime which favors the LSR, only if a significant number of traders read and deliberate upon such terms. As stated above, since the cost benefit analysis of such deliberations would usually motivate

¹²³ *ibid.*

¹²⁴ *ibid* 443.

¹²⁵ Melvin Aron Eisenberg, 'The Limits of Cognition and the Limits of Contract' (1995) 47 *Stanford Law Review* 211, 243.

¹²⁶ Rakoff (n 6) 1222.

¹²⁷ Victor P. Goldberg, 'The "Battle of the Forms": Fairness, Efficiency, and the Best Shot Rule' (1997) 76 *Oregon Law Review* 155, 164-165.

parties not to spend resources where the probability of a term coming into play is low, parties would seldom be motivated to draft terms that promote mutual interest.

3.3.2 KOR and Efficiency

While the LSR does not promote efficiency by encouraging voluntary exchange and enforcing mutually understood agreements, the KOR cures these defects. The KOR, by knocking out conflicting terms contained in the standard forms, does not allow the terms of one party to control the contract. It is in this sense that negotiation is encouraged.

Moreover, the KOR does not suffer from concerns surrounding the increase in transaction costs as a result of the application of the LSR. Since the KOR replaces conflicting terms with the default rules of law, there is no incentive for parties to engage in a prolonged exchange of standard terms. A closer look, however, leads to the opposite conclusion. In a typical contract formation, in regimes that adopt the KOR, the offeree has two options. The offeree may either contract on the terms of the offeror or may reply using its own terms. In the former case, the terms of the offeror will govern the contract and as such the offeror will be motivated to draft its standard terms in a manner that maximize its own interests. The only disadvantage of doing so is that the other party may read the standard term and decide not to contract.¹²⁸ On the other hand, if the offeree responds with its own terms then a contract will be established on the basis of non-conflicting terms, coupled with the application of default rules of law which would operate to fill in any gaps. Such an outcome would rarely maximize the interest of both parties, since in the words of Baird & Weisberg, “off the rack terms are rarely in the best interest of the parties, since they do not take into account the circumstances of each case.”¹²⁹ In other words, since default rules are drafted for application to a wide range of transactions with differing circumstances, they are capable of achieving the goals of efficiency in certain transactions – but not in all.

¹²⁸ As detailed above, such an outcome is not supported by empirical evidence.

¹²⁹ Baird and Weisberg (n 50) 1249-51

Moreover, the application of the default rules of law may well translate into undermining the intent of the parties' vis-à-vis the bargain they wished to strike.¹³⁰ Giesela Ruhl, for instance, provides the example of a situation where the parties exchanged forms both of which require notice of non-conformity of goods to be provided.¹³¹ Assume the two clauses contradict, i.e. one requires notice to be provided within one month whereas the other requires the notice to be provided within two months. In such an instance, the KOR would operate to replace the terms on notice of the parties with the default rules of law, which may allow a longer (or shorter) period for the provision of a notice – for example, three months. As such, the KOR would recognize a contract on terms that neither of the parties intended.¹³²

3.4 Goldberg's Best Shot Rule

Victor P. Goldberg, finding the existing methodologies inadequate in resolving issues raised by BOF scenarios, proposed a new solution called the Best Shot Rule (BSR).¹³³ His basic inquiry was limited to the extent to which the current methodologies motivate parties to take the other party's concerns into account and effectively contract out of default rules without losing the economic advantage of using standard forms.¹³⁴

In particular, Professor Goldberg found the approach adopted by certain domestic law rules, whereby both the formation and content of a contract were governed by the same rule, as inherently problematic.¹³⁵ He argued that neither the LRS nor the KOR are capable of motivating parties to draft their standard terms in a manner that does not solely aim at maximizing their own interests.¹³⁶ Moreover, he viewed both

¹³⁰ Viscasillas (n 113) 119-21. Noting statutory notice periods, arbitration agreements, and pricing agreements are a few examples where "the character of the intended bargain" may change.

¹³¹ Giesela Ruhl, 'The Battle of the Forms: Comparative and Economic Observations' (2003) 24 University Pennsylvania Journal of International Economy Law 189.

¹³² Viscasillas (n 113) 119. She states, "Under many regimes the statutory notice period can be much shorter than the period provided in either of [the] clauses.... Such an Application... would seem to go against the will of both parties."

¹³³ Goldberg (n 127).

¹³⁴ *ibid.*

¹³⁵ The legislation under analysis was the UCC, before it was revised in 1996. The concern is still relevant in the case of the Convention, which at the outset seems to regulate both formation and content, in cases of BOF, via a single rule contained in Article 19.

¹³⁶ Goldberg (n 127).

as being incapable of giving primacy to the intention of the parties and limiting transaction costs.

The BSR, while imperfect, he argues, is capable of limiting such undesirable outcomes, while motivating parties to draft terms that take the interests of the other party into account.¹³⁷ His solution is based upon the final-offer arbitration mechanism. According to the BSR, when faced with diverging terms, the court should choose the one which it perceives to be fairer of the two. Fairness here is to be judged on the basis of the “golden rule,” namely, “Do unto others as you would have them do unto you.”¹³⁸ As such, in cases of BOF, a court should view the standard forms exchanged in the current transaction with the standard forms used by the parties when they are acting in the opposite capacity – that is, compare the form of the seller in a particular transaction with the ones used by it when it is acting as a buyer. Such an analysis, he argues, would enable a court to determine what the parties’ consider to be fair.¹³⁹ The court however is not allowed to import terms from the standard forms that the parties have used in another transactions. Rather, the court must choose one of the terms in conflict, albeit the one that is closest to what the parties consider to be fair.

Professor Goldberg is quick to admit that “operationalizing fairness will not be easy.”¹⁴⁰ Firstly, parties do not always act in both capacities and as such a court will be unable to apply the golden rule in various instances. Moreover, the exercise of ascertaining which term is the fairer of the two is bound to dramatically increase transaction costs. Simply put, since flexible standards incur higher transaction costs than strict ones, litigation costs under the BSR will be higher than that incurred through the application of either the LSR or the KOR.¹⁴¹ The goal of certainty is also undermined to the extent that neither of the parties may be sure which of the two conflicting terms governs their contract.

¹³⁷ *ibid.*

¹³⁸ *ibid.*

¹³⁹ *ibid.*

¹⁴⁰ *ibid.*

The degree to which the BSR takes the realities of international trade and the particular transaction into account is also questionable. This is because the methodology of ascertaining what a party may have considered as fair when it was acting in the other capacity (buyer/seller) may well result in a one size fits all approach. Of course the circumstances of each transaction are different and resultantly, that which may be considered fair in one transaction may yield the opposite result in another transaction. As such, the application of the golden rule in the ascertainment of fairness might well lead to absurd results.

3.5 Article 19 of the Convention

In light of the concerns of the drafters, coupled with the cost-benefit analysis of the KOR and LSR, this paper shall now turn to analyze the text of the Convention on the treatment of BOF scenarios.

The methodology of contract formation as recognized by the Convention is contained in Article 19(1), which states: “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.”¹⁴² Interestingly, this article was not a subject of debate during the drafting stages of the Convention and was adopted without any amendments.

Since the rules on contract formation as contained in the Convention are largely similar to those recognized under English law, it is unsurprising that that the LSR has found its way into its text.¹⁴³ This is not to say that the Convention specifically identifies the Last-Shot Rule as the appropriate methodology to be adopted in the resolution of BOF scenarios, but rather simply creates a distinction between acceptance and a counter offer. The corollary of this, as explained above, is the application of the LSR when the terms of the offer and acceptance do not correspond.

¹⁴² Convention, Article 19.

¹⁴³ By virtue of this article, the Convention adopts the traditional approach of contract formation whereby the offer and acceptance must be mirror images of one another.

The remaining sub-parts of the article, however, qualify this requirement. Article 19(2) states:

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.¹⁴⁴

As such, the article distinguishes between material and non-material modifications/additions, and in the case of the latter, recognizes the existence of a contract even though the terms of the offer and acceptance do not match. In such instances the terms of the acceptance are incorporated into the contract, unless the offeror objects.

Article 19(3) provides a non-exhaustive list of terms, variation of which would be considered to materially alter the terms of the offer. It reads:

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.¹⁴⁵

The impact of this article is to view virtually all terms that are modified in practice as material modifications.¹⁴⁶ As such, Article 19(3) operates to place the fate of such

¹⁴⁴ Convention, Article 19(2).

¹⁴⁵ *ibid*, Article 19 (3).

¹⁴⁶ Michael P. Van Alstine, 'Consensus, Dissensus, and Contractual Obligation Through the Prism of Uniform International Sales Law' (1996) 37 *Virginia Journal of International Law* 1 <<http://www.cisg.law.pace.edu/cisg/biblio/alstine3.html>>; Peter Schlechtriem, *Commentary on the UN Convention on the International sale of Goods* (1st edn, Oxford University Press 1998); See also John O. Honnold, *Uniform Law for International Sales under the 1980 United Nations Convention* (Kluwer Law International 1982) 193; Henry D. Gabriel, 'A Primer on the United Nations Convention on the International Sale of Goods: From the Perspective of the Uniform Commercial Code' (1997) 7 *Indiana International & Comparative Law Review* 279, 284

modifications and consequently the contents of the contract on the methodology adopted in Article 19(1) i.e. the LSR. It is on these grounds that most academics, before the delivery of Opinion No. 13 of the Advisory Council, favoured the application of the LSR in cases of BOF arising under the Convention.¹⁴⁷ It would however be incorrect to assume that this stance was unanimously accepted by the legal community. Rather, literature on the BOF issue proposes a number of solutions, ranging from the adoption of the KOR; limitation of Article 19 to cases where the contract has not been performed;¹⁴⁸ viewing inconsistent terms as a declaration by the parties of derogation from, and resultantly the inapplicability of Article 19;¹⁴⁹ resolution of BOF issues through the application of the general principles upon which the Convention is based;¹⁵⁰ and even recourse to the dictates of domestic law on the issue.¹⁵¹

3.5.1 AC Opinion No. 13

On the 20th of January 2013, the Advisory Council (AC) delivered an opinion on the requirements that standard terms must fulfill in order to form part of the contract and on the fate of standard forms when they are in conflict.¹⁵² The AC held that the issues raised by the use of standard terms are to be determined according to the dictates of the Convention thereby setting aside opinions which held that the

<<http://cisgw3.law.pace.edu/cisg/biblio/gabriel2.html>>; Joseph Lookofsky, *Understanding the CISG in the USA: a compact guide to the 1980s United Nations Convention on Contracts for the International Sale of Goods* (2nd edn, Kluwer Law International 2004) 55.

¹⁴⁷ C. M. Bianca and Michael Joachim Bonell, *Commentary on the International Sales Law: The 1980 Vienna Sales Convention* (Fred B. Rothman & Co., 1987) 178-80; Enderlein and Maskow, at 101; Enderlein, Maskow and Strohbach, at 94; Farnsworth, at 3-1, 3-16-3-17; Gabriel (n 31) 1057-58; CISG-AC Opinion No. 13 Inclusion of Standard Terms under the CISG, Rapporteur: Professor Siegfried Eisele, College of Law, University of South Africa, Pretoria, South Africa. Adopted by the CISG Advisory Council following its 17th meeting, in Villanova, Pennsylvania, USA, on 20 January 2013.

¹⁴⁸ Christian Mouly, 'La formation du Contrat' in *La Convention De Vienne Sur La Vente Internationale Et Les Incoterms* 57, 69.

¹⁴⁹ Ibid.

¹⁵⁰ Louis F. Del Duca and Patrick Del Duca, 'Practice Under the Convention on International Sale of Goods (CISG): A Primer for Attorneys and International Traders' (1996) 29 *Uniform Commercial Code Law Journal* 99 (Part II), 122; Frans J. A. van der Velden, 'Uniform International Sales Law and the Battle of Forms' in Jean George Sauveplanne (ed), *Unification And Comparative Law In Theory And Practice-Contributions In Honor Of Jean George Sauveplanne* 233, 243 (Jean George Sauveplanne edn, 1984).

¹⁵¹ Ulrich Huber, 'Der Uncitral-Entwurf Eines Übereinkommens Über Internationale Warenkaufverträge' (1979) 43 *Rabels Zeitschrift für ausländisches und internationales Privatrecht* / *The Rabel Journal of Comparative and International Private Law* 413, 445.

¹⁵² AC Opinion (n 151)

resolution of BOF scenarios falls outside the scope of the Convention. It made reference to Articles 8 and 9 and held that the Convention provides rules for the interpretation of the statements made by the party. These articles, coupled with Part 2 of the Convention, which governs contract formation, were held to be sufficient for the resolution of disputes arising from the use of standard terms, including BOF scenarios.

Interestingly, the Council referred to the dictates of Article 19 and concluded that the most appropriate methodology for the resolution of issues raised by BOF scenarios is the application of the KOR.¹⁵³ The Council stated:

Where both parties seek to incorporate standard terms and reach agreement except on those terms, a contract is concluded on the basis of the negotiated terms and of any standard terms which are common in substance unless one party clearly indicates in advance, or later on but without undue delay objects to the conclusion of the contract on that basis.¹⁵⁴

This conclusion of the Council is surprising since it seems to be in direct contradiction with the letter of Article 19.¹⁵⁵ As explained above, Article 19 operates to classify a reply to an offer, which differs in terms, as a counter offer.¹⁵⁶ As a result of this methodology, a bare reading of Article 19 suggests that the Convention favours the LSR in the resolution of BOF scenarios. The opinion of the AC on the other hand advocates the adoption of the KOR.¹⁵⁷ Unfortunately, the AC does not specify how this conclusion follows from the dictates of Article 19. The opinion does however admit that a strict legal interpretation of Article 19 mandates the application of the LSR in cases of BOF. This, however, is viewed by the AC as a secondary concern to the more important concerns of certainty, fairness and

¹⁵³ *ibid.* The AC states, “The Battle Of Forms issue falls squarely within the scope of the CISG and should not be resolved with reference to domestic law as it deals with the contract formation process covered in Articles 14-24.”

¹⁵⁴ *ibid.*

¹⁵⁵ *ibid.* This fact is recognized in the opinion.

¹⁵⁶ The only exception to the rule is where the additional or contradictory terms do not materially alter the terms of the contract.

¹⁵⁷ AC Opinion (n 151). The AC stated, “The knock-out approach will apply to a battle of forms situation unless a party has explicitly excluded the operation of the rule by explicitly indicating in advance that it will not be bound by other standard terms than its own.”

foreseeability.¹⁵⁸ The AC refers to policy grounds that warrant such a result.

The policy concerns taken into consideration by the AC may be summed up as follows:

- 1) The intention of the parties must be given paramount importance, rather than displacing the same by incorporating a term which does not represent mutual intention. In the view of the AC, “the Knock-Out Rule has the advantage that it is in conformity with the intention of typical parties in international commercial relations.”¹⁵⁹
- 2) The realities of international trade must be taken into account. In the opinion of the AC, the application of the KOR leads to acceptable results in cross-border trade situations.

Interestingly the AC does not detail the source of these policy concerns and as such seems to be creating law rather than interpreting it.

According to the methodology adopted throughout this thesis, the interpretation of the Convention in a manner that undermines rules extracted through a literal interpretation of the Convention, via the application of arbitrarily selected standards, is against the very fabric of the Convention. Thus, while the AC does indeed reach a conclusion which seems to be relatively more in line with the concerns of the drafters, the same lacks legal legitimacy to the extent that it does not follow the appropriate standards for the interpretation of the Convention.

This chapter concludes that the AC did indeed identify the correct methodology (i.e. the KOR) for the resolution of BOF scenarios under the Convention. Criticisms of the opinion as discussed above stem from the fact that the AC did not concretely specify how its conclusion abides by the interpretative methodology contained in

¹⁵⁸ Ibid. The AC states, “Although the Last Shot Rule seems to be in accordance with a strictly literal interpretation of Article 19, it often leads to results which are random, casuistic, unfair and very difficult to foresee for the parties.”

¹⁵⁹ Ibid. The AC added, “The rule avoids an arbitrary choice between the two sets of competing standard terms, instead using only those elements which are common to both sets. This accords with the actual intention of both parties.”

Article 7 of the Convention, or with Articles 31-33 of the Vienna Convention. This chapter shall therefore, in its conclusion, demonstrate how an application of these articles warrants the application of the KOR.

3.6 Conclusion

As detailed in Chapter 1 of this thesis, the Convention must be interpreted first in line with the dictates of Article 7, and then recourse may be made to the rules contained in the Vienna Convention.¹⁶⁰ Moreover, Article 31 of the Vienna Convention states that in the interpretation of treaties, attention must be paid to the text, context and the object and purpose of the treaty.¹⁶¹ Moreover, Article 32 of the Vienna Convention allows for recourse to supplementary means of interpretation (such as the travaux), when the interpretation derived following the dictates of Article 31 of the Vienna Convention leaves the meaning ambiguous, obscure or leads to an absurd or unreasonable result.¹⁶²

Opinion No. 13 of the AC correctly identifies the fact that the application of the LSR in line with a textualist interpretation of the Article 19 “often leads to results which are random, casuistic, unfair and very difficult to foresee for the parties.”¹⁶³ As a result, an interpretation derived from the travaux – which remedies such an unreasonable result – is allowed, by the Vienna Convention. The object and purpose of the Convention, on the other hand, illuminates the fact that it has to be interpreted in line with the Convention’s international character, and should be one that reduces transaction costs.

The interplay between the textualist interpretation, which leads to the application of the LSR, and the contextualist interpretative methodology, which would not allow for the LSR as a result of its impact on transaction costs, leaves the meaning of Article 19 vis-à-vis the resolution BOF scenarios ambiguous. As such, reference can be made to the travaux for the identification of the proper methodology for the resolution of the BOF scenario.

¹⁶⁰ Vienna Convention On The Law Of Treaties (27 January 1980).

¹⁶¹ *ibid* Article 31.

¹⁶² *ibid* Article 32 .

¹⁶³ AC Opinion (n 151) para 10.6.

As detailed in the section on travaux in this chapter, while the drafters were unable to agree on a methodology for the resolution of BOF scenarios, they clearly required that the resolution of the issue be in line with: a) the intention of the parties (party autonomy) b) the realities of international trade and c) barring the potential of opportunistic behaviour.

It is argued that the first requirement is best fulfilled if the terms of the contract are those that have expressly been agreed between the parties. In other words, the existence of conflicting terms simply raises the presumption that an agreement has not been reached on those terms. Since the KOR functions to exclude conflicting terms, it can be stated that the KOR operates to give primacy to the principle of party autonomy to this extent.

Indeed, subjectively understood agreements best satisfy the requirement of party autonomy. The Convention adopts this stance in Article 8(1).¹⁶⁴ Limitations in ascertaining the true intention of the parties however require an objective inquiry into the intent of the parties. As such, Article 8(2) states, “Statements made by and other conduct of a party is to be interpreted according to the understanding that a reasonable person of the same kind as the other party would have had in the same circumstances.”¹⁶⁵ Such an objective inquiry, in this context requires reference to: a) the terms of the standard forms and b) the past dealings between the parties, industry custom and trade practice as stipulated by Article 9 of the Convention.¹⁶⁶

Article 9(1) of the Convention states that parties are bound by “usage to which they have agreed and by any practices which they have established between themselves.”¹⁶⁷ The application of such usage and practice should take precedence over the unexamined terms of the standard forms simply on the grounds that while the parties have agreed to such usage and practices, the same cannot be said of unexamined boiler plate clauses. Moreover, Article 9(2) of the Convention states that

¹⁶⁴ Convention, Article 8(1).

¹⁶⁵ Convention, Article 8(2).

¹⁶⁶ Convention, Article 9.

¹⁶⁷ *ibid.*

the parties are bound by trade custom. It should, however, be noted that only those trade usage(s) are implied into the contract which the parties knew of (or should have known of), and is widely known to and used by parties to similar contracts in the particular trade. In the words of Professors Ostas and Darr, “Such shared customs and experiences facilitate communication and provide evidence of mutual, albeit tacit, understandings.”¹⁶⁸ Indeed, by limiting usages that the parties are bound by, to those that they are aware of or should be aware of, Article 9 itself is based upon the principle of party autonomy. As such, it is argued that where the terms contained in the standard forms of the parties conflict with such custom and practices, the latter should be given preference over the former. In other words, as explained above, while it is difficult to infer a so-called meeting of the minds from the terms contained in standard forms, trade usages and practices implied by Article 9 are not subject to such a criticism. As a result, standard terms that are in conflict with such usage and practices should be knocked out of the contract in favour of the terms implied by Article 9.

An objection to this approach could be that by giving primacy to implied terms (custom, practice) over express terms that are contained in the standard forms, the dictates of Article 6 are being undermined. Such a criticism however is bound to fail since Article 6 allows derogation by agreement or in other words operates to give primacy to those terms that have been agreed between the parties. Considerations of the realities of international trade however suggest that parties rarely read standard forms.¹⁶⁹ As such, it is difficult to state that parties have agreed to derogate from such custom and practices as a result of a clause contained in the standard form of one of the parties. Indeed, allowing such derogation would operate to motivate parties to act in an opportunistic manner as one party could replace custom and practices established between themselves by including a clause to that effect in their form, while being well aware that the other would probably not notice the same.

¹⁶⁸ Ostas and Darr (n 2) 412.

¹⁶⁹ The consideration of the realities of international trade is important since they provide insights into the object and purpose of the Convention; additionally, the travaux reveals that these realities formed one of the policy concerns during the drafting stages of Article 19. As such, a proper methodology for the resolution of BOF scenarios must give due regard to the realities of international trade.

Such an approach would therefore require of the parties, who wish to derogate from such custom and practices, to expressly stipulate the same in their contracts rather than in their standard forms. This is in line with the following assertion of the AC: “Standard terms that are so surprising or unusual that a reasonable person of the same kind as the relevant party could not reasonably have expected such a term in the agreement, do not form part of the agreement.”¹⁷⁰

Indeed, a standard term that contradicts usage to which the parties have expressly agreed to and practices which they have established between themselves – along with widely known and observed trade usage – would be categorized as surprising and unexpected.

Such an approach, however, does not view standard forms as providing no utility to the parties. Rather, commercial reality clearly demonstrates that parties, more often than not, make use of standard terms as a result of their impact on transaction costs. As discussed above, transaction costs are reduced as parties need not negotiate on terms that are not considered material by them, by including the same in their standard forms. Consequently, a rule such as the LSR, which operates to incentivise the reading of standard forms or to engage in a prolonged exchange of forms, would increase transaction costs. Moreover, parties usually delegate the responsibility of drafting such forms to their lawyers, while limiting the power of subordinates in the hierarchy of the firm to negotiate with potential parties on such terms.¹⁷¹

Consequently, methodologies for the resolution of BOF scenarios should limit the inclusion of standard terms to those that are generally not considered by a reasonable person of the same kind as the relevant party as surprising or unreasonable. Allowing otherwise would require that subordinates in the hierarchy of the parties’ firms be empowered to negotiate on non-material terms. Such an approach would completely undermine the transaction cost-reducing rationale for the use of standard forms.¹⁷²

As such, the approach advocated for the resolution of the BOF scenario is one which operates to exclude all conflicting terms contained in the standard forms of the

¹⁷⁰ AC Opinion (n 151).

¹⁷¹ Ostas and Darr (n 2).

¹⁷² *ibid.*

parties. Moreover, in order to curb the potential of opportunistic behavior on the part of the parties and to keep the utility of standard forms as a mechanism of reducing transaction costs intact, it is necessary that parties are not allowed to incorporate surprising or unusual terms in their standard forms. Gaps created in the contract should then be filled via reference to the terms implied by Article 9 of the Convention. Finally, reference should be made to the terms remaining in standard forms after conflicting terms have been knocked out. This methodology satisfies the requirements of Articles 31 and 32 of the Vienna Convention, as it takes the object and purpose of this Convention into account, and satisfies the concerns of the drafters detailed above (the travaux). Moreover, this recommended approach to the resolution of the issues raised by BOF scenarios remedies the unreasonableness of the methodology derived from a textualist interpretation of Article 19.

Chapter 4 Open Price terms

A strict compliance with the classic contract law which demands rigidity in fixing the price term is a convenient trap-door through which the imprudent or unscrupulous obligor can escape, leaving the innocent obligee to bear not only the loss of expected benefits but also the burden of liability to sub-purchasers.¹

Introduction

The economic crisis of the 1930s, followed by the change in consumption habits witnessed in the 1950s, and the continuous transformations and innovations in technologies of production and distribution have all contributed to shifting the polarization of economic activity from production to distribution.² This led to the multiplication of exclusive distribution contracts, franchise agreements and other long-term contracts for sale.

Historically, the laws of states on the sale of goods were designed in light of the commercial framework prevailing at the time. For instance, Roman law on the sale of goods – which greatly influenced the laws of other European states – was designed in accordance with the requirements of petty shop keepers who did not make long-term commercial plans.³ As a result, these laws are unable to effectively and efficiently govern long-term contracts formed in a very different commercial context.⁴ For instance, in the case of discrete contracts, the price is easy to demine and set ex-ante. As a result, rules requiring certainty of the price for the formation of a valid contract

¹ Harold J. Berman, 'Excuse for Nonperformance in the Light of Contract Practices in International Trade' (1963) 63 Columbia Law Review 1413, 1437.

² Frederick H. Miller and William D. Hawkland, *Hawkland's Uniform Commercial Code Series* (Thomson & Reuters 2015).

³ Various academics have labelled the requirement of price being fixed with reasonable certainty as an "ancient principle" of common law derived from the code promulgated by the Roman Emperor Justinian in the sixth century. Traditional common law would therefore find contracts with open price terms to be invalid on the grounds of failure to establish an essential element of sale with sufficient certainty. Douglas C. Berry, David M. Byers, and Daniel J. Oates 'Open Price Agreements: Good Faith Pricing in the Franchise Relationship' [2007] Franchise Law Journal 45.

⁴ Karl N. Llewellyn, 'Cases and Materials on Sales' (Callaghan & Co 1930) 1.

do not pose any major issue in such transactions. In the case of long-term contracts, on the other hand, it may be too expensive or even impossible to concretely determine and agree on a price ex-ante. Such uncertainty may be attributed to the frequency of fluctuations in the price of the goods that constitute the subject matter of the contract, especially in instances where the goods are to be delivered at a date much later than when the contract is entered into.⁵ Traditional domestic laws were based upon a commercial framework that predated the prevalence of long-term contracts; because of this, these laws did not take such considerations into account.

In order to remedy these inefficiencies, various new theoretical frameworks were constructed. In the early 1970s, for instance, Professor Macneil introduced a distinction between discrete and relational transactions.⁶ According to this distinction, a discrete contract is simply a contract of limited duration wherein the obligation of each party is defined. Such agreements, argued Professor Macneil, do not subject the sharing of risk and profits to external factors that are outside the control of the parties.⁷ Relational transactions on the other hand, represent long-term contracts wherein the rights and obligations of the parties are not easy to define. Consequently, risk-sharing and division of profits in such contracts are intentionally made subject to external factor such as, for instance, the market price of the goods.⁸

⁵ In such circumstances, the rules of traditional common law would prove to be too inflexible for the business needs of the contracting parties. See L. Vold, 'Open Price Arrangements in the Sale of Goods' (1930) 5 *Temple Law Quarterly* 208.

⁶ Ian R. Macneil, 'The Many Futures of Contracts' (1973) 47 *Southern California Law Review* 691; Ian R. Macneil, 'A Primer of Contract Planning' (1974) 48 *Southern California Law Review* 627; Ian R. Macneil, 'Contracts Adjustment of Long-Term Economic Relationships under Classical, Neoclassical and Relational Contract Law' (1978) 72 *Northwestern University Law Review* 854; See also Charles J. Goetz and Robert E. Scott, 'Principles of Relational Contracts' (1981) 67 *Virginia Law Review* 1089.

⁷ Macneil 1978 (n 6).

⁸ The distinction was hardly original. Rather, Toullier had already identified the difference between 'snap-shot' agreements and 'successive' contracts in the context of French law as early as 1833. See Shael Herman, 'The Contribution of Roman Law to the Jurisprudence of Antebellum Louisiana' (1996) 56 *Louisiana Law Review* 257. For the purposes of this thesis, a fixed price term is defined as a complete term, applicable regardless of the state of the world. As a result, a fixed price term is not contingent upon any factor. Open price terms on the other hand are inherently incomplete terms. For instance a term stating that the price of the goods is to be calculated on the basis of the market price prevailing at the time of delivery is an open price term since it is inherently variable. Since open price terms are simply terms that are contingent upon a host of factors, and resultantly variable, they may take various forms. For instance, a price term setting a maximum and minimum price is open since the exact quantum of the price is not concretely defined. Other examples include price terms that state that the price is to be set: through agreement between the parties, in a reasonable manner, by reference to a particular index compiled by a third party, by the court etc.

Take, for instance, the example of a business format franchise, where the franchisor requires that the franchisee purchases goods from a particular (or set of) franchisor-approved vendors. In such circumstances, the franchisee must purchase goods from such vendors for as long as the franchise agreement remains in effect, which may be decades after the agreement is entered into. In such a situation, the franchisee would wish to enter into a long-term contract with the vendors in order to ensure the supply of the requisite goods. The parties, however, would not always be able to agree on the price at which the goods would be sold in the future. Such a problem would easily be remedied through the use of open price terms, since these terms provide the parties with the requisite flexibility to adapt their contract to changing conditions, thereby decreasing the parties' exposure to the risk of price fluctuations – while ensuring (albeit to a degree) that the required goods would be available for sale in the future.⁹

The prevalence of such long-term contracts since the end of the nineteenth century requires commercial law to incorporate a degree of flexibility in the rules on contract formation. It is therefore unsurprising that various delegates present during the drafting of the Convention advocated for the adoption of rules on price terms that would operate to allow parties to enter into long-term contracts. The delegate of the Republic of Korea for instance argued during the Eighth Meeting of the First Committee, “In the case of long-term contracts in particular, some gaps were inevitable and although there might be some difficulties in filling them, it was better to retain a degree of flexibility.”¹⁰

Opponents of the incorporation of such flexibility in the setting of the price on the other hand, argued that while the use of open price terms is highly prevalent in the context of commercial sales, they might operate to impose a price which was never intended by the parties.¹¹ Take for example the comment of the delegate of the

⁹ William L. Prosser, ‘Open Price in Contracts for the Sale of Goods, (1932) 16 Minnesota Law Review 733, 734.

¹⁰ Legislative History, 1980 Vienna Diplomatic Conference, Summary Records of Meetings of the First Committee, 8th Meeting, 17 March 1980
<<http://www.cisg.law.pace.edu/cisg/firstcommittee/Meeting8.html>> accessed: 11 May 2014 (Vienna Diplomatic Conference, 8th Meeting’).

¹¹ *ibid.* In essence, proponents of the recognition of such terms argued for their necessity in the current state of international commerce, while opponents advocated the need of objective certainty in the essential terms of contracts.

France that “while it was difficult to determine the price of such goods [raw materials] ex-ante, especially in the case of long-term contracts, it would be patently unfair on the weaker party to be subject to prices upon which it had no control.”¹² Thus, the delegate of France was simply concerned with the fact that without the requirement of a fixed price, one of the parties could well find itself in a position where it would have to agree to a price without having the opportunity to bargain.

As such, the choice between the incorporation of fixed or open price terms is simply a balance between certainty on the one hand and flexibility on the other. Certainty has the advantage of providing parties clarity as to the parameters of their obligations. On the other hand, flexibility – as shall be elaborated below – has the advantages of efficient allocation of risks, reduction of transaction costs, and limiting the potential of opportunistic behavior.¹³

The issue that forms the subject-matter of this chapter is whether the dictates of the Convention make provisions for effectively dealing with the issues surrounding the difficulty of ex-ante setting of the price in long-term contracts. It will be argued that the issue of whether the Convention should recognize contracts with open price terms was marred with disagreement during the drafting stages.¹⁴ The issue was finally resolved through a compromise solution, which entailed the incorporation of two separate articles that seemingly contradict one another. Consequently, one of the most problematic issues raised in the drafting of the Convention is the interplay between Articles 14 and 55.¹⁵

This chapter attempts to analyze the utility of and the extent to which parties to a long-term contract can utilize open price terms in their contracts governed by the Convention. The first part of the chapter will analyze the utility of open price terms

¹² *ibid* Para 82.

¹³ Ronald J. Gilson, Charles F. Sabel and Robert E. Scott, ‘Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration’ (2009) 109 *Columbia Law Review* 431, 435.

¹⁴ As shall be explained later in this chapter, one of the weaknesses of the rules of the Convention from an efficiency perspective lies in the fact that Article 55, which recognizes open price terms (albeit to an extent), implies the price prevailing at the time of conclusion of the contract rather than the price prevailing at the time of delivery.

¹⁵ Alejandro M. Garro, ‘Reconciliation of Legal Traditions in the U.N. Convention on Contracts for the International Sale of Goods’ (1989) 23 *The International Lawyer* 443, 475.

to commercial parties, in comparison with fixed price terms. In particular, open price terms will be compared with fixed price terms on the basis of their impact upon: (a) the allocation of risk between the parties and (b) transaction costs. With regards to risk allocation, it shall be concluded that neither of the two mechanisms is capable of optimal risk allocation in all scenarios; rather, the ascertainment of which mechanism is to be preferred is dependent upon a large host of factors. It shall further be argued that the use of open price terms operate to decrease ex-ante transaction costs and motivates parties to renegotiate. The second part of this chapter will move on to analyze the fault lines between legal traditions that led to the compromise solution of incorporating seemingly inconsistent articles on the issue of the recognition of open price terms. It shall be argued that the evolution of mercantile practice has given rise to concerns over the formalist/prescriptive nature of domestic rules on the recognition of open price terms, and as a result, jurisdictions seem to be converging towards a framework that replaces formalism of rules with flexibility aimed towards enforcing the intention of the parties. Such convergence, however, has not been uniform, as will be demonstrated by a comparison between UK, US and French law on the issue. Equipped with this analysis, the chapter will proceed to evaluate the extent to which the Convention adopts a formalist/prescriptive approach towards the issue of open price terms. It shall be concluded that while the rules of the UK, US, France and the Convention recognize open price terms, they diverge on the issue of the recognition of agreements to agree and consequently, contracts that stipulate that the price is subject to renegotiation.

4.1 Part 1: The Utility of Open Price Terms in Long Term Contracts

4.1.1 Open Price or Fixed Price Terms?

This section compares open price terms with fixed price terms on the basis of their impact on: (a) the allocation of risk between the parties and (b) transaction costs. It is argued that the mechanism that efficiently allocates risk and lowers transaction costs would be preferred by the parties to a sales contract.¹⁶ This section of the paper

¹⁶ While Professor Polinsky attributes the use of open price terms solely to risk allocation strategies, Professor Goldberg argues that risk allocation has little to do with the use of price terms. Instead he argues that price adjustment mechanisms and issues raised by their use are related to the framework of the relational exchange approach to contracts. See Victor P. Goldberg, 'Price Adjustment in Long-term Contracts' [1985] Wisconsin Law Review 527, 528; See A. Mitchell Polinsky, 'Fixed Price

therefore attempts to analyze the potential of each mechanism in achieving these goals.

4.1.2 Advantages Related to the Efficient Allocation of Risk

The question raised here is whether open price terms on the basis of spot price (price prevailing at the time of delivery) are more efficient in risk allocation than contracts with fixed price terms. For the purposes of this section the following scenario, framed by Polinsky, shall be utilized:

In a contract for the sale of goods, the seller is also the manufacturer and is not certain of its production costs, like all other manufacturers in the industry. Moreover, for simplicity, consider that the supply curve is flat, so that the equilibrium price at the time of delivery is equal to the costs incurred by the seller.

In such a case, the buyer would opt for a fixed price term so long as its' valuation of the goods are certain.¹⁷ This is because a fixed price contract would provide the buyer with a certain profit, so long as the price so fixed reflects high valuation of the goods. As such, a fixed price contract insures the buyer against positive price fluctuations. In contrast, the use of open price terms in such a situation would, from the perspective of the buyer, simply give rise to uncertainty.

The seller on the other hand would prefer an open price contract calling for price at the time of delivery (hereafter referred to as spot price).¹⁸ This is for the following reason: if the production costs of the seller are increasing, so will the supply curve, and as a result the equilibrium spot price will increase as well. In other words, since the seller's cost of production is equivalent to the price in the spot market, an increase in costs is offset by a similar increase in spot price. The increase in spot price then acts as insurance for the seller against the uncertainty of production

Versus Spot Price Contracts: A Study in Risk Allocation' (1987) 3 Journal of Law, Economics, and Organization 27, 41-43.

¹⁷ See Polinsky (n 16).

¹⁸ *ibid.*

costs.¹⁹ The use of a fixed price contract, on the other hand, would have the impact of shifting the entire risk of fluctuation in the production cost onto the seller.

Since each party would opt for a different mechanism in the example above, the issue of which is more appropriate simply comes down to the ascertainment of which party is more risk averse. If, for instance, the seller is risk neutral while the buyer is risk averse, then attempts to impose an open price term on the buyer may well have a crowding out effect. A similar conclusion follows for the seller if a fixed price term is incorporated into the contract.

The above example, however, would seldom be a representation of the real world. This is because, in most industries, the equilibrium spot price is dependent upon a host of factors – including the fluctuations of industry supply and demand curves. The result, however, does not change in models that account for supply and demand curves with a gradient greater than zero.²⁰ Professor Polinsky, in recognition of this fact, creates a model where both the seller's and buyer's valuations are unknown.²¹ Moreover, the production cost is directly correlated with fluctuations in the supply curve and the buyer's valuation is similarly directly and imperfectly correlated with the demand curve.²²

In such a case, an open price term continues to insure the seller against price fluctuations for the same reasons as in the example above.²³ It should however be noted that, unlike the case in the example discussed above, such insurance is not perfect. This is simply a result of the fact that the production cost is no longer perfectly correlated with fluctuations in the supply curve. Consequently, the

¹⁹ *ibid.*

²⁰ In the example above, as a result of a flat supply curve, equilibrium spot price is equal to the costs incurred by the seller.

²¹ *ibid.* The conclusions reached in the first scenario stand true for this one as well – i.e. from the perspective of the seller a fixed price contract acts as insurance against demand curve variations while a spot price contract insures against uncertainty in production costs. Conclusions for the buyer are a mirror image of those for the seller discussed above. A fixed price contract acts as insurance against uncertainty in the variation of the supply curve whereas a spot price contract provides insurance against uncertainty in the valuation of the goods.

²² In this scenario, the equilibrium spot price is naturally dependent upon fluctuations of both the demand and supply curves.

²³ *ibid.* See Polinsky (n 16).

insurance provided by an open price contract in such an instance might well fall short of the cost incurred by the seller in production.

Even though an open price contract may go a long way in protecting the seller against unpredictable price fluctuations, it is questionable whether it is preferable to a fixed price contract from the perspective of a risk averse seller. As explained above, since spot price in this scenario is also a product of shifts in the demand curve, an additional element of uncertainty is added to the equation. The seller need not only protect itself from shifts in the supply curve but must also take fluctuations in the demand curve into account while pricing the contract.²⁴ The use of a fixed price contract in such an instance would operate to protect the seller from fluctuations in the demand curve.

From the perspective of the buyer, the results are the same.²⁵ An open price contract (spot price) will protect a buyer from fluctuations in the price whereas a fixed price contract will insure the buyer against fluctuations in the supply curve. It therefore seems that neither a fixed price contract nor an open price contract can effectively provide the seller or the buyer efficient insurance against both supply and demand side risks. The question then is: which methodology is preferable, given that neither is perfect?

The answer to this question, it is asserted, lies in the comparison of the utility, or disutility, of each mechanism in any given scenario. As such, a fixed price contract is to be preferred when the disutility of an open price contract exceeds that of a fixed price contract. The calculation of the utility of each mechanism is a product of a large host of factors; these include the degree to which the parties (individually) are risk averse, the degree of uncertainty in the potential fluctuations in both the supply and demand curves, and the gradient of both the supply and demand curves.

4.1.3 The Economic Advantages of Cooperation

²⁴ *ibid.*

²⁵ *ibid.*

Recent theories question the use of open price terms as a mechanism of risk sharing. They point towards the widespread use of open price contracts in long-term sales, even in cases where they operate to inefficiently distribute risk.²⁶ Data collected by Professor Mulherin, for instance, demonstrates that open price terms have been employed even in instances where the seller was a large risk neutral company.²⁷ This goes against the observations made above, which would support the use of open price terms where the producer was risk averse so as to shift risk from this producer. Professor Goldberg therefore argues that the greatest motivation for the use of open price terms lies not in their potential of efficient risk-allocation, but rather in the potential benefits of increased co-operation.²⁸

Under a fixed price contract, the division of profits is established at the outset. Parties may, however, expend resources in ascertaining the possible fluctuations in the price of the goods ex-ante, with a view of capturing a larger share of the pie. Such activities would lead to an increase in transaction costs, thereby diminishing the joint return of the transaction. Moreover, parties would be motivated to expend more resources if it results in a greater degree of capture of the division of profits. As such, the greater the potential of capture resulting from fluctuations in price, the higher the potential transaction costs. Open price terms that allow for price adjustment, however, would diminish the value of special information, thereby lowering the incentive to collect such information and, consequently, decrease transaction costs.²⁹

4.1.4 Conclusions

While commercial practice does not support the use of open price terms as a mechanism of risk sharing, it would be incorrect to state that open price terms cannot aid in the efficient allocation of risks. In fact, the use of open price terms can go a long way in distributing risks in accordance with the specific ‘type’ of each party,

²⁶ See Mark P. Gergen, ‘The Use of Open Terms in Contract’ (1992) 92 Columbia Law Review 997, 1054.

²⁷ J. Harold Mulherin, ‘Complexity in Long-Term Contracts and Analysis of Natural Gas Contractual Provisions’ (1986) 2 Journal of Law, Economics, & Organization 105, 114-15.

²⁸ Goldberg (n 16).

²⁹ *ibid.*

and would operate to remedy certain concerns of risk averse parties while they are considering whether to conclude a long term contract. Provided that the relative utility of the two pricing mechanisms, in this regard, is a product of a host of factors, it is impossible to state that one is preferable to the other in all cases. It is similarly clear that, in various instances, the use of open price terms would indeed bring efficiency to commercial transactions.³⁰ Moreover, the use of open price terms in the framework of long-term contracts incentivizes co-operation between the parties which leads to a decrease in transaction costs.

In order to ascertain how the domestic laws of states have evolved to provide flexibility while retaining – albeit to a limited extent – the advantages of certainty, this chapter shall now analyze the laws of UK, US and France on the matter. These jurisdictions have been chosen for comparison due to the diversity of the stances adopted thereunder. Specifically, US law has evolved to provide the greatest degree of flexibility on price terms while French law has been extremely cautious in its evolution on the matter. UK law on the other hand seems to occupy the middle ground between these two extremes.

4.2 Part 2 Open Price Terms in National Laws

4.2.1 Recognition of open price terms in the law of the United States

Up till the turn of the twentieth century, the primary source of commercial law in the US was common law rather than statutory law.³¹ During that period, US law did not recognize contracts with open price terms.³² For instance, in the seminal case of *Lambert v Hays*, it was specifically noted, “A contract for the sale of goods which is

³⁰ For example, as discussed above, the use of fixed price terms can have a crowding out effect in certain instances, which can be remedied through the use of open price terms.

³¹ Stewart Macaulay, ‘Long-term Continuing Relations: the American Experience Regulating Dealerships and Franchises’ in Christian Joerges (ed), *Franchising and the Law: Theoretical and Comparative Approaches in Europe and the United States* (Nomos 1991) 181.

³² An exception to this rule is founded in the case of *Acebal v Levy*, whereby a contract with open price terms would be held to be valid if the goods had been delivered to the buyer. In such an instance the court would supply a reasonable price. See *Acebal v Levy* (1834) 10 Bing. 376, 3 LJCP 98.

silent as to the price fails for uncertainty.”³³ The facts of certain cases, however, proved rather problematic for the application of this rule. For instance, in disputes concerning contracts for the sale of goods on open price terms, where the goods had been delivered and used, the possibility of restitution was severely limited.³⁴ As such, courts would have to engage in the exercise of evaluating the price of the delivered goods, so as to place the parties in the position they would have been had the contract not been performed. This exercise would generally be focused on the ascertainment of the reasonable price of the goods. In doing so, courts would essentially be providing the term, the absence of which had formed the basis of their decision of finding the contract invalid.³⁵

The primary issue with this approach was that it did not take commercial realities into account. As explained above, commercial actors generally incorporate open price terms in their contracts since they operate to lower transaction costs and provide flexibility by allowing the evolution of their contractual relationship in light of changed circumstances. By limiting the use of such terms, however, common law in certain circumstances operated to undermine the intention of the parties in favor of formalism.

As early as 1906, such concerns gave momentum to the efforts to amend US law so as to provide legal validity to contracts with open price terms.³⁶ These efforts resulted in the promulgation of Section 9 and 10 of the Uniform Sales Act 1906.³⁷

³³ *Lambert v. Hays* 136 App. Div. 574 (New York App. Div. 1910). For an opposite conclusion prior to the enactment of the Uniform Commercial Code (hereinafter referred to as ‘UCC’) see *Hoadly v. M’Laine*, (1834) 10 Bing. 482, 3 LJCP 162.

³⁴ *Acebal* (n 32). “Undoubtedly the law makes that inference where the contract is executed by the acceptance of the goods by the Defendants, in order to prevent the injustice of the Defendant taking the goods without paying for them ... But it may be questionable whether the same reason applied to a case where the contract is executory only, and where the goods are still in the possession, or under the control, of the seller.” *Acebal* (n 32).

³⁵ The obligation to pay a reasonable price under such circumstances was considered to be quasi-contractual rather than in contract. See *Prosser* (n 9).

³⁶ An analysis of cases suggests that the rule prior to the enactment of the Uniform Sales Act 1906 was the following: where the contract is silent as to the price and the contract has been executed, the buyer must pay a reasonable price. See for example *James v. Muir* (1876) 33 Mich. 223; *Taft v. Travis* (1883) 136 Mass. 95; *Comstock v. Sanger* (1898) 121 Cal. 641, 54 Pac. 101; *Leist v. Dierssen* (1906) 4 Cal. App. 634, 88 Pac. 812; *Stout v. Caruthersville Hardware Co.* (1908) 131 Mo. App. 520, 110 S. W. 619; *Smith v. State* (1911) 9 Ga. App. 227, 70 S. E. 969.

³⁷ Uniform Sales Act 1906. It is interesting to note that these sections of the Uniform Sales law ostensibly mirror their counterparts in the SGA 1893. See Donald J. Smythe, ‘Why was the Uniform Sales Act Adopted in some States but not Others’ (2008) 5

The act does recognize contracts with open price terms under certain circumstances; however, two tenants of formalism are found to be incorporated into it, namely: A) the requirement that the contract be interpreted literally, and B) written terms outweigh unwritten expressions of agreement.³⁸ The adoption of such formalism led judges, who had been trained in traditional common law, to interpret the section as “a mere declaration of the common law,” and consequently courts continued to hold agreements with open price terms as invalid.³⁹ As such, there could be instances where the unwritten expressions of agreement showed a validly concluded agreement yet the court bound by the formalism of the act would be unable to enforce the legitimate expectations of the parties.

In light of these findings, Professor Llewellyn believed that the issues surrounding open price contracting could be overcome if the law recognized the working rules established between commercial parties.⁴⁰ In particular, the act suffered from two major flaws that had to be remedied before the law could effectively reflect and cater for commercial practise. Firstly, instead of being grounded in legal doctrine, the law had to be designed on the basis of a contextual approach. This was achieved by making the context the primary factor in the ascertainment, by courts, of what the agreement means.

