

CROSS-BORDER CONTRACTING

HOW TO DRAFT AND NEGOTIATE
INTERNATIONAL COMMERCIAL CONTRACTS



International
Trade
Centre

TRADE IMPACT FOR GOOD

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How to draft and negotiate
international commercial contracts

About the handbook

With firms increasingly trading digitally across borders, business communities, legal practitioners and governments are developing innovative ways to facilitate business deals, sound contractual arrangements, and efficient dispute settlement mechanisms.

In close collaboration with its pro-bono committee of professionals, ITC is contributing to these new legal approaches with this handbook by harmonizing and enhancing the practice of international business related to cross-border commercial contracting.

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For more information on Model Contracts, see: <https://precontractual.com>

Correction to Cross-border contracting: How to draft and negotiate international commercial contracts (2018)

In the above-mentioned publication, on page 77, new text was added '...a term. In interpreting the contract, the defined term must be substituted by the definition of that term.' Also on page 77, point 3, the last sentence was modified, '...see best practice rule 13.' On page 77 to 78, points 4 to 8 were modified/replaced with new text. Page 79, first paragraph, the rule has been changed from 4 to 8. Starting on page 79 through to page 82, points 12 to 23 have been modified/replaced.

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Acronyms and abbreviations

CISG	United Nations Convention on Contracts for the International Sale of Goods
ICC	International Chamber of Commerce
ITC	International Trade Centre
IP	Intellectual property
IPR	Intellectual property rights
JVC	Joint venture contract
LOI	Letter of intent
L/C	Letter of credit
MSME	Micro, small and medium-sized enterprise
MOU	Memorandum of Understanding
NDA	Non-disclosure agreement
SME	Small and medium-sized enterprise
UCC	Uniform Commercial Code
UCP600	Uniform Customs and Practice for Documentary Credits
UNCITRAL	United Nations Commission on International Trade Law
UNIDROIT	International Institute for the Unification of Private Law
URDG	Uniform Rules for Demand Guarantees
URC 522	Uniform Rules of Collection
WIPO	World Intellectual Property Organization

Abbreviated ITC Model Contract titles

Title	ITC Model Contract – official title
Alliance agreement	Alliance Agreement
Joint venture agreement	Contract for an International Corporate Joint Venture
Sales agreement	Contract for the International Commercial Sale of Goods
Long-term supply agreement	Contract for the International Long-Term Supply of Goods
Manufacturing agreement	International Contract Manufacture Agreement
Distribution agreement	Contract for the International Distribution of Goods
Commercial agency agreement	Contract for an International Commercial Agency
Services agreement	Contract for the International Supply of Services

Executive summary

This handbook is a guide to preparing international commercial contracts. It is intended to support the use of *Model Contracts for small firms: Legal guidance for doing international business*, prepared by ITC's Pro Bono Committee on International Commercial Model Contracts for Small and Medium-sized Enterprises.¹

This book can also be read independently, as it:

- gives practical, detailed guidance on how to draft a contract;
- examines the merits of commonly used contract clauses;
- discusses key legal aspects of conducting business internationally; and
- provides insight into the (legal) dynamics of international trade.

Chapter 1 is a short introduction of what a 'contract' is, how agreements are reflected in writing, and how contracts are interpreted in a cross-border context. It identifies different styles of contracting and explains how contracts are typically structured. The chapter also explores two contract types used in the precontractual stage of a transaction – non-disclosure agreements and letters of intent (or Memorandum of Understanding). Finally, the chapter touches upon legal tech, explaining how businesses can benefit from automated contract creation and contract lifecycle management. It is particularly useful for non-lawyers.

Chapter 2 focuses on the ITC Model Contracts. Both lawyers and non-lawyers get a better understanding of when and how the Model Contracts should be used most efficiently with a discussion of common negotiation parameters. This chapter also discusses how the contracts can be tailored to fit a specific business need. This is key for non-lawyers and helps lawyers and law students to better understand the main types of commercial contracts used in international trade.

Chapter 3 outlines general principles of clear and precise contract drafting. This covers basic skills, discussing techniques that may improve the readability of a contract or accelerate negotiations. The chapter also explains how vague terms such as reasonable, best efforts and reasonable endeavours can be used and gives best practice on using definitions and defined terms. Using these techniques should make a contract less ambiguous, more consistent and less old-fashioned. Although mostly aimed at lawyers, non-lawyers will also appreciate the practical insights.

Chapter 4 concentrates on the scope and merits of the clauses reused across the ITC Model Contracts, sometimes with little or no variation in wording. The clauses include a change of circumstances affecting the contractual relationship, events of force majeure, confidentiality of information exchanged, warranties regarding the quality of supplied goods or services, appropriate limitation of the parties' exposure to any liability under the contract, dispute resolution

¹ <http://www.intracen.org/model-contracts-for-small-firms/>

mechanisms, and boilerplate clauses. These subjects are important but some are usually not negotiated. The chapter provides relevant proposals for compromises.

Chapter 5 examines the legal frameworks and principles underlying the ITC Model Contracts. For non-lawyers, it is an introduction into a myriad of legal aspects of contracts. It shows that contractual parameters are largely universal (also in an international setting). With reference to the UNIDROIT Principles on International Commercial Contracts (UNIDROIT Principles), it introduces fundamental concepts of contract law.

The chapter examines international sales related to the most successful convention, the United Nations Convention on Contracts for the International Sale of Goods, contractual devices for delivery of goods (INCOTERMS) and the international options for payment, such as documentary collection and letters of credit. The final two sections give an insight into intellectual property law and competition law – legal subjects of increasing importance for small and medium-sized enterprises.