The second failing of the act was that its rules were too general; as a result, these rules were insensitive to certain circumstances that led parties to act contrary to the norm of risk allocation in commercial transactions, as they were based on a one size fits all approach. This was remedied by replacing the abstract general rules with those of the particular trade and industry. Consequently, US law has abandoned the approach of literal interpretation of open price contracts in favour of one that enforces such contracts on the basis of the facts as they are interpreted by the particular trading identity of the parties.⁴¹

<<http://extranet.isnie.org/uploads/isnie2008/smythe.pdf>> accessed: 27 March 2014.

³⁸ Robert E. Scott, ‘The Rise and Fall of Article 2’ (2002) 62 Louisiana Law Review 1009, 13.

³⁹ Berry and others (n 3) 51.

⁴⁰ See Macaulay (n 31) 188.

⁴¹ E. Allen Farnsworth, ‘Contracts’ (4th edn, Aspen Publishers 2004) 108.

As such, recognizing the limitations of the formalism contained in the act, the UCC was drafted with the intention to allow flexibility in the formation of contracts by substituting the bargain paradigm – that is, every essential term of the agreement must be settled for the court to be able to grant a remedy, with the intention of the parties to the contract.⁴²

Article 2-305 of the UCC implies a reasonable price at the time of delivery under three circumstances, namely: (a) the parties are silent as to price (b) the price is to be agreed between the parties and they fail in the same and (c) the price is to be set by a third party and it is not so set. Only the first of these is recognized by under the Uniform Sales Act, whereas the contract would be invalidated under the remaining two.⁴³ Moreover, Sub-article 2 of Article 2-305 specifically recognizes agreements whereby one party is empowered to set the price.⁴⁴

Such an approach, it is argued, places severe curbs on the potential of opportunistic behavior by one party. Take for instance scenario (c) detailed in the paragraph above. In such a case, the UCC will not allow a contract to be set aside simply because the price term empowered a third party to fix the price and it was not able to do so as a result of the fault of one of the parties. Rather, the UCC places limits on the potential of opportunistic behavior by providing that a reasonable price is to be charged in such circumstances. Surprisingly however, the UCC empowers the innocent party in such a circumstance to identify what is considered the reasonable price. Since such an approach would undoubtedly operate to motivate opportunism on the part of the innocent party i.e. to require a price that maximizes its return, the UCC has limited

⁴² UCC, Section 1-201(3) states, “The bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance as provided in this Act.” Comment 1 to Section 1-205 states, “The meaning of the agreement is to be determined by the language used by [the parties] and by their action, read and interpreted in the light of commercial practices and other surrounding circumstances.” In the words of Speidel, under the UCC “[I]f the seller and buyer agree to the future sale of described goods in a stated quantity and clearly state that they intend to contract, the bargain is enforceable even though no other terms have been agreed.” Anon, ‘UCC Section 2-305(1)(c): Open Price Terms and the Intention of the Parties in Sales Contracts’ (1967) 1 Valparaiso University Law Review 381, 398 citing Professor Richard Speidel, ‘Annual Convention of the Association of American Law Schools’ December 28, 1966.

⁴³ Hawkland believes that the approach adopted under the UCC to the recognition of open price terms ensures a “fairer and juster” result relative to a no-contract outcome. See William D. Hawkland, *Sales and Bulk Sales* (American Law Institute-American Bar Association, Committee on Continuing Professional Education, 1976) 74.

⁴⁴ UCC, Article 2-305 (2).

such discretion by imposing the obligation to act in good faith while ascertaining the reasonable price standard.⁴⁵

Even before the code was enacted, scholars began to raise concerns vis-à-vis the exact definition of the requirement of good faith as contained in this subsection.⁴⁶ Resulting disagreements on the exact definition of the principle have hampered the ability of commercial actors to use open price terms while contracting.⁴⁷ Douglas et al. for instance, after analyzing a host of judgments on the issue, state, “The resulting, often circular, legal discourse is anything but instructive and has realized many of the worst fears of the UCC drafting committee.”⁴⁸

As mentioned above, absent a concretely defined principle of good faith, the utility of empowering one party to ascertain a reasonable price is greatly undermined. One potential way around this problem is to empower courts to identify the reasonable price. Such an approach, however, has its own shortcomings. Firstly, adjudication of disputes is costly and transaction costs operate to shrink the joint return of the parties under the contract.⁴⁹ Secondly, in efficiency terms, leaving the determination of the price to the courts is efficient in cases where courts possess special knowledge and expertise that enable them to identify the price in a more cost efficient manner than the parties themselves. In such a case, expertise that would enable the courts to better ascertain the price would include the existence of cost effective mechanisms for the accumulation and analysis of price related information. It is, however, commonplace that “parties can determine appropriate performance together better and more cheaply than can courts.”⁵⁰

4.2.2 UK Law

Prior to the promulgation of The Sale of Goods Act 1893 (SGA 1893), English

⁴⁵ Berry and others (n 3) fn 20, 50.

⁴⁶ Hearing Before The Enlarged Editorial Board January 27-29, (1951) 6 Business Lawyer 164, 186. According to Berry and others, “Almost from its inception, the UCC’s open price provision has been misconstrued and misapplied.” See Berry and others (n 3) fn 20, 50.

⁴⁷ For instance, one of the factors in the assessment of the good faith criterion – namely commercial reasonability – is too vague a standard to provide any meaningful guidance.

⁴⁸ Berry and others (n 3) 49.

⁴⁹ Litigation costs are a part of transaction costs.

⁵⁰ Gergen (n 26) 1000.

courts did not recognize the validity of agreements with open price terms. Based on the principle of autonomy (freedom of contract) English law did not allow courts to make the agreement for the parties by implying terms where the parties had been unable to agree or were otherwise silent. English law, therefore, by giving primacy to the intention of the parties, imposed upon them the correlative responsibility to determine the content of their obligations.⁵¹

This rule was subsequently relaxed in the case of *Wilks v Davis*, where the court held that it possessed the power to ascertain the price, which was originally agreed to be set by a valuator without specifically identifying its identity.⁵² It must be noted that the ruling of *Wilks* did not overturn the rule expounded in previous cases such as *Darbey* – it merely added to it. As such, before the enactment of the SGA 1893, English courts would not intervene to ascertain the price of an otherwise validly concluded contract unless the agreement could be read in a manner that empowered it to do so. Thus, an agreement that named third party evaluators empowered to ascertain the price would operate to bar the court from entering into such an exercise.⁵³ In such a scenario, if the evaluators failed to ascertain the price, the court would be left with little choice but to find the agreement unenforceable.

In 1893, with the promulgation of the new SGA, the stance adopted by English law on the recognition of contracts with open price terms was substantially altered.⁵⁴

⁵¹ See Windeyer J. decision in the case *Hall v Busst* (1960) 104 CLR 206, wherein he discusses the outcome and ratio of cases concerning open price terms prior to the promulgation of the SGA. See also *Darbey v Whitaker* (1857) 4 Drewry 134. The ratio of the case was that equity would not decree specific performance in cases where one of the essential elements of the contract is still to be determined at the time of trial.

⁵² *Wilks v Davis* (1817) 3 Mer 507.

⁵³ This result was well established in the case of sale of land. As early as 1807, Sir William Grant in *Milnes v. Gery* (1807) 14 Ves Jun 400 said: “Upon the principle, that a fixed price was an essential ingredient in a contract of sale, the ancient Roman lawyers doubted, whether an agreement, that did not settle the price, was at all binding. Justinian's Institutes and the Code state that doubt; and resolve it by declaring, that such an agreement should be valid and complete, when and if the party, to whom it was referred, should fix the price: otherwise it should be totally in-operative: ‘quasi nullo Pretio Statuto;’ and such clearly is the Law of England.” He added: “The case of an agreement to sell at a fair valuation is essentially different. . . . In that case no particular means of ascertaining the value are pointed out: there is nothing therefore, precluding the Court from adopting any means, adapted to that purpose.”

⁵⁴ The SGA was a product of a review by Chalmers of cases adjudicated during the nineteenth century and was promulgated to reflect, albeit to an extent, the realities of commercial practice. John Macleod, *Consumer Sales Law: The Law relating to Consumer Sales and Financing of Goods* (Routledge 2009) 4.

Between 1893 and 1979 various amendments were made to the act, and resultantly the SGA 1979 was drafted to consolidate these amendments. Interestingly, however, the rules on the validity of open price terms remain ostensibly identical.

Section 8

(1) The price in a contract of sale may be fixed by the contract, or may be left to be fixed in a manner agreed by the contract, or may be determined by the course of dealing between the parties.

(2) Where the price is not determined as mentioned in Sub-section (1) above the buyer must pay a reasonable price.

(3) What is a reasonable price is a question of fact dependent on the circumstances of each particular case.

Section 9

(1) Where there is an agreement to sell goods on the terms that the price is to be fixed by the valuation of a third party, and he cannot or does not make the valuation, the agreement is avoided; but if the goods or any part of them have been delivered to and appropriated by the buyer he must pay a reasonable price for them.

(2) Where the third party is prevented from making the valuation by the fault of the seller or buyer, the party not at fault may maintain an action for damages against the party at fault.

Even though the legal community has had over a hundred years of experience dealing with these sections, their interpretation is still a fountain of disagreement. Specifically, there is great confusion surrounding the question of whether the phrase “left to be fixed in a manner agreed by the contract” includes the possibility of the price to be agreed between the parties themselves. Notwithstanding this limitation of the act, the text of the provisions detailed above coupled with the evolution of their interpretation by courts clearly demonstrates the tendency of English law to come to the aid of the parties by endeavoring to give effect to formal agreements that the

parties clearly intended to have a legal effect.⁵⁵ It should, however, be noted that courts will not fill in the gaps in the agreement where there is insufficient evidence of what the parties intended.⁵⁶ Thus, English courts simply strive to ascertain, from the circumstances surrounding the contract, what the intention of the parties was. However, if the courts are unable to identify the same, for instance due to the obscurity of language used, courts will not make an agreement for the parties.⁵⁷

Where the parties are silent as to the price

The dictates of Sections 8(2) and (3) are quite clear on the issue and operate to imply a reasonable price as determined by the circumstances of each case.

A third party is empowered to set the price

The dictates of Section 9 recognize the validity of price terms that empower a third party to set the price. While such a position operates to enforce the intention of the parties, the second sentence of Section 9(1) does seem to favor formalism. This statement however should not be taken to mean that the section was drafted with the view of subjecting the intention of the parties to formalist requirements.

Unfortunately, however, until 1982, courts did interpret the section in such a manner and would invalidate a contract in instances where the third party failed to set the price even though the parties clearly intended to be bound by the contract. In 1984, the House of Lords (HL) overturned previous case law on the issue.⁵⁸ In the case of *Sudbrook Trading Estate v Eggleton*, the HL validated the existence of a contract that empowered a third party to ascertain the price. The third party had, however, failed to do so. The HL held that the correct approach to be adopted in such cases was for the court to ascertain whether the parties intended to be bound by a fair and reasonable price with the mechanism simply representing a means to this end; or whether the mechanism itself was essential in determining the price to be paid. The

⁵⁵ *Sudbrook Trading Estate v Eggleton* [1983] AC 444 House of Lords.

⁵⁶ *G Scammell and Nephew Ltd v HC & JG Ouston* [1941] 1 AC 251.

⁵⁷ *ibid.* Viscount Simons, in his judgement, stated, "The phrase in dispute was so vaguely expressed that ...it requires further agreement to be reached between the parties before there could be a complete consensus ad idem." Viscount Maugham stated, "No one could agree upon the true construction of the agreement, it was impossible to hold that a contract had been formed."

⁵⁸ See *Sudbrook Trading Estate* (n 55).

court held that if the mechanism was simply a means of ensuring that a fair price was to be paid, then the intention of the parties should be enforced. This would be achieved if the court substituted the mechanism identified by the parties with its own mechanism whereby a fair and reasonable price may be ascertained. On the other hand, if the agreed mechanism is found to be essential and it fails in setting the price, then according to the HL, courts should invalidate the agreement, for any other outcome would be tantamount to undermining the intention of the parties by imposing terms that they clearly did not intend to be bound by.⁵⁹

The pricing of the goods is entrusted to one of the parties

In *May & Butcher*, Viscount Dunedin stated, “With regards to price it is a perfectly good contract to say that the price is to be settled by the buyer.”⁶⁰ Thus, English law recognizes the validity of contract that empowers one party to set the price. Such a stance is in line with the autonomy-based theory of contract; indeed, if the parties intended to conclude a contract whilst empowering one of them to set the price, courts should implement such an intention. It should be noted, that when one party is entrusted to set the price, there is an underlying assumption that it would do so in a fair and reasonable manner. Indeed, the goal of commercial parties is to make profits and profits are undoubtedly based on price.⁶¹ It is therefore unlikely that parties would intend to be bound by agreements, the price term of which would operate to allow one party to act opportunistically and seize all the returns from the transaction. Consequently, the discretion of the party setting the price is never unfettered; it cannot exercise its discretion “dishonestly, for an improper purpose, capriciously, arbitrarily or in a way in which no reasonable party would do.”⁶²

The price is left to the future agreement between the parties

According to the majority view, a contract cannot be concluded on the terms that

⁵⁹ For an example of cases where the price mechanism was considered to be essential see *Gillatt v Sky Television Ltd* [2000] 2 BCLC 103 and *Infiniteland Ltd v Artisan Contracting Ltd* [2005] EWCA Civ 758, [2005] All ER (D) 236.

⁶⁰ *May & Butcher Ltd. v R* [1934] 2 KB 17.

⁶¹ See Llewellyn (n 4).

⁶² Ewan McKendrick, *Contract Law* (11th edn, Palgrave Macmillan 2015) 64.

certain essential elements are to be agreed between the parties at some future date.⁶³ In the case of *May & Butcher*, for instance, the court held that the inability of the parties to agree on the price at the conclusion of the contract could be equated with the inability of a third party to ascertain a price under Section 9 of the SGA, which leads to the invalidation of the contract.⁶⁴

Opponents of this view on the other hand argue that such a scenario is to be governed by Sub-section 2 of Section 8 rather than Sub-section 1. Thus, in such circumstances the buyer must pay a reasonable price, the ascertainment of which falls to courts and tribunals rather than the parties themselves. Indeed, invalidating agreements on the grounds that certain terms are left to future agreements in instances where the parties clearly intended to be bound by the agreement operates to undermine the autonomy-based theory adopted by English courts for over a century.⁶⁵ It is on these grounds that this part of the decision has been labelled as “commercially unsound” by various commentators.⁶⁶

Professor Bridge opines that Section 62(2) of the SGA limits the applicability of common law rules to the contracts of sale of goods to the extent that they are not in conflict with its provisions.⁶⁷ However, since the common law rules on agreement to agree seem to conflict with the dictates of Section 8 of the SGA, according to professor Bridge, the same are not applicable to contracts that fall within its scope.⁶⁸

In the case of *WN Hillas & Co Ltd v Arcos Ltd*, the House of Lords (HL) reached an opposite conclusion to the ruling of *May & Butcher*.⁶⁹ The case concerned the sale of

⁶³ See *May* (n 60); *Courtney and Fairbairn Ltd v Tolaini Bros. (Hotels) Ltd* [1975] 1 WLR 297.

⁶⁴ *ibid.* Lord Buckmaster, for a unanimous court, therefore held that a valid contract had not been executed.

⁶⁵ Provided that the mechanism of future agreement was simply a means of ascertaining the fair and reasonable price.

⁶⁶ Michael Howard, ‘Contracts Expressly Providing for Further Agreements’ (1977) 4 Otago Law Review 14, 17.

⁶⁷ Michael Bridge, *The Sale of Goods* (2nd edn, Oxford University Press 2009) 32.

⁶⁸ *ibid.*

⁶⁹ *WN Hillas & Co Ltd v Arcos Ltd* [1932] UKHL 2. The Court of Appeals (CA) however followed the ratio of *May* (n 60) and found the agreement void as essential terms of the contract were to be set through future agreement.

lumber of “fair specification” and contained an open price term.⁷⁰ After the agreement was entered into, the market price of Russian softwood skyrocketed and the seller attempted to get out of the bargain by arguing that the agreement was void as a result of uncertainty of essential terms, which had yet to be agreed between the parties. Had the ruling of *May & Butcher* been applied, as it was in the Court of Appeals, the court would have had little choice but to find the contract void on the grounds of being an agreement to agree.

Lord Wright, however, argued that businessmen and merchants “Record the most important agreements in crude and summary fashion; modes of expression sufficient and clear to them in the course of their business may appear to those unfamiliar with the business far from complete or precise.”⁷¹

On these grounds, he argued that in such situations the intention of the parties to enter into and be bound by a contract should not be defeated, but rather courts should strive to interpret contracts “fairly and broadly” so as to preserve their subject matter.⁷²

According to Atiyah et al. the two cases can be read in a harmonious manner.⁷³ They state that the ruling of *May & Butcher*, rather than laying a rule of general application on the fate of contracts with open price terms, simply reflects the court’s conclusion that the parties in the case had not reached a concluded agreement. If this argument is accepted, then the stance of English law on open price terms can be summarized as an acceptance of the validity of such contracts – so long as the circumstances reveal the intention of the parties to be bound by the agreement when it is concluded.

⁷⁰ The price term read: “Whatever the conditions are, buyers shall obtain the goods on conditions and at prices which show to them a reduction of 5 per cent on the FOB value of the official price list at any time ruling during 1931.”

⁷¹ *WN Hillas* (n 69).

⁷² This rule was, however, qualified by the proviso that courts should not create contracts where there are none.

⁷³ Patrick Selim Atiyah, John Norman Adams, and Hector L. MacQueen, *Sale of Goods* (Pearson Education 2005) 31.

Such a conclusion, however, is far from reality – as is revealed by an analysis of judgments delivered after *Hillas*. In *Courtney Ltd v Tolaini Bros*, for instance, Lord Diplock specially stated that that Lord Wright's ruling in *Hillas* was bad law.⁷⁴ Lord Denning argued:

If the law does not recognise a contract to enter into a contract (when there is a fundamental term yet to be agreed) it seems to me it cannot recognise a contract to negotiate. The reason is because it is too uncertain to have any binding force ... a contract to negotiate, like a contract to enter into a contract, is not a contract known to the law... I think we must apply the general principle that where there is a fundamental matter left undecided and to be the subject of negotiation, there is no contract.⁷⁵

The decisions in *May & Butcher*, *Hillas* and *Courtney* demonstrate that English courts attempt to adopt an approach which tries to avoid the wanton destruction of agreements on the one hand and the imaginative creation of agreements on the other. As a result, a court will not substitute its own intent where the mechanism adopted by the parties fails, unless it can be shown that the mechanism so adopted was simply a means to an end rather than essential in its own right. Such a stance, it is argued, is firmly grounded in the autonomy-based theories of contracts, and can provide a degree of flexibility in contractual interpretation whereby opportunistic behaviour can be minimized.⁷⁶

4.2.3 French Law

Historically, French commercial law was based upon the principle of party autonomy.⁷⁷ The principle was based upon assumptions of equality between the

⁷⁴ Lord Diplock stated: “Though an attractive theory, should in my view be regarded as bad law.” See *Courtney* (n 63), per Lord Diplock.

⁷⁵ See *Courtney* (n 63), per Lord Denning MR, 301-302.

⁷⁶ In *Hillas* (n 69), the seller attempted to have the contract declared invalid after the price of the wood had skyrocketed, where as in *Foley* the buyer attempted to take advantage of the missing price term so as to allow the buyer to purchase the fuel from elsewhere. In both these cases the breaching party was acting opportunistically.

⁷⁷ The principle of party autonomy in the context of French law is referred to as the “will theory of contract.” Rudolf B. Schlesinger, Pierre G. Bonassis, and Cornell Law School, ‘*Formation of Contracts - A Study of the Common Core of the Legal Systems*’ (Oceana Publications 1968) 244.

parties coupled with the expectation that competing interests would achieve a balanced agreement.⁷⁸ As such, under traditional French law, contractual obligations derived their validity from the intention of the parties and courts did not possess the power to intervene and substitute or imply terms into the contract.⁷⁹ Rather, the courts were merely servants of the parties whose mandate was limited to enforcing their common intent – “*minister de la volonté des parties.*”

The rules on price terms under French law are contained in Articles 1591 and 1592 of the Civil Code.⁸⁰ Read together, these articles state demonstrate that the price must be determined by the parties, even though it is not necessary that the price is fixed.⁸¹ It is sufficient for the purposes of the formation of a contract that the price is determinable at the time the contract is concluded, without the intervention of a judge.⁸² As such, the existence and content of the terms of an agreement are to be ascertained on the basis of the will of the parties. As a result, pricing should be the product of negotiations between two parties, not one, and the court is empowered only to ascertain the intention of the parties and may not substitute the same with its own opinion.

The developments in industrial capitalism witnessed at the end of the nineteenth century proved the assumptions upon which French contract law was based to be inaccurate.⁸³ Indeed, the Roman rule contained in Article 1591, while reasonable in the commercial context of the times of the Roman Empire, seems out of place in the current commercial context. As one French commentator famously stated, the rule was designed for shop keepers who do not make long-term commercial plans.⁸⁴ The

⁷⁸ *ibid.*

⁷⁹ Artur Nassbaum, ‘Comparative Aspects of the Anglo-American Offer-and-Acceptance Doctrine’ (1936) 36 *Columbia Law Review* 920.

⁸⁰ Article 1591 of the French Civil Code (hereinafter referred to as ‘CC’) reads: “The price of the sale must be determined and designated by the parties.”

⁸¹ Article 1591 adopts the Roman rule requiring certainty of the price term, which while suitable for Roman times, is not capable of regulating commercial relationships efficiently in the context of the twenty-first century. These concerns have led commentators to label the rule as an obsolete code provision. Edward A. Tomlinson, ‘Judicial Lawmaking in a Code Jurisdiction: A French Saga on Certainty of Price in Contract Law’ (1997) 58 *Louisiana Law Review* 101, 102.

⁸² Cass. req., Jan. 7, 1925, D.H. 1925, 57; Friedrich Kessler and Edith Fine, ‘Culpa in Contrahendo, Bargaining in Good Faith, and Freedom of Contract: a Comparative Study’ (1964) 77 *Harvard Law Review* 401, 409.

⁸³ Equality between contracting parties, for instance, is rarely observable in the current commercial context.

⁸⁴ See Tomlinson (n 81).

principle of autonomy was therefore supplanted with legal principles – such as the duty to act in good faith – which, it was hoped, would operate to minimize the impact of the lack of equality between the parties and rule out “unfair agreements.”⁸⁵ The incorporation of these principles has, however, had the impact of allowing judicial intervention (albeit constrained) in the ascertainment of the intention of the parties.⁸⁶

The parties are silent as to price

This situation is probably the best example of when the principle of autonomy as contained in traditional French law is supplanted with the principle of good faith and fairness. In such instances – i.e. where the parties are completely silent as to price – the prima facie inference is that the parties have not reached an agreement on one of the essential elements of the sale and therefore there is no contract. French law, however, does not limit the ascertainment of the terms of the agreement solely to the written contract.⁸⁷ Consequently, courts are empowered to ascertain, from the circumstances surrounding the agreement, what the parties intended. Thus, a judge may decide that the parties intended to imply the market price of the goods at the time of conclusion of the contract or at the time of delivery.⁸⁸ As such, French law recognizes the validity of agreements that do not include a clause on price.

The price is subject to future agreement between the parties

The application of the principle of party autonomy as contained in French commercial law requires the parties to agree upon at least the essential terms of the

⁸⁵ CC, Article 1134 (3) of the Civil Code states that contracts must be “performed in good faith.” This article did not receive any attention before the 1970s, leading commentators to state that the article “was in a state of deep sleep.” See Tomlinson (n 81) 113; Donald Harris and Denis Tallon (eds), *Contract Law Today: Anglo-French Comparisons* (Clarendon Press 1991).

⁸⁶ *ibid.* These developments have led various commentators to state that the law has moved from giving primacy to the autonomy of the will of the parties to giving primacy to the “autonomy of socialized will.”

⁸⁷ Harris and Tallon (n 85).

⁸⁸ Isabelle Corbisier, ‘The pricing in commercial contracts for sale of goods Comparative Reflections’ *International Journal of Comparative Law* 40 (1988) 767; Judicial intervention however is no longer limited by the sole considerations of the circumstances surrounding the agreement, but may take into account the dictates of commercial fairness and good faith. Thus, in this context, it is hard to determine the extent to which the judge is actually implying the true intention of the parties into the contract.

agreement for the existence of a validly concluded agreement.⁸⁹ The existence of a clause which requires the parties to agree on the price at a later date is itself evidence that the parties have not been able to agree on one of the essential terms of the contract.⁹⁰ Unlike the scenario discussed above, where the parties are completely silent as to price, the court cannot imply the market price of the goods into the agreement since there is no evidence that that is indeed what the parties intended.

The price term makes reference to market price prevailing at a future date

Since a price term that makes reference to the market price prevailing in a specified market at a designated date is determinable without the intervention of the courts, it is considered valid under French law.⁹¹

The price is to be fixed by a third party

Article 1592, read with Article 1134, allows parties to a contract for the sale of goods to empower a third party to establish the price of the goods.⁹² Article 1592, however, states that if the third party is unable to determine the price then there is no contract. This raises the following question: what will be the outcome of a case where one of the parties does not participate in the appointment of the third party or where it continuously postpones the appointment of the same? Various commentators have argued that such circumstances represent instances of bad faith performance in contravention of Article 1134 of the civil code.⁹³ Proponents of this approach therefore asserted that courts should pass an order of specific performance in such scenarios. This was subsequently rejected by the Court of Cassation (Supreme Court of France) when it held that the court, when called upon to resolve such disputes can only award damages to the innocent party.⁹⁴ The reason for the

⁸⁹ Cass. Corn., 24 March 1965, Bull. Civ III, No. 232 J.C.P. 65 II 14378.

⁹⁰ *ibid.*

⁹¹ Cass. req., Feb. 5, 1934, 1934 Gaz. Pal., 2, 331; Cass. com., Feb. 17, 1931, D.P. 1931, 1, 41, note Pierre Voirin.

⁹² CC, Article 1592; Article 1134.

⁹³ Corbisier (n88).

⁹⁴ Cass. Civ, April 25, 1952, D., 52, 635.

adoption of such an approach is primarily based upon the aversion to judicial intervention in the context of French law.⁹⁵ In other words, if a third party empowered to set the price failed to do so, courts would essentially be re-writing the contract by substituting a new mechanism for price determination – for instance, by implying a price into the contract themselves or empowering another third party to do so.⁹⁶

One party is empowered to set the price

Before 1995, while ascertaining the validity of a price term that empowered one party to set the price, the first question courts would consider was the balance of the bargaining power between the parties.⁹⁷ If the court found that the parties possessed equal bargaining power ex-ante, the court would move on to determine whether the power so provided is completely discretionary or whether the contract places objective limits on the exercise of such discretion.⁹⁸ Such an approach was based upon the consideration of protecting the party which was placed in a weaker position as a result of the price term. Thus, a court would not validate a contract which provided unfettered discretion to one party in setting the price. Rather, such a price term would be validated if it was phrased in a manner whereby it was to conform to some objective standards not entirely within the control of the party setting the price.⁹⁹

The approach adopted by courts in instances where the parties did not possess equal bargaining power was much more restrictive. In such instances, the court did not consider whether the contract placed objective limits on the exercise of the power to set price, but rather with the possibility that one of the parties may use such power opportunistically in the drafting of the price term.¹⁰⁰ It was considered immaterial whether the greater bargaining power had actually been used in an opportunistic

⁹⁵ See CC, Article 1592.

⁹⁶ See the *Pompistes de marque* decisions of 1971.

⁹⁷ *ibid.*

⁹⁸ *ibid.*

⁹⁹ Thus a clause stating that the price charged would conform to the price charged by the seller to its most favoured buyer is considered objectively determinable, in that objectively ascertainable limits have been placed upon the discretion of the party in setting the price.

¹⁰⁰ See *Pompistes de marque* cases Cass. ass. plin., Dec. 1, 1995, D. 1996, Jur. 13.

manner. Rather, the mere existence of imbalance in the bargaining power was considered sufficient for the invalidation of such agreements.¹⁰¹

This approach, it is argued, would operate to drive small and medium firms out of business since such firms, as a result of their size, would not be able to enter into contracts with large firms that preferred to leave the price term open in such a manner. Secondly, this approach did not take the reality of the world of commerce into account, wherein contracts with open price terms that empower one party to set the price are frequently entered into and performed without dispute. Moreover, such an approach gives primacy to concerns of protection of the weaker party, over and above concerns of efficiency. Economic efficiency is undermined since a court would invalidate a contract due to the possibility of arbitrariness in setting of the price, even though no such arbitrariness is found in fact. Such an approach, it is argued, operates to allow parties to act opportunistically, since they may have a contract set aside whenever they find a better deal elsewhere. Various commentators therefore argued that rather than invalidating the contract, which seems to be overkill, courts should simply sanction opportunism in the setting of the price by the dominant party.¹⁰²

These concerns led courts in France to reconsider its interpretation of the Article 1591. In particular, the court realized that its policy of invalidating price terms that left the determination of the price to one of the parties, based on concerns of protecting the weaker party, was doing more harm than good.¹⁰³

In 1995, the Court of Cassation, was called upon to adjudicate upon a set of four cases which concerned the use of open price terms in contracts for the sale of goods.¹⁰⁴ In the seminal judgment delivered by the full court of twenty five judges, it was held that the dictates of Article 1591 were satisfied by a term which allowed

¹⁰¹ Corbisier (n 88)

¹⁰² Louis Vogel, *Plaidoyer pour un revirement: contre l'obligation de détermination du prix dans les contrats de distribution* (D. 1995), Chron. 155, at 162.

¹⁰³ Specifically, this approach operated to invalidate almost all long-term agreements for sale and distribution of goods.

¹⁰⁴ The lower court had nullified these contracts under the rationale of the *Pompistes de marque* cases (n 101)

one of the parties to set the price.¹⁰⁵ Such a clause, according to the court, did indeed refer to a determinable price i.e. the seller's quoted price. The court, however, as is customary for civil law courts, did not provide reasons or attempt to define the phrase determinable. The court proceeded to state that the only requirement imposed upon the party setting the price was that it had to do so in good faith.¹⁰⁶ In essence, the court used the dictates of Article 1134 (and the requirement to act in good faith in particular) to take into account the needs and circumstances of contemporary commercial relationships while interpreting a code which was drafted at a time when environment of commercial transactions was very different.

In a nutshell the provisions of the civil code were interpreted to require:

- 1) A price term referring to the seller quoted price is valid.¹⁰⁷
- 2) The party empowered to set the price must do so in good faith.
- 3) If the requirements of point 2 above are not satisfied, then the innocent party may obtain damages or have the contract set aside.
- 4) A price term which is completely silent as to price does not fail for uncertainty.

Recourse to the provisions of Article 1134(3) – i.e. the requirement that parties act in good faith in setting the price – seems to represent a convergence towards the stance adopted under US law. In other words, the courts have abandoned the unconscionability approach in regulating the behaviour of the parties at the performance stage, in favour of using the concept of good faith to impose substantive obligations on the parties at both the formation and performance stage. According to Tomlinson, “These obligations are policy-based and, at the performance stage, require a party to inform, advise, and cooperate with the other party in achieving the expected benefits of the contract.”¹⁰⁸ Such an approach makes sense from an efficiency perspective; sharing of information and other forms of co-operation severely curbs the possibility of opportunistic behaviour and operates to reduce transaction costs. Unfortunately, the potential of reaping these benefits is greatly

¹⁰⁵ *Vassall*. D. 1996, Jur. at 18, J.C.P. 1996, 22565.

¹⁰⁶ French law therefore adopted a position similar to that of UCC Article 2-305(2) which reads, “A price to be fixed by the seller or by the buyer means a price for him to fix in good faith.”

¹⁰⁷ See *Vassall* (n 105).

¹⁰⁸ Tomlinson (n 81) 140.

undermined by the fact that French law has been unable to define what constitutes good faith in the setting of price. This has led commentators to fill the gap, resulting in a multitude of proposed definitions, none of which has been unanimously accepted.

4.3 The fault lines: an analysis of the Travaux préparatoires

Article 12 (which became Article 14) of the United Nations Commission on International Trade Law Draft (Draft Convention), and fell under Part 2 of the Convention, read:

(1) A proposal for concluding a contract addressed to one or more specific persons constitutes an offer 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.¹⁰⁹

Article 12 of the Draft Convention requires an offer to be sufficiently definite, which includes the requirement to expressly or implicitly fix or make provisions for determining the price. As such, an offer which does not establish price, or a method to determine it, will fail due to uncertainty. A bare reading of Draft Article 12 therefore suggests that the draft Convention did not recognize a contract that was completely silent as to price.¹¹⁰ The dictates of Draft Article 51 (became Article 55), which fell under Part 3 of the Convention, suggested otherwise however.

Draft Article 51, which had been formulated and adopted after ten years of deliberations before Part 2 of the Convention was voted upon, read:

¹⁰⁹ Legislative History, 1980 Vienna Diplomatic Conference, Draft Articles of the Convention submitted to the Plenary Conference by the First Committee, 4 April 1980, A/CONF.97/11/Add.1 and 2 <http://www.cisg.law.pace.edu/cisg/chronology/jdraft-04.html> accessed: 25 March 2014 (hereinafter referred to as 'Vienna Diplomatic Conference, Draft Articles').

¹¹⁰ While Draft Article 12 is concerned with the validity of an offer rather than of contract, most delegates present at the Eighth Meeting of the First Committee believed that a contract could only come into existence if made through an offer-acceptance formula, which required the offer to expressly or implicitly fix or make provisions for determining the price.

If a contract has been validly concluded but does not state the price or expressly or impliedly make provision for the determination of the price of the goods, the buyer must pay the price generally charged by the seller at the time of the conclusion of the contract. If no such price is ascertainable, the buyer must pay the price generally prevailing at the aforesaid time for such goods sold under comparable circumstances.¹¹¹

The existence of these seemingly contradictory articles can be attributed to the fault lines between the multitude of legal traditions present during the drafting stages of the Convention, on the issue of open price terms.

At the turn of the century, the domestic laws of various jurisdictions, identifying the need to provide the business community with flexibility in the formation of their agreements had begun to recognize the validity of contracts of sale that provided the basic terms of the contract but left the price open for later determination.¹¹² Other jurisdictions however were wary of the recognition of such terms. Developing nations, whose imports comprised of manufactured goods while their exports were predominantly raw materials, were concerned that the use of open price terms would shift the risk of price increase between the time the contract was entered into and the time of delivery entirely upon them.¹¹³ As a result, the use of open price terms would operate to their disadvantage.¹¹⁴ The domestic laws of certain industrialized European economies similarly viewed contracts with open price terms with a

¹¹¹ Draft Article 51 of the 1978 Draft Convention.

<http://www.cisg.law.pace.edu/cisg/text/secomm/secomm-51.html>

¹¹² For instance, the UCC explicitly recognizes contracts with open price terms. See UCC, § 2-305.

¹¹³ See S. K. Date-Bah, 'Problems of the Unification of International Sales Law from the Standpoint of Developing Countries' (1980) 7 *Digest of Commercial Laws of the World* 39, 47: "If a contract can be formed without an agreement on price, this would create the danger of buyers being landed, after vague negotiations, with sales contracts whose contract prices would be imposed by the courts: many such courts would be in the developed countries and could impose unreasonably high prices for manufactured goods. Such contract prices would tend to be the sellers' prices and, as is well-known, while the prices of the raw materials exported by the developing countries are generally fixed in the commodity markets of the developed world, the prices of manufactured goods are usually determined by the manufacturers themselves;" Professor Schlechtriem similarly states, "Price transparency is a given at most for raw materials, i.e., for the products of the developing countries, but not for the industrial goods imported by these countries." Peter Schlechtriem, *Uniform Sales Law: the UN-Convention on Contracts for the International Sale of Goods* (Manz 1986) 50.

¹¹⁴ *Ibid.*

degree of hostility,¹¹⁵ especially in the case of exclusive dealing contracts and franchise contracts.¹¹⁶

Socialist countries were also averse to the concept of open price terms as a result of the fact that their contracts had to conform to the “predetermined macroeconomic government plan.”¹¹⁷ As a result, the domestic law of these states gave primacy to the security of the contract and foreseeability. For this reason, under the domestic law of socialist states at the time of drafting, open price contracts were considered invalid.¹¹⁸

Deliberations on the issue of the extent to which the Convention should recognize open price terms were spread over four meetings of the First Committee. This part of the chapter shall highlight the concerns raised in each.

4.3.1 Eighth Meeting of the First Committee

At the Eighth Meeting of the First Committee, Article 12 of the Draft Convention came under review. The primary cause of controversy at the meeting was the requirement contained in the second sentence of Draft Article 12(1), which required that the price of the goods be fixed expressly or implicitly. The stance adopted by delegates on the issue can roughly be divided into three categories: a) those who advocated for complete flexibility and the rejection of the prescriptive formalism of the second sentence b) those who wished to retain the sentence for its value of listing examples of what constitutes a sufficiently definitive offer and c) those who argued for the retention of formalism as a result of aversion to flexibility on the matter.

Complete flexibility: a rejection of formalism

¹¹⁵ Though for separate reasons. See, for example, the objection raised by the delegate of France during the Eighth Meeting of the First Committee, reproduced in Part 2 of this chapter.

¹¹⁶ See for example Judgment of Dec. 13, 1982, Arrdt No. 1062, Cass. civ. Comm.

¹¹⁷ See Garro (n 15).

¹¹⁸ Rosett argues at 285, “The representatives of centrally planned, authoritarian economies [are not] likely to place great value on private autonomy, the right of parties to opt out of legal regimes by contract, or opportunities for informal, unwritten contracts.” Arthur Rosett, ‘Critical Reflections on the United Nations Convention on Contracts for the International Sale of Goods’ (1984) 45 Ohio State Law Journal 265.

The delegates of UK, Austria, US, Norway and Finland were particularly concerned with the formalism contained in the article and submitted proposals for the deletion of its second sentence.¹¹⁹

The delegate of the United Kingdom, Mr. Feltham, argued that if a state had ratified both Part II and III of the Convention, there would be a great deal of uncertainty regarding the fate of a contract that did not stipulate the price.¹²⁰ He therefore opined that the apparent inconsistency between the two articles should be remedied by omitting the second sentence of Draft Article 12(1) from the final text of the article. Such omission, in his view, was necessary, since Article 51 clearly stipulated the methodology to be adopted in ascertaining the price where the contract did not expressly contain one.¹²¹ Retention of the sentence would therefore do nothing more than give rise to uncertainty regarding the interplay between the two articles.¹²²

The delegates of Ireland and the US similarly questioned the utility of the sentence. They stated that if the sentence was setting down a rule, then it was unsatisfactory, since it did not cater for various other factors that might be of similar importance such as the time of delivery, currency of payment etc.¹²³ On the other hand, if the sentence was simply listing examples of factors that might give rise to a valid offer, then it was unnecessary for the purposes of the Convention.¹²⁴

¹¹⁹ Both Finland and Norway were similarly concerned with the prescriptive nature of the article. They therefore submitted amendments whereby the second sentence would either be deleted, failing which the article would be redrafted in a manner that rendered the existence of a proposal completely dependent upon the intention of the parties. For the proposal of Norway see Para 71 and for the proposal of Finland see Para 78, Vienna Diplomatic Conference (n 8). Proposed Amendments [Finland (A/CONF.97/C.1/L.29)] and [Norway (A/CONF.97/C.1/L.38)] can be found in Legislative History, 1980 Vienna Diplomatic Conference G. Report of the First Committee, A/CONF.97/11 <http://cisgw3.law.pace.edu/cisg/1stcommittee/summaries29.html> accessed: 25 March 2014 (hereinafter referred to as 'Vienna Diplomatic Conference, G. Report').

¹²⁰ Vienna Diplomatic Conference (n 10) Para 68.

¹²¹ *ibid.*

¹²² Document A/CONF.97/C.1/L.36 in Vienna Diplomatic Conference, G. Report (n 119). The delegates of the Republic of Korea and Sweden supported the proposal of the delegate of the UK on the grounds that the realities of international trade required flexibility in terms, especially those on price. The delegate of Sweden stated, "Although in most cases prices were indicated, contracts were often concluded without any specification of prices, more attention being paid to other important conditions, such as, for example, speedy delivery in the case of inexpensive spare parts." Paras 91.

¹²³ *ibid* Para 81.

¹²⁴ *ibid.*

The middle ground

The delegate of Belgium was of the opinion that the existence of a contract should be objectively determinable, and consequently, the existence of the second sentence was crucial as it provided certain instances of when a proposal would amount to an offer.¹²⁵ The delegate did not, however, view the sentence as prescribing a concrete methodology, derogation from which would render an offer invalid.¹²⁶ Rather, Professor Dabin specifically stated that the utility of the second sentence lay in the fact that, rather than stipulating a rule, it simply listed examples of instances where an offer would be valid.¹²⁷ Thus, in his view, the Convention did indeed allow for open price terms so long as the existence of the contract was “objectively determinable.”¹²⁸

Complete certainty: the need for formalism

The delegates of Spain, Hungary and Greece, on the other hand, favored certainty and argued for the retention of the sentence.¹²⁹ They argued that the existence of the elements listed in the sentence were necessary to determine the existence of an offer, without which it would be difficult or even impossible to determine whether a contract had indeed been concluded. They therefore argued for a formalist approach towards the ascertainment of whether a contract existed.¹³⁰

The delegate of France, however, supported the retention of the sentence on different grounds. Ghestin argued that rather than being a question of flexibility versus certainty, the article was required as a matter of procedural fairness. Giving the

¹²⁵ See Vienna Diplomatic Conference (n 10) Para. 72.

¹²⁶ The delegate of Egypt agreed with this interpretation. Vienna Diplomatic Conference (n 10) Para 70.

¹²⁷ *ibid.* “Finland, Norway and Sweden agreed with this interpretation and stated that the second sentence, as it stands, should be understood to give only an example of what is a definite offer but that it should not be understood to be a definition.” Legislative History, 1980 Vienna Diplomatic Conference, F. Analysis of Comments and Proposals by Governments and International Organizations on the Draft Convention on Contracts for the International Sale of Goods, and on Draft Provisions Concerning Implementation, Reservations and Other Final Clauses Prepared by the Secretary-General Document, A/CONF.97/9, 21 February 1980 <http://www.cisg.law.pace.edu/cisg/Fdraft.html> accessed: 25 March 2014 (hereinafter referred to as ‘Vienna Diplomatic Conference, F. Analysis’).

¹²⁸ *ibid.*

¹²⁹ See Vienna Diplomatic Conference (n 10) Paras 74, 75, 79 and 80.

¹³⁰ *ibid.*

example of raw materials, he argued that while it was difficult to determine the price of such goods ex-ante, especially in the case of long-term contracts, it would be patently unfair on the weaker party to be subject to prices upon which it had no control.¹³¹ Thus the delegate of France was simply concerned that absent the requirement of a fixed price, one of the parties could well find itself in a position where it would have to agree to the price charged by the other, without having the opportunity to bargain.¹³²

The delegate of the USSR, as explained above, was concerned that the recognition of the validity of open price terms would operate to undermine the planned macro-economic policies of his state. The delegate therefore argued for the deletion of the phrase “expressly or implicitly,” to rule out the possibility of an offer being recognized even though it did not explicitly identify the price.¹³³

The proposals to amend the article to either omit reference to the implicit fixing of price and those calling for a deletion of the second sentence were rejected.

4.3.2 Eleventh Meeting of the First Committee

At the Eleventh Meeting of the First Committee, the Working Group submitted two proposals whereby the dictates of the second sentence would be made more flexible.¹³⁴ Both proposals had the same impact, which was to turn into mere examples the requirements listed for a proposal to be “sufficiently definite.”¹³⁵ Before the proposals were put to vote, the Chairman specifically noted the inconsistency between the two articles and supported the adoption of a proposal that

¹³¹ Interestingly, at the time of drafting French law policed open price terms with the view of “protecting the weaker party.” See Tomlinson (n 81).

¹³² See Vienna Diplomatic Conference (n 10) Para 82.

¹³³ Union of Soviet Socialist Republics (A/CONF.97/C.1/L.37): “In paragraph 1, delete the words ‘or implicitly’, or the words ‘expressly or implicitly’, in order to avoid complications that may arise in interpreting the idea of *implicit* fixing of the procedure for determining the quantity and the price, particularly in the light of the examples given in the Secretariat’s commentary on Article 12 of the draft Convention [became CISG Article 14] (paragraphs 14 - 17).”

¹³⁴ Legislative History, 1980 Vienna Diplomatic Conference, Summary Records of Meetings of the First Committee, 11th Meeting, 18 March 1980, Para 47 <http://www.cisg.law.pace.edu/cisg/firstcommittee/Meeting11.html> accessed: 26 March 2014 (hereinafter referred to as ‘Vienna Diplomatic Conference, 11th Meeting’).

¹³⁵ The two proposals did not garner the necessary support for their adoption.

would have the impact of remedying the apparent inconsistency between them, thereby allowing for the adoption of the Convention as a whole without concerns of inconsistency between, at least, the two articles.¹³⁶

The delegate of Ghana, however, did not see a contradiction between the dictates of the two articles. In his view, Article 12 simply stated that for a proposal to be considered an offer it must stipulate the price. Article 51, on the other hand, was concerned with the price to be implied in situations where a contract had been validly concluded in conformity with domestic laws that recognize contracts with open price terms.¹³⁷ While such an interpretation would remedy the perceived inconsistency between the two articles, it was not discussed further, for reasons unknown.

4.3.3 Twenty-fourth Meeting of the First Committee

At the Twenty-fourth Meeting of the First Committee, the proposal to delete Article 51 was brought to vote. The issue at this stage was the apparent contradiction between the provisions of Articles 12 and 51. The delegate of Ghana noted that the delegates had adopted varying and at times contradictory interpretations of the interplay between the two articles. Thus, while he favored the retention of the article, he was concerned that its current text would give rise to a great deal of confusion on the interplay between Articles 12 and 51, thereby placing obstacles in the adoption of the Convention by various states.¹³⁸

The delegate of Chile similarly noted that the existence of Article 12 in its current formulation would operate to deter various Latin American countries from ratifying the Convention, since their domestic laws recognized and the realities of

¹³⁶ Vienna Diplomatic Conference, 11th Meeting (n 134) Para 49.

¹³⁷ Vienna Diplomatic Conference, 11th Meeting (n 134) Para 66

¹³⁸ Legislative History, 1980 Vienna Diplomatic Conference, Summary Records of Meetings of the First Committee, 24th Meeting, 26 March 1980, Para 27

<<http://www.cisg.law.pace.edu/cisg/firstcommittee/Meeting24.html>> accessed: 26 March 2014 (hereinafter referred to as ‘Vienna Diplomatic Conference, 24th Meeting’).

international trade required the use of open price terms. Thus, in his view, the existence of Article 51 in its current form would operate to motivate such countries to at least ratify Part III of the Convention, even though they might not ratify Part II.¹³⁹

The delegate of France submitted a proposal whereby Article 51 would be amended to bring it in line with the dictates of French law on the matter.¹⁴⁰ According to this amendment, a contract that does not stipulate the price would be valid under the Convention if it provides guidelines for determining it.¹⁴¹ Like the stance adopted by French domestic law at the time, the amendment – if accepted – would outlaw instances of procedural unfairness while continuing to recognize certain types of open price terms, such as reference to an index or empowering a third party to set the price.¹⁴² This, in the view of the delegate, would serve the interest of those delegates who were concerned with the difficulty of setting a price in long-term contracts. Price terms empowering one party to set the price, or leaving the price to the future agreement between the parties, would however fail on the grounds of being indeterminable at the time the contract was concluded. This would resolve the concerns of certain delegates against the price not being determinable ex-ante.¹⁴³

The delegate of Australia however objected to the amendment proposed by France on the grounds that a search for a compromise solution should not come at the cost of jeopardizing the ability of the Convention to cater for the realities of trade. Specifically, he was concerned that the requirement of providing guidelines for determining the price did not conform to commercial practice. “In reality, many contracts contained no guidelines whatsoever for the price fixing procedure. He believed that Article 51 as originally drafted constituted a reasonable solution.”¹⁴⁴

Interestingly, the delegate of Ghana completely changed his view on the interplay between the two articles. Contrary to the interpretation adopted by him at the

¹³⁹ Ibid, Para 31.

¹⁴⁰ Ibid. (A/CONF.97/C.1/L.205) Para 43.

¹⁴¹ Ibid.

¹⁴² That is, the possibility of price being imposed upon one party by the other without the possibility of negotiations on its quantum.

¹⁴³ (n 138) Para 44.

¹⁴⁴ Ibid. Para 53.

Eleventh Meeting whereby he felt the articles could be read in a harmonious manner, the delegate stated that Article 51 was naturally “subordinate” to Article 12. This according to him was evidenced by the fact that Article 51 began with the statement, If a contract has been validly concluded. He was therefore of the opinion that Article 51 would only be applicable in cases where a contracting state had not ratified or accepted Part II of the Convention.¹⁴⁵

4.3.4 Twenty-ninth Meeting of the First Committee

At the Twenty-ninth Meeting of the First committee, an *ad hoc* Working Group, comprising the representatives of Argentina, France, Ghana, Pakistan, Sweden and the USSR was given the task of revising the text of Article 51 to make it more acceptable to the delegates. The proposal attempted to resolve the two major grounds for disagreement between delegates on the issue of the recognition of open price terms.¹⁴⁶ The first concerned the relationship between Articles 12 and 51, which was resolved by retaining the opening phrase of Article 51 which states that the article is applicable only “where a contract has been validly concluded.”¹⁴⁷

The representative of Greece rightly pointed out that reference to a validly concluded contract was meant to cover validity under the national law, validity under the Convention and even validity under a combination of both.

The second issue concerned the last sentence of the article, whereby the buyer would have to pay the price generally charged by the seller at the conclusion of the contract. Since the delegates of various jurisdictions (for example, France and the USSR) had raised serious concerns against providing one party a greater degree of control, relative to the other, in setting the price, the sentence had to be amended. This was achieved by replacing the sentence with one that referred to “the price generally charged at the time of the conclusion of the contract.”¹⁴⁸ It is unclear why the

¹⁴⁵ Ibid. Para 54.

¹⁴⁶ Legislative History, 1980 Vienna Diplomatic Conference, Summary Records of Meetings of the First Committee, 29th Meeting, 31 March 1980, Para 45 (A/CONF.97/C.1/L.232) (hereinafter referred to as ‘Vienna Diplomatic Conference, 29th Meeting’).

¹⁴⁷ Ibid.

¹⁴⁸ Para 46. The joint proposal was adopted by 29 votes to 4.

Working Group chose this methodology over one referring to the price at the time of delivery. Certainly, if the parties wished to be bound by the price charged at the time the contract was concluded, they could have easily done so, as its quantum would be easily determinable. Moreover, such a methodology would not be efficient relative to one referring to the spot price at the time of delivery in the case of long-term contracts, which leave the price open simply because of uncertainty.

The discussion above illuminates the fact that there was little, if any, clarity surrounding the interplay between the two articles even when they were finally adopted. While certain delegates believed Article 51 to be relevant when a state had not ratified Part II of the Convention, others did not see any apparent contradiction between the two since they viewed them to be concerned with completely different issues. Even though the proposal of the ad hoc Working Group was adopted, there is little evidence that all delegates agreed that the impact of the term “where a contract has validly been concluded” was to harmonize the dictates of the two articles.

It is clear, however, that while all recognized that the realities of international trade had given rise to the need for flexibility in setting the price term, the question was simply whether the utility of such flexibility outweighed the utility of certainty. In other words, the issue was simply whether flexibility could be provided without undermining the advantages of certainty, which had historically been valued under the domestic laws of various jurisdictions.

4.5 Open price terms under the Convention

Parties to long-term contracts seldom conclude their contracts following a mechanical offer-acceptance formula. This gives rise to the question of whether the Convention, through the dictates of Part II – Article 14 in particular – only recognizes contracts formed through such a methodology.¹⁴⁹ If the answer to the question is in the affirmative, then one may easily conclude that the dictates of the Convention do not represent or effectively complement commercial realities, and as

¹⁴⁹ The travaux reveal that various delegates indeed wished for the Convention to limit recognition of contracts to those formed following the mechanical formula. See, for example, the comments made by the delegate of the USSR at the Eighth Meeting of the First Committee.

a result parties concluding contracts through a method other than the offer-acceptance formula would be better off by expressly derogating from the application of the Convention. Such an outcome would completely undermine the whole purpose of the unification exercise, namely to unify the law and provide a degree of certainty to the parties vis-à-vis their respective rights and obligations.

In order to ascertain whether the Convention allows for the formation of contracts that do not follow the offer and acceptance mechanism it is first essential to understand the interplay between Article 4 and the rules on formation. The first sentence of Article 4 expressly notes that formation of contracts for sale fall within the scope of the Convention. Consequently, through the application of Article 7, the text of the Convention is the sole source of identifying the recognized methodologies of contract formation.

Moreover, even though Article 4 differentiates between validity (which falls outside the scope of the Convention) and formation, there is one area of over-lap between the two i.e. a valid contract cannot be concluded unless the rules of formation as included in the Convention are satisfied. This overlap translates into the fact that, on issues of contract formation, validity is indeed part of the Convention. Validity here would include defenses to enforcement and the requirement of conforming to the mechanics of consent (as opposed to the validity of consent which is governed by the applicable law identified through the rules of PIL).

Therefore, the question of whether contracts that do not conform to the offer and acceptance formula are recognized by the Convention must be answered through a review of the articles of the Convention itself.

The Convention undeniably allows for the formation of contract through means other than the offer-acceptance formula; for instance, Article 18(3) provides that a contract may be concluded “by performing an act,” and Article 8(3) provides that statements (including terms of agreements) are to be construed in the light of “any subsequent conduct of the parties.” It therefore makes sense to state that Article 14 is concerned only with whether a communication should be construed as an offer and does not limit or have any implications on the validity of a contract of sale that does

not conform with the offer-acceptance mechanism. As such, parties who wish to enter into long-term contracts are not limited by the dictates of Article 14 on the methodology they may adopt; rather, Article 14 simply provides one of the methods of contract formation.

The fact that the Convention is the sole source of rules of formation on contracts that are governed by it is not unanimously accepted. As shall be discussed below, certain commentators view the dictates of Article 14 to be a *sine qua non* for the formation of a valid contract; these commentators limit the application of Article 55 to instances where the member state has entered into a reservation vis-à-vis Part II of the Convention. Another view holds that since Article 4 expressly omits concerns of validity from the scope of the Convention, Article 55 is solely concerned with cases where the contract has been validly concluded through the application of domestic law identified through the rules of PIL. This chapter will now turn to analyze each of these views.

Under the most restrictive view, Article 14 is given precedence over Article 55; as such, implicit or explicit stipulation of price is considered a *sine qua non* for the formation of a valid contract.¹⁵⁰ Professor Farnsworth, for instance, contends that contracts with open price terms cannot be recognized under the Convention, since under Article 55, a price term may be implied “where a contract has been validly concluded” and under Article 14 a contract cannot be validly concluded without a sufficiently definite price term.¹⁵¹

Various courts have adopted this position while interpreting the interplay between Article 14 and 55. In one famous case, for instance, the court held that a contract for the sale of aircraft engines had not been validly concluded since it did not include the price for all the types of aircraft engines from which the buyer could

¹⁵⁰ In one case concerning a contract with open price terms the court concluded: “It is necessary [for the application of Article 55] to assess whether a contract of sale has been concluded and whether it is valid.” Supreme Court, Czech Republic, 25 June 2008 <<http://cisgw3.law.pace.edu/cases/080625cz.html>> accessed: 27 March 2014; see also, CLOUT case. No. 908 [Handelsgericht Zürich, Switzerland, 22 December 2005] <<http://cisgw3.law.pace.edu/cases/051222s1.html>> accessed: 27 March 2014.

¹⁵¹ E. Allan Farnsworth, ‘The Vienna Convention: History and Scope’ (1984) 18 The International Lawyer 17.

choose.¹⁵² As such, according to the court, the proposal for the sale of jet engines did not constitute an offer under the provisions of Article 14(1). Though the case was primarily decided on the basis of the provisions of Article 14, the court did consider Article 55 in passing and stated that the price of the jet engines could not be determined on the basis of Article 55 since “jet engine systems have no market price.”¹⁵³ However, it would have made no difference even if the jet engines had a market price. This is because the court’s reasoning, in line with the restrictive view, gave the provisions of Article 55 a secondary position in relation to the provisions of Article 14. The court resultantly decided the case on the basis of the requirements of a valid offer as contained in Article 14, and concluded that absent a sufficiently definite provision on price, no valid offer existed.¹⁵⁴

Professor Garro attempts to resolve this inconsistency by stating that Article 55 was incorporated to respond to the desire of the Scandinavian countries to accept Part III of the Convention without Part II, and to have a provision in Part III in case the price has not been determined.¹⁵⁵ While *prima facie* this argument makes sense, it is neither in line with the interpretational methodology to be adopted under the Convention nor is it supported by the travaux.

This is because, if Article 55 was incorporated only to apply where a member state has made reservations vis-à-vis Part II of the Convention, then the article would be rendered redundant in cases where Part II has been incorporated. Such a stance does not appreciate the fact that each article of the Convention has equal legitimacy and value. Nor does it recognize the fact that the primary proponents of the inclusion of Article 55 were the delegates of the United States, Belgium and Austria – none of whom have entered into a reservation vis-à-vis the application of Part II of the

¹⁵² CLOUT case No. 53 [Legfelsbb Biróság, Hungary, 25 September 1992]
<<http://cisgw3.law.pace.edu/cases/920925h1.html>> accessed: 27 March 2014

¹⁵³ *ibid.* The judgment of this case rested on the fact that the buyer had the option to choose which jet engines to buy even after the purported acceptance. The court was therefore of the opinion that this right to choose on behalf of the buyer translates into the fact that the buyer could not have conveyed a valid acceptance even if the term on price had been sufficiently definite.

¹⁵⁴ According to Flechtner (a proponent of the liberal view), the court ignored the autonomous character of the Convention and interpreted it through a domestic lens. He states, “The decision ignores the international character of the Convention by straining for an interpretation favorable to the party of the same nationality as the court.” Harry M. Flechtner, ‘The Several Texts of the CISG in a Decentralized System: Observations on The Uniformity Principles in Art 7(1) of the UN Sales Convention,’ (1998) 17 *Journal of Law and Commerce* 187, 205.

¹⁵⁵ See Garro (n 15) 463.

Convention. Indeed, it would be quite surprising for a US-trained practitioner to learn that even after great efforts of the US delegate to have open price terms recognized under the Convention, the same is not applicable to the US itself.

In any case, only certain Scandinavian states, totaling only 4 out of 83 contracting states, opted to enter into a reservation through the invocation of Article 92 of the Convention. There seems to be no evidence that this reservation was made as a result either of the apparent contradiction between Articles 14 and 55 or because these states were opposed to open price terms.¹⁵⁶ In fact, the domestic law of these states expressly recognizes open price contracts. For instance the Swedish Act of 1905 on the Purchase of Goods states (Art. 5): “Where a contract purchase has been concluded without the price having been fixed, the buyer must pay what the seller demands unless it is deemed unreasonable.”¹⁵⁷

The limitations of the approaches that give precedence to Article 14 over 55 can be highlighted through the recognition of the fact that in various cases the contract is not concluded by a clear-cut exchange of offer and acceptance, but by a series of communications or by simply executing a contract of sale.¹⁵⁸ If the rules contained in Article 14 are to be followed, then such contracts can never be validly concluded. Such a result has great implications on the world of trade; it would outlaw all forms of agreements unless they adhered to the mechanical rules of offer and acceptance, thereby creating a firm barrier in what has otherwise long been considered an appropriate method of contracting. The travaux in any case clearly reveal that the drafters were concerned with the possibility of such an interpretation and consequently, incorporated the term “where the contract has validly been concluded” at the beginning of Article 55. It is therefore asserted that the text of Article 55 is sufficient in itself to displace such an interpretation.

¹⁵⁶ On the contrary, the travaux reveal that they actually supported the retention of Article 51 of the draft Convention and argued against the retention of the second sentence of the draft Article 12(1).

¹⁵⁷ John O. Honnold, *Uniform Law for International Sales under the 1980 United Nations Convention* (3rd edn, Kluwer Law International 1999) 353-357.

¹⁵⁸ Loukas Mistelis, ‘Article 55 CISG: The Unknown Factor’ (2005) 25 *Journal of Law and Commerce* 285; See also, Gabuardi, Carlos A, ‘Open price terms in the CISG, the UCC and Mexican Commercial Law.’ *Review of the Convention on Contracts for the International Sale of Goods (CISG)* (2002). <<http://www.cisg.law.pace.edu/cisg/biblio/gabuardi.html>>.

According to another view, any issue hinging on the validity of a contract due to open price terms, must be resolved by recourse to domestic law, since Article 4 excludes questions relating to the validity of contracts from the scope of the Convention. As such, proponents of this school of thought argue that before the provisions of Article 55 can be applied, it must be ascertained whether the law applicable by virtue of the choice-of-law rule recognizes contracts of sale that do not stipulate a fixed or determinable price.¹⁵⁹ If the domestic law so identified recognizes the validity of contracts that do not contain a price term, then the court is to imply the price charged at the time of conclusion of the contract into the agreement, as required by Article 55.¹⁶⁰ This view fails to appreciate the fact – as eloquently phrased by the delegate of Greece during the Twenty-ninth Meeting of the First Committee – that reference to a validly concluded contract in Article 55 was not confined to the question of validity under national law as identified through the application of the rules of PIL. Rather, “it was meant to cover validity under the national law,¹⁶¹ validity under the Convention,¹⁶² and even validity under a combination of both.”¹⁶³ As such, reference to a validly concluded contract at the beginning of Article 55 includes contracts that have validly been concluded under the dictates of the Convention as well.

According to the most liberal view, a contract which does not expressly or implicitly set price may nonetheless be valid on the basis of the subsidiary method of determining price set forth in Article 55. Professor Honnold adopts this position and argues that since the provision “impliedly [makes] reference to the price generally charged at the time of the conclusion of the contract, [a contract cannot be] declared void on the grounds of its failure to stipulate price.”¹⁶⁴ Whereas Article

¹⁵⁹ For instance, an arbitral tribunal stated, “Since, article 4 CISG, does not deal with the validity of the contract itself, its validity has to be determined according to the applicable national law.” International Commercial Arbitration Court at the Chamber of Commerce and Industry of the Russian Federation, Russian Federation, 30 May 2001
<<http://cisgw3.law.pace.edu/cases/010530r2.html>> accessed: 27 March 2014.

¹⁶⁰ *ibid.*

¹⁶¹ Which would include the concept of the validity of consent; defences to enforcement such as mistake and fraud; and the validity of substantive content of the agreement – for example, whether the subject matter of the agreement is illegal.

¹⁶² For example, the dictates of Article 29.

¹⁶³ Vienna Diplomatic Conference (n 147) Para 57.

¹⁶⁴ He states: “[B]y virtue of these articles, when the parties have made no provision concerning the price their intent to conclude the contract must be clear, but the Convention does not deny effect to that intent.” See Honnold (n 157) 137.

14 (1) requires that the price be at least implicitly fixed, Article 55 indicates that a contract with open price terms is valid with an “implicit” price fixed by operation of law – i.e. the price “generally charged at the time of the conclusion of the contract.”¹⁶⁵ In other words, once a contract is concluded, the validity of an offer becomes irrelevant (which constitutes the scope of Article 14(1)) irrespective of whether a provision was made for determining the price.¹⁶⁶ Professor Honnold’s opinion seems to be the correct one, at least to the extent that it is conceivable and even plausible to reconcile the two provisions.¹⁶⁷ The opinion, however, seems to suggest that a contract formed through the offer-acceptance formula may be valid even if the offer did not contain a provision on price. Such a conclusion is extremely surprising as it raises the following question: what is the utility of stipulating requirements for a proposal to amount to an offer in the chapter on formation of contracts, if a contract based on the offer-acceptance formula may be valid even though it does not fulfill the requirements contained in the article? In any case, such an interpretation completely undermines the hard-won compromise by states that advocated for formalism in the drafting of Article 14.

The following conclusions regarding the application of Articles 14 and 55 can be reached for the discussion above:

- 1) Article 14 is only concerned with communications that purport to be offers and not with the validity of contracts formed through a methodology other than a mechanical offer-acceptance formula.
- 2) The Convention recognizes that contracts can be made without following the two-step offer-acceptance formula.
- 3) Article 55 operates when a contract has validly been concluded following a methodology other than the mechanical offer-acceptance formula.

4.5.1 To what extent are open price terms recognized under the Convention?

¹⁶⁵ Gyula Eörsi, ‘Comments on Article 14 CISG [Offer]’ in C. Massimo Bianca and Michael Joachim Bonell, *Commentary on the International Sales Law: The 1980 Vienna Sales Convention* (Giuffrè 1987) 139.

¹⁶⁶ Joseph P. Griffin and Michael R. Calabrese, ‘The New Rules for International Contracts’ (1988) 74 ABA Journal 62.

¹⁶⁷ Professor Honnold’s opinion is supported by various other scholars. See Schlechtriem (n 113).

4.5.2 Article 14

As explained above, where a contract is formed through the offer-acceptance formula, the proposal – to be considered an offer – must establish the price either explicitly or implicitly, or make provisions for determining it. While there is no issue surrounding the interpretation of the term “explicitly,”¹⁶⁸ there is disagreement on what implicit fixing of the price and provisions for determining it entail.

4.5.3 Where the parties are silent as to price

The dictates of Article 14 clearly state that a proposal for concluding a contract will not amount to an offer if it is completely silent as to price.¹⁶⁹ As such, parties concluding a contract on the basis of the offer-acceptance formula must make some reference to the price to be charged. One tribunal has, however, found otherwise. In the *Computer hardware devices* case,¹⁷⁰ a German seller brought a claim for payment of purchase price against a Swiss buyer. The contract between the two, the seller asserted, was formed following the acceptance of the offer sent by the buyer. The buyer argued that a contract had never come into existence since the proposal it sent did not contain any stipulation on price. The court rejected the buyer’s argument on the grounds that the circumstances clearly showed that the parties intended to be bound by the agreement.

The reasoning of the court, though very brief, clearly shows that the court adopted an interpretation which was in line with the dictates of German domestic law on the matter.¹⁷¹ Unfortunately, however, the court following the concise, discussion-less nature of judgment drafting in civil law countries did not provide any reason for the adoption of such an approach.¹⁷² Interestingly, however, the court did state that any

¹⁶⁸ A price is explicitly fixed when the contract stipulates a numerically concrete quantum.

¹⁶⁹ The only exception to this rule is where the parties have established a practise between themselves on the matter, or there exists a trade custom/usage on pricing. See CISG, Article 9.

¹⁷⁰ CLOUT case No. 330 <<http://cisgw3.law.pace.edu/cases/951205s1.html>>.

¹⁷¹ Handelsgericht St. Gallen, Switzerland, 5 December 1995 <<http://cisgw3.law.pace.edu/cases/951205s1.html>> accessed: 28 March 2014.

¹⁷² The only reasoning provided on the point is “Owing to the terms ‘order,’ ‘we order’ and ‘delivery due immediately,’ the recipient may have and must have assumed that, from the side of the orderer, an

seller would have interpreted the proposal in accordance with the requirements of the principle of good faith to constitute an offer. Such a ruling is surprising since, as discussed in Chapter 2, the Convention does not directly impose any substantive requirement of good faith on the parties in the interpretation of the underlying contract.

4.5.4 One party is empowered to set the price

Under the Convention, one party may not possess the power to unilaterally determine the price at a later stage. While there is no express provision to this effect, to allow this would be in complete contradiction with the general principles of the Convention. For instance, the underlying spirit of Articles 8, 9, 18, 19 and 29 rests on the principle that all terms must be agreed between the parties and no party shall have the power to impose any requirement on the other without the other party's prior consent.

However, this should not be interpreted to mean that the Convention imposes an absolute bar on the possibility of empowering one party to settle the price. Rather, the impact of the principle upon which these provisions are based, coupled with the dictates of Article 14, simply require that the mechanism for setting the price should be one that allows a neutral observer to determine the same. As such, the Convention would allow for a mechanism which empowers one of the parties to set the price, so long as the mechanism is one that requires the use of an objective standard while exercising the discretion. Take for instance the ruling of the *Magnesium case*, which involved a contract for the sale of magnesium on a provisional price, which was to be revised once the magnesium had been resold by the buyer.¹⁷³ A bare reading of the price term, the court noted, seemed to suggest that the buyer was empowered to revise the price without limitation on the exercise of this discretion. Such a mechanism, as discussed above would operate to undermine the general principle

intention to be bound to the purchase of the plotters existed (*cf. v. Caemmerer/Schlechtriem*, para. 13 on Art. 14 CISG); delivery took place and the invoice was sent within a few days.”

¹⁷³ ICC Court of Arbitration, Paris, 1995

<<http://www.unilex.info/case.cfm?pid=1&do=case&id=240&step=FullText>> and

<<http://www.unilex.info/case.cfm?pid=1&do=case&id=240&step=Abstract>> accessed: 28 March 2014.

upon which Articles 14, 8, 9, 18, 19, 29 and 55 are based. The court however noted that the circumstances surrounding the agreement revealed the fact that the parties had concluded the agreement on the basis of cordial relations that existed between them. Moreover, the provision on price simply demonstrated that the parties were relying on relational factors rather than legal ones in establishing the rights and obligations of each party.

Noting the relational nature of the transaction, the court proceeded to ascertain whether the relationship between the parties would indicate an objective criterion to be followed while setting the price. In other words, the court applied the provisions of Articles 8 and 9 to determine whether the parties had established any practices between themselves or whether a custom on price existed in the trade concerned. The court argued that there was no ascertainable market price for magnesium and consequently, parties involved in the sale and purchase of the mineral would usually determine the price on the basis of a host of factors including “the cost of transport, the quality of the mineral, the quantities bought, the link between each of them which can result in linking clause establishing a relationship between the price of the finished product and the mineral.”¹⁷⁴ The court ordered the buyer to pay a price which was based upon these factors.

It is asserted that the court adopted the correct methodology in this case. In essence, it did not invalidate a contract, circumstances surrounding the formation and performance of which clearly reflected that the parties intended to be bound by it. Rather the court gave primacy to the intention of the parties by ascertaining whether an objective criterion could be identified from the circumstances which would operate to provide a degree of certainty as to price, as required by Article 14. The relational nature of the transaction then led to questions about whether the parties had established a practice between themselves or whether a custom existed which satisfied the dictates of the Convention. Since the existence of a practice or custom automatically raises the presumption that the parties have impliedly made reference to it, the court was able to identify the objective criteria to be used in setting the price from the intention of the parties, rather than making the contract for

¹⁷⁴ *ibid.*

the parties – i.e. substituting a mechanism of its own choice in favor of the one adopted by the parties.

This leads to the conclusion that Article 14 requires, at minimum, that the methodology for setting of price, in cases where a contract has been formed following the offer-acceptance formula, should be an objective one – i.e. based upon objectively identifiable standards. As such, empowering one party to determine the price is recognized under Article 14 as long as the exercise of such discretion is limited by factors outside the control of the parties. Thus, a clause that reads “the buyer will determine the price” will not be considered sufficient to satisfy the requirements of Article 14,¹⁷⁵ whereas one that reads “the seller will determine the price on the basis of production costs, transportation costs and profit margins prevailing in the trade” will satisfy the requirements.

4.5.5 When parties are silent upon price but there is either a trade practice or prior dealing between the parties with respect to price

The discussion above clearly reveals that a price term that is based on an objectively ascertainable standard is considered valid under the dictates of Article 14. Since only those practices and usages are recognized that the parties have established between themselves and have agreed to respectively, there is no possibility of the imposition of a term that the parties have not agreed to.¹⁷⁶ In other words, since such practices and usages provide objective guidelines, reference to them does make the price term determinable. As such, a price term referring to custom or practice is considered valid for the purposes of Article 14. In one case, it was held that the requirements of the article are met even if the proposal is silent as to price, so long as a custom or practice as to price exists.¹⁷⁷ In *Geneva Pharmaceuticals Tech. Corp. v. Barr Labs. Inc.* the Federal District Court of New York determined that a custom of pricing

¹⁷⁵ Provided that no usage or practise as defined in Article 9 can be identified.

¹⁷⁶ Article 9(2) further reads that parties are considered to have impliedly made reference to a usage which they knew of or should have known of and is widely recognized in the particular trade.

¹⁷⁷ U.S. District Court for the Southern District of New York, United States, 21 August 2002
<<http://cisgw3.law.pace.edu/cases/020821u1.html>> accessed: 28 March 2014.

existed within the pharmaceutical industry.¹⁷⁸ This custom “implied, unwritten supply commitments ... that were not embodied in legal documents.”¹⁷⁹ Thus, within the pharmaceutical industry, there existed a custom that provided a pricing policy which was used by the court to provide a mechanism for price fixation. This case leads to the conclusion that where a custom of pricing exists, the same is automatically incorporated into the proposal if it is silent as to price. Such a conclusion seems to be correct in that it is in conformity with the dictates of Article 9 which basically state that the parties are bound by known and observed customs and established practices.

4.5.6 An agreement to agree on price

Since Article 14 states that a proposal is sufficiently definite as to price if it makes provision for determining it, the question raised is what constitutes a valid provision. In other words, what extent of clarity should a provision for determining the price have in the identification of its quantum? For instance, must the provision be so clear that the parties at any time during performance may be able to concretely determine the price of the goods, or is it sufficient that the parties can concretely identify the price at the time of payment?

With regards to the first scenario – i.e. where the parties are able to identify the price during performance – courts and academics agree that the dictates of Article 14 are satisfied. The second scenario, however, raises certain difficulties with regards to the parameters of such implicit fixing of the price. Certain courts have held that setting a minimum and maximum price range would satisfy the dictates of Article 14, even though the actual price would have to be agreed at a later date.¹⁸⁰ Such a stance is surprising since parties can only concretely determine the price of the goods until it is fixed at a later date. Take for instance the case of *Chinchilla pelts*.¹⁸¹ In this case, the parties agreed to the shipment of chinchilla pelts without expressly agreeing on a specific price per pelt. Instead, the parties established a price range (between 35 to

¹⁷⁸ *ibid.*

¹⁷⁹ *ibid.*

¹⁸⁰ CLOUT Case No. 106 [Oberster Gerichtshof, Austria, 10 November 1994]

<http://cisgw3.law.pace.edu/cases/941110a3.html> accessed: 28 March 2014.

¹⁸¹ *ibid.*

65 German marks) for the pelts. The parties, however, made no provision for the method of agreeing on the price within the range. After shipment, the seller claimed 50 German marks per pelt from the buyer and the buyer refused to pay the same on the grounds of the price being unreasonable for the quality of pelts delivered. Having found that pelts of middle quality were sold in the market at a price up to 60 German Marks, the court considered that a price of 50 German Marks per pelt was a reasonable one. On appeal, the Oberster Gerichtshof (Supreme Court of Austria) determined this range constituted a valid price.

Other decisions go a step further than the *Chinchilla pelts* case by finding terms that subject the price to future agreement between the parties. In *Société Fauba v. Société Fujitsu*, for instance, the court found a validly concluded agreement even though the offer did not specify the price, on the grounds that the intention of the parties clearly demonstrated their intention to be bound by the agreement.¹⁸² The case concerned the sale of electronic components at a fixed price. The buyer subsequently requested reduction in the agreed price to reflect fluctuations in the market price of the goods, and the seller agreed. Though the contract referred to an objectively identifiable mechanism for the determination of the price, it was still subject to agreement between the parties. In other words, while the price was to be amended in light of the fluctuations in the market price of the goods, the price did not have to correspond to the market price of the goods. The court when called upon to determine whether a contract had been concluded, ruled that the agreement between the parties to renegotiate the price term did not invalidate the contract. The court however did not comment upon whether an offer which leaves the price term to be agreed between the parties at a later date would be sufficiently definite. Rather, the court simply stated that the mechanism whereby price was to be adjusted rendered the same determinable in the given circumstances without expressly stating which legal principle the court had relied upon in reaching this conclusion.

¹⁸² Published in French: [1996] UNILEX; Witz, Claude, Les premières applications jurisprudentielles du droit uniforme de la vente internationale - Convention des Nations Unies du 11 avril 1980, Librairie Générale de Droit et de Jurisprudence (L.G.D.J.), Collection Droit des Affaires, Paris (1995), 135. Reported on in English: [1996] UNILEX.

A completely different conclusion was however reached in the *Telex* case.¹⁸³ This case concerned a telex communication sent by the seller indicating the nature of the goods and their quantity while being silent as to the exact price of the goods. It however did state that the price would be agreed ten days prior to the beginning of the New Year. The court concluded that this simply constituted an agreement to agree on the price on a later date but did not constitute a method for determining price. The tribunal noted that in this particular instance, Article 55 was not applicable since the parties had implicitly indicated the need to reach agreement on the price in future.

A comparison of these cases reveals that courts will not validate contracts formed following the offer-acceptance methodology, the price term of which simply states that it is subject to future agreement between the parties. Instead, courts will attempt to ascertain whether such agreement has to be made on the basis of objectively identifiable factors that are outside the influence of the parties. If the answer is in the affirmative, then courts will validate the agreement. If, however, no such objective factors are identifiable, the dictates of Article 14 will not be satisfied; as a result, the contract would be invalidated.

4.5.7 Article 55

Article 55 applies when a contract is concluded using a mechanism other than an offer-acceptance formula. As such, in cases where a contract has been concluded following any other methodology of contract formation, but does not contain a price term, Article 55 operates to imply the price charged at the time of the conclusion of the contract. This raises the question of the utility of such a term. In other words, since the price prevailing at the time of the conclusion of the contract is usually easily determinable, why would the parties not include the same in their contract if they wished to be bound on those terms? Indeed the fact that the parties chose not to incorporate the same does lead to the inference that the parties did not wish to

¹⁸³ CLOUT Case No. 139 [Tribunal of International Commercial Arbitration at the Russian Federation Chamber of Commerce and Industry, Russia, 3 March 1995]
<http://cisgw3.law.pace.edu/cases/950303r1.html> accessed: 28 March 2014.

contract on it, and the incomplete nature of the agreement gives rise to the inference that the parties were uncertain with regards to the future price of the goods.

As discussed above, various domestic laws in such circumstances usually make reference to the price charged at the time of delivery. In the realm of the Convention, however, such an implication may translate into the imposition of a price on the parties that they never intended to be governed by.

It is argued that referring to the price at the time of conclusion of contract provides greater advantages to the parties. Since parties can easily ascertain the price prevailing at the time of conclusion, they can easily ascertain whether they wish to contract on it or otherwise. If the answer is in the affirmative then they may save on the transaction cost of adding the price term into the contract as Article 55 would operate to imply the same.¹⁸⁴ If, on the other hand, the article referred to the price prevailing at the time of delivery, parties would be motivated to expend resources to agree upon a mechanism that does not leave them at the mercy of potential price fluctuations. In other words, uncertainty and the higher costs associated with ascertaining the price prevailing at the time of delivery would increase transaction costs as a whole. In any case parties that do not draft lengthy contracts, relying instead on the relational nature of their transaction, may well be surprised to find that they are bound to pay a price the quantum of which they neither knew nor contemplated at the time of conclusion.

In any case, it must be noted that Article 55 implies a term only when the contract, formed through a methodology other than the offer-acceptance formula, is completely silent as to price. Moreover there are no limitations other than the fact that no one party may be given unfettered discretion in setting the price,¹⁸⁵ on the types of open price terms that can be incorporated into a contract formed in such a manner.

¹⁸⁴ Such transaction costs will usually be negligible: given that the parties would have expended resources associated with ascertaining the price prevailing at conclusion of their contract, the only cost to be saved is the cost associated with drafting of the price term.

¹⁸⁵ This, as discussed above, implies the requirement that the price term be tied to objectively identifiable standards.

The discussion above should not be taken to mean that parties are bound by the dictates of Articles 14 and 55 whenever their sale is governed by the Convention as a result of the application of Article 1. Rather, the Convention simply provides a set of default rules which can be derogated from through express agreement. Consequently, parties may enter into a contract following an offer-acceptance methodology without making any reference to the price. Such an approach is possible through the principle of party autonomy contained in Article 6 of the Convention. In other words, parties may simply derogate from the application of the provisions of the Convention relating to price.¹⁸⁶

4.6 Conclusions:

This chapter argues that the use of open price terms in various instances such as long-term contracts would increase the overall efficiency of the transaction. Indeed the use of open price terms is prevalent in the current commercial context. As such, if the Convention does not recognize the validity of contracts concluded on such terms, parties to contracts of international sales of goods would contract around its application. Such an outcome would undermine the objectives of the Convention since unification would merely become a theoretical achievement if parties consistently contract around the instrument.

The discussion above, however, reveals that the two seemingly contradictory articles (Articles 14 and 55) can be read in a harmonious manner that allows for a contextualist interpretation of the Convention on the issue of the use of open price terms. As such, the Convention allows parties to make use of open price terms, and thereby takes commercial realities into account. There are however certain limitations to the use of such terms. For instance, in cases where the contract has been concluded following a mechanical offer-acceptance formula, the contract will fail due to uncertainty if the offer is completely silent as to price.¹⁸⁷ Moreover, in such instances one party cannot be afforded unfettered discretion in setting the price;

¹⁸⁶ CISG-AC Opinion No. 16, Exclusion of the CISG under Article 6, Rapporteur: Doctor Lisa Spagnolo, Monash University, Australia. Adopted by the CISG Advisory Council following its 19th meeting, in Pretoria, South Africa on 30 May 2014

¹⁸⁷ Provided that the dictates of Article 9 in such an instance do not imply a price into the contract.

rather, it is necessary that the mechanism for the setting of the price renders the same objectively determinable. In instances where the contract is concluded using a mechanism other than the offer-acceptance formula, and the contract is silent as to the price, Article 55 would imply the price charged at the time of conclusion of the contract.

The methodologies contained in Article 14 and 55 represent a balance between flexibility and certainty. Commercial reality requires flexibility in the setting of price, at least in the context of long term contracts; at the same time, efficiency concerns – such as limiting the potential of opportunistic behavior – require that the parties are not allowed to strategically impose a price to their advantage on the other party, after the conclusion of the contract. As such, this chapter concludes that the methodology contained in the Convention on the issue of open price terms is indeed one that would further the ends of efficiency while allowing parties sufficient flexibility – as is required by the realities of international trade.

Chapter 5 The Notice Requirement

“For the seller, failure of the buyer to give notice is perhaps the first line of defence; for the buyer, it can be a thunderbolt out of the sky.”¹

Introduction

Article 35 of the Convention imposes on the seller the duty to “deliver goods which are of the quantity, quality and description required by the contract and which are contained or packaged in the manner required by the contract.”² If the seller breaches this duty, the buyer is allowed to invoke the remedies provided under the Convention.

By virtue of the strict approach to liability contained in Article 45 of the Convention, non-performance by the seller of any of his contractual obligations entitles the buyer to demand damages.³ For the invocation of other remedies, however, factors such as the severity of breach must be taken into account. For instance, the remedies of avoidance of contract under Article 49 require a “fundamental breach of contract.”⁴ Other remedies available to the buyer include reduction of price⁵ and the provision to the seller of extra time to cure defects.⁶

¹ Barkley Clark, ‘The First Line of Defence in Warranty Suits: Failure to Give Notice of Breach’, (1982) 15 Uniform Commercial Code Law Journal 105, 106.

² Convention, Article 35. For an analysis of what constitutes ‘lack of conformity’, see Franco Ferrari, ‘Specific Topics of the CISG in the Light of Judicial Application and Scholarly Writing’ (1995) 15 Journal of Law and Commerce 101; Bianca in C. Massimo Bianca and Michael Joachim Bonell, *Commentary on the International Sales Law: The 1980 Vienna Sales Convention* (Giuffrè, 1987) 273.

³ Convention, Article 45 states “(1) If the seller fails to perform any of his obligations under the contract or this Convention, the buyer may: (a) exercise the rights provided in Articles 46 to 52, (b) claim damages as provided in Articles 74 to 77; (2) The buyer is not deprived of any right he may have to claim damages by exercising his right to other remedies; (3) No period of grace may be granted to the seller by a court or arbitral tribunal when the buyer resorts to a remedy for breach of contract.”

⁴ Convention, Article 49.

⁵ Convention, Article 50.

⁶ Convention, Article 48.

In this framework of remedies provided by the Convention, Article 39 operates to impose upon the buyer the requirement to provide a notice specifying the alleged non-conformity as a pre-requisite for the invocation of any remedy.⁷

Unfortunately, there existed a wide array of views amongst the drafters of the Convention vis-à-vis the importance and preferred impact of the non-provision of a notice of non-conformity.⁸ Consequently, the text of the article was a result of a uneasy compromise.⁹ It is therefore hardly surprising that questions concerning the timeframe within which the notice is to be provided have constituted one of the most recurring issues that have been brought before courts for adjudication.¹⁰

In order to properly appreciate the tensions prevalent during the drafting stages of Article 39, it is essential to understand the different approaches adopted by various legal regimes on the requirement, or lack thereof, of the notice specifying lack of conformity. The next section shall therefore provide a brief analysis of the requirement as it is contained in US, English, French and German Law. The reason for choosing these specific jurisdictions for analysis is twofold:

- 1) Each of these jurisdictions adopts a different approach. These include the no notice requirement as contained in French law, while UK law holds an

⁷ The article reads: “(1) The buyer loses the right to rely on a lack of conformity of the goods if he does not give notice to the seller specifying the nature of the lack of conformity within a reasonable time after he has discovered it or ought to have discovered it. (2) In any event, the buyer loses the right to rely on a lack of conformity of the goods if he does not give the seller notice thereof at the latest within a period of 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.”

⁸ According to Professor Schlechtriem the article was “one of the Conference's most difficult problems”. See Peter Schlechtriem, *Uniform Sales Law: The UN Convention on Contracts for the International Sale of Goods* (Manz 1986) 70.

⁹ Anselmo Martinez Canellas, ‘The Scope of Article 44 CISG’ (2005) 25 *Journal of Law and Commerce* 261, 263.

¹⁰ See Ferrari (n 2) 99: “One of the most important issues of the CISG . . . appears to be . . . the notice to be given to the seller in case of non-conformity of the goods”; “This is hardly surprising since the around one-fifth of the cases arising from the predecessors of the Convention, namely ULIS, centered on this issue”. See Peter Birks (ed), *The Frontiers of Liability* (Vol. 2, Oxford University Press, 1994) 43. The AC in opinion number 2 notes: “The provisions regarding the notice that should be given by the buyer to the seller of goods in case of their alleged lack of conformity to the contract were among the most disputed matters in the preparation of the CISG. The proper interpretation of those provisions is in turn one of the most controversial matters in its implementation since it involves both fact and law.” See CISG-AC Opinion no 2, Examination of the Goods and Notice of Non-Conformity: Articles 38 and 39, 7 June 2004. Rapporteur: Professor Emeritus, Eric Bergsten, Pace University School of Law, New York (hereinafter referred to as ‘AC Opinion No. 2’).

intermediate position and provides a right of inspection.¹¹ In this case, failure to provide a notice specifying the non-conformity of the goods operates to bar only the right to reject the goods and avoid the contract. The right to claim damages, however, is retained. Article 2-607 of the UCC seems to be a mirror image of the rule contained in Article 39 of the Convention. German law on the other hand, imposes a requirement to provide a notice without hesitation, nonconformity with which operates to bar the invocation of any remedy by the buyer.

- 2) Even though the compromise solution was partially attributed to concerns of developing countries vis-à-vis the impact of the notice requirement, it was not a product of the position adopted under their domestic law. These concerns will be highlighted in the section on the analysis of the travaux.

5.1 Comparative Analysis of National Laws on the Notice Requirement

5.1.1 English Law

Section 34 of SGA 1893 provided that the buyer is not deemed to have accepted the goods, unless he or she has had a reasonable opportunity to examine them. Section 35 however provided an exception to this rule. By virtue of this section, a buyer who did any act which gave the impression that the buyer had accepted the goods could not subsequently reject them even though the buyer had no reasonable opportunity of examining them.¹² Therefore, a buyer who resold the goods while they were in transit could potentially lose the right to examine them on delivery.¹³ The section was however amended by Section 4(2) of the Misrepresentation Act 1967 which inserted the phrase “except where Section 34 of this act provides otherwise” in Sub-section 1 of Article 35.¹⁴ The impact of this amendment was to solidify the right of the buyer to examine the goods by removing the presumption of acceptance in cases where he

¹¹ It should be noted that while the buyer is provided the right to inspect the goods under English law, the same does not amount to an obligation to inspect as contained in Article 38 of the Convention.

¹² The section lays down three instances where the buyer is deemed to have accepted the goods: (a) when he informs the seller of acceptance (b) he does any act inconsistent with the seller's ownership of the goods or (c) after the lapse of a reasonable time he retains the goods without informing the seller of their rejection. Of these three instances, the second causes difficulty in the interplay between Section 34 and 35. See for example *Hardy & Co v Hillerns & Fowler* [1923] 2 K.B. 490; *E. & S. Ruben v Faire Bros and Co. Ltd* [1949] 1 All ER 215.

¹³ See for example *Hammer and Barrow v Coca-Cola and Others* [1962] NZLR 723.

¹⁴ Misrepresentation Act 1967, Section 4(2).

or she does any act in relation to the goods which is inconsistent with the ownership of the seller, without having a reasonable opportunity to examine them.

Section 35 of the SGA 1979, adopts the same approach as its amended predecessor. Sub-section 2 of this section states, “Where goods are delivered to the buyer, and he has not previously examined them, he is not deemed to have accepted them... until he has had a reasonable opportunity of examining them.”

In cases where the examination reveals a defect in the goods the buyer should, by virtue of Sub-section 4 of Section 35, inform the seller of the non-conformity within a reasonable time. If the buyer does not provide a notice, he or she is deemed to have accepted the goods.

It is interesting to note that Article 34 of the SGA 1979 states that the seller is bound to provide a reasonable opportunity to the buyer to examine the goods on request. As a result, English law does not place an obligation on the buyer to inspect the goods and provide a notice of non-conformity, but simply gives a right to the buyer to inspect them.¹⁵ The section however does not list any sanctions for non-compliance by the seller – that is, as a result of refusal to allow inspection on request. Case law however reveals that such non-compliance would be tantamount to destroying the lawfulness of the tender, so as to preclude the seller from arguing that the buyer had indeed accepted the same where the latter rejects them.¹⁶

Sub-section 4 of Section 35 states, “The buyer is also deemed to have accepted the goods when after the lapse of a reasonable time he retains the goods without intimating to the seller that he has rejected them.”¹⁷ As such, if after the passing of a reasonable time after delivery, the buyer does not inform the seller of the non-conformity, he or she is deemed to have accepted them in their current state.¹⁸ The

¹⁵ The subsection reads, “The buyer is also deemed to have accepted the goods when after the lapse of a reasonable time he retains the goods without intimating to the seller that he has rejected them.”

¹⁶ *Isherwood v Whitmore* (1843) 11 M. W. 347 in *Lorymer v. Smith* (1822) 1 B&C1 wherein it was held that noncompliance with the dictates of Article 34 constitute a discharging breach.

¹⁷ Section 35, Sale of Goods Act 1979 (hereinafter referred to as ‘SGA’).

¹⁸ SGA, Section 59 states that the “question what is a reasonable time is a question of fact.” Professor Bridge notes, “The fact-based character of this head of acceptance has rendered it the most difficult of heads to apply in practice, through the paucity of reported disputes helped to persuade the law commissioner not to recommend statutory change, and in particular not to introduce fixed periods for

impact of acceptance is simply to bar the rights of the buyer to reject the goods and avoid the contract.¹⁹ The right to claim damages however is retained.²⁰ The question of what constitutes reasonable time is a question of fact, to be decided on the basis of the circumstances of each case.²¹

5.1.2 German Law

The requirement of the provision of a notice specifying the non-conformity of the goods has long been established in German law. Article 377 of the German Commercial Code (HGB), which applies where both parties to a sales contracts are merchants, states, “The purchaser...upon discovery of any defect must immediately (un-hesitantly) give notice thereof to the vendor.”²² If the non-conformity is obvious the time limit begins to run from the date of delivery, whereas if the nonconformity is hidden, the time limit commences from the date of its discovery. In this context the term without hesitation – or “un-hesitantly” – is defined as “with no blameworthy hesitation.”²³ If the notice is not provided, a presumption of acceptance of the goods is raised and, as a result, under the framework of German law the buyer loses the right to invoke any remedy otherwise available to him or her.

The greatest difference in the approach adopted under German law, relative to those discussed in this section, lies in the interpretation of “reasonable time.”²⁴ A review of case law reveals that German courts, more often than not, interpret the term “un-

different classes of goods.” Michael Bridge, *The Sale of Goods* (2nd edn, Oxford University Press 2009) 637.

¹⁹ English law allows for the termination of a contract in two situations: 1) where the breach goes to the root of the contract and 2) a condition of their contract has been breached. See Bridge (n 18) 595-596. It is essential to note that Section 11(4) of the SGA “points to an implied or express term permitting rejection of the goods after acceptance.” Bridge (n 18) 631.

²⁰ Ingeborg Schwenzer, Pascal Hachem, and Christopher Kee, *Global Sales and Contract Law* (Oxford University Press 2012) 423.

²¹ SGA 1979, Section 59. Section 35 (6)(a) shows that time taken merely in requesting or agreeing to repairs and for carrying them out, is not to be counted.

²² German Commercial Code, Article 377

<[http://www.archive.org/stream/germancommercial00germuoft/germancommercial00germuoft_djvu.t](http://www.archive.org/stream/germancommercial00germuoft/germancommercial00germuoft_djvu.txt)

²³ Bürgerliches Gesetzbuch (BGB - Civil Code), Article § 121. Translation taken from Camilla B. Andersen, ‘Reasonable Time in Article 39 (1) of the CISG-Is Article 39 (1) Truly a Uniform Provision?’ (1998) 10 Pace International Law Review 403.

²⁴ Andersen (n 23).

hesitantly” to require notice within three to five working days.²⁵ Thus German law imposes a very strict requirement on buyers, i.e. they must inspect the goods and provide notice in a very short period of time or risk losing the right to rely on remedies provided under the HGB.

5.1.3 US Law

Under § 2-606 of the UCC, a buyer is not deemed to have accepted the goods unless he or she has had a reasonable opportunity to inspect them.²⁶ As such, American law, like English law, speaks in terms of right rather than obligation vis-à-vis inspection of the goods. Section 2-602 states that if the buyer wishes to reject the goods, he or she must do so within a reasonable time of the delivery of the tender. Read together these articles operate to bar the exercise of the buyer’s right of rejection in instances where the buyer does not provide a timely notice to the seller after inspection. In other words, like the position adopted under English law, unless the buyer provides the seller a notice of non-conformity within a reasonable time, he or she is deemed to have accepted the goods and resultantly loses the right to avoid the contract. Once the goods have been accepted Section 2-607(3) (a) comes into play. The origins of this requirement in codified American law can be traced back to Section 49 of the Uniform Sales Act 1906.²⁷ This section imposes upon the buyer the duty to notify the seller of any defects in the goods delivered within a reasonable time of their discovery.²⁸ American courts, after taking the facts of each case into account, usually hold that a period of little over a month is reasonable.²⁹ Failure to provide a notice of non-conformity within the reasonable period results in the loss of all

²⁵ Ingeborg Schwenzer, ‘National Preconceptions that Endanger Uniformity’, (2007) 19 Pace International Law Review 103, 105. Camilla Baasch Andersen, after a review of German case law on the subject concludes, “In practice, this domestic time-frame is a flexible one which must be reasonable; however, this is usually stressed as reasonably brief, and notice periods of over two weeks will rarely be tolerated.” Andersen (n 23).

²⁶ The exception to this rule, like the stance adopted under the unamended version of SGA 1893, is when the buyer does anything that is inconsistent with the seller’s ownership of the goods.

²⁷ Samuel Williston was clearly inspired by section 377 of the German Commercial Code while drafting Section 49 of the Uniform Sales Act. It is interesting to note that while First Restatement of Contracts (of which Williston was a reporter) incorporated the notice requirement, the same was omitted from the Second Restatement of Contracts.

²⁸ The reasonable time period commences after the defects have been discovered or should have been discovered.

²⁹ James J. White and Robert S. Summers, *Uniform Commercial Code* (West Pub. Co. 1995) §§ 11-12 at 419. This however is not the case for perishable goods where the reasonable time period is usually confined to a few days. Schwenzer (n 25).

remedies otherwise available under the UCC.³⁰ In this regard the text of the UCC seems to be a mirror image of Article 39(1).

5.1.4 French Law

French law differs from the stance adopted by the legal regimes discussed above in that it does not impose an obligation, nor provides a right to inspect the goods and provide a notice of non-conformity.

In 1978, the Court of Cassation held that the seller “has the duty to deliver an effective product appropriate for the users need.”³¹ Moreover Article 1184 of the French Civil Code (CC) specifically obliges the seller to deliver goods free from defects. This means that where the goods do not conform, the buyer may require specific performance, demand rescission and/or claim damages³² without having to provide a notice detailing the non-conformity complained of.³³ The only limitation to the filing of such a claim is that the suit must be instituted within a year of delivery.³⁴

5.1.5 Conclusions

While most legal systems require the provision of a notice, it would be incorrect to assert that legal systems are *converging* on the recognition of such a requirement. Moreover, legal systems that do require a notice, differ on the requirements of such notice. For instance, German law requires notice to be provided immediately or “un-

³⁰ In the cases of *Standard Alliance Indus. v. Black Clawson Co.* 587 F.2d 813 (6th Cir. 1978) and *Eastern Air Lines v. McDonnell Douglas Corp.* 532 F.2d 957 (5th Cir. 1976) for example, the court overturned verdicts in favor of the buyer on the basis of non-conformity with the notice requirement. It is important to note that while the section states that the buyer loses the right to rely on any remedy, remedies of rejection and revocation are governed by special notice rules. In any case, non-compliance with these notice rules does operate to bar exercise of these remedies.

³¹ Cass f 22 November 1978, JCP 1979 II. 19139.

³² If the defect is one that renders the goods incapable of being used for their intended purpose, the buyer may claim a reduction of price or resolution of the contract. See Christian Campbell (ed), *International Product Liability [2007]* (Lulu. com 2007) 355.

³³ In cases of latent defects however French law imposes an obligation on the buyer to provide the seller with a notice of such defects within a short period from the moment he has discovered them or should have discovered them. See Article 1648 of the Code Civil (hereinafter referred to as ‘CC). Once the notice is provided the buyer may choose between entering into negotiations with the seller or may file a suit against him. The suit however must be filed within one year from the time the notice was sent. See CC, Article 1648 (2).

³⁴ CC, Article 1648 (2).

hesitantly” whereas American law requires the notice to be provided within a reasonable timeframe. In practice, these terms have been interpreted to imply very different timeframes. For example, German courts rarely hold a notice sent after the passing of two weeks to conform to the requirements of German law on the issue.³⁵ American courts on the other hand usually condone notice periods of little over a month.³⁶

There are further differences in the impact of such notices under domestic legal systems. For instance, while German and US law operate to bar the invocation of any remedy where the notice requirement is not fulfilled, English law only requires such a notice where the buyer wishes to avoid the contract.

Given these differences in national approaches to the issue of notice of non-conformity, the issue turned out to be “one of the Conference’s most difficult problems.”³⁷ In order to properly appreciate the rule contained in Article 39, it is essential to analyze the relevant portion of travaux préparatoires. As has been asserted throughout this thesis, such an analysis is essential since it provides valuable insight into the intent of the drafters, and the general objectives the article intended to achieve.

5.2 Analysis of the Travaux Préparatoires

During the drafting stages of the Convention, a policy split vis-à-vis the impact of the requirement of a notice of non-conformity of goods surfaced between developed, Western states on the one hand and developing states on the other. As early as the Sixteenth Meeting of the First Committee, delegates belonging to developing states began to urge the exclusion of the requirement of provision of notice specifying non-conformity, on the grounds that the impact of late or non-provision of such notice

³⁵ Andersen (n 23).

³⁶ Schwenzer (n 25) 105.

³⁷ Schlechtriem (n 8).

would have a draconian effect³⁸ – i.e. the buyer would lose the right to invoke any remedy under the Convention.³⁹

The predecessor of Article 39 of the Convention, that is Article 39 of ULIS, required buyers to provide a notice of non-conformity promptly upon the discovery of the defect or after it ought to have been discovered.⁴⁰ This proved to be a very exacting standard in practice. This was particularly true for unsophisticated buyers of complicated goods, as is often the case in sale of goods contracts involving parties belonging to developing nations. Professor Date-Bah for instances stated,

Apart from the slower pace of life [in developing countries], there is the problem that the examination of technologically sophisticated goods may not be capable of being done promptly at particular destinations because of the absence locally of people with the requisite skills to carry out such examination.⁴¹

Similarly, there were concerns that developing nations did not have the requisite infrastructure such as communication links which were essential for compliance with the dictates of the Draft Article.⁴²

³⁸ Mr. Date-Bah, the delegate of Ghana for instance stated, “His delegation wished to see Article 37(1) [became CISG article 39(1)] deleted and the matter regulated by paragraph 2. The sanction contained in paragraph 1 was too draconian.” Legislative History, 1980 Vienna Diplomatic Conference, Summary Records of Meetings of the First Committee, 16th Meeting, Article 37 [became CISG Article 39] (A/CONF.97/C.1/L.111, L.125, L.124, L.137, L.131, L.75) (hereinafter referred to as ‘Vienna Diplomatic Conference, 16th Meeting’)

<<http://cisgw3.law.pace.edu/cisg/firstcommittee/Meeting16.html>> accessed: 23 March 2013.

³⁹ The article reads, “The buyer shall lose the right to rely on a lack of conformity of the goods if he has not given the seller notice thereof promptly after he has discovered the lack of conformity or ought to have discovered it. If a defect which could not have been revealed by the examination of the goods provided for in Article 38 is found later, the buyer may nonetheless rely on that defect, provided that he gives the seller notice thereof promptly after its discovery. In any event, the buyer shall lose the right to rely on a lack of conformity of the goods if he has not given notice thereof to the seller within a period of two years from the date on which the goods were handed over, unless the lack of conformity constituted a breach of a guarantee covering a longer period.”

⁴⁰ Article 39 of the Convention Relating to a Uniform Law on the International Sale of Goods (1964) (hereinafter referred to as ‘ULIS’).

⁴¹ Samuel Kofi Date-Bah, ‘The Convention on the International Sale of Goods from the Perspective of the Socialist Countries’ in *La Vendita Internazionale, La Convenzione Di Vienna Dell’11 Aprile 1980* (A Giuffrè 1981) 29.

⁴² Richard M. Birch III, ‘Article 44 of the UN Sales Convention (CISG): A Possible Divergence in Interpretation by Courts from the Original Intent of the Framers of the Compromise’ (2006) 4 *Regent Journal of International Law* 1, 3.

The circumstances prevailing in developing nations, therefore, were not conducive to such a rule. This however does not mean that delegates of developing countries were opposed to the requirement for the provision of a notice specifying lack of conformity but rather, they were concerned with the outcome if the notice was not provided promptly.⁴³ Indeed, denial of all remedies where notice was not provided in a timely fashion was opposed so strongly that certain delegates were concerned that the provision would discourage developing countries from ratifying the Convention altogether.⁴⁴

It is therefore unsurprising that delegates belonging to developing states proposed a solution whereby the requirement of provision of notice is maintained but the impact of failure to furnish such a notice in a timely fashion be likened to cases of failure to mitigate loss.⁴⁵ If accepted this proposal would operate to reduce the amount of damages recoverable without barring recovery altogether.⁴⁶

⁴³ For instance at the 16th Session of the First Committee, Mr. Khoo the delegate of Singapore said, "Article 37 [became CISG Article 39] was one of the most controversial in the entire Convention. All would agree that the buyer should give notice of non-conformity, within a reasonable time, since otherwise the credibility of his claim might be questioned. The point on which the Committee was divided was what sanctions should be attached to failure to give notice in time. There was much to be said for the view that the sanction provided in the present text of the Convention was draconian." See Vienna Diplomatic Conference, 16th Meeting (n 38).

⁴⁴ Mr. Waititu, the delegate of Kenya stated, for instance: "The very rigorous sanction to which a buyer might be subjected under the existing text might discourage many countries from accepting the Convention. The sanction in question was not commonly known, and he urged the Committee to consider carefully whether it should rightly be the intention of the Conference to impose it." See Vienna Diplomatic Conference, 16th Meeting (n 38).

⁴⁵ The amendment proposed by Ghana read: "1. Delete Article 37 [became CISG Article 39], paragraph (1), and the words 'In any event' at the beginning of Article 37 [became CISG Article 39], paragraph (2) 2. Alternatively, Article 37 [became CISG Article 39] should be revised to read as follows:

(1) The buyer must give notice to the seller specifying the nature of a lack of conformity within a reasonable time after he has discovered it or ought to have discovered it.

(2) If the buyer fails to give the notice referred to in paragraph (1) above, such failure shall be regarded as a failure to mitigate loss and the party in breach may rely on Article 73 [became CISG Article 77] to reduce the damages payable by him.

(3) [Same text as the present Article 37 [became CISG Article 39], paragraph 2.]” See Vienna Diplomatic Conference, 16th Meeting (n 38).

⁴⁶ Interestingly, quarters from which support and opposition of the proposal emanated shows the industrialized v. developing states divide on the matter. The representatives of Kenya, Pakistan, China, Nigeria, the United Kingdom, Mexico, Singapore, and Libya argued in support of the proposal. The representatives of the Netherlands, Korea, Switzerland, Sweden, Bulgaria, Denmark, Austria, Australia, Japan, Belgium, the Federal Republic of Germany, and Spain opposed it. For a well-documented account of the debates see Elizabeth Hayes Patterson, 'United Nations Convention on Contracts for the International Sale of Goods, Unification and the Tension Between Compromise and Domination', (1986) 22 Stanford Journal of International Law 263, 290.

Delegates of developed nations however saw this proposal to be directly contradictory to the aims Article 39 was meant to achieve. Mr. Hjerner, the delegate of Sweden for instance stated that

Reduction of damages was an unsatisfactory remedy, and was as hard on the seller as on the buyer. The main purpose of the rule was in fact to secure evidence in the case of dispute. If the seller were to establish the cause of the defects complained of, he would need to know of them at an early stage... Furthermore, the Ghanaian proposal overlooked the duty of the seller to repair goods⁴⁷ or to deliver substitute goods.⁴⁸

Moreover, there were concerns that the retention of claims where notice of non-conformity had not been provided within a timely fashion would operate to place the buyer in a position where he or she could act in an opportunistic manner.⁴⁹ That is to say, a buyer who discovers non-conformity would be motivated to observe the price of the goods and decide his course of action accordingly. It was therefore necessary, in the opinion of certain delegates, to retain the requirement for the notice to be provided as soon as possible in order to ensure that the transaction is completed soon after the seller has performed his obligations under the contract.⁵⁰

Certain delegates of industrialized states went as far as equating the requirement of notice as established usage in commercial circles.⁵¹ Delegates of developing states on the other hand, viewed the provision as nothing short of a trap for the relatively unsophisticated buyers in their country, and were resultantly not willing to accept a complete bar on the right to claim damages. Predictably, the issue emerged to be amongst the most debated, with arguments spread over three days with eight

⁴⁷ While the Swedish delegate saw this as a duty, Article 48 clearly provides the seller a right to cure rather than obligating him to do so.

⁴⁸ Vienna Diplomatic Conference, 16th Meeting (n 38).

⁴⁹ *ibid* Para 55.

⁵⁰ Various commentators argue that the notice requirement is also in the interest of the buyer. For instance, Professors Enderlein & Maskow argue that: "It is in the interest of the buyer himself to inform the seller because the latter can do nothing to cure the lack before he becomes aware of it." Fritz Enderlein and Dietrich Maskow, 'International Sales Law: United Nations Convention on Contracts for the International Sale of Goods: Convention on the Limitation Period in the International Sale of Goods: Commentary' (Oceana 1992) 159-160.

⁵¹ *ibid* Para 65. See comment of Mr Herber, delegate of the Federal Republic of Germany.

proposed amendments.⁵² After prolonged debate a compromise solution was adopted, whereby the requirement of the provision of a notice specifying non-conformity was retained under Article 39. The requirement that the notice be provided promptly however was replaced with the term “within a reasonable time” to allow for flexibility.⁵³ In particular, this amendment was in response to the concern of developing nations that buyers prevailing in those states would often need to procure expert foreign advice which seldom would be meet the requirement of promptness. Moreover, Article 44 was inserted to allow a buyer to reduce the value of the defect from the price of the goods and claim damages⁵⁴ provided he or she was able to furnish a “reasonable excuse” for failure to give the notice as required by Article 39.⁵⁵

The travaux therefore reveal the intended objectives of Article 39 as follows:

- 1) **Information-Related Concerns:** To minimize instances of bad faith termination (opportunism), by allowing the seller to examine the goods and determine whether the non-conformity complained of actually existed or not. Moreover, the requirement that the notice be provided in a timely fashion aids in the proper determination of whether the defect complained of is a result of handling or use of the goods before or after liability of damage was transferred from the seller to the buyer. As such, information-related concerns simply require that the seller be provided the opportunity to collect evidence at an early stage.⁵⁶
- 2) **Mitigation Through Cure:** To ensure that other articles of the Convention can properly be applied, for instance a seller cannot repair or substitute the

⁵² See session 16, 17 and 18 of the Working Group. See also Alejandro M. Garro, ‘Reconciliation of Legal Traditions in the UN Convention on Contracts for the International Sale of Goods.’ (1989) 23 *The International Lawyer* 443.

⁵³ ULIS, Article 39 used the term ‘promptly,’ thereby imposing a more stringent standard upon the buyer.

⁵⁴ Damage claims however cannot include claims for loss of profit under Article 44.

⁵⁵ Article 44 states, “Notwithstanding the provisions of paragraph (1) of Article 39 and paragraph (1) of Article 43, the buyer may reduce the price in accordance with Article 50 or claim damages, except for loss of profit, if he has a reasonable excuse for his failure to give the required notice.”

⁵⁶ See comment of Mr. Hjerner (Sweden) at Para 52 Vienna Diplomatic Conference, 16th Meeting (n 38).

goods in conformity with Article 46 unless he or she has been made aware of the lack of conformity.⁵⁷

5.3 Economic Analysis of the Objectives

The primary impact of the notice requirement is to shift the costs of the seller's breach on to the buyer, if the notice is not provided in a reasonable time. In economic terms such a shift of liability can be justified if: (a) it translates into decreasing the potential costs that the seller or commercial community as a whole would incur if such a notice requirement was not present and (b) the costs so saved outweigh the liability placed on the buyer. If such costs are not avoided then there is the possibility that parties would begin to view the Convention with a sense of distrust. This assertion is based on the findings of Professor Mermin that parties generally "expect default rules of law to be reasonable. When this expectation is not met, enforcement becomes difficult coupled with the "danger of spreading disrespect of the law."⁵⁸

5.3.1 Mitigation and Cure

"The most important reason for requiring notice is to enable the seller to make adjustments or replacements or to suggest opportunities for cure to the end of minimizing the buyer's loss and reducing the seller's own liability to the buyer."⁵⁹

As the analysis of the travaux reveal, certain delegates were concerned that without notice of defects from the buyer, the seller would not be able to exercise the right to cure defects under Article 48. If cure by the seller operates to minimize the losses

⁵⁷ Article 46 of the Convention states: (2) "If the goods do not conform with the contract, the buyer may require delivery of substitute goods only if the lack of conformity constitutes a fundamental breach of contract and a request for substitute goods is made either in conjunction with notice given under Article 39 or within a reasonable time thereafter. (3) If the goods do not conform with the contract, the buyer may require the seller to remedy the lack of conformity by repair, unless this is unreasonable having regard to all the circumstances. A request for repair must be made either in conjunction with notice given under Article 39 or within a reasonable time thereafter."

⁵⁸ Samuel Mermin, *Law and the Legal System: An Introduction* (2nd edn, Little, Brown 1982) 28-29.

⁵⁹ James J. White and Robert S. Summers, *Handbook of the Law under the Uniform Commercial Code*, (2nd edn, West Pub Co. 1980) § 10-11.

incurred by the buyer as a result of the breach,⁶⁰ then provision of a notice which enables cure is economically efficient.⁶¹ In this regard, like the avoidable consequences doctrine, rules protecting the right of one party to minimize the loss, further the joint interest of the parties.⁶²

Moreover, there may be instances where the buyer attempts to get out of the contract on the basis of trivial defects, not because of any real dissatisfaction, but because there was a better deal available elsewhere.⁶³ In such instances, the notice requirement operates to prevent opportunistic behavior on the part of the buyer and provides an opportunity to the seller to mitigate the loss through opportunity to cure.

However, it is important to note that while rules on mitigation operate to bar recovery of the loss that could have been avoided by the buyer, the notice requirement operates to bar recovery in its entirety. Such an over-reaching impact is difficult to justify as efficient since the efficiency of such a rule can only be found where the prejudice to the seller resulting from non-provision of the notice outweighs the cost to the buyer. The rule, however, operates to maximize costs to the buyer by completely barring recovery, thereby limiting instances where prejudice to the seller would outweigh the costs to the buyer.⁶⁴ The value of the notice rule as a default is therefore questionable in this regard.

⁶⁰ Timely/early cure can limit consequential losses where for instance the defective machine sold by the seller was to be used in the production process of the buyer. Other instances where cure would operate to minimize the buyers' losses are where the buyer wishes to keep the goods and the seller is the lowest-cost provider of cure.

⁶¹ Provided that the costs associated with the provision of notice are negligible, or in any case do not, coupled with the loss after mitigation to the buyer, exceed the economic advantages associated with the cure.

⁶² In efficiency terms the joint interest of commercial parties is defined as the maximization of their joint return under the contract.

⁶³ For instance because of a drop in the market price of the goods Charles J. Goetz and Robert E. Scott, 'The Mitigation Principle: Toward a General Theory of Contractual Obligation' (1983) 69 *Virginia Law Review* 967, 997.

⁶⁴ For instance, cases where cure by the seller could not avoid certain consequential damages to the buyer, there seems little grounds, if any, to bar recovery of such consequential damages due to non-provision of a timely notice.

5.3.2 Advantages Associated with Information

Sellers suffer from an information disadvantage relative to the buyer about the condition of the goods that have been delivered. This is simply the result of the fact that once the goods have been delivered the seller no longer has access to them. As such, unless the buyer notifies the seller, the latter will not have sufficient evidence, if any, about the non-conformity complained of. In other words, notification by the buyer enables the seller to collect evidence before it is lost as a result of passage of time.⁶⁵ An additional advantage of access to and verification of information about the nonconformity complained of reduces the possibility of the institution of completely frivolous or trumped-up suits by the buyer.⁶⁶

Moreover, since information is essential for future commercial planning, the exchange of information is economically valuable. For instance, awareness of potential liability would have an impact on the seller's motivation to enter into further credit purchases. If the potential liability is high, a seller might not be able to pay for goods that it has purchased for resale after the delivery of the non-conforming goods to the buyer. Information of the potential liability then would operate to aid the seller in saving costs associated with financial overextension.⁶⁷

5.3.3 Settlement

According to Professor Clark, the notice requirement provides an additional economic advantage in the form of encouraging settlement.⁶⁸ This argument makes sense to the extent that pre-litigation settlement carries less cost than litigation itself, thereby mitigating the impact on the joint return of the parties as a result of non-

⁶⁵ The impact of time on evidence collection was phrased by the Supreme Court of the US in 1974 when it stated "evidence has been lost, memories have faded, and witnesses have disappeared." *American Pipe and Constr. Co. v. Utah* 414 U.S. 538 (1974) <<http://openjurist.org/414/us/538>> accessed 24 March 2013.

⁶⁶ Jerry J. Phillips, 'Notice of Breach in Sales and Strict Tort Liability Law: Should There Be a Difference?' (1972) 47 Indiana Law Journal 457, 466-468.

⁶⁷ Reitz, for instance, argues that earlier repose would operate to conserve the total wealth of society, "because situations of default and especially bankruptcy also may involve substantial losses for the creditors involved." John C. Reitz, 'Against Notice: A Proposal to Restrict the Notice of Claims Rule in UCC § 2-607(3)(a)' 1988 (73) Cornell Law Review 534, 555.

⁶⁸ Clark (n 1) 110.

conformity.⁶⁹ It must however be noted that the promotion of settlement justification assumes that the sooner the parties begin negotiating after the breach, the greater the chances of reaching a settlement. For if the chances of reaching an economically justifiable settlement are not dependent upon the time when the settlement begins there is little reason, in this regard, to impose a timely notice requirement on the buyer.

There seems little proof that providing an early start date for settlement procedures would increase the likelihood of the parties actually reaching such a settlement.⁷⁰ Empirical studies on the other hand show that such an impact would be achieved if the law provided for an end date to the settlement procedure rather than a starting one.⁷¹ Professors Rubin and Brown argue that even in cases where the parties begin the settlement process well in advance of the deadline, settlement is usually reached close to the deadline.⁷² In other words, while an end date to the settlement procedure would demotivate parties to insist on their self-serving demands and aspirations, a starting date would not carry any such impact.

Even if it is assumed that the notice requirement motivates parties to settle – instead of going through the channel of formal adjudication – there are concerns that it might operate to produce settlements that favor the party with greater bargaining power.⁷³ These concerns might de-incentivize the use of informal settlement procedures and motivate the innocent party to opt for formal adjudication, at least in instances where the innocent party is the one with relatively less bargaining power.⁷⁴ Furthermore, the notice rule – due to the uncertainty of requirements such as the provision regarding reasonable time – would give rise to litigation rather than limit it.

⁶⁹ *ibid.*

⁷⁰ Jeffrey Z. Rubin and Bert R. Brown, *The Social Psychology Of Bargaining And Negotiation* (Elsevier 2013) 120-24.

⁷¹ *ibid.*

⁷² *ibid.*

⁷³ See Owen M. Fiss, 'Against Settlement' (1984) 93 Yale Law Journal 1073.

⁷⁴ *ibid.* Such an argument, however, does not take into account that the party in breach, is automatically rendered the one with weaker bargaining power – at least in the realm of dispute resolution – since most default rules operate against it. As a result, the concern should be phrased as the “possibility that informal settlement mechanisms might favor the innocent party,” which in itself does not seem to be unjustified. In any case the existence of a formal dispute mechanism would deter parties from negotiating a settlement that is patently unfair towards one party. In other words, reasonable commercial parties would be able to identify that insisting on a settlement that is unfair to the other would increase transaction costs for both since it would result in formal adjudication.

5.3.4 Repose

Professors White and Summers claim that the notice requirement carries with it the advantage of repose.⁷⁵ In the context of the Convention, repose is indeed one of the policy reasons for the incorporation of the notice requirement as is evidenced by the travaux and the existence of Article 14(2). The repose argument is based upon the assumption that the expectation that a claim will be barred after a certain period of time has positive impacts on social utility.⁷⁶ According to Professor Fisher, the social utility function of repose lies in the fact that it “enhance(s) commercial intercourse by freeing individuals from the distraction and disruption of litigation.”⁷⁷ It must be recognized that the economic value of the notice requirement rules vis-à-vis the repose argument lies not simply in the peace of mind provided to the seller, but in the planning process in commerce as a whole.⁷⁸

5.3.5 Conclusions

- The notice requirement operates to prevent instances of opportunistic behavior on the part of the buyer and provides an opportunity to the seller to mitigate the loss through opportunity to cure.
- The provision of a timely notice allows the seller to collect evidence while it is still available. Information of the potential liability is economically valuable since it aids the seller in saving costs associated with financial overextension.⁷⁹
- Notice requirement provides repose, which – like the advantage of information – enables sellers to make and focus on future commercial plans/transactions.

⁷⁵ White and Summers (n 59) 422.

⁷⁶ In the words of Professors White and Summers, “There is some value in allowing sellers, at some point, to close his books on goods sold in the past and to move onto other things.” White and Summers (n 59) 344.

⁷⁷ Archibald Cox and John T. Dunlap, ‘Developments in the Law, Statutes of Limitations’ (1950) 63 Harvard Law Review 1177, 1185.

⁷⁸ *ibid.*

⁷⁹ Reitz (n 67).

As indicated above, a rule which bars invocation of any remedy by the buyer is justified to the extent that the economic advantages accruing to the seller as a result of the rule outweigh the costs to the buyer. The efficiency-based justification of the cut-off rule contained in Article 39 is therefore dependent upon the extent to which the rule operates to minimize the joint costs of the parties.

An analysis of the economic advantages of the rule (detailed above) clearly show that the seller faces potential loss which could be minimized or avoided altogether through the provision of a timely notice. It is similarly clear that the potential harm/loss to the seller would rarely, if ever, amount to the full amount of the buyers potentially barred claim.⁸⁰ For instance, a seller loses the chance to cure the defect if it is not provided with a timely notice; however, it is hard to imagine instances where the harm to the seller as a result of the lost opportunity to cure would outweigh the full amount of the buyers claim.

This leads to the conclusion that it would be preferable in economic terms and resultantly from the perspective of the parties, if the application of the rule on barring the invocation of remedies was limited to instances where the loss to the seller as a result of the non-provision of the notice outweighs the total amount of the buyers claim. Such an approach would however lead to a drastic increase in costs associated with litigation – i.e. additional costs associated with proving prejudice would be incurred. These litigation costs would in turn operate to shrink the joint return of the parties. Moreover, such a requirement would impose a further risk on the seller i.e. he or she may no longer be able to prove prejudice as a result of loss of evidence which would have been collectable had the notice been provided in a timely fashion. In the words of Reitz, “a rule that overprotects sellers by cutting off some valid claims for no reason may be better for both buyers and sellers than a more complex rule that creates more litigation and fails to protect sellers adequately.”⁸¹

⁸⁰ Barring the buyer’s claim is justified in economic term if the potential loss to the seller as a result of the non-provision of the notice outweighs the total amount of the buyer’s claim, so long as the buyer has a prima facie case.

⁸¹ Reitz (n 67) 579.

Thus while it cannot be stated that the notice rule would achieve the most economically efficient outcome in every instance, there certainly is economic value in the rule. Moreover, the rule as it is contained in the Convention is designed to allow for flexibility in cases where requirement of prompt notice would place too heavy a burden on the buyer, through the incorporation of the reasonable time standard. This standard, however, comes at the expense of clarity.⁸²

While such flexibility is essential in order to further the ends of justice and fairness, it is essential that the users of the Convention have a certain degree of certainty with regards to their obligations and potential liability in this regard. In other words, a buyer should be provided with some degree of guidance vis-à-vis how and when the obligation of notice is fulfilled. Unfortunately, as shall be discussed below, neither courts nor academics have provided any firm guidance as to the methodology to be adopted in the calculation of reasonable time. The water is further muddied by the incorrect application of other articles, such as Article 38, in the interpretation of the term.

The Use of Article 38 in Ascertaining Reasonable Time

Article 38 imposes a duty on the buyer to inspect the goods “within as short a period as is practicable in the circumstances.”⁸³ Article 39 on the other hand states, “The buyer loses the right to rely on a lack of conformity of the goods if he does not give notice to the seller specifying the nature of the lack of conformity within a reasonable time after he has discovered it *or ought to have discovered it.*” [Emphasis added]

Since the notice has to be provided within a reasonable time after the non-conformity was discovered, Article 38 can play an instrumental role in determining when the reasonable time period is to commence. Various courts and tribunals however have used Article 38 beyond the ascertainment of when the reasonable time period should

⁸² In 2007, Ingeborg Schwenzer noted that 247 arbitral and court decisions concerned the interpretation of the phrase reasonable time. See Schwenzer (n 25) 111.

⁸³ It is important to note that there is disagreement with regards to what is meant by “within as short a period as is practicable in the circumstances.” For instance, Reishofer believes examination should be immediate; Pitz states that where there are no special circumstances, examination must be done within 3-4 days of delivery; while Ferrari believes that examinations should simply be hurried. See Ferrari (n 2).

commence; and have applied the provisions of the same in the determination of the length of the reasonable period.⁸⁴ It is asserted that the two timeframes are completely separate and the determination of both depends on a different set of factors.

This is not to ignore the fact that in certain instances the same factor might well be necessary in the determination of the two timeframes; for instance, the perishable nature of the goods would be an important factor in determining, firstly, when the defect ought to have been discovered, and secondly, what period is considered reasonable.

This thesis is however of the view that the factors essential for the proper determination of the two timeframes are sometimes very different and the interrelationship of Articles 38 and 39 is not proper grounds for applying a factor useful in the determination of one to the exercise of determining the other.

The view of Anna Veneziano serves as an example. Veneziano states that one of the factors to be taken into account in the determination of when the non-conformity ought to have been discovered and the length of the reasonable time standard is whether the defects are easily discoverable by the parties.⁸⁵ While she correctly states that the factor is essential in order to determine when the buyer ought to have discovered the non-conformity, it is hard to see how it has any application in the ascertainment of the length of the reasonable time standard. As such, while the difficult discoverability of defects might push the start of the reasonable timeframe back or forward, it does not impact the length of the reasonable time period.

⁸⁴ Take for instance the decision in CLOUT case No. 310 [Oberlandesgericht Düsseldorf, Germany, 12 March 1993] <http://cisgw3.law.pace.edu/cases/930312g1.html> accessed: 12 April 2013. While ascertaining whether the seller had fulfilled the requirements of Article 39 the court stated, “[A] period for notification of twenty-five days is neither short nor reasonable in the sense of Arts. 38 and 39 CISG.” This judgment seems to indicate that the court saw no difference between the timeframes of Articles 38 and 39. Moreover, in reaching its decision the court applied the factor of the date of delivery in measuring the length of the reasonable timeframe. For a similar ruling, see *Rechtbank van Koophandel Kortrijk*, Belgium, 16 December 1996 <<http://cisgw3.law.pace.edu/cases/961216b1.html>> accessed: 23 March 2013, wherein the court stated, “A period of approximately two months after delivery was not reasonable, taking into account that the defects were easily noticeable.”

⁸⁵ Anna Veneziano, ‘Non-Conformity of Goods in International Sales: A Survey of Current Caselaw on CISG’ [1997] *International Business Law Journal* 39, 51.

5.4 Factor Essential for Determining Reasonable Time

The travaux shed little light, if any, on what factors are to be taken into account in the determination of the length of reasonable time.⁸⁶ Unfortunately, the travaux do not even provide any form of clarity as to whose interests the provision is meant to protect. An analysis of the legislative history of the provision seems to suggest that Article 39 was merely a restatement of the rule contained in its predecessor, the ULIS. The only difference between the two provisions seems to lie in the fact that the term “promptly” was replaced with the term within a reasonable time. Now since Article 39 of the ULIS was drafted with the aim of protecting the seller from allegations of non-conformity from the buyer which he or she could not protect themselves from; at first glance it would seem that the provision as incorporated in the Convention was meant, solely, to protect the interest of the seller. A closer analysis of the amendment however reveals that it was a product of concerns that the provision was too strict for the buyer and the amendment was introduced to allow a greater degree of flexibility to the buyer in the provision of the notice.⁸⁷

It is argued that identification of the interest that the provision sought to protect is of importance in the ascertainment of how the term reasonable time is to be interpreted. For instance, if the provision is sought to protect the interests of the seller then it would logically follow that the timeframe within which notice so to be provided is to be reasonable according to the seller. The fact that the amendment to the ULIS version of Article 39 represented a flexible compromise in favor of the buyer, however, provides a counter balance to this consideration.⁸⁸ Professor Andersen, in recognition of this issue, recommends that courts should attempt to ascertain the amount of time that would be considered reasonable by both the seller and buyer independently.⁸⁹ She draws support from the stance adopted by Professor Honnold on the issue, where he states that courts should take a “wide range of factors into

⁸⁶ Similarly, the secretariat commentary and the Convention are silent as to the provision of guidelines of what constitutes reasonable time.

⁸⁷ See for example Ferrari (n 2) “...the time requirement of the ULIS was shorter.”

⁸⁸ Ingeborg Schwenzer (ed), *Commentary on the UN Convention on the International Sale of Goods (CISG)* (3rd edn, Oxford University Press 2010) 608.

⁸⁹ Camilla Baasch Andersen, ‘The Duty to Examine Goods under the Uniform International Sales Law-An Analysis of Article 38 CSIG’ (2007) 18 *European Business Law Review* 797.

account” in the assessment of reasonable time,⁹⁰ and argues that an assessment of the intention of both the seller would enable the adjudicator to reach a more subjective solution in individual cases.⁹¹

While what the parties consider to be reasonable time is one of the factors essential for the determination of the timeframe under Article 39, it is only one of many. Neither academic commentary nor judicial decisions have however been able to concretely identify a comprehensive list of factors that must be taken into account in the determination of the length of the reasonable time frame.

While this thesis recognizes the fact that Article 39 in its very nature is a compromise for flexibility, it is argued that the end users of the Convention should at least be provided with a framework that enables them to gauge what would be considered reasonable time to provide notice in. Similar concerns have led a group of academics to formulate a method of applying the term to a predetermined vantage point of a fixed period.⁹²

Professor Schwenzer, for instance, proposes the “informal adoption” of a period of one month as a vantage point in the consideration of what constitutes reasonable time within the meaning of Article 39.⁹³ According to this proposition, the facts of each case are to determine whether there are any considerations that would operate to shorten or increase the one month period. For instance, in a case of sale of generic non-perishable goods, the nature of the goods might operate to increase the period over one month.⁹⁴ Other factors – such as the buyer’s awareness of the seller operating under a deadline – would operate to shorten the period.⁹⁵ A balance of the

⁹⁰ See John Honnold and Harry M. Flechtner, *Uniform Law for International Sales under the 1980 United Nations Convention* (Kluwer Law International 2009) 281: “The determination of the ‘reasonable period’ for notice following the time when the buyer discovers (or ought to have discovered) the non-conformity would be influenced by a wide range of factors.”

⁹¹ Andersen (n 89).

⁹² Such a stance is not alien to national legal systems. Under Italian law for instance, a period of 8 days is provided for the provision of a notice. See Peter Schlechtriem (ed), *Commentary on the UN Convention on the International Sale of Goods* (Oxford University Press 1998).

⁹³ Schwenzer (n 25) 105. She however noted that when the reporter on Article 39 stated that an analysis of case law on the provision shows a “cautious convergence in the direction of the noble month” at a conference held in 2005, participants belonging to the common law world raised sharp objections to such a predetermined period. Schwenzer (n 25) 103.

⁹⁴ See also CLOUT case No. 248 [Schweizerisches Bundesgericht, Switzerland, 28 October 1998] <<http://cisgw3.law.pace.edu/cases/981028s1.html>> accessed: 26 March 2013.

⁹⁵ Landgericht Köln, Germany, 11 November 1993 <<http://cisgw3.law.pace.edu/cases/931111g1.html>> accessed 25 March 2013.

impact on the timeframe of all such factors on the one month period should result in the identification of what constitutes reasonable time.⁹⁶

This one month vantage point approach has found favour with a few tribunals, especially German courts. For instance, in *The Machine for producing hygienic tissues case*, the court held that since the defect was not easily discernible, the buyer should be provided a week to decide whether to hire an expert and a further two weeks should be provided for the expert to carry out its examination.⁹⁷ Finally under the dictates of Article 39(1), the court concluded that a period of one month was reasonable for the buyer, after receiving the expert's report, to notify the seller of the non-conformity.

The court therefore distinguished the two timeframes and decided that considerations such as the nature of non-conformity and the consequential appointment of an expert affect the timeframe of when the seller ought to have discovered the non-conformity. The court however provided no reasoning for its adoption of the one month frame. By doing so, the court fell into the most obvious trap of what is known as the noble month – i.e. it did not specify or even enter into the exercise of identification of factors which may shorten or extend the one month period.

While the vantage point approach has been recognized and adjudicated over in various cases in the last few years, there seems to be no agreement vis-à-vis the length or the approach to be adopted in the measurement of such presumptive periods. The effect is that a wide array of periods, ranging from as little as fourteen days after delivery to as much as a month after inspection, have been held as suitable presumptive periods.⁹⁸ Unfortunately, judgements rarely provide any guidance as to

⁹⁶ It is interesting to note that the period of one month proposed by Schwenzer is not an arbitrarily/randomly-identified period. Rather it is based upon a consideration of what is considered reasonable time within which notice of non-conformity is to be provided in various jurisdictions. By identifying such domestically accepted timeframes, she is able to find a balance in the period of one month. Professor Andersen suggests that since one month takes into account the precepts of domestic law, the compromise of recognizing it as reasonable time should not be too hard a pill to swallow for signatory states and would limit discrepancies in practice. There is however little support of this proposition in practice. Andersen (n 23).

⁹⁷ Clout case No. 319 [Bundesgerichtshof, Germany, 3 November 1999]
<<http://cisgw3.law.pace.edu/cases/991103g1.html>> accessed: 25 March 2013.

⁹⁸ CLOUT case No. 167 [Oberlandesgericht München, Germany, 8 February 1995]
<<http://cisgw3.law.pace.edu/cases/950208g2.html>> accessed: 25 March 2013; CLOUT case No. 423

how the presumptive periods have been calculated or what factors are to impact them. Such a lack of explanation, has translated to form an impediment in the recognition of the Convention's international character. In other words, reference to case law emanating from foreign jurisdictions is of little, if any, use when it fails to provide clear reasoning for its decisions.⁹⁹

This thesis is of the opinion that given the common law world's aversion to such vantage points, there is not much hope for the development of any meaningful consensus on the length of the presumptive period. Moreover, even if such consensus were to develop, there is little evidence that any significant clarity would result from it.

This is because the presumptive period is subject to a large host of factors that either increase or decrease this period. More often than not, such factors operate to render the presumptive period completely redundant; for instance, the perishable nature of goods would render any presumptive period of over a couple of weeks completely inapplicable.

This thesis therefore argues that the best method of interpreting the article lies not in the hunt of the identification of some unanimously accepted vantage point, but is rather achieved through a proper identification of the factors that must be taken into account in the determination of the two time frames.

Such an approach is cognizant of the fact that the very use of the term reasonable was intended to provide flexibility and as such, this approach does not claim to provide complete certainty vis-à-vis the definition of the term. Instead, it solely focuses on the identification of factors essential for the determination of the term,

[Oberster Gerichtshof, Austria, 27 August 1999] <http://cisgw3.law.pace.edu/cases/990827a3.html> accessed: 25 March 2013.

⁹⁹ Without providing any meaningful guidance about the rationale of their judgment, the following have been suggested as the reasonable time (presumptive) for giving notice: a few days after discovery of the lack of conformity: one week (following one week for examination under Article 38) CLOUT case No. 285 [Oberlandesgericht Koblenz, Germany, 11 September 1998] <<http://cisgw3.law.pace.edu/cases/980911g1.html>> accessed: 26 March 2013; eight days following discovery 112; two weeks (following one week for examination) see CLOUT case No. 359 [Oberlandesgericht Koblenz, Germany, 18 November 1999] <<http://cisgw3.law.pace.edu/cases/991118g1.html>> accessed: 26 March 2013.

through an analysis of case law, scholarly writings and the legislative history of the Convention.

The identification of such factors, it is argued, while not being able to provide a uniform scale which can be applied to fit almost every set of facts in the determination, does attempt to identify the weights used in the scale – which are the different factors in question.

5.5 Recommended Approach to the Interpretation of Reasonable Time

As explained above, one of the primary reasons for the incorporation of the notice requirement was to provide efficiency in instances where the goods did not conform to the contract. In the commercial world of today, time is a valuable commodity; wastage of time can result in diminishing the joint returns of the parties. On the other hand, restricting the notice period to a very short time frame would operate to place too heavy a burden on the buyer, who would then attempt to negotiate derogation from the terms of Article 39(1) through the express incorporation of a notice period in the contract. While such derogation is permitted by the Convention, it undermines the goals of the Convention of providing uniformity.¹⁰⁰ In other words, an inefficient default would not be conducive to the objective of legal uniformity, since parties would be motivated to derogate from it through agreement.

As argued above, while Articles 38 and 39 are interconnected, there is a difference between the inspection period and the reasonable time period. As such, it is asserted that the recognition of the differentiation between the two is an essential prerequisite for a proper application of the two articles. Any adjudicator charged with the duty of applying the said articles must therefore start by framing issues in the following terms:

- 1) **Have the parties derogated from the application of Article 39, by express agreement to a specific timeframe for notification?** If yes, then by virtue of Article 6 the agreed timeframe will apply. It is extremely important to note that such agreement operates to exclude the application of Article 39, and as

¹⁰⁰ See Convention, Article 6.

such considerations of reasonableness of the agreed timeframe are of absolutely no relevance. Unfortunately, at least one tribunal has erred by not recognizing this fact. In the *Cow Hides case*, the tribunal upheld the agreed notice timeframe since, in the view of the tribunal the notice period satisfied the requirements of Articles 38 and 39.¹⁰¹ Surely, even if it had not been considered reasonable by the tribunal, the agreed timeframe for notification would have had to be upheld in any event by way of Article 6 of the Convention which as explained above, allows parties to derogate from the Convention.¹⁰²

If the contract is silent as to the notice period, then the court should move on to framing issues 2 and 3 below.

2) **Upon which date was the non-conformity ought to have been discovered (unless the buyer had in fact discovered it sooner)?**

a) Practise or usage agreed between the parties: Since the Convention operates in a manner to give primacy to the agreement between the parties, it logically follows that the parties are bound to whatever practise they have agreed between themselves.¹⁰³ Such practices, however, differ from express agreements which were the subject of issue 1 outlined above. This is because such practices are rarely expressly stipulated in the contract but can be ascertained from the conduct of the parties. Such conduct can then be used to gauge the intention of the parties' vis-à-vis what they consider to be reasonable. For instance, in the *Dyed Textiles case*, the court interpreted the practice of the buyer to demand expedited delivery of the goods to constitute a practice which implies that the buyer would inspect the goods immediately upon delivery.¹⁰⁴

¹⁰¹ CLOUT case No. 303 [International Court of Arbitration, ICC, 1 January 1994] <<http://cisgw3.law.pace.edu/cases/947331i1.html>> accessed: 28 March 2013.

¹⁰² *ibid.* The only limit to such derogation is that it is subject to Article 12.

¹⁰³ Convention, Article 9.

¹⁰⁴ CLOUT case No. 634 [*Landgericht Berlin, Germany, 21 March 2003*] <<http://cisgw3.law.pace.edu/cases/030321g1.html>> accessed: 28 March 2013.

b) The presence of a Trade Usage on inspection: Parties are bound by trade custom only so far as it can be proved that the parties had actual knowledge of the usage or ought to have knowledge of it.¹⁰⁵ Moreover, the usage must be one that is widely known to, and regularly observed by, parties to contracts of the type involved in the particular trade concerned.¹⁰⁶ If such a custom exists on inspection, then the same will be implied into the agreement between the parties and resultantly, the dictates of Article 38 would become inapplicable.

c) Inspection needs: The discoverability of the defects must be taken into account while ascertaining when the buyer ought to have discovered non-conformity. Issues of such discoverability, it is asserted, are only relevant in the determination of this time frame and have no applicability in the determination of the notice period.

The relationship between inspection needs and the determination of when the buyer should have discovered the non-conformity is easy to see and as such, facts such as the need of expert opinion, the nature of the goods (whether the goods are unique, complicated, and/or delivered in instalments) should operate to extend the inspection period.¹⁰⁷

d) Awareness on behalf of the seller of ‘special’ circumstances: The court must examine whether the seller had actual knowledge of some special circumstance that delayed inspection by the buyer. Such circumstances would include, for example, knowledge of the fact that the buyer is a retailer who simply sells goods packaged by the seller).

e) Type of goods: Perishable goods and goods with an affinity to a particular season such as seasonal fruits would require immediate inspection whereas complex machinery would allow for inspection period to commence relatively later.

¹⁰⁵ Convention, Article 9.

¹⁰⁶ *ibid.*

¹⁰⁷ See for instance CLOUT case No. 45 [ICC, France, 1 January 1989]

<<http://www.cisg.law.pace.edu/cases/895713i1.html>> accessed: 28 March 2013.

- f) Nature of the buyer:** Small inexperienced firms lacking expertise would generally require a longer period of time to discover defects than large experienced firms.

While this list of factors for the determination of when the buyer ought to have inspected the goods is neither exclusive nor results in the identification of a specific answer that fits all cases, it is asserted that it provides adjudicators with some of the tools necessary in the ascertainment of the time of inspection independent of concerns of when notice should be given.

Since the timeframe within which notice is to be provided commences when inspection is completed,¹⁰⁸ only once the time at which the non-conformity was discovered or ought to have been discovered has been identified should the court proceed to identify the reasonable time within which notice is to be provided.

3) What is the timeframe within which the buyer should have provided notice of non-conformity, after the date found in point 2 above?

- a) **of the Trade usage on notice requirement:** as discussed above, any international trade usage which determines the timeframe is to be taken into account by virtue of Article 9(2).¹⁰⁹
- b) **Practices established between the parties:** according to the dictates of Article 9(1), the parties are bound by any usage to which they have agreed and by any practices which they have established between themselves. As such, the court must enter into the investigation of any practice or usage established between the parties that may have an impact on the length of the term.¹¹⁰ An example of such practice is the speed of communication established by the parties. If the parties usually communicate quickly with one another, the seller will be entitled to

¹⁰⁸ Or when the buyer ought to have discovered it.

¹⁰⁹ Rb Zwolle, Netherlands, 5 March 1997 <<http://cisgw3.law.pace.edu/cases/970305n1.html>> accessed: 5 March 2013.

¹¹⁰ CLOUT case No. 423 (n 98).

expect a speedier notice, and providing this will be required of the buyer.¹¹¹

- c) **Special nature of the goods**: Perishable goods would require a prompt notice in the interest of the seller's loss adjustment. Similarly seasonal goods or goods with affinity to a particular season (such as fashion-related clothing) would also require a shorter notice requirement.¹¹² Notice with respect to durable or non-seasonal goods, in contrast, could be subject to a longer notice period.¹¹³ It is essential to note that the obviousness of the defect or otherwise, has absolutely no application in the ascertainment of what constitutes reasonable time.¹¹⁴
- d) **Buyers' plans to process the goods**: Such acts would include further handling or processing of the goods by the buyer that might make it difficult to determine if the seller was responsible for a lack of conformity.¹¹⁵ Similar considerations would include the existence of delay in notice that results in depriving the seller of the opportunity to check the factual basis of the buyer's complaint and to offer repair or substitution.¹¹⁶ This head should be applied in conjunction with the one detailed directly below.

¹¹¹ Franco Ferrari, Harry M. Flechtner, and Ronald A. Brand, *The Draft UNCITRAL Digest and Beyond: Cases, Analysis and Unresolved Issues in the UN Sales Convention* (Sellier European Publishers 2003).

¹¹² See, for instance, CLOUT case No. 828 [Gerechtshof 's-Hertogenbosch, Netherlands, 2 January 2007] <<http://cisgw3.law.pace.edu/cases/070102n1.html>> accessed: 1 April 2013; CLOUT case No. 723 [Oberlandesgericht Koblenz, Germany, 19 October 2006] <<http://cisgw3.law.pace.edu/cases/061019g2.html>> accessed: 1 April 2013; CLOUT case No. 825 [Oberlandesgericht Köln, Germany, 14 August 2006] <<http://cisgw3.law.pace.edu/cases/060814g1.html>> accessed: 1 April 2013; Rechtbank van Koophandel Veurne, Belgium, 19 March 2003 <<http://cisgw3.law.pace.edu/cases/030319b1.html>> accessed: 1 April 2013.

¹¹³ District Court in Komarno, Slovakia, 24 February 2009 <<http://cisgw3.law.pace.edu/cases/090224k1.html>> accessed: 25 March 2013; Obergericht Zug, Switzerland, 19 December 2006 <<http://cisgw3.law.pace.edu/cases/061219s1.html>> accessed: 25 March 2013; Landgericht München, Germany, 27 February 2002 <<http://cisgw3.law.pace.edu/cases/020227g1.html>> accessed: 25 March 2013; CLOUT case No. 167 (n 98).

¹¹⁴ Such factors are relevant in the ascertainment of *when* the timeframe commences, not the length of the timeframe itself.

¹¹⁵ See CLOUT case No. 3 [Landgericht München, Germany, 3 July 1989] <<http://cisgw3.law.pace.edu/cases/890703g1.html>> accessed: 3 April 2013.

¹¹⁶ Judicial Board of Szeged, Hungary, 5 December 2008 <<http://cisgw3.law.pace.edu/cases/081205h1.html>> accessed: 3 April 2013.

- e) **The buyer's duty to limit the seller's loss:** Since one of the reasons for the formation of Article 39 was to protect the rights of the seller, it would seem essential for the court to take the impact of the notice requirement on the seller's rights. As such, a buyer invoking the remedy of avoidance of contract should take into account the possibility of mitigation of loss by resale by the seller while calculating the length of the notice period. Similarly, awareness on the part of the buyer of some special obligation of the seller which might be breached due to a non-timely notice, such as where the seller was operating under a deadline, should operate to shorten the period.
- f) **The nature of the remedy chosen:** If the buyer chooses to avoid the contract the seller will need more time to take care of his or her goods, whereas a remedy of damages or price reduction places no such pressures on the seller.¹¹⁷ As such, the notice period in instances where the buyer wishes to claim damages while retaining the goods should be longer than in instances where he wishes to reject them.

A proper appreciation of the approach outlined above should enable a court to discover the intent of what buyer and seller would consider reasonable in the circumstances. An equitable balance between the two should enable the court to then ascertain the length of the reasonable time frame. While such a method does not provide any substantial degree of uniformity, it does grant a degree of certainty to the end users of the Convention who would at least be aware of the factors that are to be used in the determination of the time period.

5.6 Specifying the Nature of the Lack of Conformity

The issue of the degree of specificity required for the fulfillment of the notice requirement has raised a great deal of disagreement between courts and scholars alike. While a majority of judgments on the issue favor an interpretation that requires

¹¹⁷ See for instance, CLOUT case No. 938 [*Kantonsgericht Zug, Switzerland, 30 August 2007*] <<http://cisgw3.law.pace.edu/cases/070830s1.html>> accessed: 9 April 2013; [*Monomeles Protodikio Thessalonikis, Greece, 2003*] <http://cisgw3.law.pace.edu/cases/030001gr.html> accessed: 9 April 2013.

a precise and detailed notice,¹¹⁸ certain commentators and tribunals have questioned the utility of such a stringent requirement.¹¹⁹

Since the issue of what exactly the notice should constitute is to be answered in line with the functions the notice is supposed to serve,¹²⁰ Honnold argues that a notice that merely specifies that the goods are defective would not allow for the achievement of the objectives of the notice requirement and as such would not fulfill the requirements of Article 39.¹²¹ He does, however, state that buyers should not be required to provide details of the non-conformity with a high degree of precision since, in this electronic age, the seller can inquire about details – if needed – on the receipt of the notice.¹²² In any case, a stringent requirement on specificity would be out of touch with commercial reality; as the travaux reveal, the parties in the situation may well be unsophisticated buyers dealing with complex machinery and, as such, incapable of providing the relevant information with a high degree of precision.

This is not to say that a notice simply titled ‘non-conforming goods’ would fulfill the requirements of Article 39. Rather, what is required is that the buyer conveys all defects known to him or her to the seller.¹²³ Indeed, according to the statement made

¹¹⁸ See for example Oberlandesgericht Linz, Austria, 1 June 2005 <<http://cisgw3.law.pace.edu/cases/050601a3.html>> accessed: 10 April 2013, holding that the “notice must be precise”; Hof van Beroep Antwerpen, Belgium, 14 February 2002 <<http://cisgw3.law.pace.edu/cases/020214b1.html>> accessed: 10 April 2013, holding that the notice should provide “a complete picture of the complaints”; Landgericht Saarbrücken, Germany, 2 July 2002 <<http://cisgw3.law.pace.edu/cases/020702g1.html>> accessed: 10 April 2013; Landgericht Marburg, Germany, 12 December 1995 <<http://cisgw3.law.pace.edu/cases/951212g1.html>> accessed: 10 April 2013, holding that the notice should allow the seller to determine the buyers’ complaints “without further investigation.”

¹¹⁹ See John O. Honnold, *Uniform Law for International Sales under the 1980 United Nations Convention* (Kluwer Law International 1999) 277-278; See CLOUT case No. 938 (n 117); AC Opinion No 2 (n 10).

¹²⁰ Ibid. While a host of purposes have been listed in the preceding part of this chapter, Honnold limits the same to providing “the seller an opportunity to obtain and preserve evidence of the condition of the goods and to cure the deficiency.”

¹²¹ Ibid. Honnold argues that such a notice would fail since it simply states that there is a defect without specifying “the nature of the lack of conformity.” At page 278.

¹²² Ibid. 277.

¹²³ This stance has been adopted in a few judgments. In Landgericht Bamberg, Germany, 23 October 2006 <<http://cisgw3.law.pace.edu/cases/061023g1.html>> accessed: 12 April 2013 for example the court stated, “Should any lack of clarity remain for the seller concerning the nature or extent of the non-conformity after a notice has been submitted, the seller can be expected to inquire of the buyer.”

by the delegate of Federal Republic of Germany during the 16th Meeting of the First Committee, this conclusion seemed quite obvious.¹²⁴

Case law, on the other hand, reveals a very different picture. This may partly be attributed to the fact that the law of Germanic countries, where the majority of the case law on the provision has been adjudicated, places a very stringent requirement upon the buyer vis-à-vis communication of non-conformity.¹²⁵ Interestingly, this stringency has found its way in the German text of the Convention which states that the buyer must specify the defect with *genau zu bezeichnen* (i.e. with precision). Given this peculiarity in the German text of the Convention, it is difficult to ascertain the degree to which German courts are influenced by the dictates of German domestic law while interpreting the article.¹²⁶ It is, however, clear that the imposition of such a stringent requirement upon buyers increases transaction costs – thereby undermining efficiency.

An example is the *Agricultural Machine Case* decided by the LG Marburg, wherein it was held that a notice of non-conformity failed to conform with the requirements of Article 39 since it did not identify the serial number of the machine delivered or the date of its delivery. The machine however was the only one of its type purchased by the buyer from the seller and resultantly there could not have been any ambiguity surrounding which machine formed the subject matter of the notice. The court however stated that the “seller could not be required to search through sales ledgers to locate the documents for the machine in question.”¹²⁷

The rationale for requiring this degree of specificity is difficult to justify, when one weighs the prejudice to the buyer as a result of such a rule, against that of the seller in the absence of such a rule. This is so that the seller does not seem to lose any of the protections afforded to him by the notice requirement, as a result of the buyer’s lack of precision in detailing the non-conformity. For instance, since the seller can

¹²⁴ Mr. Herber (Federal Republic of Germany) stated, “Under Article 37 [became CISG Article 39], the buyer would lose his claim – a very severe sanction – if he did not notify the buyer of any defects known to him. For that purpose he had, however, a reasonable period of time which could amount to as much as two years -- a long period in commercial terms.” See Vienna Diplomatic Conference, 16th Meeting (n 38) Para 62.

¹²⁵ That is the standard imposed upon the buyer by the ULIS.

¹²⁶ An exception to the homeward trend is found in the judgment of CLOUT case No. 319 (n 97).

¹²⁷ Landgericht Marburg, Germany, 12 December 1995

<<http://cisgw3.law.pace.edu/cases/951212g1.html>> accessed: 15 April 2013.

inexpensively inquire into the details of the alleged non-conformity upon receipt of a notice that does not specify the same in detail,¹²⁸ it cannot be argued that the seller's ability to collect evidence or send the relevant experts for examination is prejudiced. Similarly, the seller's ability to offer cure or potential recourse to the supplier is not diminished, so long as the notice is provided within a reasonable time. Even if such inquiry carries certain costs, they have to be higher than the potential loss to the buyer resulting from non-specificity in the notice,¹²⁹ for the requirement of precision to be justifiable. Such a scenario, however, is hard to imagine in the context of the commercial world of today.

An example is the judgment in the *Facade Stones Case*.¹³⁰ This case involved the sale of stones between a German buyer and an Italian seller. After delivery, the buyer gave the seller a notice of non-conformity of goods under Article 39. In particular, the buyer alleged that: (a) goods were not labelled in the manner agreed between the parties; (b) the borings were not made or placed in the agreed manner; (c) that the sills and stones did not conform to the size agreed; and (d) the mounting glue was defective.¹³¹ In essence, the buyer had provided the seller with all the information he had about the non-conformity. On the basis of this information, the seller agreed to the claim of nonconformity of borings and reduced the purchase price.

On action by the seller for the recovery of the (reduced) purchase price, the buyer counterclaimed for damages.¹³² In the opinion of the court, the buyer had failed to detail the non-conformity complained of with the required degree of specificity. The court argued, for example, that while the buyer stated that the stones did not conform to the agreed size it did not state the quantity of non-conforming stones.¹³³ Similarly, with regards to the glue the court stated that while the buyer alleged that the glue used to mount the stones was defective, it failed to allege the exact quantity of stones treated with the defective glue.¹³⁴ It is hard to see how the seller was prejudiced as a

¹²⁸ Indeed, it would be more economically efficient to require the seller to check his ledgers or inquire in such a case, than to impose a bar on the remedies available to the buyer if he does not specify such details in the notice.

¹²⁹ That is, subject to Articles 40 and 44, the bar to invoke any remedy under the Convention.

¹³⁰ CLOUT case No. 364 [Landgericht Köln, Germany, 30 November 1999]
<<http://cisgw3.law.pace.edu/cases/991130g1.html>> accessed: 17 April 2015.

¹³¹ *ibid.*

¹³² *ibid.*

¹³³ *ibid.*

¹³⁴ *ibid.*

result of not being informed of the number of non-conforming stones so long as he was made aware that certain goods did not conform. If such information was indeed essential for the seller in deciding how to respond, for instance by offering cure, he could have, as stated above, simply inquired.

In any case, a literal interpretation of the German text of the article cannot be adopted since it clearly diverges from all authenticated versions of the Convention.¹³⁵ The fact that the German text of the treaty is not as authoritative as other texts is made clear by the fact that the Convention was authenticated in six languages which did not include German.¹³⁶ This fact was accepted by the Supreme Court of Switzerland in the *Used Laundry Machine* case.¹³⁷

In this case, the Supreme Court of Switzerland, referred to the French and English texts and concluded that the requirements to be met by a notice are less strict than that which may be inferred from the German wording of Article 39(1). The court specifically referred to the term *préciser de ce défaut* (i.e. specifying the nature of the lack of conformity) as the requisite standard as opposed to specifying with precision. As such the court was of the opinion that

In order to circumscribe the nature or type of the lack of conformity, it is sufficient if the buyer communicates that a machine or parts thereof are not functioning and indicates the appropriate symptoms. It is not necessary that he also elaborates the causes of the functional faults.¹³⁸

Surprisingly, the court's ruling on the facts of the case was in direct contradiction to this finding. Thus while the court held that a description of the symptoms would suffice for the purposes of Article 39, it went on to conclude that the buyer must specifically mention each defect with a degree of specificity that goes beyond simply identifying the symptoms.

¹³⁵ Vienna Convention on the Law of Treaties (1969), Article 33.

¹³⁶ The Convention was authenticated in Arabic, Chinese, English, French, Russian and Spanish. See Ulrich Magnus, *Tracing Methodology in the CISG: Dogmatic Foundations CISG Methodology* (Sellier European Law Publishers 2009).

¹³⁷ CLOUT case No. 885 [Bundesgericht, Switzerland, 13 November 2003] <<http://cisgw3.law.pace.edu/cases/031113s1.html>> accessed: 17 April 2013

¹³⁸ The buyer indicated in its letter dated 5 September 1996 that the delivered machine was not usable, the "machine distillation system did not function" and "the delivered machine components did not function." As such, the buyer stated the individual functional faults or missing parts, and demanded corrective measures.

Such an interpretation goes against Opinion Number 2 delivered by the Advisory Council, wherein the Council asserted that the requirement of specificity has to be interpreted in light of the circumstances of each case, and as such, simple statement of the symptoms of a defect may well satisfy the requirements of Article 39 in appropriate circumstances.¹³⁹ Interestingly, such a stance had been adopted by the Bundesgerichtshof almost five years before the advisory opinion was delivered.¹⁴⁰

This reveals that even in the same jurisdiction, the requirement of specificity as contained in Article 39 has been interpreted inconsistently. Such divergence has created a great degree of uncertainty amongst both commentators and the end users of the Convention. For the consumers of the Convention, such uncertainty opens the doors to dire consequences i.e. a bar on claims.

5.6.1 Recommended Approach to the Degree of Specificity Required

The preceding discussion should not, however, be interpreted to mean that the same degree (or lack thereof) of precision should be required of all buyers, regardless of their individual characteristics or that of the goods concerned. In other words, requiring a higher degree of precision from an expert buyer, relative to an unsophisticated one, makes sense from an efficiency perspective. This is because expert buyers by their very nature are presumed to be able to examine the goods with relative efficiency – i.e. inexpensively.¹⁴¹ Even if this presumption fails, a secondary presumption – i.e. such buyers are expected to know details of the non-conformity with a higher degree of precision relative to inexperienced buyers – operates to place a higher standard on them.¹⁴²

¹³⁹ AC Opinion No 2 (n 10).

¹⁴⁰ CLOUT case No. 319 (n 97). In this case the court stated, “In case of defective technical equipment, a description of the symptoms should suffice in order to satisfy the requirements of Article 39(1) CISG. A specification of the reasons causing the defect is not required.”

¹⁴¹ This is based upon the assumption that since the expert buyer has possession of the goods, he or she can examine or have them examined inexpensively relative to the seller who would have to hire examiners in a state other than his own.

¹⁴² The fact that the buyer bears the burden of proving that he or she has fulfilled the requirements of Article 39 is unanimously accepted. Part of discharging this burden is proving that he or she had

Similarly, the nature of the goods has an impact on the degree of specificity required. For instance, uncomplicated goods do not require expert examination for the defects to be ascertained. As a result, any buyer can list the non-conformity in detail without incurring additional costs. In such a scenario, it would be unsound from an efficiency perspective\ if the seller was placed in a position where the seller would have to inquire the details of the non-conformity which the buyer is already aware of. In the case of complicated goods, on the other hand, it would be economically unsound to obligate buyers, especially if they are unsophisticated, to list the details of the alleged non-conformity with precision. As explained above, such a requirement would operate to minimize the joint return of the parties, since the costs to the buyer resulting from non-provision of such details would more often than not, if not always, outweigh the advantages to the seller.

In conclusion, an interpretation of the specificity requirement of Article 39 that places too heavy a burden on the buyer, regardless of the buyer's characteristics, should not be preferred. This is because it ignores the commercial reality which the Convention is meant to govern, to the extent that the identity and nature of the parties involved are not taken into account. This omission in analysis places obligations upon the parties which they are not well suited to fulfil. Thus, this thesis argues that buyers should only be obligated to inform the seller of all defects known to the buyer.¹⁴³ This rule should be complemented with the assumptions that: (a) expert/skilled buyers are presumed to know details of the nonconformity with greater precision than unsophisticated ones, and (b) cases involving generic goods require nonconformity to be specified with a greater degree of precision than technical ones.

5.7 The Exception to the Rule of Article 39

As discussed above, the impact of non-provision of a timely notice results in the deprivation of all remedies available to the buyer under the Convention. In order to limit this drastic consequence, certain delegates submitted proposals to amend the

fulfilled the requirement of specificity. In the context of the approach identified as the correct one in this chapter, carrying the burden would entail proving that the buyer has provided all relevant information possessed, which would in turn entail proving that the presumption has been met or providing rebuttal evidence which shows that the presumption does not hold in the context.

¹⁴³ A list of symptoms satisfies this requirement.

wording of Article 39 to make it less stringent. By way of compromise, Articles 40 and 44 were introduced into the Convention.

Article 40 states, “The seller is not entitled to rely on the provisions of Articles 38 and 39 if the lack of conformity relates to facts of which he knew or could not have been unaware and which he did not disclose to the buyer.” As such the article operates to allow the buyer to retain all remedies available to him under the Convention. Such an approach is in conformity with the rationale underlying the requirement of timely provision of notice. Firstly, if the seller is aware of the non-conformity then the information gathering rationale is not relevant, since there is no information asymmetry between the parties in such an instance. Moreover, the provision of a notice in such an instance will not provide any extra advantage that would enable the seller to cure the defect. For similar reasons, a notice will not enable repose on the part of the seller. In fact, where the seller is aware of the non-conformity, the notice requirement will simply operate to increase transaction costs – for example, through costs incurred in drafting the notice itself.

Moreover, if notice were to be required even in instances where the seller was aware of the non-conformity, the seller could act in bad faith at the expense of the buyer i.e. opportunistically. For instance, sellers would know that even when they sell defective products they have a defense to the buyer’s rejection of the goods. Here, the seller could use the threat of challenging the timeliness of notice, regardless of whether it has been provided in a timely fashion in the circumstances.

As will be discussed in greater detail, while Article 40 is concerned with the bad faith (opportunistic behavior) of the seller, Article 44 is subject to the bona fide intentions of the buyer. Accordingly, Article 44 allows the buyer to retain the remedies of reduction of price and damages where the buyer can provide a reasonable excuse for failure to provide a timely notice.

Due to the fact that both these articles incorporate vague terms, they have been the subject of dispute in a large number of cases. Courts however, have been unable to agree upon the basic elements of the two articles i.e. the idea of reasonable excuse, and the presumption that parties could not have been unaware. Unfortunately, the

legislative history of the articles is also not of much use in defining these vague terms.

5.7.1 Interpretation of ‘could not have been unaware’

The most adjudicated upon issue – and indeed one that has given rise to the greatest degree of disagreement – within the realm of Article 40 is the standard of awareness required for its application.¹⁴⁴

One arbitration decision recognized the degree of disagreement that the term had generated and argued that a literal interpretation of the article would suggest that, in order to prevent the protections of Article 39 from becoming illusory, Article 40 requires something more than a general awareness that goods manufactured by a seller “are not of the best quality or leave something to be desired.”¹⁴⁵ It seems that while the tribunal saw no problem in finding the requirements of Article 40 to be met in cases of fraud, it could not view the application of the same in cases of gross negligence on the part of the seller.¹⁴⁶ As such, the tribunal limited the application of the article to cases containing at least “deliberate negligence” as differentiated from “ordinary or gross negligence.”¹⁴⁷ Professor Schwenzer seems to support such an interpretation of the article but lists guidelines in instances where knowledge can be presumed.¹⁴⁸

On the other hand, the court in *The Cashmere Sweaters Case* reached exactly the opposite conclusion. In this case, a German buyer, the defendant, ordered cashmere sweaters from an Italian seller, the plaintiff.¹⁴⁹ The seller sued the buyer for the outstanding purchase price. The buyer sought set-off, claiming that the buyer had

¹⁴⁴ Alejandro M. Garro, ‘The Buyer’s Safety Valve under Article 40: What Is the Seller Supposed to Know and When’ (2005) 25 Journal of Law and Commerce 253.

¹⁴⁵ CLOUT case No. 237 [Arbitration Institute of the Stockholm Chamber of Commerce, Sweden, 5 June 1998] <<http://cisgw3.law.pace.edu/cases/980605s5.html>> accessed: 17 April 2013.

¹⁴⁶ *ibid.*

¹⁴⁷ The tribunal concluded that the level of seller awareness of non-conformities that is required to trigger Article 40 is “conscious disregard of facts that meet the eyes and are of evident relevance to the non-conformity.”

¹⁴⁸ She lists: i) defective goods resold; ii) selling goods with defect that the seller should have been aware of on account of his duty to keep his product under observation; iii) defects discernible from superficial check or standard test if the seller is the manufacturer. Ingeborg Schwenzer in Schlechtriem (n 92) 323.

¹⁴⁹ CLOUT case No. 232 [Oberlandesgericht München, Germany, 11 March 1998] <<http://cisgw3.law.pace.edu/cases/980311g1.html>> accessed: 17 April 2015.

notified the seller that the sweaters were defective. In ascertaining whether the requirements of Article 40 had been met, the court stated that Article 40 was applicable if the seller overlooked obvious defects in the goods that could have been detected through the exercise of ordinary care.

The above two judgments reveal that there is a split between those who assert that the requirements of Article 40 are met if the seller's ignorance is due to gross or even ordinary negligence, and those who would require something more, approaching deliberate negligence. Matters become more complicated when questions such as is the seller under a duty to investigate for the purposes of Article 40 arise. In other words, there is a split between those who argue that a seller is under no obligation to investigate for possible non-conformities, and those who assert that the seller must not ignore clues and may have a duty to examine the goods for lack of conformity in certain cases. Professor Schwenger for instance goes beyond literal language of Article 40, suggesting that the seller has an obligation to examine the goods to ascertain their conformity.¹⁵⁰ Other scholars have, however, taken a more flexible approach to the issue. Professor Huber, for instance, defines, "could not have been unaware" as "a little bit less than cunning and a little bit more than gross negligence."¹⁵¹

Lastly, the article is uncertain as to upon whom the burden of proving that the seller could not have been unaware rests. While there is no doubt that as a general rule of the Convention, the party benefiting from a claim must lift the burden of evidence to prove it, certain courts have found the burden to have shifted in certain circumstances.¹⁵²

For instance, in a Dutch case concerning maggots in mozzarella, the Court allowed the buyer time to prove that the maggots were in the cheese at the time of shipment, and added in *obiter dictum* that if they succeeded the seller's knowledge would be

¹⁵⁰ Ingeborg Schwenger in Schlechtriem (n 92) 323.

¹⁵¹ Huber, cited in Enderlein and Maskow (n 50) 164.

¹⁵² CLOUT case No. 773 [Bundesgerichtshof, Germany, 30 June 2004]
<<http://cisgw3.law.pace.edu/cases/040630g1.html>> accessed: 17 April 2013.

presumed.¹⁵³ As such, the court was of the opinion that if the buyers are able to show that the obvious defect existed while the goods were still in the seller's possession, then the burden of proof lies on the seller to prove that he did not know or could not have been aware. It may therefore be implied that the court viewed gross negligence on part of the seller to satisfy the requirements of Article 40.

Partial reversal of the burden of proof due to a presumption of the seller's awareness under Article 40 is problematic since it is based upon the presumption that the provisions of Article 40 are met where the seller had been grossly negligent. Since questions of whether the existence of actual knowledge or opportunism is essential is still contested, it is almost impossible to gauge the legitimacy of the reversal of the burden of proof.

While the travaux and the case law do not provide any meaningful guidance vis-à-vis the resolution of this issue, it is argued that the answer lies in the very wording of Article 40. This is simply recognition of the fact that the term "could not have been unaware" was chosen instead of terms more flexible in favor of the buyer such as "should have known." While the latter would incorporate instances of negligence, the former clearly does not. Moreover, since the philosophy behind the incorporation of Article 40 was to punish instances of opportunism on part of the seller, it would logically follow that Article 40 should not apply where such opportunism cannot be proved. Moreover, such opportunism must be proved by the buyer on a balance of probabilities, and as such presumptions of opportunistic behavior are not sufficient to either satisfy the requirements of Article 40 or to shift the burden of proof on the seller.

5.7.2 Article 44

As discussed above, the delegates of developing states were concerned with the draconian effect of the failure to provide the required notice under Article 39. By way of compromise, Article 44 was drafted which allows the buyer to retain the

¹⁵³ See CLOUT case No. 98 [Arrondissementrechtbank Roermond, Netherlands, 19 December 1991] <<http://cisgw3.law.pace.edu/cases/911219n1.html>> accessed: 17 April 2013.

remedies of price reduction and damages, except loss of profits, in cases where the buyer can provide a reasonable excuse for any failure to conform to the requirements of Article 39(1).¹⁵⁴

A lot of ink has been spilled in the ascertainment of what constitutes reasonable in this given context.¹⁵⁵ This part of the paper however is concerned with the analysis of the utility of such a provision in the framework of Article 39 and 40. According to Professors Hurber and Schwenger, the utility of this provision is found in instances where the buyer provides a notice but does not specify the nature of the non-conformity with sufficient detail, or where the notice is provided slightly after the lapse of reasonable time.¹⁵⁶ As explained above, concerns such as the size of the buyer's business, the level of expertise of the buyer etc. are instrumental in the determination of the length of the reasonable time period contained in Article 39. As a result, in cases where the buyer has provided a notice and the same is found not to conform to the dictates of Article 39, it is difficult to see how the buyer could possibly avail the protection contained in Article 44 when it has provided the notice shortly after the end of the reasonable timeframe. In other words, since most considerations of what constitutes a reasonable excuse are already applied in the ascertainment of the reasonable time period, the possibility of the invocation of Article 44 and as a result its utility is questionable in cases where a notice has been provided but not in conformity with the dictates of Article 39.¹⁵⁷

The argument that Article 44 operates to protect the buyer in instances where it has provided a notice that does not list the non-conformity in sufficient detail is similarly unpersuasive. The utility of specifying the nature of the lack of conformity operates to aid the seller in sending and where required hiring the relevant specialist for examination of the alleged defect. Failing such specificity, the seller would

¹⁵⁴ Article 44 has absolutely no impact on the requirements of Article 39(2), and as a result the remedies available to the buyer are restricted to the two-year timeframe.

¹⁵⁵ See, for example, Sanna Kuoppala, *Examination of the Goods Under the CISG and the Finnish Sale of Goods Act* (Turun yliopisto 2000); John C. Reitz, 'A History of Cutoff Rules as a Form of Caveat Emptor: Part I-The 1980 UN Convention on the International Sale of Goods' (1988) 36 *The American Journal of Comparative Law* 437.

¹⁵⁶ Schwenger/Hurber in Schlechtriem (n 92) Article 44.

¹⁵⁷ In the words of the AC: "[I]t may be questioned whether Article 44 added anything to the notice regime, since both Article 38 and Article 39 contain language that can fairly be interpreted to reach any result that Article 44 was intended to reach." AC Opinion No. 2 (n 10).

potentially be disadvantaged since he or she would be exposed to a framework that may result in economic wastage to his or her detriment.¹⁵⁸ Moreover, such specificity would enable the seller to substitute or repair the goods, where permitted by the circumstances. However, it would be wrong to conclude that absent such specificity in the notice, the seller would not be able to hire experts or cure the defects before the institution of legal proceedings. Rather, in this electronic age the seller can simply inquire details if required, on the receipt of the notice.¹⁵⁹ Such inquiry would seldom carry high costs and resultantly seems to be preferable relative to a framework that obliges buyers to conform to a vague standard of specificity, failing which they lose the right to invoke certain remedies.

In instances where the buyer has not provided a notice, the utility of Article 44 is similarly questionable. This is because Article 44 will only be invoked once the buyer has become aware of the non-conformity within two years of delivery. The question then is why the buyer would choose to invoke Article 44 rather than provide a notice under Article 39(1). Indeed, such a notice would be considered to be timely if the buyer has a reasonable excuse justifying the delay.

Moreover, Article 44 does not preclude the duty to inspect the goods under Article 38. As a result, omission to inspect the goods in a manner and time consistent with the circumstances of the case will bar the invocation of Article 44. In other words, if the buyer does inspect the goods in accordance with the requirements of Article 38 and becomes aware of the defect there does not seem any reasonable reason why the buyer would not inform the seller of the same.¹⁶⁰

5.7.3 The Remedies Under Article 44

Not allowing avoidance of contract where the buyer does have a reasonable excuse for non-compliance with the dictates of Article 39(1) makes sense from an efficiency

¹⁵⁸ For instance, since the seller does not know the exact nature of the defect he or she might send the wrong experts for examination.

¹⁵⁹ Honnold (n 119) 277.

¹⁶⁰ Gabriel Moens argues that in such circumstances the buyer should not be allowed to invoke the provisions of Article 44 because he or she has “acted without the care required of a businessman.” This diminishes the reasonability of the excuse provided. Peter Gillies and Gabriël Moens, *International Trade & Business Law & Policy* (Routledge 1998) Section 3.3.

presepctive. Firstly, where the buyer avoids the contract, the goods are returned to the seller, who may find that he or she has lost the opportunity to dispose of them elsewhere as a result of passage of time.¹⁶¹ There are added concerns that the market price of the goods may have declined as a result of external factors – for example, newer innovations.¹⁶² Moreover, there is a possibility the seller would have lost claims of defects in the goods against the original manufacturer, and as such will not be able to pass the liability on to the original source.¹⁶³ As a result, if the buyer is allowed to avoid the contract after the passage of considerable time after delivery,¹⁶⁴ the seller could potentially incur losses greater than that incurred by the buyer thereby decreasing the joint return from the sale.

Similarly, there is economic value in not allowing claims for lost profits under Article 44. If the seller had been informed in a timely manner of the defects, the seller could have offered cure which would have saved consequential damages such as lost profits. The buyer should therefore not be allowed to avoid such losses since it is presumed that the seller was in a position to avoid the same if the seller had been made aware of the defects in a timely manner. On the other hand, the mitigation/cure rationale provides no grounds for protecting the seller from losses incurred as a result of non-conformity, which could not have been avoided through further acts of the seller.¹⁶⁵

Moreover, the utility of right of the buyer to reduce the price of the goods in such circumstances is questionable. Had the seller been offered the opportunity to cure the defects, the resultant loss to the buyer would have been less. It therefore seems that by invoking the remedy of price reduction under Article 44 read with Article 50, the buyer is relying on the a failure of the other party to perform, where the loss resulting from such failure was partially caused by the buyers' omission of providing an opportunity to cure.¹⁶⁶ In any case, such a remedy is subject to the rules of

¹⁶¹ This is especially true in the case of seasonal goods.

¹⁶² Take for example the market for electronic goods which given the pace of innovations in technology is extremely volatile.

¹⁶³ This includes passing liability to the carrier for damages caused during transit.

¹⁶⁴ In any case less than two years.

¹⁶⁵ This statement is in line with the dictates of Article 77.

¹⁶⁶ Convention, Article 80.

mitigation contained in Article 77, and as a result the buyer can only reduce the price to the extent of damages incurred after mitigation.

The provision of the right to claim damages other than lost profits however seems to be in line with the considerations underlying the framework of Articles 39, 40 and 44. The objection to such recovery lies in the fact that the seller has lost the opportunity to collect rebuttal evidence. Thus, even though the onus of proving the quantum of loss rests on the buyer, the seller's ability to defend him- or herself from trumped-up cases is severely undermined. The question then is whether the prejudice to the seller as a result of not being provided the remedy to collect evidence outweighs the advantages to the buyer of retention of right to claim damages other than loss of profits. Professor Reitz, for instance, argues that the loss of evidence rationale does not apply in a majority of commercial cases involving technical goods since buyers usually rely on impartial third party expert evidence.¹⁶⁷ In any case, a review of case law on the article reveals that courts correctly begin with the assumption that the goods were not defective at the time of delivery. Moreover, courts tend to raise the presumption that the lesser the persuasive value of the reasonability of the delay, the greater the presumption that the buyer's claim is unfounded. Taken together, such a methodology of the interpretation of the article seems to counter-balance the prejudice the seller faces due to his or her inability to collect evidence in a timely fashion.

In any case, the article does undermine the possibility of repose. In the words of Professor Schlechtriem:

Protection of the seller's interest in regarding the transaction as fully completed may put a considerable burden on the seller, particularly because 'reasonable excuse for his failure to give the required notice' is indefinite and open to an interpretation favorable to the buyer. Certainly there is some danger that buyers may assert non-conformity for two years and, on the basis of Article 44, withhold remaining payments or take recourse against securities (suretyships or guarantees).¹⁶⁸

¹⁶⁷ Reitz (n 155) 441.

¹⁶⁸ Schlechtriem (n 8) 69-70.

Professor Huber argues that the only instance where Article 44 would provide some value to the parties is instances where an expert is hired to carry out the examination and fails to identify the lack of conformity. A differentiation is to be created between instances where both parties have agreed upon the nomination of a particular expert and where the buyer unilaterally nominates an expert. In the former case, it can be stated that since both parties had agreed that the inspection would be carried out by a neutral inspection body, the buyer cannot be stated to have taken on the liability of bearing the consequences of an incorrect examination alone and thus would have a reasonable excuse for the non-timely provision of the notice.¹⁶⁹ It is however difficult to see why this reasoning cannot be applied to the calculation of reasonable time under Article 39. Indeed in such circumstances it cannot be said that the buyer ought to have discovered the defect in accordance with Article 38, at the time of inspection by the mutually nominated expert.¹⁷⁰ As a result, the reasonable period would begin to run from the date that the non-conformity was actually discovered. As such, the utility of Article 44 in such circumstances seems doubtful.¹⁷¹

5.8 Conclusions

The interpretation of the articles concerning the requirement of the provision of a notice must give due regard to the realities of commercial transactions. Failing this, parties would be motivated to contract around the rules of the Convention on the matter. It is therefore argued that an appropriate interpretation of the dictates of Article 39 must take the circumstances of each case into account. Consequently, an interpretation of the specificity requirement of Article 39 that places too heavy a burden on the buyer, regardless of the buyer's characteristics, should not be preferred. This is because, an approach requiring a high degree of specificity ignores the commercial reality which the Convention is meant to govern, to the extent that the identity and nature of the parties involved are not taken into account. This omission in analysis places obligations upon the parties which they are not well

¹⁶⁹ This reasoning was adopted in Arbitral Award No. 9187 June 1999 ICC.

¹⁷⁰ This is simply a result of the fact that the buyer does not bear the liability of wrongful inspection.

¹⁷¹ Sonja Kruisinga, *(Non-) conformity in the 1980 UN Convention on Contracts for the International Sale of Goods: A Uniform Concept?* (Vol. 46, Intersentia nv 2004) 122.

suited to fulfil. As such, buyers should only be obligated to inform the seller of all defects known to them.¹⁷² This rule should be complemented with the assumptions that: (a) expert/skilled buyers are presumed to know details of the nonconformity with greater precision than unsophisticated ones, and (b) cases involving generic goods require nonconformity to be specified with a greater degree of precision than technical ones.

Requiring a high degree of specificity regardless of the characteristics of the buyer, is difficult to justify, when one weighs the prejudice to the buyer as a result of such a rule, against that of the seller in the absence of such a rule. This is so that the seller does not seem to lose any of the protections afforded to him by the notice requirement, as a result of the buyer's lack of precision in detailing the non-conformity.

In this context, it makes logical sense to limit the application of the dictates of Article 39, in instances where the seller knew or could not have been unaware of the lack of conformity of the goods.¹⁷³ Indeed, where the seller is aware of the non-conformity, the notice requirement will simply operate to increase transaction costs – for example, through costs incurred in drafting the notice itself. Moreover, if notice is to be required even in instances where the seller was aware of the non-conformity, the seller could act in bad faith at the expense of the buyer i.e. he or she would be motivated to act in an opportunistic manner.

The dictates of Article 44 on the other hand are concerned with the bona fide intentions of the buyer. Accordingly, Article 44 allows the buyer to retain the remedies of reduction of price and damages where the buyer can provide a reasonable excuse for failure to provide a timely notice. It is argued that if the dictates of Article 39 are interpreted with due regard to the circumstances of the case, article 44 would add little to the framework of the requirement of notice. However, the article does provide a failsafe in instances where courts incorrectly interpret the requirements of Article 39. In any case, the articles analysed in this chapter, if interpreted appropriately, would go a long way in increasing the efficiency of the agreement.

¹⁷² A list of symptoms satisfies this requirement.

¹⁷³ Convention, Article 40.

Chapter 6 Rate of Interest under Article 78

“[The] view that there is a true gap in the Convention within the meaning of Article 7(2) so that the applicable interest rate should possibly be determined autonomously in conformity with the general principles underlying the Convention is to be preferred, not least because the immediate recourse to a particular domestic law may lead to results which are incompatible with the principle embodied in Art. 78 of the CISG, at least in the cases where the law in question expressly prohibits the payment of interest”¹

Introduction:

The value of British sterling today is not the same as its value a year from now.² This variation in the value of currency implies that the present value of money is itself an object of worth, and as such, a party that has unjustly been deprived of it must be compensated for its loss.³ One mechanism used by court to achieve this is the principle of interest. Ideally therefore, interest should operate to place the parties in the same position as they would have been had the breaching party paid sums to the injured party as soon as they became payable.

Michael Knoll, in his paper ‘A Primer on Prejudgment Interest’, argues that the basic objective of awarding interest can be summed under the headings of fairness and efficiency.⁴ Fairness, he argues simply requires that the injured party be compensated for the loss it has incurred as a result of delay in payment.⁵ Efficiency, as used by him, demands that the breaching party be incentivised to act in good

¹ See CLOUT case No. 93 [Internationales Schiedsgericht der Bundeskammer der gewerblichen Wirtschaft - Wien, Austria, 15 June 1994] <<http://cisgw3.law.pace.edu/cases/940615a3.html>> accessed: 9 August 2014.

² The difference between the two values is called the discount rate, i.e. the rate of change of the value of a pound in a year.

³ See *Procter & Gamble Distributing Co. v. Sherman*, 2 F.2d 165 (S.D. New York 1924).

⁴ Michael S. Knoll, ‘A Primer on Prejudgment Interest’ (1996) 75 Texas Law Review 293.

⁵ *ibid* 295-296.

faith.⁶ As in the commercial world, funds can only be borrowed on terms that require the payment of interest; the breaching party is unjustly enriched if it is only required to pay back the principal to the injured party. In such a scenario, interest operates to ensure that parties to a contract are not motivated to delay payment and take reasonable precautions.⁷ Moreover, the efficiency rationale also operates to motivate parties not abuse the judicial process by stretching out litigation on one pretext or the other. In other words, since delay in judgment would simply translate into the defendant having use of interest free funds, the breaching party would be incentivised to stretch out the litigation process, thereby benefiting at the expense of the injured party.⁸ As such, interest operates to de-incentivise parties from acting opportunistically and delaying payment of sums in arrears,⁹ by obligating the debtor to completely compensate the creditor. Part 1 of this chapter will analyse the travaux of Article 78 in order to show that the objectives that the drafters of the article wished to achieve can, in part, be summed up into these categories.

Predictably, an incorrect calculation of the Rate of Interest (ROI) does little in the achievements of the goals which led to the incorporation of the concept in the Convention. Under the Convention, the right to recover interest on sums that are in arrears is contained in Article 78¹⁰. Unfortunately the article is silent as to the methodology that is to be adopted in the ascertainment of the rate at which interest is to be charged.¹¹ In the words of Professor Ziegel, the article is “more conspicuous for the questions it fails to answer than the questions it answers”.¹² The article reads “If a party fails to pay the price or any other sum that is in arrears, the other party is

⁶ *ibid.* The term efficiency/good faith as used by Knoll can be equated to barring opportunistic behaviour.

⁷ See James A. Henderson Jr., ‘Product Liability and the Passage of Time: The Imprisonment of Corporate Rationality’ (1983) 58 *New York University Law Review* 765.

⁸ Of course, stretching out litigation would only be beneficial where the rate of interest generally charged to the breaching party on loans exceeds litigation costs.

⁹ See Geoffrey P. Miller, ‘Issues in Civil Procedure: Advancing the Dialogue A Symposium: Comment: Some Thoughts on the Equilibrium Hypothesis’ (1989) 69 *Boston University Law Review* 561.

¹⁰ Article 78 of the United Nations Convention on Contracts for the International Sale of Goods 1980 (hereinafter referred to as the ‘Convention’) reads: “If a party fails to pay the price or any other sum that is in arrears, the other party is entitled to interest on it, without prejudice to any claim for damages recoverable under article 74”.

¹¹ John Y. Gotanda, ‘When Recessions Create Windfalls: The Problems of Using Domestic Law to Fix Interest Rates under Article 78 CISG’ (2009) 13 *The Vindobona Journal of International Commercial Law and Arbitration* 229.

¹² Jacob S. Ziegel, ‘Report to the Uniform Law Conference of Canada on Convention on Contracts for the International Sale of Goods’ (University of Toronto, July 1981) 149.

entitled to interest on it, without prejudice to any claim for damages recoverable under article 74.”¹³

The lack of guidance as to the method of calculating the applicable ROI has resulted in the formation of various techniques to ascertain the same. Given the nature of commercial transactions, it seems necessary that the parties to a dispute should be able to concretely identify their rights and obligations under the law; the same is not possible where the applicable law is the Convention. This fact is made clear by a review of the case law on article 78.

While most courts, particularly German and Swiss tribunals have applied the dictates of domestic law¹⁴; others, though a minority, have found the dictates of the Convention concrete enough in formulating the appropriate ROI.¹⁵ Proponents of both these approaches however, agree that the drafters were unable to agree upon a methodology for the ascertainment of the ROI, and as such there are difficulties in identifying the appropriate ROI via implication.

This fact should however, not be interpreted to mean that the travaux do not provide any guidance on the matter¹⁶. On the contrary, this paper asserts that travaux provide a comprehensive list of guidelines that must be followed in the ascertainment of the appropriate ROI. Indeed, the Vienna Convention allows recourse to be made to the travaux, in instances where the application of the elements contained in Article 31 of that convention leave the meaning obscure.¹⁷

Recourse to the travaux is of particular importance in the case of Article 78. This is so as, unlike various lacunae in the Convention, the issue of ROI was extensively

¹³ CISG, Article 78

¹⁴ There are two generally cited reasons for this approach: 1) The calculation of the ROI has been left outside the scope of the Convention or 2) There are no concretely ascertainable general principles of the Convention capable of providing a methodology for the calculation of the interest rate.

¹⁵ Francesco G. Mazzotta, ‘CISG Article 78: The Endless Disagreement Among the Commentators, Much Less Among the Courts’ in Pace International Law Review (ed), *Review of the Convention on Contracts for the International Sale of Goods (CISG) 2003-2004*. See also, Liu Chengwei, ‘Recovery of Interest’ [2003] Nordic Journal of Commercial Law of the University of Turku 1

¹⁶ Professor Honnold is amongst those who believe that the travaux provide ‘little or no guidance’ on the issue. John Honnold and Harry M. Flechtner, *Uniform Law of International Sales* (Kluwer Law International 2009) 603.

¹⁷ Article 31 of the Vienna Convention on the Law of Treaties 1969.

debated during the drafting stages of the Convention. As such, a great degree of guidance is contained in the travaux in the form of policy consideration behind the tabling of alternative approaches on the matter and the respective criticisms levied against the same.

Moreover, this thesis maintains that a precondition to the achievement of the objectives of uniformity in this area of law is the recognition of foreign judgments by courts.¹⁸ While a review of the case law on the issue does reveal the creation of a trend of referring to, or at least recognising, the dictates of foreign decisions on the issues under review, it is argued that the true achievement of the goal of uniformity requires a step further i.e. wide ranging acceptance of a particular interpretation. While demands for such acceptance might well be a bit too idealistic, maybe even bordering on naivety, there can be no doubt that the achievement of that goal cannot occur so long as interpretations do not address criticisms that led to the rejection of various formulations during the drafting stages. The next part of this paper shall therefore attempt to highlight the guiding principles behind the respective criticisms levied upon the various formulations tabled during the drafting of Article 78.

6.1 Part 1: Travaux of Article 78

6.1.1 The Working Group (1974)

The issue of interest arose at the Fifth Session of the Working Group in 1974.¹⁹ Since the objective of the Working Group was to consider recommendations from states on existing texts to make them acceptable to a larger number of states or alternatively, ascertaining whether a new text would be necessary, an obvious starting point on the issue of interest was Article 83 of the ULIS. Article 83 read:

Where the breach of contract consists of delay in the payment of the price, the seller shall in any event be entitled to interest on such sum as is in arrears at a rate equal to the official discount rate in the country where he has his

¹⁸ See Convention, Article 7 (1).

¹⁹ Also John O. Honnold, *Documentary History of the 1980 Uniform Law for International Sales: Studies, Deliberations and Decisions That Led to the 1980 United Nations Convention with Introductions and Explanations* (2nd edn, Kluwer Law International 1989) 175.

place of business or, if he has no place of business, his habitual residence, plus 1%.²⁰

Interestingly the Working Group adopted the article, which clearly stipulated a methodology for the calculation of the ROI, without any change at that session.²¹ In fact, the travaux reveal that once the fact that the Convention would govern interest was established, it seemed obvious to the drafters that the same would include a methodology to calculate the same. Moreover, as shall be detailed bellow, subsequent attempts to exclude such a methodology from the ambit of the article on interest were vehemently opposed.

The Working Group at its Sixth Session made a substantial change to the text of Article 83 by importing the stipulation that the ROI shall in no case be lower than the Rate Applied to Unsecured Short Term Commercial Credit (RASCC) in the creditor's country.²² The amendment was based on concerns of fairness i.e. the adoption of a methodology that calculates interest at the official discount rate would not adequately compensate a creditor who would have possibly been forced to borrow at higher rates applied to commercial credits as a result of delay in payment.²³ Moreover, there were concerns relating to opportunism, I.e. the calculation of interest on the basis of official discount rate might enable a debtor to take advantage of the lower rate (relative to the RASCC) and delay payment.²⁴

It is essential to note that the concern that the methodology would result in incentivising delay in payment did not arise from objections against unjust enrichment of the buyer; but was rather phrased in terms of hindering the objective of complete compensation of the injured party. This is not to say that unjust enrichment was not a concern during this stage of drafting, but simply to point out

²⁰ Article 83 of the Convention relating to a Uniform Law on the International Sale of Goods 1964, (hereinafter referred to as 'ULIS').

²¹ See Doc. A (9) V YB 44 A/CN.9/87.

²² See Doc. A (11) VI YB 62 A/CN.9/100. Note Article 83 of the ULIS made reference to the payment of interest to the seller on payment of price in arrears.

²³ *ibid.*

²⁴ *ibid.*

that the same was a subordinate to the primary driving motivation of ensuring complete compensation.²⁵

6.1.2 Committee deliberations on the UNCITRAL “Sales” Draft (1977)

Concerns surrounding unjust enrichment of the debtor under the methodology adopted by the ULIS properly surfaced during the Committee Deliberations on the Sales Draft.²⁶ It was primarily on these grounds that certain proposals tabled during this stage were rejected. For instance the proposal that the place of calculation of ROI should be the debtors country was rejected by the committee on the basis that if the ROI prevailing at the debtor’s country was less than that prevailing in the creditors, then the debtor would be incentivised to delay payment since he would have use of funds at a lower cost than his own cost of capital.²⁷ As such, any formulation of ascertainment of the ROI that potentially could unjustly enrich the debtor was not acceptable to the majority of the members of the Committee.²⁸

Moreover, the concern that the payment of interest at the RASCC in the creditor’s place of business may translate into a penalty on the debtor, was not afforded much attention.²⁹ For illustrations let’s suppose that the debtors’ cost of capital is X whereas that of the creditor is Y. If $Y > X$ and the debtor is forced to pay interest at

²⁵ For an account on how the drafters viewed the goal of unjust enrichment to be subordinate to that of complete compensation in the drafting of article 78 see Opinion Number 14 of the Advisory Council. CISG-AC Opinion No. 14, Interest under Article 78 CISG, Rapporteur: Professor Doctor Yesim M. Atamer, Istanbul Bilgi University, Turkey. Adopted unanimously by the CISG Advisory Council following its 18th meeting, in Beijing, China on 21 and 22 October 2013

<<http://www.cisg.law.pace.edu/cisg/CISG-AC-op14.html>> accessed: 13 August 2014.

²⁶ See Legislative History, 1980 Vienna Diplomatic Conference, Summary Records of Meetings of the First Committee, 34th meeting, A/CONF.97/C.1/L.247

<<http://www.cisg.law.pace.edu/cisg/firstcommittee/Meeting34.html>> accessed: 13 August 2014 (hereinafter referred to as ‘Vienna Diplomatic Conference, 34th Meeting’); Legislative History, 1980 Vienna Diplomatic Conference, Summary Records of Meetings of the First Committee, 37th meeting A/CONF.97/C.1/L.248/Add.2 and Add.3

<<http://www.cisg.law.pace.edu/cisg/firstcommittee/Meeting37.html>> accessed: 13 August 2014 (hereinafter referred to as ‘Vienna Diplomatic Conference, 37th Meeting’); Doc. C(4) O.R. 390.

²⁷ See for example the comment made by the delegate of Ghana at the 34th Meeting of the First Committee where he stated: “Alternative I in particular might lead the debtor to fail to pay the price or any other sum in arrears in order to have cheap credit.” (Vienna Diplomatic Conference, 34th Meeting) Para. 15; Honnold, (n 19) 353.

²⁸ The proposal whereby the place of calculation of the ROI would be the debtor’s country was rejected *was rejected by 15 votes to 8*.

²⁹ For instance where the rate of commercial credits at the debtor’s country is lower than that in the creditors state.

the rate of Y then the debtor is penalized since it could have borrowed the amount at the lower rate of X³⁰. In other words, since restitution demands the payment at X, the debtor is penalized to the extent of (Y-X) when he is forced to pay interest at the rate of Y. It therefore transpires that from the very beginning, the provision on interest on sums in arrears was tailored to ensure that the claimant be fully compensated and the debtor is not unjustly enriched even if the same amounted to a penalty on the debtor. Various other concerns however, forced the Committee to omit the article from the 1977 Sales Draft. These concerns can be summed up under the umbrella of ‘terminological concerns’ and ‘public policy concerns’.

6.1.2.1 Terminological concerns:

The provision on interest, under deliberation at the Sessions of the Committee, made reference to the official discount rate and the RASCC. Various delegates observed that the former term lacked certainty since various countries did not have an official discount rate.³¹ This issue was of minor consequence, as the second part of the article calculating interest at RASCC would automatically become applicable since the creditors entitlement under the second part would be more than the interest payable in instances where the official discount rate did not exist. As such, no material issue would arise if the RASCC in the seller’s country could easily be calculated. Certain delegates however, pointed out that the RASCC was a variable rate, calculated upon the basis of the nature of sales and the parties involved.³²

As such the variable nature of the RASCC led various delegates to assert that the use of the rate in formulating a methodology to calculate the ROI would generate uncertainty, and would seldom result in the complete compensation of the creditor. This thesis argues that the use of the RASCC in devising a methodology under article 78 is permissible since methodologies to calculate the same, with reasonable accuracy, have been devised by financial-economists for decades³³. In response to

³⁰ The term ‘penalized’ is used here to refer to any sums the debtor may be forced to pay over that which is demanded by restitution.

³¹ 1980 Vienna Diplomatic Conference, 34th Meeting (n 26).

³² *ibid*. Considerations such as the credit history of the debtor and the quality of the collateral provided have a bearing on the rate at which short term commercial credit is extended.

³³ See for instance Robert C. Merton, ‘On the Pricing of Corporate Debt: The Risk Structure of Interest Rates’ (1974) 29 *Journal of Finance* 449.

the concern that the RASCC is based upon the characteristics of the parties, Part 2 shall identify factors associated with characteristics of the parties that must be represented in the interest rate calculation and how the RASCC incorporates the same³⁴. In order to put to rest the concerns surrounding the possibility that a variable rate might not adequately compensate the parties Part 3 of this thesis shall show how a short-term floating interest rate is preferable to a fixed one.

6.1.2.2 Public Policy Concerns:

It was noted that inclusion of a provision on interest may make it extremely difficult for certain states that either outlawed the charging of interest entirely or placed a cap on the amount of interest recoverable, to become signatories of the Convention.³⁵ Take for instance the case of Egypt, a signatory to the Convention.³⁶ Under Egyptian national law, the charging of interest while allowed is severely circumscribed.³⁷ Under the Egyptian Civil Code, interest accrues incrementally at the rate of 4% civil suits and 5% on commercial suits. Moreover, the parties may agree to a ROI, but the same cannot exceed 7% or accrue to exceed the principal.³⁸

Given these concerns, the delegation of the United Kingdom proposed placing the issue of interest rate outside the scope of the Convention.³⁹ Such a stance, it was thought, would enable states with public policy concern over the issue to adopt the Convention without demanding the right of reservation to the article under consideration.⁴⁰ Moreover, adoption of the recommendation would bridge the gap

³⁴ For instance, the likelihood that the debtor may default as a result of bankruptcy.

³⁵ See for example the comment of the Delegate of Egypt in 1980 Vienna Diplomatic Conference, 34th Meeting (n 26), Para 10.

³⁶ The Convention entered into effect in Egypt on the 1st of January 1988.

<<http://www.cisg.law.pace.edu/cisg/countries/cntries.html>> accessed: 13 August 2014.

³⁷ See John Y. Gotanda, 'Awarding Interest in International Arbitration', (1996) 90 The American Journal of International Law 40, 47.

³⁸ Article 226 of The Civil Code of The Arab Republic Of Egypt 1949.

³⁹ The proposal read: "This Convention does not affect any right of the seller or buyer to recover interest on money". (A/CONF.97/C.1/L.226) in 1980 Vienna Diplomatic Conference, 34th Meeting (n 26), Para. 12.

⁴⁰ Mr. Nicholas, the British delegate, stated that the present text was unsatisfactory in that it required the seller to pay interest on refunds, but there was no corresponding obligation laid on the buyer who was late in paying the price. He noted that a solution would be to include a general provision for the recovery of interest on all sums in arrears, however previous experience convinced him that it would be unrealistic to hope to reach a generally acceptable text within the ambit of the Diplomatic Conference. Therefore, the only practical solution was to leave it to the applicable national law (Vienna Diplomatic Conference, 34th Meeting); Mr. Date-Bah, the Ghana delegate, stated that interest

between the stances adopted by the western and socialist states, by allowing recourse to domestic law through the application of the rules of Private International Law (PIL). This recommendation however was rejected by a large number of delegates who believed that the omission of the subject from the Convention would act a barrier to the Conventions' objective of uniformity.⁴¹

Given the lack of consensus on any of the various proposals put forth during the Diplomatic Conference, the Committee attempted to formulate provision that essentially consolidated the dictates of the preceding proposals. The ad hoc Working Group charged with this task returned with three alternative texts.⁴² The first of these texts adopted a methodology that would calculate interest at the RASCC at the main domestic financial center of the party claiming payment.⁴³ Like the previous proposals, this proposal was rejected on the grounds that the methodology could potentially allow a party to benefit by operating opportunistically.⁴⁴ For instance a debtor could intentionally delay payment in order to benefit from the lower interest rate prevailing at the creditors' country.

Another concern surrounding the acceptance of the ROI prevailing in the creditor's country was the fact that it did not always reflect the commercial reality of the agreement. Mr Wagner, the delegate of the German Democratic Republic for instance stated that various developing and socialist countries pay for their imports from their foreign trade earnings.⁴⁵ As such, a delay in payment would force such

should be paid, but the subject was too complicated to be encompassed by a single uniform rule. Not only did national policies and structures of interest differ, but commercial interest usually operated at several levels (Vienna Diplomatic Conference, 34th Meeting); Mr. Wagner, the German Democratic Republic delegate, stated that interest was a matter on which differences between economic systems were involved and it would be impossible to find an equitable solution (Vienna Diplomatic Conference, 34th Meeting).

⁴¹ *ibid.* Mr. Hjerner, the Swedish delegate for instance, stated that the main difficulty with the United Kingdom proposal was that it would tend to lead to difficulties in regard to conflicting legislations.

⁴² (A/CONF.97/C.1/L.247).

⁴³ Alternative 1 reads: "If a party fails to pay the price or any other sum that is in arrears, the other party is entitled to interest thereon at the rate for a short-term commercial credit or at another similar appropriate rate prevailing in the main domestic financial centre of *the party claiming payment*." Legislative History, 1980 Vienna Diplomatic Conference, G. Report of the First Committee [Outline of committee proceedings] Document A/CONF.97/11

<<http://www.cisg.law.pace.edu/cisg/1stcommittee/summaries78,84.html>> accessed: 17 August 2014 (hereinafter referred to as 'Vienna Diplomatic Conference, 34th Meeting').

⁴⁴ Alternative 1 was rejected by 22 votes to 17 (Vienna Diplomatic Conference).

⁴⁵ Mr Wagner, the delegate of the German Democratic Republic (Vienna Diplomatic Conference, 34th Meeting) Para 6.

countries to seek credit from international markets. Consequently, the application of the ROI prevailing in the country of the creditor would not result in the compensation of the creditor thereby violating the fairness criteria.⁴⁶

The second alternative put forth by the ad hoc Working Group read:

If a party fails to pay the price or any other sum that is in arrears, the other party is entitled to interest thereon at the rate for a short-term commercial credit or at another similar appropriate rate prevailing in the main domestic financial center of the party in default, or, in case the other party's actual credit costs are higher, at a rate corresponding thereto but not at a rate higher than the first said rate in his own country.⁴⁷

This proposal attempted to set aside the deficiencies of proposal one, by formulating a methodology of interest rate calculation that would bar a creditor whose place of business is in a western state from delaying payment in order to take advantage of the lower interest rate prevailing in his country. Moreover, the proviso to the proposal addressed the concerns of certain developed states i.e. they could potentially be undercompensated where their actual credit costs were higher than what was recoverable under the RASCC in the debtor's country. This was achieved by allowing recovery up to the RASCC prevailing at the creditor's country. As such this proposal attempted to address all fairness and efficiency related concerns that had led to the rejection of previous proposals.

While this proposal received overwhelming support from socialist and developing states, western-industrialized states seemed to be skeptical of the methodology adopted under the proposal.⁴⁸ Opposition to the proposal was based upon the fact that even though the alternative allowed a creditor to recover interest at the rate at which he would theoretically be able to raise the sum in arrears from the domestic financial market; it did not represent the reality of financial markets.⁴⁹ This is so as the prevailing rate of short-term commercial credits is applied for the most solvent

⁴⁶ See Doc. C(4) O.R. 416

⁴⁷ See Doc. C(5) O.R. 138.

⁴⁸ Honnold, (n 19) at 636

⁴⁹ See the comment of Professor Ziegel the delegate of Canada, (Vienna Diplomatic Conference, 34th Meeting) Para 22.

borrower and as such, there could be various instances where the injured party's actual credit costs were higher than what was represented by the RASCC. As a result, there could be instances where the RASCC would not adequately compensate the creditor.⁵⁰ On the basis of this concern, this chapter argues that reference to the prime rate is only justified where the party whose cost of capital is being referred to can actually raise funds without security at that rate.⁵¹ In cases involving small corporations that cannot raise sums at the prime rate, one of two approaches may be adopted. First, reference can be made to the rate at which the party whose cost of capital is being referred to, can or is borrowing. Where this is not possible, the objective of compensation demands that the prime rate be adjusted to reflect the risk that creditor is subjected to⁵².

Though the third alternative represented little more than a rewording of the methodology adopted in alternative 2, it did not garner much support. When the three alternatives were put to vote at the Conference the first and the third were rejected, while the second alternative was accepted with twenty in favour and fourteen against.⁵³ Though the outcome of the voting seems to suggest that the delegates had found a compromise solution capable of majority acceptance, it was decided that the article be sent to the Drafting Committee before being voted upon at the Plenary Conference. The task handed to the Drafting Committee was one of form rather than substance, i.e. the committee was only tasked with removing the use of technical language from the text of the article.⁵⁴

The Committee however went beyond the task it had been delegated with, and returned an article the text of which raised more ambiguity than the text that was handed to the Committee in the first place.⁵⁵ Unsurprisingly, the text came under

⁵⁰ *ibid.*

⁵¹ The prime rate is the obvious proxy since there is little risk that the company will default.

⁵² For a very good account on how the prime rate can be adjusted see Knoll (n 4)

⁵³ Vienna Diplomatic Conference, 34th Meeting.

⁵⁴ *ibid.*

⁵⁵ U.N. Document A/CONF.97/11/Add.1 and 2 (April 4, 1980) quoted in Mazzotta (n 15). It reads: "If a party fails to pay the price or any other sum that is in arrears, the other party is entitled to interest on it at the normal rate for a short-term commercial credit prevailing in the main financial centre in the State where the party in default has his place of business or, in the absence of such a rate, at another similar appropriate rate prevailing in that centre. (2) However, if the other party's actual credit costs are higher, he is entitled to interest on the sum in arrears at a rate corresponding to such credit costs, but not in excess of the rate defined in the preceding paragraph prevailing in the main financial centre in the State where he has his place of business."

attack from various delegates, at the Conference's Tenth Plenary Meeting, on grounds of it being vague and uncertain.⁵⁶

Given the difficulty of finding a methodology that would be acceptable to the delegates, the Working Group decided to recommend a provision based on the highest common factor. According to Mr Khoo, the Singapore delegate and Chairman of the Working Group on interest, the common factor in this case was the recognition of the fact that the Convention should at least contain a clear statement on the question of interest, even if the same is silent as to the methodology to calculate it.⁵⁷

The resulting article read "If a party fails to pay the price or any other sum that is in arrears, the other party is entitled to interest on it, without prejudice to any claim for damages recoverable under article 74".⁵⁸ As such even though the drafters were unable to agree upon a methodology whereby interest rate could be determined, they agreed that the question of a party's right to recover interest should remain within the scope of the Convention. The basic reason for this demand was to ensure that interest rate is not treated simply as a part of damages; the stance adopted by the domestic law of various delegates. As such, Article 78 should not be simplified to merely symbolize the fact that the drafters wished to make the question of a party's entitlement to interest, one that is governed by the Convention. Rather, the method of recognition of this right sheds light on the fact that the drafters were in fact, setting in stone one of the elements of the calculation of the ROI. The 'method' here was the separation of the right of interest from the heading of damages whereby the right of interest was unaffected by defences based upon article 79 and became

⁵⁶ Mr. Nicholas, the British delegate, stated that "the text was neither satisfactory nor applicable. Its authors had indicated that one of its main qualities was its great flexibility. As regarded flexibility, however, the text contained such ambiguities that it would inevitably give rise to controversies and disputes, and thus to divergent interpretations, depending on national legislations." A/CONF.97/11/Add.2, p.13; A/CONF.97/L.16, L.17 and L.18; Mr. Lebedev, the Soviet delegate, stated that "the existing text was incompatible with the objective sought, namely to develop, in clear and precise terms, a formula for the calculation of interest. The wording, instead of settling the situation in a uniform and clear manner, introduced uncertainties under the guise of flexibility". *Ibid.* Mr. Sam, the Ghana delegate, stated that "some of the expressions used such as main financial centre or interest at a rate corresponding to the actual credit costs required clarification". *Ibid.*

⁵⁷ Alternative 2, U.N. Document A/CONF.97/C.1/L.247 Report Of The First Committee To The Plenary Conference (A/CONF.97/11/Add.2).

⁵⁸ Convention, Article 78

recoverable without proof of fault. As such, the drafters were able to ensure that recovery of interest would be immune to any framework that limited the same to considerations of proof, contributory negligence and delay.⁵⁹ It is therefore asserted that while the Convention does not expressly set a mechanism whereby the ROI can concretely be ascertained, it is definitely not completely silent on the contours of such a mechanism.

It is essential to note that while concerns that the creditor may be forced to raise capital at higher costs than the RASCC in the country where it has its place of business,⁶⁰ as a result of the breach, were ‘in issue’ while the article was being debated, they ceased to be so. With over a quarter of a century with experimenting with the provisions of the Convention, the interplay between different articles of the Convention has become increasingly clear. So has the fact that the fabric that ties article 74, 75 and 76 with article 78 addresses these concerns.⁶¹

In a nutshell, Article 78 allows for interest to be awarded “without prejudice to any claim for damages recoverable under article 74”. As such, if a party is able to meet the requirements for the claim of damages under Section 2 of the Convention, then any recognizable loss can be recovered.⁶² Thus if a party is forced to seek credit from international market, or raise funds at a higher rate than the debtors’ cost of capital as a result of delay in payment the ROI charged thereunder can be recovered under article 74. As such, this is not a matter of concern of the ROI under article 78.

One possible criticism to this argument is the fact that since Article 78 recognizes the right of interest regardless of the defenses of article 79 or the requirements of article 74, denying the right to claim interest at the rate charged upon the addition sums that

⁵⁹ Since the judgement in *Allen v Sir Alfred McAlpine & Sons Limited* [1968] 2 QB 229 various common law courts have limited the claim of interest where there has been unjustifiable delay in claiming the same. A similar approach has been adopted in cases of contributory negligence. See *Quorum AS v Shramm* (2001) 19 Construction Law Journal 224 where the court stated “Delay should only be characterised as unreasonable for present purposes when, after making due allowance for the circumstances, it can be seen that the claimant has neglected or declined to pursue his claim for a significant period.”

⁶⁰ For example, in instances where the parties are forced to seek credit from international trade markets as a result of the delay in payment.

⁶¹ For a discussion on the link between these Articles see n 25.

⁶² For an account on the requirements under section 2 of the Convention see Jeffrey S. Sutton, ‘Measuring Damages under the United Nations Convention on the International Sale of Goods’ (1989) 50 Ohio State Law Journal 737.

had to be borrowed from international markets is tantamount to restricting the right to interest. This thesis however, maintains that no possible formulation of calculating the ROI that calls for the application of RASCC of foreign markets is possible without the precondition that the procurement of the same be proved. Allowing otherwise would equate to the provisions of the freedom of parties to unilaterally choose the rate at which to claim interest. That is to say that if a party does not have to prove loss caused as a result of having to borrow funds at a particular rate, it could potentially be motivated to act opportunistically by claiming the most favourable RASCC of foreign markets.⁶³ Moreover, while Article 74 provides a mechanism to the injured party to claim any losses incurred, no such mechanism exists for a party that could wrongfully be forced to pay interest at the rate of the other party's choosing.

6.1.3 Conclusion:

1. Proposed solutions revolved around the formation of a methodology that would primarily ensure that
 - The injured party is completely compensated while the debtor is not unjustly enriched. It should be noted that article 78 gives greater weight to compensation of the creditor than it gives to disgorgement of profits from the debtor.
 - The potential of opportunistic behaviour is restricted.
2. The use of RASCC is devising a methodology under article 78 is permissible if the same can concretely be identified and does not deprive the claimant of complete compensation.
3. The ROI should not over-compensate the injured party.

6.2 Part 2 Case Law and scholarly opinion

Various courts and commentators point towards the dictates of domestic law for the determination of the interest rate before attempting to identify whether there are any general principles upon which the Convention is based, that would be capable of

⁶³ For instance this was one of the major grounds for the rejection of alternative 1 put forth by the *Ad Hoc* Working Group.

providing a methodology for the calculation of the ROI. Proponents of this approach base their argument on one of the following views:

6.2.1 The issue of interest lies squarely outside the scope of the Convention:

Various tribunals have applied the dictates of domestic law in the belief that the entire issue of ROI is not governed by the Convention⁶⁴; as opposed to the majority view that the issue is governed by, though not expressly settled in the Convention.⁶⁵ Take for instance the case decided by of Landgericht [District Court] Aachen.⁶⁶ Here the court stated:

It has been argued that the interest rate must be determined by having recourse to the general principles of the CISG in order to achieve an internationally uniform regulation. Against this, it has been argued that a uniform solution could not be achieved at the conferences for the drafting of the CISG, as the different opinions about the interest obligation were irreconcilable... Preferable is the opinion that the interest rate is to be taken from the applicable national law supplementing the CISG, which in turn is to be determined in accordance with the conflict of laws rules of the forum State.⁶⁷

Given that the Travaux reveal that proposals tabled during the drafting stages whereby the ROI would expressly be placed outside the scope of the Convention were clearly rejected, it is extremely difficult to identify the justification for the adoption of such an approach. Unfortunately none of the decisions adopting this

⁶⁴ For instance various decision apply the domestic law of the creditor without even recourse to the rules of PIL see for example, Clout case No. 4 [Landgericht Stuttgart, Germany, 31 August 1990] <<http://cisgw3.law.pace.edu/cases/890831g1.html>> accessed: 20 August 2014 and Clout case No. 6 [Landgericht Frankfurt a.M., Germany, 16 September 1991] <<http://cisgw3.law.pace.edu/cases/910916g1.html>> accessed: 20 August 2014> accessed: 20 August 2014; See also, Christian Thiele, 'Interest on Damages and Rate of Interest Under Article 78 of the U.N. Convention on Contracts for the International Sale of Goods' (1998) 2 Vindobona Journal of International Commercial Law and Arbitration 3.

⁶⁵ In such instances, courts have applied the dictates of the domestic law of the creditor as the law applicable, independently of whether the rules of private international law made that law applicable; see Bezirksgericht Arbon, Switzerland, 9 December 1994 <<http://cisgw3.law.pace.edu/cases/941209s1.html>> accessed: 20 August 2014; CLOUT case No. 6 (n 64); CLOUT case No. 4 (n 64).

⁶⁶ Landgericht Aachen, Germany, 20 July 1995.

⁶⁷ *ibid.*

stance provide any justification in support of their view⁶⁸. Take for instance the judgment of *Pretura circondariale di Parma* that involved a contract for the sale of goods between a Swiss buyer and an Italian seller⁶⁹. Two months after the agreed upon date for the dispatch of goods, the buyer sent a notice of cancellation of order and refund of price with interest to the seller on the grounds of non-performance by the latter. The court, finding in favour of the buyer, awarded him interest at the Italian statutory rate without reference to the dictates of the Convention on the issue. Ignorance of the dictates of the travaux, it seems, led the court to adopt the view that the issue was outside the scope of the Convention and as such, reference to national law was warranted⁷⁰.

Similarly, in another case concerning the sale of home appliances between a German seller and a Swiss buyer, a German court awarded interest without reference to any provision of the Convention even though the same was clearly applicable.⁷¹ Following breach by the buyer, the seller claimed refund of price plus interest to be calculated at the rate of 13.5%. The buyer on the other hand counterclaimed for a reduction of price and interest to be calculated at a rate of 6%. The court awarded interest at 13.5%, without explaining why the rate claimed by the buyer had been adopted. It is however clear from the judgement that the court did not take the dictates of the Convention into account while validating the rate.⁷²

A review of case law reveals that unlike the cases discussed above, most tribunals adopting this stance tend to make reference to the domestic law of the creditor in the

⁶⁸ For instance, see judgment in CLOUT case No. 6 (n 64). In this case the court held that: "The level of the interest rate has not been set forth in Art. 78 CISG. Consequently, the relevant obligor is to pay the interest rate which is due and payable pursuant to the relevant national substantive law of the creditor".

⁶⁹ CLOUT case No. 90 [*Pretura circondariale di Parma*, Italy, 24 November 1989]

<<http://cisgw3.law.pace.edu/cases/891124i3.html>> accessed: 28 August 2014

⁷⁰ Interestingly, the court completely ignored the dictates of article 84 as well by awarding interest from the date of avoidance of the contract.

⁷¹ The applicability of the Convention to this dispute was accepted by the court. It was only on the question of interest rate calculation that the dictates of the Convention were entirely ignored.

⁷² For similar rulings see judgment in CLOUT case No. 253 [*Repubblica e Cantone del Ticino, La seconda Camera civile del Tribunale d'appello*, Switzerland, 15 January 1998]

<<http://cisgw3.law.pace.edu/cases/980115s1.html>> accessed: 20 August 2014

<<http://cisgw3.law.pace.edu/cases/980115s1.html>> accessed: 9 August 2014; CLOUT case No. 93 (n

1); ICC Arbitration Case No. 9448 of July 1999 <<http://cisgw3.law.pace.edu/cases/999448i1.html>>

accessed: 20 August 2014; CLOUT case No. 380 [*Tribunale di Pavia*, Italy, 29 December 1999]

<<http://cisgw3.law.pace.edu/cases/991229i3.html>> accessed: 20 August

2014 <<http://cisgw3.law.pace.edu/cases/991229i3.html>> accessed: 20 August 2014.

ascertainment of the applicable ROI.⁷³ In the Judgment in *CLOUT case No. 201* for instance, the court concluded that while the Convention governed the right of a party to claim interest, the issue of ROI had been left outside its scope. As such the court concluded, “In cases where, as brought forward by the seller, the buyer is in arrears with his obligation to pay the price, which should be the majority of all cases, the rate of interest is...to be determined by the law of the seller”.⁷⁴

If ROI is indeed a lacuna intra legem then reference to the rules of PIL in order to identify the applicable law is indeed in conformity with the appropriate methodology for the application of the rules of the Convention. However, even if ROI has been left outside the scope of the Convention, there is little justification, if any, for the application of the law of the creditors place of business unless it is identified by an applicable procedural rule on the matter.⁷⁵ Courts adopting the approach of the application of the creditors domestic law however, more often than not, simply state that the ROI has been excluded from the scope of the Convention and as such reference must be made to the law of the creditor, without identifying the considerations which led to this conclusion.⁷⁶

Scholarly commentaries on the other hand have attempted to justify such a stance. Thiele for instance, highlights the fact that the proposal to set a fixed ROI in the article was rejected during deliberations. This he states may imply that the drafters wished to devolve the determination of ROI to domestic law.⁷⁷

The argument that the lack of agreement amongst the drafters implies that they intended the question to be resolved by reference to domestic law does make superficial sense. A deeper inquiry into the subject however reveals that, unlike various gaps in the Convention, the drafter were aware of this particular one and did indeed attempt to resolve it at multiple stages of the drafting process. As such, if the drafters indeed wished for the question to be lacuna intra legem, and as such

⁷³ See for example the judgment in *CLOUT case No. 201* [Richteramt Laufen des Kantons Berne, Switzerland, 7 May 1993] <<http://cisgw3.law.pace.edu/cases/930507s1.html>> accessed: 20 August 2014.

⁷⁴ *ibid.*

⁷⁵ For instance, the law identified through the forum’s rule of PIL without reference to article 7(2).

⁷⁶ See n 68.

⁷⁷ Thiele n 64. He concludes that the legislative history does not decisively settle the debate.

resolved according to the dictates of national law, they could have expressly stated so; as they did for instance, on issues of validity.⁷⁸

In any case, aversion to a fixed rate of interest did not stem from the fact that the drafters preferred to devolve the determination of ROI to domestic law; but rather from the fact that a fixed rate of interest would not fulfil the objectives of either fairness or efficiency. Fairness would be undermined since a fixed rate would seldom reflect commercial reality, thereby hindering the goal of complete compensation and avoidance of unjust enrichment. Efficiency, on the other hand would be undermined since one party would definitely benefit from a lower interest rate than what is applicable to his own cost of capital. This would incentivise such a party to act opportunistically for example, by avoiding out of court settlement or delaying litigation.

B) Though interest lies within the scope of the Convention, determination of the rate has been devolved to national law through the application of the rules of PIL: This is the most widely held opinion amongst both academics and legal practitioners, and has been labelled the ‘unanimous opinion’ in various places.⁷⁹ In a nutshell, the argument is founded upon the belief that while the Convention governs the issue of ROI, it is silent with regards to the methodology of calculating the same. As such, the question must be answered by reference to the applicable law by virtue of the rules of PIL. Interestingly, courts adopting this approach refer to the dictates of article 7(2) to justify recourse to domestic law yet omit mention of the requirement of referring to the general principles upon which the Convention is based⁸⁰ or simply state that there are no general principles that can be used to infer the appropriate

⁷⁸ See n 25.

⁷⁹ In the words of one tribunal “There has been formed a unanimous opinion that the details of interest are governed by the national law applicable by ways of private international law” Gritli Ryfel, *Die Schadensersatzhaftung des Verkäufers nach dem Wiener Übereinkommen über internationale Warenverträge vom 11. April 1980*, Diss. Bern/Frankfurt/New York/Paris/Wien, 1992, S. 86; v. Caemmerer/Schlechtriem (Hrsg.), *Kommentar zum Einheitlichen UN-Kaufrecht*, München 1990, Art. 78 Para. 4 quoted in Volker Behr, ‘The Sales Convention in Europe: From Problems in Drafting to Problems in Practice’ (1998) 17 *Journal of Law and Commerce* 263.

⁸⁰ See for instance case abstract of the judgment by Tribunal Cantonal Valais [Canton Appellate Court], Switzerland, 20 December 1994 <<http://cisgw3.law.pace.edu/cases/941220s1.html>>. In this case the court considered the interest rate to be a question governed, but not expressly settled, by CISG (Art. 7(2) CISG), but directly, without first reference to general principles underlying the CISG, applied the statutory rate of the State whose law would have been the governing law of the contract in the absence of CISG (Italy).

ROI.⁸¹ For instance, the Appellate Court of Switzerland held that while the ROI was governed by the Convention, it had not been expressly settled in it.⁸² In support of its methodology in identifying the appropriate rate, the court referred to the dictates of Article 7(2). Surprisingly however, the court applied the fixed statutory rate of interest of the state whose law would be applicable by virtue of the rules of PIL, without first reference to general principles upon which the Convention is based.⁸³ Moreover, while there is widespread agreement amongst at least European courts and scholars that the rules of PIL should determine the law which shall provide a methodology to calculate the interest rate; there is disagreement on the method of the use of PIL in determining the same.⁸⁴ These diverging opinions can roughly be categorized into two classifications:

6.2.1.1 Law applicable to contract:

Academics and practitioners belonging to the first classification assert that since the issue of interest rate is part of the contract, the law applicable to the contract in absence of the Convention should be used to settle the issue.⁸⁵

⁸¹ See judgment in ICC Arbitration Case No. 7565/1994

<<http://www.unilex.info/case.cfm?pid=1&do=case&id=141&step=FullText>> accessed: 20 August 2014. Here the court stated: "According to Article 7.2 of the Convention, questions not expressly settled by it shall be determined either in accordance with the general principles on which it is grounded or by the law which shall be elected according to private international law." Yet it went on to hold that "*As the general principles do not settle the matter [...]* and the parties have referred to the laws of Switzerland, it seems justified to refer to Article 73 of the Swiss Code of obligations whereby, in the absence of a determination of the rate of interest by agreement or law or usages, that rate shall be 5% per annum."

⁸² Tribunal Cantonal Valais [Canton Appellate Court], Switzerland, 20 December 1994

<<http://cisgw3.law.pace.edu/cases/941220s1.html>> accessed: 20 August 2014.

⁸³ *ibid.*

⁸⁴ Mazzotta (n 15).

⁸⁵ See for instance CLOUT case No. 5 [Landgericht Hamburg, Germany, 26 September 1990]

<<http://cisgw3.law.pace.edu/cases/900926g1.html>> accessed: 23 August 2014

; CLOUT case No. 1 [Oberlandesgericht Frankfurt a.M., Germany, 13 June 1991]

<<http://cisgw3.law.pace.edu/cases/910613g1.html>> accessed: 23 August 2014; CLOUT case No. 79 [Oberlandesgericht Frankfurt a.M., Germany, 18 January 1994]

<<http://cisgw3.law.pace.edu/cases/940118g1.html>> accessed: 23 August 2014; CLOUT case No. 83 [Oberlandesgericht München, Germany, 2 March 1994]

<<http://cisgw3.law.pace.edu/cases/940302g1.html>> accessed: 23 August 2014; CLOUT case No. 281 [Oberlandesgericht Koblenz, Germany, 17 September 1993]

<<http://cisgw3.law.pace.edu/cases/930917g1.html>> accessed: 23 August 2014; CLOUT case No. 82 [Oberlandesgericht Düsseldorf, Germany, 10 February

1994] <<http://cisgw3.law.pace.edu/cases/940210g2.html>> accessed: 23 August 2014 have all held that the law applicable to the issue of interest is the law that governs the contract apart from the Convention itself.

It is interesting to note that according to the rules of PIL in Europe, the result of the application of this methodology usually results to the application of the law of the state of the seller.

This is because, where the contract is silent, expressly or through implication, as to the applicable law, rules of PIL generally point towards the law of the country to which the contract is most closely related.⁸⁶ This is usually the law of the seller since in contracts of sale since the characteristic obligation is performed in the state of the seller.

Unfortunately the fact that reference to the ROI set by the domestic law of the seller does not tackle many of the concerns that hindered the process of reaching an agreement on the methodology to calculate ROI during the drafting stages has not been considered by any of the proponents of this stance.

6.2.1.2 Application of PIL regarding loans:

The second approach on the other hand asserts that rather than referring to the law applicable to the contract, the issue of interest rate should be settled on the basis of applicable law, which has been ascertained independently.⁸⁷ This argument is based upon the assertion that the claim of interest most closely resembles an involuntary

⁸⁶ Article 4 (2) of the EEC Convention on Law Applicable to Contractual Obligations states: “Subject to the provisions of paragraph 5 of this Article, it shall be presumed that the contract is most closely connected with the country where the party who is to effect the performance which is characteristic of the contract has, at the time of conclusion of the contract, his habitual residence, or, in the case of a body corporate or unincorporated, its central administration. However, if the contract is entered into in the course of that party's trade or profession, that country shall be the country in which the principal place of business is situated or, where under the terms of the contract the performance is to be effected through a place of business other than the principal place of business, the country in which that other place of business is situated.” An exception is contained in Article 4(3) which states: “Where it is clear from all the circumstances of the case that the contract is manifestly more closely connected with a country other than that indicated in paragraphs 1 or 2, the law of that other country shall apply” Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I) [2008] OJ L 177/6 <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:177:0006:0016:en:PDF> accessed: 20 August 2014.

⁸⁷ See Gert Reinhart, ‘Fälligkeitszinsen und UN-Kaufrecht’ in *Praxis des Internationalen Privat- und Verfahrensrechts* (Giesking 1991), 378 cited in Franco Ferrari, *Contracts for the International Sale of Goods: Applicability and Applications of the 1980 United Nations Convention* (Martinus Nijhoff Publishers 2011) 250

loan thrust upon the creditor.⁸⁸ Proponents of this stance therefore assert that the issue should be determined through the application of PIL regarding loans.⁸⁹

6.2.1.3 Law of the place of payment:

A third approach adopted by tribunals is to make reference to the law of the place of payment. This view is based upon the belief that since the Convention does not govern the rate of interest the same has to be determined by reference to the law designated by the rules on conflicts of laws. Interestingly, at least two tribunals have identified the law so designated to be the law of the place of payment. Unfortunately neither of these two judgments provide any justification of how the law of the place of payment has been identified through the application of PIL. Take for instance the judgment delivered by the District Court Almelo.⁹⁰ This case involved the sale of goods between a German seller and a Dutch buyer. The court applied the rules of PIL under Dutch national law⁹¹ and found the law of Germany to be applicable. Since Germany was a party to the Convention, the court referred to article 78 and found the buyer liable to pay interest on the sums in arrears. Interestingly, the court held that since the ROI is not determined by the Convention, the law of the country where the price was to be paid regulates it. This conclusion is surprising since the court did not refer to German law, which it had determined to be the applicable law by virtue of the rules of conflict of laws.

In this case, the applicable law was identified through the application of the Rome Convention which states

To the extent that the law applicable to the contract has not been chosen in accordance with Article 3, the contract shall be governed by the law of the

⁸⁸ Behr (n 79).

⁸⁹ Ibid.

⁹⁰ Arrondissementsrechtbank Almelo, Netherlands, 9 August 1995
<<http://www.unilex.info/case.cfm?pid=1&do=case&id=155&step=Abstract>> accessed: 20 August 2014.

⁹¹ Which in this case was Art. 4 of the 1980 Rome Convention on the Law Applicable to Contractual Obligations.

country with which it is most closely connected. Nevertheless, a severable part of the contract which has a closer connection with another country may by way of exception be governed by the law of that other country.⁹²

It may be inferred from this article that the court was of the opinion that the question of rate of interest was more ‘closely connected’ to the law of the place of payment than the law identified to be governing all other aspects of the sale contract. It must be understood that Article 4 of the Rome Convention is not concerned with concerns such as complete compensation of the injured party, or prevention of opportunistic behaviour, but was rather drafted to promote the ends of uniformity, predictability and certainty. Moreover, in the absence of express (or implied) choice of law, there are rarely (if ever) any justice-based grounds for preferring one law to the other.⁹³ As stated by Professor Stone, there seems to be “no intelligible perspective from which the importance of the various connections (such as the residences of parties, and the places of negotiation and performance) can rationally be assessed and compared”⁹⁴. These concerns have led Simon Atrill and Jonathan Hill to assert that the correct construction of Article 4 remains unclear.⁹⁵

As such, a court may at its discretion, find the right of interest to be most closely connected to any one domestic law from a list of laws which may become applicable as a result of one of the parties having its place of business in one state, the state where the contract was negotiated, the place of payment or even the currency of payment. Such a result, it is asserted would lead to a great degree of uncertainty and unpredictability as is demonstrated by the case discussed above.

Fortunately, the Rome 1 regulation has remedied this situation.⁹⁶ Rome I classifies contracts into eight categories, and lists the determinative connecting factors for each

⁹² Convention on the Law Applicable to Contractual Obligations 1980.

⁹³ Peter Stone, *EU Private International Law* (2nd edn, Edward Elgar Publishing Ltd 2010) 290.

⁹⁴ *ibid.*

⁹⁵ Simon Atrill, ‘Choice of Law in Contract: The Missing Pieces of the Article 4 Jigsaw’ (2004) 53 *The International and Comparative Law Quarterly* 549; Jonathan Hill, ‘Choice of Law in Contract under the Rome Convention: The Approach of the UK Courts’ (2004) 53 *The International and Comparative Law Quarterly*, 325

⁹⁶ European Commission Proposal for a Regulation of the European Parliament and the Council on the Law Applicable to Non-Contractual Obligations <(Rome II) <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:52003PC0427>> accessed: 20 August 2014.

type of contract for the purposes of identifying the applicable law.⁹⁷ In particular it specifies that in contracts of sale of goods the seller's law governs. Moreover, it does not contain the second sentence of article 4(1) of the Rome Convention quoted above regarding severable parts of the contract.

It is asserted that the purpose of creating a separate section on interest was to ensure that the same was not equated with damages. In particular, the drafters wanted to ensure that concerns relevant to the application of the articles on damages were not transplanted to that on interest. Moreover, as discussed above, claims based upon the fact that the creditor was forced to 'cover' the impacts of the breach by raising additional capital, fall in the domain of damages and not interest. This is so as the claim is not based upon inflation, or the risk of the debtors' default due to bankruptcy while the sums are in arrears (concerns surrounding the computation of ROI), but rather on the 'cost of substitution of funds' that the creditor incurred. In order to properly understand the principle of interest, it is extremely important to recognize what is meant by the terms 'compensation' as used in this context. The term compensation simply requires that the parties are placed in the position they would have been had the breach never occurred. Thus compensation demands that apart from the principal, the creditor should receive the time value of the sums. As such compensation requires the debtor to pay the principal adjusted for inflation.

Moreover, it must be understood that substitution of a riskless asset with a risky one, even if both are priced the same, will not completely compensate the creditor.⁹⁸ As such, the creditor must be compensated for the additional risk that he incurs. This risk is represented by the risk that the debtor may default for instance as a result of bankruptcy. Since risk increases with time, the longer the sums are in arrears the higher the risk would be. The actual rate of increase of such risk is relatively easy to ascertain since courts are called upon to calculate the same ex-post.⁹⁹

⁹⁷ Nils Willem Vernooij, 'Rome I: An Update on the Law Applicable to Contractual Obligations in Europe' (2009) 15 *The Columbia Journal of European Law Online* 71.

⁹⁸ Royce de R. Barondes, 'Rejecting the Marie Antoinette Paradigm of Prejudgment Interest' (2004) 43 *Brandeis Law Journal* 1, 2.

⁹⁹ Tribunals called upon to calculate such risk can simply refer to the change in the debtors' cost of borrowing during the period sums were in arrears.

In summary, the principle of interest simply requires that the creditor be paid the principal adjusted for inflation plus the risk that the debtor will default. As such, reference to the law of the seller is only warranted when it represents these elements. It is asserted that this would seldom be the case. Take for instance a scenario where the seller is the creditor. Here his cost of capital would reflect the risk that the buyer would default, since the institution advancing such capital would obviously price it on the basis of this factor. The risk that the creditor may default however is of absolutely no relevance for the calculation of the ROI and as such, reference to his cost of capital in such instances will not fulfil the objective of complete compensation.

6.2.2 While the issue is a lacunae patere legem, reference is to be made to the Creditors cost of funds:

While various decisions support the application of the creditor's cost of funds, there is disagreement between proponents of this stance vis-à-vis whether the statutory ROI of the creditor's state should be applied or whether reference should be made to the bank-lending rate or whether the creditors' weighted average cost of capital should apply¹⁰⁰. Those applying the bank-lending rate usually do so on the grounds that the creditor would have received interest on sums due in that country, had the debtor paid on time.¹⁰¹ Such justification is surprising, given that the bank-lending rate does not usually reflect the amount of interest that the creditor would have been able to 'earn' had the debtor paid on time. Rather, granting interest at the bank-lending rate seems to represent indemnification of the rate of interest the creditor could have incurred had he been forced to borrow funds as a result of non-payment of the debtor. Thus, such an approach can only be justified if the creditor did in fact borrow, for allowing otherwise could lead to the unjust enrichment of the creditor rather than his compensation.¹⁰²

¹⁰⁰ See for example Judgment by Rechtbank van koophandel, Hasselt, Belgium, 9 October 1996 <<http://www.unilex.info/case.cfm?pid=1&do=case&id=264&step=Abstract>> accessed: 20 August 2014.

¹⁰¹ See Rechtbank van koophandel Hasselt, Belgium, 8 November 1995 UNILEX Database of <<http://www.unilex.info/case.cfm?pid=1&do=case&id=265&step=Abstract>> accessed: 20 August 2014.

¹⁰² The bank rate is almost always higher than the interest recoverable under savings accounts.

These concerns have led certain academics to argue that ROI should be calculated at the creditor's weighted average cost of capital¹⁰³. Keir and Keir for instance, argue that the ROI should reflect the average cost of the creditors' debt, preferred stock and common stock.¹⁰⁴

This chapter argues that the cost of creditors' stock is of absolutely no relevance for the purposes of interest rate calculation. Keir and Keir on the other hand argue, that had the debtor paid on time, the creditor would have invested its proceeds in its own business. The loss that the creditor suffered as a result of delay of payment is therefore best reflected in the return that its business has generated since the sums became due. This argument is flawed on two grounds. First, Keir and Keir's analysis is based upon a publicly traded company, which would obviously have access to capital markets. As long as the creditor can raise sums to replace the sums that are in arrears, the debtor cannot be said to have deprived it of any attractive opportunities. Of course, the debtor would be liable to reimburse the creditor for the difference between the cost of the substitute funds and the interest that the debtor is paying on the sums in arrears. Such reimbursement however, will fall under the realm of damages and not interest.

Second, awarding interest on the basis of the cost of the creditors' borrowing would undermine the objectives of fairness and efficiency. Take for instance a scenario, where the creditor either did not raise any funds as a result of the breach or there was no incremental increase in the creditor's trend in borrowing during the prejudgment period. In such a circumstance, the cost of the creditor's capital is of no relevance and awarding the same would potentially lead to the unjust enrichment of the creditor. These concerns have led Lanzillotti and Esquibel to argue that interest should be calculated on the basis of the creditor's cost of borrowing only when the creditor was a net borrower during the prejudgment period.¹⁰⁵

¹⁰³ Robert F. Lanzillotti and Amanda K. Esquibel, 'Measuring Damages in Commercial Litigation: Present Value of Lost Opportunities' (1990) 5 *Journal of Accounting, Auditing & Finance* 125.

¹⁰⁴ John C. Keir and Robin C. Keir, 'Opportunity Cost: A Measure of Prejudgment Interest' (1983) 39 *The Business Lawyer* 129, 147.

¹⁰⁵ Lanzillotti and Esquibel (n 103).

Even where the creditor had raised further capital, the cost of such capital reflects the risk that the new investors bear, as opposed to the harm caused to the creditor as a result of the delay. Such investors would seldom look towards the claim of sums in arrears in satisfaction of their claim, and as such, the cost of additional funds would reflect in part the risk of default of creditor raising the additional capital and additional risks. These additional risks are represented, in part, by the position the additional funds raised by the creditor take in its capital structure.¹⁰⁶ It makes absolutely no sense for obligating the debtor to pay for these additional risks under the heading of interest; since doing so would be tantamount to obliging the debtor to pay for risks that are unrelated to the claim the creditor has against it I.e. risks that are transferred to the creditors new investors.

In the converse scenario, where the creditor's cost of capital is less than the debtor's risk of default, the creditor is not being adequately compensated for the risks it bears if interest is calculated on its cost of capital. As such both the objectives of fairness and efficiency are undermined if reference is made to the creditors cost of capital in such instances.

6.2.3 ROI should be calculated at the statutory rate prevailing at the creditor's place of business:

The Advisory Council (AC) in Opinion Number 14 titled 'Interest under article 78', stated that absent an agreement between the parties on the ROI to be charged on sums in arrears, the applicable ROI is that which would have been charged by the courts at the creditor's place of business on a contract not governed by the Convention.¹⁰⁷ The opinion expressly notes that while the applicable ROI is not contained in the Convention, the drafters did not exclude the issue from its scope.

Moreover, it correctly identifies the fact that the primary objective of the Article 78 is to compensate the creditor but limits compensation to providing the creditor the time value of the sums in arrears. As such, the opinion does not take into account the

¹⁰⁶ The risk of repayment of a secured debt is lower than that of an unsecured one.

¹⁰⁷ See n 25.

additional risk of the debtor's default which is borne by the creditor. Interestingly, the opinion states that "Choosing a specific interest rate which is thought to best compensate the losses of the creditor would be too far reaching a goal given the drafting history of the Convention. Therefore this Opinion only looks for the law which presumably is best applied to compensate the losses of the creditor."¹⁰⁸

Resultantly while the Council notes that the objective of article 78 is to compensate the creditor, it settles for a methodology that, in its own view, would seldom achieve that goal.

Moreover, the Opinion completely excludes disgorgement of profits from the objectives that Article 78 intended to achieve. Such a conclusion is surprising, given that limiting opportunistic behaviour on the part of the debtor was clearly an objective, though subsidiary, that the drafters had in mind during the drafting stages of article 78. In any case, the Opinion does note that there may be instances where the domestic law of the creditor's place of business does not reflect the reality of market conditions, and advocates that the way around this is to claim damages under article 74. Such a stance is quite astonishing since the opinion begins by noting the reasons for the separation between the section on damages and interest, yet goes on to provide a solution that clearly ignores the same. In other words, it operates to limit the recovery of interest to solely that which is provided in the domestic law of the state where the creditor has its place of business, and subjects the residual amount necessary for the complete compensation of the creditor to the limits contained in the provision on damages. Resultantly the remaining amount under this methodology is subject to defenses such as those contained in Article 79.

Furthermore, while the opinion recognizes the fact that the domestic law to be referred to in the ascertainment of the ROI may well over compensate the creditor, it simply classifies the same as a side-effect. This is surprising since various delegates throughout deliberations on the text of the article vehemently opposed any methodology that would operate to unjustly enrich the creditor.¹⁰⁹

¹⁰⁸ *ibid.*

¹⁰⁹ See for example the comment of the delegate of Czechoslovakia "On the other hand, he should not be permitted to demand an excessive rate of interest"; Comment of the delegate of Sweden "when determining interest rates, to establish a realistic scale of rates that were neither excessive nor artificial" (Vienna Diplomatic Conference, 34th Meeting).

The opinion however does recognize the fact that the methodology advocated by it would lead to a situation where the creditor would not be able to claim any amount in the form of interest where the domestic law identified does not provide any rule for the recovery of the same. It is here that the greatest weakness of the advocated methodology for ROI calculation lies. That is to say, by subjecting the ROI to domestic law, the intent of the drafters, who clearly intended that the creditor be compensated, is undermined. Moreover this methodology seems to ignore the international nature of the Convention in its interpretation by subjecting its evolution to the dictates of domestic law. In the words of the Council “If the lawmaker in the country of the creditor does not react properly to the changes in the market, it cannot be the role of a tribunal to simply bypass these residual interest rules in order to find a more adequate interest rate for international disputes.”¹¹⁰ This thesis on the other hand argues that the purpose of the Convention was to displace “legal barriers in international trade and promote the development of international trade.”¹¹¹ By placing the question of and the further development in the methodology for the calculation of the ROI in the hands of national legislatures, the opinion clearly undermines these goals.

6.2.4 ROI should be ascertained through reference to the law of the residence of the debtor.

Hans Stoll, the primary proponent of this argument, asserts that the basic requirement of the interest rate provision contained in the Convention is to ensure that the debtor is not allowed the advantage of working with the sum in arrears, rather than ensuring that the creditor is adequately compensated.¹¹² The policy behind the chapter on damages on the other hand, he asserts, is to compensate the injured party; the drafters by separating interest from the same have clearly shown that such considerations are not applicable to article 78. Proponents of this stance

¹¹⁰ See n 25.

¹¹¹ Convention, Preamble.

¹¹² Hans Stoll, ‘Internationalprivatrechtliche Fragen bei der landesrechtlichen Ergänzung des Einheitlichen Kaufrechts’, in Andreas Heldrich, Dieter Heldrich, Hans Jurgén Sonnenberger (eds), *Konflikt und Ordnung: Festschrift für Murad Ferid zum 70. Geburtstag* (Beck, 1978) 509-10. For an analysis of Stoll's argument see Behr (n 79) 290.

further contend that, apart from creating a completely distinct chapter on interest, the drafters reinforced this separation by expressly providing that a party is entitled to interest “without prejudice to any claim for damages recoverable under article 74”¹¹³.

This argument acts as the foundation of the assertion that the difference between the scope and requirement of the provision on damages from that in the provision on interest simply means that the two are based on different policy concerns.¹¹⁴ This methodology however, it is asserted, fails to recognize the fact that concerns surrounding compensation of the creditor formed the fault line upon which most discussions during the drafting stages were based. While there is no doubt that the drafters were unable to concretely identify a methodology that would adequately compensate the creditor, the intention of the drafters would be completely undermined if the concern was completely omitted from ROI calculations.

Regardless of these apparent shortcomings of this approach, it has been adopted by tribunals in at least seven cases.¹¹⁵ Interestingly, only one of these seven cases expressly identifies the general principle of restitution in justification of the adoption of the approach.¹¹⁶ The remaining six, on the other hand, justify reference to the domestic law of the debtor on the grounds that since the payment of sums in arrears is the obligation of the debtor; in cases involving the payment of interest, it is the debtor’s obligation that is under dispute. Part 3 of this paper asserts that this methodology, as opposed to the one adopted by Stoll, is in line with what was intended by the drafters since it adequately fulfils the objectives of both complete compensation and efficiency.

¹¹³ This line of argument is surprising since it recognizes the fact that the impact of separating interest from the chapter on damages was simply the provision of a guarantee that a party could claim interest without proof of fault.

¹¹⁴ Footnote no.54.

¹¹⁵ Court of Appeal of Eastern Finland, Finland, 27 March 1997 <<http://www.unilex.info/case.cfm?pid=1&do=case&id=489&step=Abstract>> accessed: 23 August 2014; CLOUT case No. 1 (n 85); CLOUT case No. 634 [Landgericht Berlin, Germany, 21 March 2003] accessed: 23 August 2014; CLOUT case No. 211 [Tribunal Cantonal de Vaud, Switzerland, 11 March 1996] <<http://cisgw3.law.pace.edu/cases/960311s2.html>> accessed: 23 August 2014; CLOUT case No. 214 [Handelsgericht des Kantons Zürich, Switzerland, 5 February 1997] accessed: 23 August 2014; CLOUT case No. 85 [U.S. Federal District Court for the Northern District of New York, United States, 9 September 1994] <<http://cisgw3.law.pace.edu/cases/960311s2.html>> accessed: 23 August 2014.

¹¹⁶ CLOUT case No. 211 (n 115).

Interestingly, one tribunal has labelled the ‘reference to the domestic law of the debtor approach’ as “an isolated deviating opinion”.¹¹⁷ In this judgment, the court expressly set out the limitations of the debtor approach, ranging from the lack of a ‘general principle’ of restitution to the inability of the approach to ensure that all advantages arising from delay in payment are taken away from the debtor. Surprisingly, five of the seven judgments adopting the domestic law of the debtor approach were delivered after this judgment, yet none of them make reference to it or addresses the criticisms raised therein. This paper avoids such omission by discussing how all advantages arising from delay in payment are taken away from the debtor when he is forced to pay interest at his cost of funds calculated over a short-term floating rate, in Part 3.

6.2.5 ROI should be ascertained through reference to the law of the currency of payment.

During the drafting stages of the article, only a handful of delegates were in favour of setting a fixed rate of interest¹¹⁸. The majority of delegates on the other hand pointed towards the considerable movement of the money market, in support of their proposition that a fixed interest rate would seldom reflect commercial reality.¹¹⁹

During the discussion on whether the Convention should incorporate a fixed or a flexible ROI, issues arose with regard to the considerable difference between the ROI determined by the market in western-industrialized states and the statutory rate of interest prevailing in socialist countries. The ROI in industrialized countries was relatively high; the same resulted from a high rate of inflation. This had the impact of

¹¹⁷ See CLOUT case No. 79 (n 85). The court stated “According to the isolated deviating opinion of Stoll the legal rate [of interest] has to be determined by the domestic sales law of the debtor. In this case . . . the court has to decide according to the prevailing legal opinion. Since the amount of interest intentionally is not prescribed in the Convention, the answer can only be taken from the rules of international private law. Absent any point of reference, no principle can be decisive, because the duty to pay interest was aimed at preventing the withholding of money from being advantageous to the debtor who still has the possibility to use or invest the funds as compared to payment. Furthermore, this argument is not persuasive, since it is not guaranteed that the domestic legal rate [of interest] fully compensates for . . . the advantage of non-payment and any other calculation of interest would erase the dividing line between interest and damages.”

¹¹⁸ The delegate of the Federal Republic of Germany, for instance supported this approach. (Vienna Diplomatic Conference, 34th Meeting) at Para 9.

¹¹⁹ See (Vienna Diplomatic Conference, 34th Meeting); (Vienna Diplomatic Conference, 37th Meeting).

characterising the currency as weak. As such, delegates belonging to states with relatively weak currencies were concerned that awarding interest at the lower rate set in countries with a strong currency would never amount to complete compensation of the creditor. They therefore demanded that interest should be determined according to the rate prevailing in the state of the creditor.¹²⁰ In support of this proposition, it was asserted that the creditor might have to procure additional funds in his country, as a result of delay in payment. Socialist states and certain developing states however supported the opposite solution, on the grounds that while dealing with western states the currency of payment was usually that of a western state.¹²¹ This meant that creditors belonging to these states would, while dealing with debtors with places of business in western states, have to procure additional funds from countries with high interest rates.¹²²

Unfortunately, tribunals applying the law of the country of currency of payment have been unable to agree on a methodology that leads to this conclusion. In essence, tribunals have applied three methodologies, each of which suffers from its own respective limitations. This paper shall now turn to briefly examine each.

6.2.5.1 Via application of the rules of PIL as required by article 7(2) of the Convention:

Proponents of this stance assert that while the issue of ROI lies within the scope of the Convention, no general principles upon which the Convention is based can be identified which are capable of shedding light on the rate of interest to be applied to disputes governed by the Convention. As such, they assert that the same is to be resolved according to the law identified through the rules of PIL. Interestingly,

¹²⁰ See for example the comment of the delegate of Sweden (Vienna Diplomatic Conference, 34th Meeting).

¹²¹ (Vienna Diplomatic Conference, 34th Meeting).

¹²² See for example the comment of the Delegate of Czechoslovakia (Vienna Diplomatic Conference, 34th Meeting); André Corterier, 'A New Approach to Solving the Problem of the Interest Rate Under Article 78 CISG' (2000) 5 International Trade and Business Law Annual 33, 34 <<http://www.cisg.law.pace.edu/cisg/biblio/corterier.html>> accessed: 25 August 2014; It should be noted that during the drafting stages of the Convention interest rate in various western countries was considerably high, and therefore would form the main determinant in ROI calculation. Since then, however, interest rates have greatly declined in those states and consequently these concerns are much less relevant in the commercial context of today's.

certain tribunals find the law applicable through the rules of PIL to be the law of the currency of payment. In justification of this conclusion tribunals make reference to abstract concepts such as fairness; yet do not specify how fairness has been found to be a guiding principle for the identification of the applicable law. Take for instance the judgment in *Waste container case*¹²³. This case concerned a contract for sale of containers between a Hungarian seller and an Austrian buyer. The buyer claimed that the goods were not of acceptable quality and only paid a part of the purchase price. The seller brought an action for the payment of price and interest on sums in arrears. On the issue of interest the court was of the opinion that the Convention did not expressly govern the issue of ROI nor could the same be inferred from the general principles upon which the Convention is based. The court therefore concluded that ROI was a *lacunae praeter legem* that had to be resolved by reference to the rules of private international law. In ascertaining which law PIL made applicable, the court stated

It is accepted as a problem that it is neither logical nor fair to apply rules of one State on a sum that is expressed in the currency of another State if the currency of one of the States is stable or the influence of inflation is minor and the currency of the other State continuously diminishes in value. Given these concerns, the issue has to be resolved in conformity with the rules of PIL, taking into consideration the State of the currency.

Interestingly, even though the court based its reasoning on the fact that ROI should reflect the proper time value of money, the court went on to apply the statutory rate of interest prevailing in the country of currency of payment rather than a floating rate.¹²⁴

6.2.5.2 Where the law otherwise applicable to the contract and the payment of currency are the same:

¹²³ CLOUT case No. 164 [Arbitration Court attached to the Hungarian Chamber of Commerce and Industry, Hungary, 5 December 1995] <<http://cisgw3.law.pace.edu/cases/951205h1.html>> accessed 27 August 2014.

¹²⁴ In this case, under Austrian law; according to § 352 para.1 of the Austrian Commercial Code (UGB).

Certain tribunals have argued that since the Convention does not provide a ROI, the same has to be determined either by reference to the law otherwise applicable to the contract, or by the law of the State in which currency the price had to be paid.¹²⁵ In instances where the law of the currency of payment establishes the same ROI as that contained in the law otherwise applicable to the contract of sale, courts have had no difficulty applying the same. It is however interesting to note that courts applying this methodology do not provide any justification as to how the law of the currency of payment has been identified by the rules of PIL.¹²⁶ Rather, courts adopting this stance justify it on the grounds that it is commercially reasonable i.e. the most logical solution from an economic point of view.¹²⁷ Interestingly, the interplay between the law identified by application of the rules of PIL, and that of the law of the state of currency has never been ventured into by courts adopting this methodology. In other words, this methodology does not answer the question of which law is to prevail where the law otherwise applicable is different from the law of the state of currency.

6.2.5.3 Reference to the UNIDROIT Principle or the LIBOR

Certain courts have applied the law of the currency of payment without referring to the rules of PIL. In the identification of the ROI, certain courts adopting this stance have expressly referred to Article 7.4.9 (2)¹²⁸ of the UNIDROIT Principles, without justifying how the same is applicable.¹²⁹

¹²⁵ See Judgment in Court of Arbitration of the International Chamber of Commerce, ICC Arbitration Case, 23 January 1997 <<http://cisgw3.law.pace.edu/cases/978611i1.html>>; Case Abstract of the Judgment by Oberlandesgericht Rostock, Germany, 10 October 2001 <<http://www.unilex.info/case.cfm?pid=1&do=case&id=906&step=Abstract>> accessed: 25 August 2014; See Judgment by Oberlandesgericht Rostock, Germany, 25 September 2002 <<http://cisgw3.law.pace.edu/cases/020925g1.html>> accessed: 25 August 2014.

¹²⁶ *ibid.*

¹²⁷ See Judgment in Court of Arbitration of the International Chamber of Commerce, ICC Arbitration, 26 March 1993 <<http://cisgw3.law.pace.edu/cases/936653i1.html>> accessed: 25 August 2014. See also the ruling in Cour d'appel Paris, France, 6 April 1995 <<http://cisgw3.law.pace.edu/cases/950406f1.html>>, where the present case was appealed.

¹²⁸ The article states: "The rate of interest shall be the average bank short-term lending rate to prime borrowers prevailing for the currency of payment at the place for payment, or where no such rate exists at that place, then the same rate in the State of the currency of payment. In the absence of such a rate at either place the rate of interest shall be the appropriate rate fixed by the law of the State of the currency of payment."

¹²⁹ See Judgment in ICC Court of Arbitration, Zurich, 1996 <<http://www.unilex.info/case.cfm?pid=1&do=case&id=397&step=FullText>> accessed: 26 August 2014.

Other tribunals adopting the commercially reasonable approach have made reference to LIBOR where the payment of currency is the dollar and the parties belong to European states.¹³⁰ Take for instance the ICC court of arbitration case no 8908 where the court stated,

The Vienna Convention [CISG] lays down a general rule, in Article 78, that the liability for payment of a sum is subject to interest for late payment, but it does not lay down the criteria for calculating this interest. International case law presents a wide range of possibilities in this respect, but amongst the criteria adopted in various judgments, the more appropriate appears to be that of the rates generally applied in international trade for the contractual currency... In concrete terms, since the contractual currency is the dollar and the parties are European, the applicable rate is the 3-month LIBOR on the dollar, increased by one percentage point, with effect from the due date not respected up until full payment has been made.¹³¹

Interestingly, tribunals adopting this stance have limited the application of LIBOR to disputes concerning European community nationals only. As, such, this approach does not provide any guidance in disputes concerning non-European signatories of the Convention. Moreover, even where the parties are European community nationals, this approach is no longer applicable. As aptly noted by André Corterier:

This solution can no longer lead to satisfactory solutions for a large amount of contracts, however, once the European currency union takes effect. The same is true for contracts already made specifying ECU as currency. In such instances, the currency no longer leads to the law of a single state, whose legal interest rate might then be applied.¹³²

6.2.6 Trade usage and practise

¹³⁰ See Case Abstract of the Judgment in Court of Arbitration of the International Chamber of Commerce, ICC Arbitration, November 1996.

¹³¹ See Judgment in ICC Court of Arbitration, Milan, December 1998
<<http://www.unilex.info/case.cfm?pid=1&do=case&id=401&step=FullText>> accessed: 26 August 2014.

¹³² Corterier (n 122) 38-39.

It is a well-established fact that before recourse may be had to the rules of PIL under Article 7(2) for the resolution of gaps *praeter legem*, one must first attempt to identify whether the parties have agreed to any usage¹³³ or have agreed to a practices, which they have established between themselves.¹³⁴ As such, if a court finds the existence of any such usage or practice *vis-à-vis* the applicable ROI, then the same is to be given effect by the courts without venturing into the methodology prescribed by article 7(2)¹³⁵.

It must be noted that Article 9 adopts a narrow approach towards the usages and practices, which are recognized for the purpose of the contract. Firstly the parties must have agreed to the usage for it to be applicable. While the agreement can either be express or implied; implied usages, in order to be binding must fulfil a two prong test i.e. it must be one (a) “of which the parties knew or ought to have known” and (b) “which in international trade is widely known to, and regularly observed by, parties to contracts of the type involved in the particular trade concerned.”¹³⁶ As such, for a court to find a usage have to been impliedly agreed upon, it must satisfy both a subjective and objective test¹³⁷. Moreover, the term ‘trade’ has to be interpreted narrowly as well, i.e. it should be restricted to a certain product, region or set of trading partners, in light of the facts of each case.¹³⁸

In various instances, tribunals have used the dictates of Article 9 in order to identify a usage that recognises a specific interest rate. In all such instances however, courts have ignored the requirements for a usage to amount to an implied agreement. Take for instance the case of *Aguila Refractorios* where the court stated that the prime rate constitutes “an accepted usage in international trade, even when it is not expressly

¹³³ Under article 9(2), parties are bound by usages which they knew or ought to have known and which is, in international trade, widely known to, and regularly observed by, parties to contracts of the type involved in the particular trade concerned, even if the same had not been expressly agreed to by the parties.

¹³⁴ Behr (n 79) 290.

¹³⁵ Thiele n 64.

¹³⁶ Convention, Article 9.

¹³⁷ The subjective test is that the parties to the contract knew or ought to have known of the usage. The objective test is that the usage is widely known and regularly observed.

¹³⁸ Eric E. Bergsten, ‘Basic Concepts of the UN Convention on the International Sale of Goods’ in Peter Doralt (ed), *Das UNCITRAL-Kaufrecht im Vergleich zum österreichischen Recht: Referate und Diskussionen des Symposiums in Baden bei Wien, 17-19 April 1983* (Manz 1985) 20-21.

agreed between the parties”.¹³⁹ Interestingly the court did not specify which prime rate it was referring to, since the prime rate varies from country to country and in some cases, even amongst banks operating in the same legal jurisdiction.¹⁴⁰ Moreover the court did not attempt to identify whether the ‘prime rate’ was recognized in the ‘trade’ concerned.

It is asserted that since prime rate simply reflects the rate at which banks lend to solvent companies, it is based upon the assumption that there is no risk of default. Since compensation in the realm of interest rate demands that the creditor be reimbursed for the risk he is made to bear, the ROI awarded to him must make provisions for the risk that the debtor may default. This is so as awarding interest without making provision for default will result in the undercompensating of creditors as a class. Individual creditors will be under compensated ex-ante since the risk of default will reduce the value of the judgment asset below that of the original claim. Individual debtors on the other hand would be unjustly enriched. As such application of the prime rate where the risk of debtors’ default is greater than zero, would undermine the objective of fairness.

Fisher and Romaine propagate the use of a similar risk-free rate.¹⁴¹ They argue that interest should be charged at the cost of the federal governments’ cost of funds.¹⁴² Their argument is based upon the assertion that since courts do not compensate litigants for risks of litigation; the risk that the debtor may default should be excluded from the scope of ROI calculation since the same is only a risk of litigation. This argument is however, flawed to the extent that it equates litigation risks with default risk. If such a broad definition is to be attributed to the term litigation risk, then intuitively speaking, the same would incorporate the risk of delay.¹⁴³ This would then imply, that the creditor is entitled only to the principal since inflation is

¹³⁹ Argentina 23 October 1991 National Commercial Court of First Instance, Buenos Aires (*Aguila Refractarios / Conc. preventivo*)
<<http://cisgw3.law.pace.edu/cases/911023a1.html>> accessed: 3 September 2014.

¹⁴⁰ Loretta J. Mester and Anthony Saunders, ‘When does the Prime Rate Change?’ (1995) 19 *Journal of Banking & Finance* 743.

¹⁴¹ Franklin M. Fisher and R. Craig Romaine, ‘Janis Joplin’s Yearbook and the Theory of Damages’ (1990) 5 *Journal of Accounting, Auditing & Finance* 145.

¹⁴² Since the authors are concerned with interest applied by the courts of the United States, they refer to the US Treasury bill rate.

¹⁴³ I.e. delay in payment as a result of the time it took to litigate.

simply a result of delay. As such, the reasoning adopted by Fisher and Romaine does not justify application of an interest free rate, but rather justifies a bar to compensation other than recovery of the principal.¹⁴⁴

Various tribunals have similarly erred by classifying London Inter Bank Offered Rate (LIBOR) as a ‘usage’ for the purposes of article 9¹⁴⁵. For example in one arbitration award the tribunal stated “Taking into account the fact that the annual rate of 5% which the seller claims does not exceed the LIBOR rate usually applicable in international trade relations, the Tribunal found it possible to grant the seller's claim.”¹⁴⁶

The LIBOR represents the average interest rate, estimated by leading banks in London upon which they would be charged if they were to borrow funds from other banks. While various financial institutions set their own rates relative to the LIBOR, it cannot be stated that the LIBOR represents the rate prevailing in commercial transactions.¹⁴⁷ Moreover as stated above the LIBOR, in order to classify as a usage, must pass the test of being regularly observed by parties to contracts in the particular trade; a conclusion that is hardly conceivable for contracts of international sale of goods. As such, even though the LIBOR may well provide a uniform and predictable solution to the problem of uncertainty surrounding the issue of ROI, holding the same to constitute a ‘usage’ would amount to a distortion of the dictates of Article 9.

¹⁴⁴ For a detailed criticism of Fisher and Romaines’ arguments see Roman L. Weil, ‘Compensating the Plaintiff for Asynchronous Payments’ in Roman L. Weil, Michael Wagner and Peter B. Frank (eds), *Litigation Services Handbook: The Role of the Financial Expert* (3rd edn, John Wiley & Sons 2003).

¹⁴⁵ See Judgment by Tribunal of International Commercial Arbitration at the Russian Federation Chamber of Commerce and Industry, Russia Federation, 27 July 1999 <<http://cisgw3.law.pace.edu/cases/990727r1.html>> where “the Tribunal granted the claim of the [buyer] to recover annual interest on the granted sum of lost profit at the LIBOR rate plus 2% per annum, on the basis of Article 78 CISG and Article 395 of the Russian Federation Civil Code that refers to the rate of bank loan at the place of creditor”; See also Judgment in Court of Arbitration of the International Chamber of Commerce, ICC Arbitration, 26 March 1993 <<http://cisgw3.law.pace.edu/cases/936653i1.html>> accessed: 3 September 2014. The judgment was partly overruled in Cour d’appel Paris (n 127).

¹⁴⁶ See Judgment by Tribunal of International Commercial Arbitration at the Russian Federation Chamber of Commerce and Industry, Russia, 25 March 1998 <<http://cisgw3.law.pace.edu/cases/980325r1.html>> accessed: 3 September 2014.

¹⁴⁷ See n 25 stating that “like the Libor or Euribor seem satisfactory, since the scope of application of these rates is simply too narrow: The London Interbank Offered Rate is defined for just five different currencies;[69] the Euro Interbank Offered Rate just for the Euro. Therefore these rates would not provide an interest rate that could be applied for every currency” at 3.33.

6.3 Part 3 The Approach in line with the objectives of fairness and efficiency.

The issue of ROI can never truly be solved without proper appreciation of the objectives that the principle aims to achieve. As detailed above, the objective of providing the right to recover interest can be summarized under the categories of fairness and efficiency. Fairness in this context simply refers to requirement that the injured party be compensated for its loss. Efficiency on the other hand requires that the potential of parties to act in an opportunistic manner is curtailed. This is best achieved by requiring parties to take appropriate precautions when entering into contracts. Since non-payment of sums when they become due works for the benefit of prospective defendants, especially in legal regimes that have been unable to concretely develop a concrete right to claim interest, they are deterred from taking appropriate precautions.¹⁴⁸ Prospective plaintiffs on the other hand, would be motivated to take too many precautions, leading to a rise in costs. The presence of well-developed rules on interest on the other hand, would ensure that both parties take adequate precautions to protect themselves. As such, the requirement of efficiency is met when the principle of interest operates to ensure that both parties to a contract take adequate precautions.

Ignorance of these objectives has led commentators to approach the problem incorrectly. In other words, ignorance of the fact that the efficiency and fairness objectives concern both the injured party and the debtor has led commentators and courts alike to simplify resolution of the issue on the determination of whether the award is meant to compensate the creditor or punish the debtor.¹⁴⁹ The problem with such an approach is that it begins with the assumption that the two goals are mutually exclusive. Those favouring the former view usually call for the adoption of the ROI that the creditor would be subject to had he borrowed the sum when they became in arrears. Whereas those supporting the view that the award of interest is to force the debtor to disgorge any profits it may have realized and to motivate it to take

¹⁴⁸ Knoll (n 4) 296. See also Henderson (n 7) 775-776 where the author argues that the lack of award of prejudgment interest results in discouraging manufacturers for modifying defective products.

¹⁴⁹ Indeed while the travaux reveal that the goal of compensation of the creditor was the primary objective of Article 78, the delegates did view the goal of disgorgement of profits as a secondary objective.

appropriate precautions, argue for the adoption of the ROI that the defendant is subject to.

This paper argues that in cases where the parties have access to capital markets, both goals are concurrently achieved by reference to the ROI applied to credits advanced to the debtor by institutions operating in his domestic capital market.¹⁵⁰

Disgorge unjust enrichment: The debtor's decision of not paying sums that are in arrears simply implies that the debtor has elected to borrow the sums from the plaintiff.¹⁵¹ Such a decision is beneficial to the defendant only if the ROI applied to these sums is less than its cost of borrowing. If however, the two are equal then the defendant is not enriched since he could have borrowed the sums from the capital market when they became due and paid the creditor off. Had this been the case, the debtor would be in exactly the same position that he would have been in had he paid the sums when they became due. As such, reference to the debtor's borrowing rate ensures that the debtor is not unjustly enriched.

Complete compensation: As discussed above, every commercial activity carries with it a degree of risk, which must be borne by every participant attempting to make a profit.¹⁵² The risk that a participant may not be paid on time is but one such risk and the principle of interest is, among others, a mechanism that has been developed to minimize the impacts of this risk. The risk therefore is simply that the creditor may end up in a position resembling the advancement of a loan to the debtor. Consequently, it makes logical sense for the ROI to reflect the risk that the creditor undertakes by advancing a loan to the debtor; which is best represented by the rate at which the debtor borrows money in its usual course of business¹⁵³.

¹⁵⁰ This is based upon the assumption that the capital market accurately prices debt obligations. As such, ROI at the defendant's cost of borrowing simply reflects the conversion of a debt into an accurately priced investment, even though the same might not be voluntary. See Barondes (n 98) 8.

¹⁵¹ The Coerced Loan Theory, see John K. Pearson, Dillon Jackson and Tim Nohr, 'Ending the Judicial Snipe Hunt: The Search for the Cramdown Interest Rate' (1996) 4 American Bankruptcy Institute Law Review 35.

¹⁵² Knoll (n 4) 311.

¹⁵³ This is based upon the assumption that the capital market accurately prices debt obligations. As such, ROI at the defendant's cost of borrowing simply reflects the conversion of a debt into an accurately priced investment, even though the same might not be voluntary. See Barondes (n 98) 8.

Michael Knoll, the primary proponent of reference to the debtor's cost of borrowing argues that reference to the creditor's cost of borrowing does not achieve either of the two objectives upon which the principle of interest is based.¹⁵⁴ Take for instance a scenario where the debtor's cost of borrowing exceeds that of the creditor. In such a case, granting interest at the creditors cost of borrowing will not make appropriate provisions for the additional risk of default that the creditor was forced to bear.¹⁵⁵ This is simply a result of the fact that the creditor's cost of borrowing is calculated, in part, on the probability of the creditor's risk of default. As a result, if the creditor is entitled to interest at his own cost of borrowing, he will be compensated for his own risk of default not that of the debtors. Such an outcome is counter-intuitive as the creditor's risk of default is of no relevance vis-à-vis the risk he bears as a result of non-payment on sums when they become due.

This raises the issue of which interest rate applicable to the debtor should be applied to the sums in arrears. Since debts have varying positions in the capital structure of a corporation, debts with different risks are subject to differing rates of interest.¹⁵⁶ In essence, the higher a debt is on the capital structure of a firm, the higher the chances of it being paid and consequently, the lower the interest rate that it attracts. As such, the position that a debt occupies in the capital structure of a firm reflects the quantum, of risk that the same would not be paid. It therefore makes intuitive sense for the ROI to reflect the interest rate applicable to voluntary loans with the same default risks. Such a rate, it is asserted, can be identified by reference to the ROI that the debtor would/does pay on a voluntary loan occupying the same position in the capital structure of the firm.

There is however one shortcoming of this approach. Legal jurisdictions differ in the treatment afforded to monetary legal judgments vis-à-vis their categorization in the capital structure.¹⁵⁷ This divergence in classification by legal jurisdictions will lead to the identification of different indices of interest rate, i.e. jurisdictions classifying legal judgments as secured debt will make reference to the debtors cost of borrowing

¹⁵⁴ Knoll (n 4) 296; Stoll (n 112). For an analysis of Stoll's argument see Behr (n 79) 290.

¹⁵⁵ Moreover, since there is always the possibility that some debtors might actually default, creditors as a class would be undercompensated.

¹⁵⁶ Knoll (n 4) 311-317.

¹⁵⁷ *ibid* 314.

the same whereas jurisdictions classifying it as unsecured debt will make reference to that index.¹⁵⁸

Knoll provides two grounds upon which the debtor's cost of borrowing is not a suitable point of reference for the formulation of ROI when the debtor is not a publically traded company where as the creditor is.¹⁵⁹ The first argument is based on the scenario where the claim is relatively large in ratio to the wealth of the debtor. In such circumstances, the creditor might be prevented from making further investments or that the cost of such investments might dramatically increase.¹⁶⁰ Resultantly, Knoll argues the creditor may be forced to change its consumption habits.

The Coerced Loan Theory (CLT), is premised on the assumption that variations in the value of the sums in arrears is not dependent upon the characteristics of the plaintiff but rather on the risk and return of the forced investment. The CLT therefore points towards the debtor's cost of borrowing on the assumption that the debtor values the return in the same manner as the market. Since the possibility that a creditor might be forced to change its consumption habits as a result of not being paid on time, is based upon the characteristics of the creditor, it has little impact on its valuation of return. The only situation where the creditor's valuation of return might exceed that of the market is where the creditor has absolutely no means of raising further finances. This is so as, as long as the creditor has access to capital, it will be reimbursed for the difference between the debtors cost of borrowing and its own under Article 74 of the Convention.

The second argument Knoll provides for the non-suitability of the debtor's cost of borrowing is that unlike investors of a publicly traded company, the debtor is forced to hold an undiversified portfolio. Since systemic risk can be diversified though

¹⁵⁸ The term index has been used here since highly leveraged companies usually have sub-categories within each secured, mezzanine and subordinated debts. Moreover, the interest rate of each sub-category may vary significantly.

¹⁵⁹ Michael S. Knoll and Jeffrey M. Colon, 'The Calculation of Prejudgment Interest' (2005) University of Law School, Public Law Working Paper No. 06-21, 31
<<http://ssrn.com/abstract=732765>> accessed 20 September 2015.

¹⁶⁰ Knoll (n 4) 311-317.

diversified portfolio, the market does not compensate the creditor for such a risk.¹⁶¹ As such, the creditor in such circumstances is forced to bear a risk that is not reflected in the debtor's cost of funds. While this would hold true if the creditor was being compensated on the basis of the debtor's fixed cost of funds; the use of a floating interest rate alleviates all such problems. While it is impossible to calculate unsystematic risks ex-ante, and consequently a fixed ROI cannot reflect the same; ex-post it can be factored into the calculation of the ROI. In other words, the use of a floating rate ensures that the impacts of unsystematic risks will be factored into the 'return' the creditor is entitled to.¹⁶² Therefore there does not seem to be any need for requiring a different methodology for calculating the ROI where the debtor is a publicly traded company or otherwise.

The CLT has however attracted its share of criticisms. Escher and Krueger for instance, find the theory inadequate in achieving the objectives upon which the principle of interest is based.¹⁶³ Instead they propose an alternative theory which views the creditors claim to sums in arrears as a 'forward contract' which is said to be entered into at the time of breach.¹⁶⁴ This contract simply entitles the creditor to recover the sums in arrears adjusted for inflation plus 'implied financing costs' or the cost of raising debt.¹⁶⁵ Interestingly, the authors grant that in cases where there exists a risk of default, the same must be reflected in the difference between the quantum of sums in arrears and the judgment amount. Since the risk of default is simply the risk that the debtor may not be able to pay, the Cost of Carry model leads to the application of the defendants cost of borrowing. As such, in all cases where default risk exists, the Cost of Carry model supports rather than undercutting the coerced loan theory¹⁶⁶.

Similarly, Barondes in his article titled 'Rejecting the Marie Antoinette Paradigm of Prejudgment Interest' highlights what he considers to be the shortfalls of the CLT.¹⁶⁷

¹⁶¹ *ibid* 308-311.

¹⁶² *ibid* 317-320.

¹⁶³ The model is called the 'Cost of Carry Pricing Model', see Susan Escher and Kurt Krueger, 'The Cost of Carry and Prejudgment Interest' (2003) 6 *Litigation Economics Review* 12.

¹⁶⁴ *ibid*.

¹⁶⁵ *ibid*.

¹⁶⁶ As such, it is only in instances where there is no default risk associated with the sums in arrears, that the cost of carry pricing model points towards the creditors cost of borrowing.

¹⁶⁷ Barondes (n 98).

Drawing from Meckling and Jensen's theory on asset substitution in corporate finance, Barondes argues that since the CLT does not recognize the difference between a firm's equity holders and creditors, application of the theory cannot lead to the restoration of both classes to the position they had been in before the occurrence of breach.¹⁶⁸ This conclusion is based upon the fact that even if the judgment has the same present value as that of the unpaid sums when they ought to have been paid, the two have very different risk characteristics.

Basing his arguments on the assertion that "A corporation ordinarily is managed for the benefit of the shareholders, not for the benefit of its creditors or the firm as a whole"¹⁶⁹; Barondes uses two examples to show that by the replacement of a riskier asset with a relatively non-risky one, stockholders would gain more than what they are entitled to whereas, other stakeholders of the creditor would be undercompensated.¹⁷⁰ It is extremely important to note that the degree with which the debtors of the firm (creditor) are undercompensated is equal to the unjust enrichment of its equity holders. As such, the creditor corporation as a whole is neither unjustly enriched nor undercompensated.

6.4 Conclusions:

A review of the drafting history of the Convention clearly reveals that the issue of interest lies within the scope of the Convention. Moreover, while Convention does not stipulate a methodology for the calculation of the ROI it does contain guidelines on the proper methodology for its calculation. First, the separation of the issue of recovery of interest from the provision on damages clearly reveals that that ROI calculation is not subject to defenses that limit the recovery of damages. Moreover, the travaux reveal that an appropriate ROI is one that completely compensates the creditor while barring the potential of opportunistic behaviour on the part of the debtor. This chapter argues that the ROI which the creditor is entitled to must account for: a) the time value of money, b) the risk that the debtor might default.

¹⁶⁸ *ibid.* 12

¹⁶⁹ Barondes (n 98) 15.

¹⁷⁰ *ibid.*

Since the risk of the debtor's default is based upon the characteristics of the debtor, a fixed rate of interest would be unable to appropriately take such risk into account. Consequently, the ROI has to be flexible if the creditor is to be completely compensated.

It is argued that sums in arrears should be equated with a loan that the creditor has been forced to extend to the debtor. As a result, this chapter argues that an appropriate ROI that the creditor is entitled to must be one that reflects the debtor's cost of borrowing. A mechanism of ROI calculation which does not take default risk into account will result in the ex-ante under-compensation of creditors as a class while allowing debtors to be unjustly enriched. Since the ROI that the debtor pays upon sums raised through its domestic capital markets best reflects this risk, reference to the debtors borrowing costs is the correct point of reference. The application of such a rate, apart from achieving the objective of complete compensation of the creditor, fulfils the secondary objective of barring opportunistic behaviour, which the drafters had in mind during deliberations on the text of article 78. It is argued that if reference is made to the debtor's cost of borrowing as the correct ROI applicable under the Convention, then debtors as a class would lose the 'strategic' incentive to delay payment. This is premised on the fact that since the debtor would be able to raise a similar amount on similar terms from his domestic financial markets, it would be unable to profit by strategically delaying payment of the sums in arrears.

Such an approach has the additional advantage of not subjecting the issue of ROI calculation to the dictates of domestic law and is consequently in line with the international nature of the Convention. Moreover, such an approach is in line with commercial realities unlike the rules contained in various domestic statutes that do not reflect the actual rate of inflation or the risk of the debtors default. Finally, this approach, unlike those referring to domestic law statutes, does not bar recovery of interest in instances where the domestic law identified through the rules of PIL do not make any provision for the recovery of interest.

Chapter 7: The Foreseeability Default in Article 74

The economic analysis of law has both a positivist and normative role. The normative role of the economic analysis is to identify the value conflicts and ascertain how given social desires can be achieved most efficiently. The positivist role on the other hand is to explain the rules and reasoning of the law through the economic lens.¹

Articles 45(1)(b) and 61(1)(b) of the Convention provide the buyer and seller, respectively, with the right to claim damages arising from breach of contract by the other party.² Article 74 to 77 then go on to provide methodologies for the calculation of the damages, which a party should receive once it is entitled to claim the same under Articles 45 and 61. It should be noted at the outset, the Convention clearly states that parties may recover damages where the other party “fails to perform any of his obligations under the contract.”³ As such, the right to claim damages under the Convention is not subject to ‘fault’. In other words, the Convention adopts a strict liability rule.⁴

This, however, should not be taken to mean that the Convention allows for recovery of damages in all cases of breach without limitation. Rather, the Convention limits liability of failure to perform through the incorporation of rules on mitigation⁵, foreseeability⁶ and excuse.⁷

Article 74 of the Convention states:

¹ Richard A. Posner, *Economic Analysis Of Law* (7th edn, Wolters Kluwer for Aspen Publishers 2007)

² See Convention, Article 45(1) and 61(1).

³ *ibid.*

⁴ Various civil law countries on the other hand only allow recovery of damages if it can be proved that the respondent was at fault. As such it must be proved that the breach was willful, or a result of negligence. See e.g. *Bürgerliches Gesetzbuch* (hereinafter referred to as ‘BGB’), § 276; Article 1101 of the Spanish Civil Code (hereinafter referred to as ‘SCC’); Article 401 of the Russian Civil Code (hereinafter referred to as ‘GKRF’). Analysis of Fault based liability vs. strict liability is outside the scope of this chapter and as such will not be highlighted in part 1 which highlights, in part, the differences between the methodology adopted under article 74 and that of national laws.

⁵ See Convention, Article 77

⁶ *ibid* Article 74

⁷ See *ibid* Article 79. Alastair Mullis, ‘Twenty-Five Years On – The United Kingdom, Damages and the Vienna Sales Convention’ (2007) 71 *Rabels Zeitschrift fuer auslaendisches und internationales Privatrecht* 35, 51.

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. Such damages may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract, in the light of the facts and matters of which he then knew or ought to have known, as a possible consequence of the breach of contract.⁸

In a nutshell, the article limits recoverability of damages to that which the parties foresaw or ought to have foreseen at the time the contract was concluded.

Like every rule of the Convention, parties are free to derogate from the default rule on damages through agreement.⁹ Parties, however, would seldom contract out of these defaults due to ‘stickiness’, i.e. the difficulty of opting out of default rules excluding the issue of drafting costs.¹⁰ In any given transaction, request for deviation from a commonly used default rule raises suspicion on the part of the other party.¹¹ Such suspicion, more often than not, leads to a negative inference, i.e. the party asking for deviation has a trick up its sleeve. This leads the other party to ask for an economic benefit in return for deviation or, in certain cases, even motivates it to avoid contracting altogether.¹² Such an eventuality, in turn, demotivates parties to request deviation from the default. The risk of stickiness, as such, requires that the default be the most efficient methodology in all cases, which given the diverse nature of disputes is hardly possible. This does not mean, however, that default rules on damages for breach are subsequently inefficient. In fact, such default rules are extremely advantageous if they operate to maximize social welfare of parties to sales

⁸ Convention, Article 74.

⁹ Examples of instances where parties to sales contract governed by the Convention opted out of the default rules on damage recovery include Turku Court of Appeal, Finland, 12 April 2002 <<http://cisgw3.law.pace.edu/cases/020412f5.html>>; Tribunal of International Commercial Arbitration at the Russian Federation Chamber of Commerce and Industry, Russia, 27 July 1999 <<http://cisgw3.law.pace.edu/cases/990727r1.html>>; Tribunal of International Commercial Arbitration at the Russian Federation Chamber of Commerce and Industry, Russia, 23 November 1994 <<http://cisgw3.law.pace.edu/cases/941123r1.html>>.

¹⁰ Building on the work of Professors Bernstine and Spier, Professors Ben-Shahar and Pottow (2006) argue that stickiness is a far more prevalent problem than appreciated. They argue that deviation from the norm raises suspicion since it, amongst other factors, gives a negative signal about the demanding party’s treatment of relational norms i.e. it would probably not resolve disputes in a cooperative manner. Ben-Shahar, Omri and John A.E. Pottow, ‘On the Stickiness of Default Rules’ (2006) 33 Florida State University Law Review 651, 662.

¹¹ *ibid.*

¹² *ibid.*

contract as a pool.¹³ That is to say that the existence of a particular default is beneficial, if the resulting reduction of transaction costs outweighs the cost of contracting around it for parties as a pool.

This chapter is concerned with evaluating whether the foreseeability default contained in Article 74 can be interpreted in a manner that promotes social welfare of the parties to contracts of international sale of goods. In order to answer this, it is necessary to begin by identifying efficiency-based considerations that should guide the interpretation of the article, so as to minimize instances where parties would wish to contract around the default. These considerations would add to the predictability of the operation of damages provisions of the Convention from the perspective of its end users and aid courts in applying the same.

Unfortunately, the principle of foreseeability did not attract much debate during the drafting stages of the article. This means that the travaux are not of much help in the identification of the philosophical underpinnings of the Principle of Foreseeability, which could provide the grounds for an efficiency based interpretative methodology. It is argued that the prevalence of this limit to recovery of consequential damages in national laws pre-empted discussion on the inclusion of the principle in the text of the Convention. As such, this chapter attempts to identify the philosophical underpinnings of the limit as it exists in national laws. This analysis is only concerned with the identification of philosophical underpinnings of the principle of foreseeability, as distinguished from its application under domestic law.

Mindful of the fact that various tribunals have fallen prey to the homeward trend in the application of Article 74, the chapter briefly identifies certain fundamental differences between the application of the foreseeability requirement under national law and the Convention. Moreover, since it would be against the international nature of the Convention to transplant the philosophical underpinning of the principles of domestic law in the interpretation of the Convention, this chapter will attempt to identify the general principles upon which the provisions of the Convention that limit recovery of damages are based.

¹³ Social welfare is defined as the sum of participant utility excluding third part effects. George S. Geis, 'Empirically Assessing *Hadley v. Baxendale*' (2005) 33 Florida State University Law Review 897, 912.

It concludes that the regardless of legal tradition, the foreseeability limit to damage recovery operates to motivate parties to exchange information and places liability upon the best risk-avoider. Equipped with the efficiency based considerations identified in Part 1 of this chapter, Part 2 shall attempt to ascertain whether the foreseeability default promotes social welfare of the parties as a pool over the alternative of full damages default. It will be concluded that while there are too many variables that determine which default promotes efficiency, the foreseeability default does seem to be preferable over the full damages default; at least in case of contacts for the sale of generic goods, which seem to be the subject matter of most cases arising under the Convention. While there is need for empirical analysis and the formulation of mathematical techniques to concretely ascertain whether a particular default would promote efficiency relative to other defaults, it is argued that the efficiency based considerations will greatly aid tribunals in interpreting Article 74 in a manner that does promote efficiency and advances harmonization.

7.1 Part 1: The Philosophical Underpinnings of the Principle of Foreseeability

7.1.1 Historical Evolution of the Principle of Foreseeability

The incorporation of the principle of foreseeability did not attract much debate during the drafting stages of Article 74.¹⁴ In fact, the principle of foreseeability contained in Article 74 was ostensibly a reproduction of Article 82 of the ULIS.¹⁵

The lack of debate, however, is not surprising, given that most legal systems incorporate the concept of foreseeability as a limit to damages.¹⁶ Jurisdictions that do

¹⁴ Legislative History, 1980 Vienna Diplomatic Conference, Summary Records of Meetings of the Plenary Meetings, 10th Plenary Meeting, 10 April 1980 (A/CONF.97/11/Add.2). Article 70 [which became Article 74] was adopted by 48 votes to none, with 2 abstentions. A total of two amendments were suggested to the text of Article 74, both of which were rejected. Of these, one was concerned with the foreseeability rule. The proposed amendment requested the second sentence of Article 74 be amended to read: "Such damages may not exceed the reasonable expectation of loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract, in the light of the facts and matters which he then knew or ought to have known, as a possible consequence of the breach of contract." Pakistan (U.N. Document A/CONF.97/C.1/L.235).

¹⁵ ULIS, Article 82 states: "Where the contract is not avoided, damages for a breach of contract by one party shall consist of a sum equal to the loss, including loss of profit, suffered by the other party. Such damages shall not exceed the loss which the party in breach ought to have foreseen at the time of the conclusion of the contract, in the light of the facts and matters which then were known or ought to have been known to him, as a possible consequence of the breach of the contract."

¹⁶ Lajos Vékás, 'The Foreseeability Doctrine in Contractual Damage Cases' (2002) 43 *Acta Juridica Hungarica* 145, 154

not make specific reference to foreseeability on the other hand, use concepts such as ‘causality’ and ‘reliance’ to the same end.¹⁷

Unfortunately, however, the lack of debate during the drafting stages of the article, coupled with the superficial similarities between Article 74 and the common law rule of *Hadley v Baxendale* has led various academics to equate them with one another.¹⁸ Interestingly, most commentators that equate the two are trained in German law, which does not make specific reference to foreseeability as a limit on damages.¹⁹

The argument that the rule of Article 74 is a compromise in favour of the common law world ignores the evolution of the principle of foreseeability as a limitation on damage recovery.²⁰ The principle of foreseeability as limit to damages was first recognized by the Constitution of 531(AD) enacted by Justinian, where by damages were limited to *ad duplum*.²¹ Dumoulin argued that the limitation was based upon the fact that the injured party could only foresee such damages.²² This rule was subsequently adopted by the Napoleonic code, which influenced the current structure and content of the civil law regimes.²³ Indeed, both the laws of the UK and the US also adopted the rule from these sources and, as such, it cannot be stated the rules limiting recovery of damages to foreseeability was ‘invented’ in *Hadley v Baxendale*.²⁴

¹⁷ See for example BGB, Section 252

¹⁸ *Hadley v. Baxendale* [1854] EWHC J70, 9 ExCh. 341, (1854) 156 ER 145; Professor Sutton for instance states “the second sentence of article 74 closely resembles the common law foreseeability requirement derived from *Hadley v Baxendale*”. Jeffrey S. Sutton, ‘Measuring Damages Under the United Nations Convention on the International Sale of Goods’ (1989) 50 Ohio State Law Journal 737. Professor Farnsworth on the other hand is critical of approaches equating the rule of foreseeability contained in article 74 to the rule of *Hadley v Baxendale*. He states, “Any such formula is inevitably imprecise”. Allan E. Farnsworth, ‘Damages and Specific Relief’ (1979) 27 The American Journal of Comparative Law 247.

¹⁹ Herber for instance states that “the limitation to the foreseeable damages comes from Anglo-American law.” Rolf Herber and Beate Czerwenka, *Internationales Kaufrecht: Kommentar zu dem Übereinkommen der Vereinten Nationen vom 11. April 1980 über Verträge über den internationalen Warenkauf* (CH Beck 2002) 333.

²⁰ Various courts have erred in this regard. For instance In *Delchi Carrier S.p.A. v. Rotorex Corp.* the Court of Appeals for the Second Circuit stated that the Convention requires damages to be limited by the “familiar principle of foreseeability established in *Hadley v. Baxendale*.” See *Delchi Carrier S.p.A. v. Rotorex Corp.* 71 F.3d 1024 (2d Cir. 1995) 1029.

²¹ Franco Ferrari, ‘Comparative Ruminations on the Foreseeability of Damages in Contract Law’ (1992) 53 Louisiana Law Review 1257.

²² *ibid.*

²³ Such a rule is found in the legal systems of France, Belgium, Italy and Portugal.

²⁴ Certain American Judgments explicitly attribute the creation of the foreseeability limit to Pothier, who derived the same, in part, from interpretations of the constitution enacted by Justinian in 531 AD. See for example *Manass-Owens Co. v. Owens & Son*, 105 S.E. 543 (1921) and *Sinclair Refining Co. v.*

While the theoretical justifications to limits of consequential damages under domestic laws and the Convention do seem to be similar, there are fundamental differences in the way they are applied.²⁵ Moreover, even if these differences were not to exist, it would be against the nature of the Convention, as an international instrument, to interpret the same with reference to domestic concepts.²⁶ Keeping this in mind, it is argued that while the contours of the principle vary according to jurisdiction, the philosophical justification of its existence seems to be uniform. This uniformity in domestic law vis-à-vis the justification of limiting consequential loss does explain why the drafters incorporated the principle without debate.²⁷ This chapter identifies the philosophical underpinnings of the concept in UK, US and German law in order to appreciate the goals the foreseeability requirement attempts to achieve. In order to limit the homeward trend in the application of the article, differences between the principles as it exists in the Convention and domestic laws shall also be highlighted.²⁸

7.1.2 UK Law: The Hadley Rule

Hadley v. Baxendale divided damages into two types, namely those that arise naturally from the breach of contract and those that were in the contemplation of

Hamilton & Dotson, 164 Va. 203, 178 S.E. 777. It is therefore unsurprising that the court in *Sinclair Refining Co. v. Hamilton & Dotson* specifically stated that the foreseeability limit “is known as the rule in *Hadley v. Baxendale* and is sometimes spoken of as having originated in that case, though it is in reality an embodiment of civil law principles, and is substantially a paraphrasing of a rule on the subject as it had been stated at an earlier date in the Code Napoleon, by Pothier.”

²⁵ Excluding German law

²⁶ Convention, Article 7

²⁷ Djakhongir Saidov. *The Law of Damages in the International Sale of Goods: The CISG and Other International Instruments* (International Specialised Book Service 2008) 100

²⁸ Homeward trend here simply refers to the propensity of judges to interpret rules in a manner that they resemble rules contained in the domestic law of the forum. Troy Keily defines it as “the ethnocentric propensity to interpret an international convention such as the CISG in accordance with domestic principles and concepts.” Troy Keily, ‘Oklahoma outlaws foreign and international law: the impact on international trade law of America's emerging anti-foreign and international law contagion’ (2012) 16 *Vindobona Journal of International Commercial Law and Arbitration* 43. In the words of Professor Zeller the homeward trend refers to “temptation for judges and the parties settling disputes ... to look at what is familiar especially as it appears to be so at first glance.” Bruno Zeller, ‘The UN Convention on Contracts for the International Sale of Goods (CISG) - A Leap Forward Towards Unified International Sales Laws’ (2000) 12 *Pace International Law Review* 79, 88
<<http://cisgw3.law.pace.edu/cisg/biblio/zeller3.html>>

both parties when the contract was concluded (consequential damages).²⁹ While damages arising in the usual course are routinely recoverable, recovery of consequential damages was made conditional upon the principle of foreseeability. Interestingly, the reason for doing so was purely instrumental in nature. The dicta of the judgment states that if a party is made liable for unforeseeable losses the other party would not have any incentive to share information and contract on such losses.³⁰ As a result, the party in breach would not have the necessary information to take adequate precautions in order to reduce the possibility of breach and resulting damages ex-ante.³¹ As such, the principle in UK law operates to motivate parties to exchange information vis-à-vis the potential of loss, since it places liability on the basis of the existence of such knowledge at the time the contract was concluded.

The Hadley rule, however, differs in certain seminal respects from the rule contained in Article 74 of the Convention. These differences can be summed up as follows:

- 1) The Hadley rule speaks of ‘contemplated damages’, whereas, Article 74 is concerned with ‘foreseeable damages’. Since damages may be foreseeable events that are not in the contemplation of the parties, the Hadley rule is narrower than the rule contained in Article 74. Interestingly, the French Civil Code (CC), unlike the common law rule, explicitly makes reference to foreseeability rather than contemplation.³² It is in this sense, that the rule contained in Article 74 has more in common than the French legal system than the English one.
- 2) The Hadley rule is concerned with damages that are a ‘probable result of the breach’ whereas Article 74 allows for recovery of damages that are a ‘possible consequence of the breach’ regardless of the probability of them materializing. As such, the rule of Article 74 is far broader than that contained in Hadley on this particular point.

²⁹ *Hadley* (n 18).

³⁰ Bradley, J.: *Hadley* (n 18) 354.

³¹ As early as 1980, Goetz and Scott argued that the limitation placed on the recovery of damages by the rule of foreseeability operates to increase the efficiency of promissory activity by encouraging parties’ to exchange information between themselves. Such exchange of information is socially desirable since it enables the obligor to take the requisite level of precaution thereby reducing the possibility of breach and the resulting damages. Charles J. Goetz & Robert E. Scott, ‘Enforcing Promises: An Examination Of The Basis Of Contract’ (1980) 89 Yale Law Journal 1261, 1300; George S. Geis, ‘Empirically Assessing *Hadley v. Baxendale*’ (2005) 32 Florida State University Law Review 897, 907.

³² *Ibid.*

3) Article 74 determines foreseeability with reference to the party in breach,³³ whereas, the Hadley rule requires the loss to be in contemplation of both parties. This divergence, however, is not material in practice.³⁴ It must be noted that since the plaintiff will always be aware of his circumstances and dealings better than the defendant, it is always the knowledge of the breaching party that matters under Hadley.³⁵ Moreover, Article 74 judges foreseeability on the basis of “facts, which he then knew or ought to have known.”³⁶ This objective and subjective standard in relation to the party’s knowledge, it is argued, covers both kinds of knowledge established under Hadley, i.e. imputed and actual knowledge. As such, in practice, the position adopted by the Convention and UK law seems to be analogous on this point.³⁷

7.1.3 U.C.C and the Restatement (Second) of Contracts

The principle of foreseeability as a limit to damages under US law is contained in the U.C.C and the Restatement (Second) of Contracts. By virtue of Section 2-275(2)(a) of the U.C.C, the buyer’s right to recover consequential damages is limited to “any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know.”³⁸ Section 351(1) of the Restatement goes on to state that damages are not recoverable unless they were foreseeable by the party in breach at the time the contract was concluded.³⁹

³³ A similar stance is found in French law. See Article 1150 of the French Code Civil, cited in, Denis Tallon, ‘Damages, Exemption Clauses, and Penalties’ (1992) 40 The American Journal of Comparative Law 675.

³⁴ The judgment in *Czarnikow Ltd. v. Koufos* for instance, was based upon an analyses of the foreseeability of the party on breach. *Czarnikow Ltd. v. Koufos* [1966] 2 QB 695, 730.

³⁵ Corbin, cited in Arthur G. Murphey, Jr., ‘Consequential Damages in Contracts for the International Sale of Goods and the Legacy of Hadley’ (1989) 23 Washington Journal of International Law & Economics 415.

³⁶ In the words of Knapp, “Foreseeability, as understood in Article 74, depends on the knowledge of facts and matters which enable the party concerned to foresee the results of the breach” Victor Knapp, ‘Article 74’ in C. Massimo Bianca & Michael Joachim Bonell (eds), *Commentary on the International Sales Law: The 1980 Vienna Sales Convention* (Giuffrè 1987) 542.

³⁷ Djakhongir Saidov, ‘Methods of Limiting Damages under the Vienna Convention on Contracts for the International Sale of Goods’ (2002) 14 Pace International Law Review 307.

³⁸ Uniform Commercial Code, Section 2-275 (2) (a).

³⁹ Section 351 (1) reads “Damages are not recoverable for loss that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made”.

According to Professors Ayres and Gertner, there are two basic reasons for incomplete contract namely: (1) transaction costs may inhibit detailed negotiations on events unlikely to materialize, and (2) a party may simply withhold information to increase its share of gains under the contract, even in cases where sharing the information would increase the total gain from contracting.⁴⁰ The second reason for incomplete contracts, they argue, leads to the conclusion that default rules that limit damages to foreseeable events motivate parties to contract around the same, thereby, revealing information. Sharing information with the other party will maximize value, since it will be able prevent loss occasioned from such events more efficiently.⁴¹

This argument supports Professor Posner and Professor Hause's thesis that rules limiting damages, such as, the principle of foreseeability operate to place liability on the party that is the best risk-avoider.⁴² As such, a provision limiting damages to foreseeability simply equips the parties with the tools to identify which of them is most capable of economically avoiding the risk.⁴³

Since foreseeability is simply the identification of the party that can most economically avoid the risk, such a methodology incentivises taking appropriate precautions. If the best cost avoider does not take the requisite precautions, it is efficient to deny him consequential damages.

While the formula, adopted under US law, does seem to resemble that of Article 74, there are certain fundamental differences between them:

1) US law uses a subjective standard while judging foreseeability. What is under review is whether the party in breach foresaw the loss or not.⁴⁴ The Convention, on the other hand, incorporates both an objective and subjective test, i.e. damages are recoverable for loss which party in breach 'foresaw' or 'ought to have foreseen'.

⁴⁰ Ian Ayres and Robert Gertner, 'Filling Gaps In Incomplete Contracts: An Economic Theory Of Default Rules.' (1989) 99 The Yale Law Journal 87, 92-94

⁴¹ Goetz and Robert (n31) 1300

⁴² Both Hause and Posner were concerned with the rule in *Hadley v Baxendale*. Larry D. Hause, 'An Economic Approach to *Hadley v. Baxendale*' (1983) 62 Nebraska Law Review 157, 164.

⁴³ Quantum of damages are not limited by fault but rather are based entirely on the identification of the most efficient risk avoider. In other words, loss should be borne by the party who was best suited to avert the same.

⁴⁴ UCC refers to the loss resulting from needs that the 'seller' at the time of contracting 'had reason to know'. The restatement limits loss to those that were 'foreseeable by the party in breach'.

2) Like the Hadley rule, the Restatement makes reference to ‘probable result’ rather than ‘possible consequence’ as used by in the Convention. As such, the rule of Article 74 is broader than that contained in US law on this particular point.

7.1.4 German Law

German law does not incorporate the principle of foreseeability as a limit to claim damages.⁴⁵ The law does, however, achieve similar goals as that of the Hadley rule through the incorporation of the rule of adequate causation.⁴⁶

By virtue of BGB Section 252, the right to recover unrealized profits is limited to those that were probable.⁴⁷ Probability here is to be judged according to the degree of measures and precautions taken. As such, the section operates to motivate parties that place a high value on performance to share information with the other, if they wish to protect their right to claim lost profits. Moreover, Section 254 of the BGB operates to limit damage claims in cases where the injured party failed to prevent or mitigate such loss as a result of negligence.⁴⁸ For the purposes of this section, fault includes “an omission to call the attention of the debtor to the danger of unusually high damage which the debtor neither knew nor should have known, or in an omission to avert or mitigate the damage.”⁴⁹ Taken together, these sections operate

⁴⁵ This omission, has led various German scholars to conclude that the rule contained in the Convention is sourced from the common law rule of *Hadley v Baxindale*. It may however be argued that the principle of foreseeability does play a role in the application of BGB sec. 254 which states: (1) If any fault of the injured party has contributed to causing the damage, the obligation to compensate the injured party and the extent of the compensation to be made depends upon the circumstances, especially upon how far the injury has been caused predominantly by the one or the other party.

(2) This applies also even if the fault of the injured party consisted only in an omission to call the attention of the debtor to the danger of unusually high damage which the debtor neither knew nor should have known, or in an omission to avert or mitigate the damage.

⁴⁶ Vekas, for instance, states “The solution offered by the BGB reaches similar goals to that of contemplation rule by following a different dogmatic path”. Vékás (n 16) 155. According to this rule, damages can be recovered so long as the obligor’s default rendered the type of damages incurred more probable. See G. H. Treitel, *Remedies For Breach of Contract: A Comparative Account* (Oxford University Press 1988) 162.

⁴⁷ The section reads: “The damage to be compensated for also comprises the lost profits. Those profits are considered lost that in the normal course of events or in the special circumstances, particularly due to the measures and precautions taken, could probably be expected.”

⁴⁸ BGB, Section 254; It should be noted that this section (liability reduction) is rarely applied in practice. See Vékás (n 16) 154.

⁴⁹ *ibid.*

to motivate the parties to a contract to exchange information so that they may take necessary precautions on the basis of the best risk-avoider.

It is in this respect that German law operates to achieve the same results as that of English law, US law and the Convention. Take, for example, a scenario where the probability of a loss materializing is very low but the obligee possesses certain information that the other party does not, such as, the fact that the quantum of damages resulting from breach would be extraordinarily high.⁵⁰ In such a case the injured party would be motivated to furnish information that it possesses vis-à-vis such a loss to the other party. Failure to do so, would invoke Section 254 and damages would be limited accordingly. In other words, the fact that a party is aware of the probability of loss makes it the best risk-avoider and, as such, liability should fall upon him. If on the other hand, the party in breach is aware of the probability of such a loss then he is best placed to insure against it and, as such, the risk of such a loss materializing should fall on it.

There is, however, one instance where the BGB does not operate to place liability of the best risk-avoider. In case neither of parties foresaw the loss the BGB places liability upon the party in breach, whereas consequential damages under Article 74 are dependent upon them being foreseeable. The approach adopted by BGB in this scenario therefore ignores which party is the best risk-avoider, while the Convention attempts to place liability on the basis of such an ascertainment.

Other points of divergence between the approaches adopted under Article 74 and that of the BGB, include the time at which foreseeability is to be judged. Since the BGB obliges parties to share information not only before the contract was concluded but also whenever the party became aware of it; it seems that the BGB might well be more effective in the prevention of loss, since parties are motivated to take precautions at all times of performance.⁵¹

⁵⁰ That is to say that the quantum of damages surpasses that which would ordinarily be expected in such a scenario.

⁵¹ Since it allows cover for loss that became foreseeable after the conclusion of the contract.

7.1.5 Convention

As stated in Chapter 2, it would be incorrect to find general principles upon which the Convention is based by reference to domestic legal concepts. As such, this part of the chapter shall attempt to identify those general principles upon which the Convention is based in isolation from domestic law.

According to Professor Schlechtriem, the foreseeability principle is based upon the general principle of allocation of risk in a reasonable manner.⁵² Allocation of risk in a reasonable manner here simply refers to a methodology that enables the parties to a contract to calculate their potential liability at the time of conclusion of the contract; thereby, enabling them to take adequate precautions and price the contract accordingly. Such precautions would, in turn, promote commercial activity in the sense that the foreseeability test protects parties from unexpected losses. Moreover, such an approach to allocation of risks promotes economic efficiency to the extent that it saves on transaction costs. This is so as parties to a sales contract need not contract on every contingency, thereby limiting expenditure.

The risk allocation rationale of the foreseeability rule is made clear when the article is compared with the expectancy measure of damages.⁵³ If, damage awards were based on the expectancy measure, the promisor would be encouraged to take optimal precautions whereas the promisee would be discouraged from taking any precautions ex-ante. Such a methodology would operate to place liability on the promisor, even in cases where he would not be the best risk-avoider. The foreseeability rule cures this defect by limiting awards to that which could have been foreseen by the party in breach. Such a limitation, it is argued, motivates parties to act in a value-maximizing manner by voluntarily exchanging information, which is crucial for the identification of the best risk-avoider. In other words, economic efficiency is maximized since the rule on foreseeability operates to motivate parties to exchange information of unexpected losses if they wish to be protected against the same, enabling the other to

⁵² Peter Schlechtriem, *Uniform Sales Law: The UN-Convention on Contracts for the International Sale of Goods* (Manz 1986) 96. See also E. Allan Farnsworth, 'Legal Remedies for Breach of Contract' (1970) 70 Columbia Law Review 1145, 1208.

⁵³ Here expectancy measure is used as a measure that would place the injured party in the same position as it would have been in had the contract been performed, regardless of whether losses caused as a result of the breach were foreseeable or otherwise.

take adequate precautions. This would lead to a rational allocation of resources with the aim of reducing the probability or impact of breach.

Apart from the rule on foreseeability, the policy of the Convention to place liability on the best risk-avoider is evident from the rules on mitigation of loss and contributory harm.⁵⁴ While the Convention does not directly deal with the issue of contributory harm of the injured party, Article 80 does illuminate the general principle of contributory negligence as a limit to damage recovery. The article reads: “a party may not rely on a failure of the other party to perform, to the extent that such failure was caused by the first party's act or omission.”⁵⁵ As such the article does not allow recovery of loss occasioned by the conduct of the promisee. The impact of this article is to place liability on the party best suited to avoid or minimize the impact of such loss. Of course, where loss is occasioned by the conduct of one party, it is the party best suited to avoid the loss. In other words, Article 80 of the Convention places liability on the party that can minimize loss in the most economically efficient manner, thereby, minimizing the loss caused to the sum of participant utility.

Even in cases where harm is not caused by the acts of the non-breaching party; Article 77 limits the non-breaching party's right to claim damages where it could have avoided the loss by taking mitigating measures.⁵⁶ The article reads:

A party who relies on a breach of contract must take such measures as are reasonable in the circumstances to mitigate the loss, including loss of profit, resulting from the breach. If he fails to take such measures, the party in breach may claim a reduction in the damages in the amount by which the loss should have been mitigated.⁵⁷

It makes sense from an efficiency perspective, not to permit an increase in harm, which could have been reasonably mitigated. As such, Article 77 simply operates to place liability on the best risk-avoider.

⁵⁴ Convention, Articles 80, 85 and 86.

⁵⁵ *ibid* Article 80.

⁵⁶ *ibid* Article 77.

⁵⁷ *ibid*.

The excuse doctrine contained in Article 79 of the Convention similarly operates to place liability on the best-risk avoider.⁵⁸ By virtue of Article 79, a party loses its right to claim damages under the Convention where it is proved that non-performance is occasioned due to an impediment beyond the control of the promisor.⁵⁹ The rationale for this lies in the fact that, where the impediment is beyond the control of the promisor and is unforeseeable at the time the contract is concluded, it cannot be said to be the best risk-avoider and, as such, should not be held liable for resulting damages. On the other hand, if the promisor is the best risk-avoider, regardless of the fact that the impediment is beyond its control, courts do not allow reliance on the excuse doctrine.⁶⁰ This was illustrated in case titled *Macromex S.r.l. v. Globex International Inc.*⁶¹ After having entered into a contract for the sale of chicken parts to be delivered to a Romania buyer, a U.S. seller failed to tender half of the goods within the agreed date of performance. The breaching party contended that its non-performance was justified, as a result of the promulgation of a Romanian regulation that required certification of all chicken meat entering the country.⁶² When the seller, upon request of the buyer, refused to deliver the remaining goods to Georgia, the buyer initiated arbitration proceedings. The arbitrator recognized that the seller's delay did not amount to fundamental breach under Article 25 CISG.⁶³

However, its non-performance could not be justified under Article 79 CISG, since the seller could have reasonably performed by delivering the goods to Georgia.⁶⁴

⁵⁸ Convention, Article 79.

⁵⁹ Initial contributions to the Economic theory of law vis-à-vis the defence of excuse were primarily concerned with the extent to which such doctrines promote efficient risk bearing. Posner and Rosenfield, for instance, argued that one of the central purposes of contract law is to reduce transaction costs. In their view, the law is best able to achieve this by providing default rules that achieve the most efficient outcome. In the realm of excuse doctrines, they argue that default rules are efficient when they assign risk to the superior risk bearer i.e. the party which is better able to prevent the risk from materializing or is better placed to mitigate the impact of the risk. This translates into the argument that a party should be excused from non-performance arising out of impossibility or impracticality, only where the other party is the superior risk bearer and not otherwise. Richard A. Posner and Andrew M. Rosenfield, 'Impossibility and Related Doctrines in Contract Law: An Economic Analysis' (1977) 6 *The Journal of Legal Studies* 83.

⁶⁰ See for instance Bundesgerichtshof, Germany, 24 March 1999
<<http://cisgw3.law.pace.edu/cases/990324g1.html>>.

⁶¹ *Macromex Srl. v. Globex International Inc.*, International Centre for Dispute Resolution of the American Arbitration Association, American Arbitration Association, 23 October 2007
<<http://cisgw3.law.pace.edu/cases/071023a5.html>>

⁶² *ibid.*

⁶³ *ibid.*

⁶⁴ *ibid.*

This case therefore gives credence to the assertion that the breaching party will not be able to avail itself of the defences under Article 79, even if the impediment was beyond its control, as long as the party could avoid the consequences of the impediment.

7.1.6 Conclusion

The positions adopted by national legal systems and the Convention, as analysed above, illuminate that the principle of foreseeability and its related concepts, for example, in German law, operate to achieve two related goals, regardless of the legal tradition where it is operating, namely: a) to motivate parties to disclose information, and b) to place liability on the party that is the best risk-avoider. In other words, parties have been provided with a reference point that allows them to ‘size up’ the risk of contracting ex-ante and base their business decisions accordingly.

On the basis of these findings it is argued that the efficiency of any default cap on damages depends upon the degree to which it achieves the right balance between pooling and separation by motivating sharing of information through the minimization of communication costs.⁶⁵ Such a balance between pooling and separation is essential since it allows the parties to take the most efficient level of precautions, i.e. by placing liability on the best risk-avoider.⁶⁶ Take, for instance, the model developed by Professors Bebchuk and Shavell that demonstrates how default rules limiting recovery of loss aid the promisor in taking the most efficient level of precaution.⁶⁷ Since the promisor can only take the most efficient level of precautions when he is aware of the valuation placed by the buyers, an efficient default rule is one that illuminates the distribution of the ‘types’ of buyers in the most cost-efficient way.⁶⁸ In other words, an efficient default is one which promotes inexpensive

⁶⁵ Peter van Wijck, ‘Foreseeability’ in Gerrit De Geest (ed), *Contract Law and Economics* (Vol. 6, Edward Elgar Publishing 2011)

⁶⁶ An optimal level of precaution is essential since it would result in the optimal control of the entry and exist of low-valuation buyers.

⁶⁷ Lucian Ayre Bebchuk and Steven Shavell, ‘Information and the Scope of Liability for Breach of Contract: The Rule of *Hadley v. Baxendale*’ (1991) 7 *The Journal of Law, Economics, and Organization* 284.

⁶⁸ The term ‘type’ is used here to distinguish between those buyers who place a high value on performance (high value promisees) and those that place a low value on performance (low value promisees).

sharing of information, which is best achieved by taking the ‘type’ of the parties into account.⁶⁹

Part 2 of this chapter shall attempt to analyse the extent to which the foreseeability rule achieves these goals in comparison with the alternative rule of full damages default. The aim of this part is to analyse whether the foreseeability default provides the best solution to the issue of recovery of consequential damages.

7.2 Part 2. Does the foreseeability default foster the most efficiency?

7.2.1 A comparison with the full damages default

The promisor would only be able to take the optimal level of precaution if it possesses complete information about the distribution of promisees ‘type’. Ascertainment of the ‘type’ of the promisee, however, carries costs. As such, the question of which default advances efficiency is partly based upon the extent to which it leads to the ascertainment of the distribution of buyers in any given market, in the most cost efficient manner.

In a regime that incorporates a full damages default, high value promisees would not reveal their type, since the expectation measure would compensate them entirely regardless of the level of precaution the promisor takes. Given the difficulty of ascertaining the distribution of types, a promisor would simply prefer to take an intermediate level of precaution. Such an outcome, however, would result in major inefficiencies, i.e. some low valuation buyers would be driven out of the market as a result of the cost of unnecessary precautions being factored into the contract. Moreover, many contracts with high value buyers would occur since their price would be subsidized as a result of the low valuation buyers that stay in the market.

On the one hand, in regimes that limit damage recovery of consequential loss to foreseeability, high value promisees would be motivated to share information of their type, since the average level of damage recovery is intermediate. Such information,

⁶⁹ A high value buyer is one who would incur a large loss in the event of breach where as low value buyers are those who would incur a small loss in case of breach. Bebchuk and Shavell (n 73).

in turn, would make loss foreseeable and the promisor would resultantly be liable for the same. The promisor would therefore take precautions to the extent that their marginal cost equals to the marginal gain of avoided loss. Moreover, once the high value promisees make their type known, the promisor can take the adequate level of precaution for low-value promisees also, who will generally be the ones who do not contract around the rule. This would result in the optimal level of precautions taken.

On the other hand, in a regime with a full damages default, low-value promisees would be motivated to disclose information about their type. This is so as low value promisees would not wish to pay for the cost of intermediate or high level of precautions that would be factored into the price of the contract and would therefore wish to contract around the same. Since there are costs associated with contracting around the default, the most efficient way of ascertaining distribution of type is where only a minority contracts around it.⁷⁰ This is when only a minority incurs costs as a result of deviation, the increase in transaction costs is, more often than not, less than the total benefit of increased precaution.⁷¹

The discussion above leads to the conclusion that default rules limiting damage recovery to foreseeability might be preferable if the majority of buyers are low valuation buyers. In such a case, only a minority, i.e. the high valuation buyers, would engage in information sharing. As such, the default rule will operate to differentiate between high and low value buyers in a least costly manner, thereby equipping the promisor with the tools to take the optimal level of precaution in a cost effective manner.⁷² If, however, there are more high value promisees than low value ones then a full damages default is preferable for the same reasons.

The discussion above illuminates the fact that the utility of the foreseeability requirement, in efficiency terms, is dependent upon (a) the transaction costs of sharing information, and (b) the distribution of buyers between low value and high value buyers.

⁷⁰ Ian Ayres, 'Ya-Huh: There Are and Should Be Penalty Defaults' (2005) 33 Florida State University Law Review 589, 617.

⁷¹ *ibid.*

⁷² Moreover, since only a minority of buyers would contract around such a rule, the transaction costs of such information sharing should be less than the benefits of increased precaution. It is in this sense that such a default rule would further the goals of efficiency by giving parties the incentive to avoid inefficient sharing of information. See Wijck (n 78) 228.

This should, however, not be taken to mean that the foreseeability default rule is only useful when majority of the buyers place a low value on performance. In fact, the foreseeability default can be preferable even in cases where the majority of buyers place a high value on performance, so long as it leads to a separating equilibrium, whereas, the full damages default would only lead to a pooling equilibrium.⁷³ Of course, such a result is only possible where the full damages default does not motivate the minority, for whatever reason, to reveal its type by contracting around the default. In this scenario, the foreseeability default would be preferable in efficiency terms, to the extent that it leads to a separating equilibrium and it can be shown that the increase in transaction costs is less than the total benefit of increased precaution.⁷⁴

On the contrary, the foreseeability default will not be efficient when high value buyers run the risk of incurring transaction costs that are greater than the benefit to low value buyers. Moreover, if the transaction costs associated with contracting around the default is significantly greater for high valuation buyers, a complete liability default is preferable to foreseeability one.

7.2.2 The optimal default and when to contract around it

The discussion above reveals that there are whole host of factors that determine whether a particular default would achieve the goal of efficiency,⁷⁵ including, but not limited to, the cost of revealing information, the characteristics of the parties involved (high-value vs. low value), the probability of incurring consequential damages in case of breach and bargaining power.⁷⁶ As such, the informational

⁷³ A pooling equilibrium, in efficiency terms is less preferable than a separating equilibrium. See Geis (n 32).

⁷⁴ *ibid* 909-10.

⁷⁵ Richard Craswell for instance states: “We cannot decide which remedy is ‘best’ in any overall sense . . . unless we have some way of measuring the relevant effects, both good and bad, and then summing them to come up with a combined score for each of the possible remedies. But if we lack empirical data to measure the magnitudes of the various effects, any such sum will be difficult—or even impossible—to construct, so we will never know which remedy is truly the most efficient”. Richard Craswell, ‘In That Case, What Is the Question? Economics and the Demands of Contract Theory’ (2003) 112 *The Yale Law Journal* 903, 908.

⁷⁶ Posner for instance argues that these factors are too complex to determine. Buyer valuations in particular, he states, can hardly ever be concretely determined. Eric A. Posner, ‘Economic Analysis of

sharing and separation inducing effects of different defaults are dependent on a wide range of variables.

The complexity of such an inquiry has led various academics to conclude that courts and legislatures would seldom be able to concretely ascertain which default would foster efficiency in any given market ex-ante.⁷⁷ These concerns led Posner to conclude that “the economic approach does not explain the current system of contract law nor does it provide a solid basis for criticizing and reforming contract law.”⁷⁸

These concerns, it is argued, can be put to rest through empirical analysis, at least in the area of default rules. The ability of empirical analysis in the resolution of this issue is best demonstrated in a seminal paper by Gies published in 2005.⁷⁹ Since there is a great dearth of empirical analysis in the legal field, Gies relied on willingness to pay data, collected in the field of marketing. This data enabled him to estimate the distribution of buyer valuations in three simple markets, i.e. for a can of Coca-Cola, a piece of pound cake and an ergonomic pen.⁸⁰ Gies’ analysis concludes that the foreseeability default is preferable in efficiency terms to other methodologies of damage recovery,⁸¹ where the goods in question are daily goods rather than sophisticated ones.

Contract Law after Three Decades: Success or Failure?’ (2003) 112 Yale Law Journal 829. Moreover, Adler argues that the question of which default rule would achieve a separating equilibrium is better answered by economists than law makers who seldom have expertise in such areas. He however, goes on to argue that while courts may lack the necessary information to determine which default to choose, the legislature with its greater investigative resources may be better able to carry out that function. Barry E. Adler, ‘The Questionable Ascent of *Hadley v. Baxendale*’ (1999) 51 Stanford Law Review 1547. See also Ian Ayres and Robert Gertner, ‘Majoritarian vs. Minoritarian Defaults’ (1999) 51 Stanford Law Review 1591, 1609.

⁷⁷ See Adler (n 81) 1582 and Ayres and Gertner (n 88) 1609.

⁷⁸ Posner (n 88) 837.

⁷⁹ See Geis (n 32); See also George S. Geis, ‘An Experiment in the Optimal Precision of Contract Default Rules’ (2005) 80 Tulane Law Review 1109.

⁸⁰ Given the limitations of this thesis coupled with the dearth of empirical data, we accept the mathematical calculations of Gies.

⁸¹ Gies was comparing the full damage default with the foreseeability default.

7.2.3 Foreseeability default: efficient rate of performance vs efficient rate of precaution

The methodology adopted by the Convention on the limitation of damages operates to give precedence to the efficient rate of precaution over the efficient rate of performance. The impact of the adoption of such an approach is that, in certain cases, the methodology leads to instances of inefficient breach.

According to the theory of efficient breach, if the gains to the seller of breaching the contract exceed the resulting loss occasioned to the buyer, then the seller should breach, since it would be the more efficient outcome.⁸² Default rules limiting damages claims to the foreseeability requirement, on the other hand, provide inefficient incentives to perform.⁸³ Since an obligor need only account for losses that were foreseeable at the time the contract was concluded, it may completely disregard losses occasioned from events that become foreseeable thereafter. As such, even if the obligor is the best risk-avoider he need not take any precautions vis-à-vis such risks. In such a case, a seller would perform the contract even where the losses incurred by the buyer as a result of breach are less than the benefits to the seller; even though breaching the contract would be the efficient outcome. The inverse stands true as well, i.e. the seller is motivated not to perform in cases where the loss occasioned to the buyer exceeds the benefits to the seller as a result of breach; as long as the loss in question was not foreseeable at the time of conclusion of the contract even though it might have become foreseeable during performance. Default rules limiting damages to foreseeability, therefore, operate to give greater importance to the efficient rate of precaution than to efficient rate of performance.⁸⁴

The Convention, then, in its attempt to find the right balance between the optimal efficiency in performance and the need of the obligors to be able to evaluate the pricing and benefits of the contract ex-ante, adopts a solution that is based upon the reduction of communication costs. If the obligor is liable for losses that became

⁸² Nathan B. Oman, 'Failure of Economic Interpretations of the Law of Contract Damages' (2007) 64 Washington & Lee Law Review 829, 851-860

⁸³ *ibid.*

⁸⁴ Melvin Aron Eisenberg, 'The Principle of *Hadley v. Baxendale*' (1992) 80 California Law Review 563, 599.

foreseeable after the contract was concluded, then the obligee would be motivated to withhold disclosure of possible, unusual consequences of breach till the conclusion of the contract, thereby ensuring that the pricing of the contract is not influenced by the same. The possibility of such an outcome, it is argued, would act as a barrier in the achievement of an economically efficient methodology of contract formation and recovery of damages, as it would operate to incentivise opportunistic behaviour.⁸⁵

7.3 Conclusion

The discussion above illuminates the fact that the efficiency perspective highlighted in Chapter 1 of this thesis provides valuable insights into the function of the foreseeability requirement. These insights equip courts and parties alike with the tools required to ascertain the extent to which a particular default would be efficient in a given transaction. This degree of efficiency, then, allows parties to carry out an analysis of whether to stick with the default or to contract around it in a manner that maximizes the sum of participant utility.

Unfortunately, however, such an analysis, being dependent upon a whole host of variables is difficult and, in certain instances, too costly to carry out from the perspective of courts. This, however, is a concern that can be put to rest through the development of and innovation in mathematical methodologies in the field coupled with the collection of empirical data. As such, this thesis is of the view that while a lot of development is still required in the area before the efficiency perspective can provide, in a cost efficient manner, concrete answers to when a particular default is relatively efficient, the importance and utility of such an approach cannot be ignored.

⁸⁵ Charles J. Goetz and Robert E. Scott, 'The Mitigation Principle: Toward a General Theory of Contractual Obligation' (1983) 69 Virginia Law Review 967, 987.

Conclusion

If contracts were complete, there would be no-efficiency enhancing role that courts could play apart from enforcing the terms of the contract.⁸⁶ This is a result of the fact that parties to a contract have a better understanding of their dealings relative to courts. This leads to the conclusion that, *ceteris paribus*, the parties would contract on terms that would operate to maximize their joint interest. In other words, contracts simply constitute an open ended institution which allows merchants to exchange resources to their mutual advantage.⁸⁷

A complete contract is defined as one that details all possible contingencies and prescribes the appropriate performance on the materialization of each contingency.⁸⁸ Moreover, these contingencies are not limited to exogenous variables such as the market price of the goods but include endogenous responses such as the possibility of opportunism on the part of one party.⁸⁹

The realities of international trade however, reveal that contracts for the sale of goods are seldom, if ever, complete. This however does not mean that incomplete contracts are inherently inefficient. Rather, in various instances, contracts are intentionally left incomplete on the basis of efficiency enhancing rationale. For instance, drafting complete contracts carry costs such as those associated with collection of information, negotiating and drafting.⁹⁰ In efficiency terms, such costs must be balanced with the benefits of complete contracting. This is to say that, where

⁸⁶ Steven Shavell, 'On the Writing and Interpretation of Contracts' (2006) 22 *Journal of Law, Economics and Organization* 289.

⁸⁷ Ejan Mackaay, 'The Civil Law of Contract' in Gerrit D. Geest (ed), *Contract Law and Economics* (Vol. 6, 2nd edn, Edward Elgar 2011) 425.

⁸⁸ Nabil I. Al-Najjar, 'Incomplete Contracts and the Governance of Contractual Relationships' (1995) 85 *American Economic Review Papers and Proceedings* 432.

⁸⁹ George M. Cohen, 'Interpretation and Implied Terms in Contract Law' in Gerrit D Geest (ed), *Contract Law and Economics* (Vol 6, 2nd edn, Edward Elgar 2011) 126.

⁹⁰ While Posner attribute incompleteness of contracts to a cost benefit analysis, Eggleston and others focus on the capabilities of the parties who, being boundedly rational might not be able to contract on all possible contingencies. Richard Posner, 'The Law and Economics of Contract Interpretation' (2005) 83 *Texas Law Review* 1581, 1584; Karen Eggleston, Eric Posner, and Richard Zeckhauser, 'The Design and Interpretation of Contracts: Why Complexity Matters' (2000) 95 *Northwestern University Law Review* 91, 122-125.

the materialization of a particular contingency is relatively improbable the costs of negotiating on the same would outweigh its advantages.

Moreover, there are relational justifications for incomplete contracts. For instances parties may intentionally leave the contract incomplete in order to avoid contentious issues, prolonged negotiations on which, might destroy the agreement.⁹¹ Similarly, insistence on the part of one party to enter into prolonged negotiations might be taken by the other as an indication giving rise to the presumption that the party requesting such detailed negotiations is litigious.⁹² Such concerns might then lead parties to strategically leave the contract incomplete.

Such incompleteness however is of little concern if the default rules of law can operate as efficient substitutes for complete contracting. Indeed, if default rules operate in such a manner, then the costs saved as a result of the incompleteness of contracts might well outweigh the costs of judicial implication of terms i.e. the interpretation and application of default rules of law. Consequently, parties would intentionally opt to leave their contract incomplete to the extent that such default rules are capable of substituting the efficiency provided by complete contracts.

Since the Convention was formulated with the view of decreasing the costs associated with diverging national rules governing the sale of goods; it may be stated that the instrument is premised on the rationale of decreasing transaction costs by providing a unified statement of commercial law in the context of international sale of goods. The success of the Convention in this regard is therefore dependent upon the extent to which the default rules contained therein, promote efficient contracting. In other words, parties to contracts for the international sale of goods, as discussed above, would weigh the extent to which the rules contained in the Convention operate to further their collective interests while deciding whether to leave the contract incomplete or otherwise.

⁹¹ George Geis, 'An Embedded Options Theory of Indefinite Contracts' (2006) 90 Minnesota Law Review 1089, 1680-82.

⁹² Claire Hill, 'Bargaining in the Shadow of the Lawsuit: A Social Norms Theory of Incomplete Contracts' (2009) 34 Delaware Journal of Corporate Law 191, 209-10.

This thesis argues that the rules of the Convention, if interpreted properly, have the potential of increasing the efficiency of the agreement. This is partly a result of the fact that the Convention correctly identifies that the intention of the parties is the best source of filling in the gaps of the contract. Lacking divine insight however, it is impossible for courts to ascertain what exactly the intention of the parties was vis-à-vis a particular contingency, when the contract is silent as to the same.⁹³ As a result Article 9 of the Convention implies terms on the basis of practices that the parties have established between themselves and usage that they knew or should have been aware of.⁹⁴ Similarly Article 8 of the Convention interprets the statements made by and the conduct of a party according to his or her intent, where the other party knew or could not have been unaware what that intent was. Failing this, such statements and conduct are to be interpreted in line with “the understanding that a reasonable person of the same kind as the other party would have had in the same circumstances.”⁹⁵

The implication of terms, especially through industry custom raises the presumption that the Convention adopts a contextualist approach to contractual gap filling. This statement is supported by the fact that the drafters of the Convention, at each stage of the drafting process, continuously made reference to the requirements of commercial realities. As a result of such concerns, the rules of the Convention have the potential to be interpreted in a manner that would operate to maximize the joint return of the parties for instance by lowering transaction costs, placing liability on the best-risk avoider and barring the potential of opportunistic behaviour.

While flexibility in interpretation is indeed necessary for default rules to achieve the goals of efficiency when applied to the facts of each case; an equally essential requirement is that the users of the Convention be provided with a degree of certainty with regards to their rights and obligations under the default rules. The analysis of the travaux carried out in each chapter however, clearly demonstrates that the diversity of interest that sought recognition during the drafting stages of the

⁹³ Jeffrey Lipshaw, ‘The Bewitchment of Intelligence: Language and *Ex Post* Illusions of Intention’ (2005) 78 Temple Law Review 99.

⁹⁴ Convention, Article 9.

⁹⁵ Convention, Article 8(2).

Convention resulted in the need of diplomatic compromise.⁹⁶ Consequently, it is not surprising that at certain occasions the only way to reach an agreement was through the incorporation of seemingly contradictory, ambiguous and uncertain formulations.

This should not be interpreted to mean that the drafters were concerned only with reaching a final text, regardless of the instrument's internal coherence and applicability to concrete cases. Rather, the UNCITRAL and its ad hoc Working Groups were concerned with finding a workable compromise between the participating states. It was only when a workable compromise could not be identified that "the drafters of the Convention chose a technical formulation based on the lowest common denominator."⁹⁷

Such compromise solutions have led various commentators to argue that the resulting nature of the Convention as a formal statement of rules, comprising elastic terms and conflicting approaches, increases the likelihood rather than eliminating the possibility of diverging interpretation and application across legal traditions. This in turn, has been argued to undermine the goal of legal harmonization in international sale transaction.⁹⁸

A fair analysis of the Convention's usefulness as a vehicle for unification requires the weighing its advantages against its disadvantages. Thus the question to be asked is whether the Convention has been able to promote uniformity and certainty with regards to the law on international sale of goods – in other words, is a Convention that suffers for certain defects better than no Convention at all?

The fact that a large number of countries from different legal, political and economic back grounds have ratified the Convention, coupled with the sheer volume of case law that has resulted on the provisions of the Convention, provides proof of the fact that unification, albeit to a degree, has resulted in the law of international sale of goods. Furthermore, the process of unification by its very nature is a dynamic

⁹⁶ With the exception of Chapter 7 of this thesis.

⁹⁷ Alejandro M. Garro 'Reconciliation of Legal Traditions in the U.N. Convention on Contracts for the International Sale of Goods' (1989) 23 International Lawyer 443.

⁹⁸ *ibid.*

procedure. As such, the Convention should be understood as an instrument that serves as a cornerstone to the dynamic process of legal harmonization. Seen in this light, it is hard to disagree with Professor Honnald when he characterizes the Convention as “a triumph of cooperative international work.”¹⁶²

This thesis, by identifying and analysing articles of the Convention which either seemingly contradict one another or leave issues unsettled concludes that the rules of the Convention can indeed be interpreted in a manner that promotes the goal of legal harmonization by promoting efficiency from the perspective of the parties to a contract for the sale of goods. In other words, the Convention by providing default rules that are capable of being interpreted in a manner that promotes efficiency of the transaction motivates parties not to derogate from its dictates. As a result, harmonization in practice is definitely not an unachievable goal.

Indeed there are limitations to the achievement of the goals of harmonization, the greatest of which lies in the fact that there does not exist a hierarchical court structure in the interpretation of the Convention. This is particularly problematic given that the Convention, by its very nature, is not an instrument that can readily be amended. As such, courts must interpret the Convention in a manner that takes not only the current realities of, but in fact the evolution of, commercial practice into account. This should not be taken to mean that courts and tribunals are free to derogate from the interpretative and gap filling methodology contained in the Convention in the search of commercially reasonable standards. Rather, it simply means that courts should give due regard to judgments emanating from other jurisdictions.

Indeed it would be incorrect to hold that foreign judgments are binding or that judgments delivered by a relatively higher court of one jurisdiction are binding on the lower courts of another. In fact all judgments delivered have persuasive authority rather than a binding character.⁹⁹ As such, the value of a judgment from the

⁹⁹ U.S. District Court, Northern District of Illinois, United States, 21 March 2004 <<http://cisgw3.law.pace.edu/cases/040521u1.html>> accessed: 13 August 2015; Tribunale di Padova, Italy, 25 February 2004 <<http://cisgw3.law.pace.edu/cases/040225i3.html>> accessed: 13 August 2015 ; CLOUT case No. 608 [Tribunale di Rimini, Italy, 26 November 2002] <<http://cisgw3.law.pace.edu/cases/021126i3.html>> accessed: 13 August 2015; CLOUT case No. 378 [Tribunale di Vigevano, Italy, 12 July 2000] <<http://cisgw3.law.pace.edu/cases/000712i3.html>> accessed: 13 August 2015; CLOUT case No. 380 [Tribunale di Pavia, Italy, 29 December 1999]

perspective of courts in one jurisdiction is not dependent upon the position a court occupies in the hierarchal structure of courts within another jurisdiction.

The result of judgments carrying persuasive authority is simply that courts should give due regards to judgments delivered in other jurisdictions but are completely free to derogate from the same when there are reasonable grounds to do so. Such reasonable grounds however must be based on the interpretative methodology contained in the Convention or the dictates of its specific articles/ general principle rather than the personal preference of judges and arbitrators.

Courts with final appellate authority, in domestic legal systems and regional institutions like the European Union, help to enforce uniform interpretation. The Convention, however, has neither a Supreme Court nor a well-established consultative body.¹⁰⁰ Instead, an unorganized community of interpreters including (but not limited to) national courts, UNCITRAL and arbitral tribunals contribute to the corpus of interpretive wisdom. C. B. Anderson amongst others has labeled this unorganized community of interpreters as ‘global jurisconsultorium’ – i.e. the meeting of minds across jurisdictions in the interpretation of international law.¹⁰¹

Recognizing these limitations, this thesis recommends that when called upon to apply the provisions of the Convention in the resolution of disputes, courts should follow the following process of interpretation:

- 1) Disregard the rules of domestic law on the issue, at least in cases where the Convention contains an express provision governing the dispute or where general principles upon which it is based can be identified for the resolution of the issue.
- 2) Interpret the article in question with due regard to case law and scholarly opinion, regardless of the jurisdiction from which they emanate.

<<http://cisgw3.law.pace.edu/cases/991229i3.html>> accessed: 13 August 2015; Professor Di Matteo disagrees and advocates that judgments should have a binding character Larry A. DiMatteo, ‘The CISG and the Presumption of Enforceability: Unintended Contractual Liability in International Business Dealings’ (1997) 22 Yale Journal of International Law 111.

¹⁰⁰ Joshua D. H. Karton, ‘Can the CISG Advisory Council Affect the Homeward Trend?’ (2009) 13 Vindobona Journal of International Commercial Law and Arbitration 71.

¹⁰¹ Camilla B. Andersen, ‘The Uniform International Sales Law and the Global Jurisconsultorium’ (2005) 24 Journal of Law and Commerce 159, 159-160.

- 3) Give regard to the object and purpose of the article under examination, as is evident from the travaux.
- 4) Apply the dictates of good faith, with the aim of invalidating an interpretation which allows for the potential of parties to act in an opportunistic manner.

While the first two considerations operate to achieve the goals of uniformity in line with the international character of the Convention the last two would operate, albeit to a degree, to achieve the goal of efficiency by taking commercial realities into account.

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