Chapter 1. INTERNATIONAL CONTRACTS AND CROSS-BORDER CONTRACTING

Many transactions are concluded based only on a simple email or commercial quotation containing merely the key terms of a business deal. However, even such a thin basis of agreement is as enforceable as a complete contract. Even if a clause is included saying that the offer is 'subject to contract' or 'non-binding until a written agreement is signed', if the parties start acting as if there is a contract, it may be difficult to negotiate limitations of liability and contractual restrictions.

The following sections discuss what a contract is (section 1.1) and how to structure it (section 1.2), how contracts are interpreted, by law and as a consequence of contractual interpretation guidelines (section 1.3), and two types of contracts are introduced that are used in a pre-contractual context (in assessing or preparing an agreement – section 1.4). The final section 1.5 examines contract automation and other developments in the legal tech of contracting.

1.1 What is a contract?

A contract is an agreement between two or more parties determining their enforceable rights and obligations under a certain (one-off) transaction or their ongoing relationship.

A contract will often include the conditions for such rights or obligations to become effective or for its termination, covenants (and contractual prohibitions) enabling each party to enjoy the full benefit of their agreement, warranties ascertaining that each party will receive what the other party has promised, and the effects in case of a breach of contract. Chapter 4 will explain what these legal concepts (conditions, covenants, warranties and various related contract clauses) mean.

Oral or written? In a cross-border context, it is strongly recommended that a contract is in writing. A mere oral agreement may be difficult to prove and introduces considerable uncertainty regarding its precise scope and interpretation. Most contracts do not need to be in writing to be enforceable. Contracts that are by law required to be in writing typically relate to the sale of immovable property or to the grant of licences under intellectual property (copyright, use of trademark or patent).

Written contracts may be given an 'official' look and feel, following a common structure (see section (a) below), or be presented more informally (see section (b)), as a letter agreement. Normally, courts of law will accept an exchange of emails as evidence of a contract but often

emails are not written with the greatest accuracy and may easily leave important aspects of the parties' agreement unaddressed.

Requirements for validity. Some legal systems – including many common law systems – require that the parties intend to enter into the contract (where the intention is a requirement on its own) but this threshold will be met easily. In common law, this intention to be bound contractually is demonstrated by the existence of 'consideration' – the fact that each party committed itself to the other party by assuming an obligation of any valuable kind (but not illegal obligations). In practice, this requirement that a contract requires some valuable benefit for all parties is easily met (e.g. by the payment of a symbolic one dollar). The consideration is not subject to a measurement of proportionality and balance of value. Other legal systems – notably the Roman (French law-inspired) legal systems – require that the contract is not for an illicit cause (a negative criterion).

When is a contract binding? A contract is 'entered into' and becomes 'binding' once the parties reach consensus, agreement. In simple terms, this is when one party makes an 'offer' and the other 'accepts' it. For example, the supermarket offers its products for sale by allowing customers to take them from the shelves; and the customer accepts the offer by handing it over at the cashier. Once paid, the transaction is complete (ownership transferred, warranties apply, etc.). When offer and acceptance do not readily match, the other party may make a counter-offer (and this may go back and forth). This process of offer-counteroffer-counteroffer-acceptance is negotiation.

As with contracts, offer and acceptance are not subject to formalities – the context, circumstances, customs and stipulations can take any form. Therefore, if a party starts performing its presumed obligations, this will likely be proof of its 'acceptance' (of the other party's last counter-offer – see section 5.1(c)). Also, if a party sends the other an email unconditionally outlining or proposing the parameters of a transaction (or even a collaboration) without any reservation as to its being non-binding (not marked "for discussion purposes only", "subject to contract" or "subject to board approval"), that email may well constitute an offer that can be accepted by the receiver. Therefore, professional parties who make an offer will also clarify that it is subject to (conditional upon) agreement in writing.

One-off transactions and ongoing relationships. Contracts can address single transactions between parties (a simple sale of a product or batch of goods, or the provision of a certain service) as well as establish the parameters of ongoing relationships. This may affect the characteristics of the contract:

- In a one-off transaction, the rights and obligations focus on the specifications of the product or service, on the (timely) delivery and who-does-what in respect of transportation, the payment of the purchase price or service fee, and what happens if something goes wrong. Examples of such contracts are the ITC Model Contracts for the international commercial sale of goods, and supply of services.²

² <http://www.intracen.org/itc/exporters/model-contracts/>

- In an ongoing relationship, these are less urgent since such a relationship is partly built on mutual trust; The contract will provide for procedures (for forecasting, ordering and joint product development), the establishment of a relational framework (establishing the governance and evaluation of the relationship) and the formalization of continuing rights (in the use of trademarks, know-how and training).
Examples are the ITC Model Contracts for the international distribution of goods, commercial agency, long-term supply of goods and manufacturing as well as the ITC Model Contracts for international contractual alliances and corporate joint ventures.

Importance of a contract. Does it matter if there is no formal contract between the parties? Maybe not. However, if a seller has not limited their liability to a certain maximum amount and there is a defect in its supplied goods, all damages will be borne by the supplier. Conversely, if a customer failed to stipulate that the purchased goods are not manufactured in violation of laws and regulations, then the delivery of those goods might not be refused (and the customer may even be held liable for undertaking or facilitating illegal activities).

Applicable law and dispute resolution. In a cross-border contract, it is very important to provide for an appropriate dispute resolution mechanism, and to determine which national law will govern the contract. In many international transactions, (mediation combined with) arbitration is inevitable.

‘Contract’ or ‘agreement’? There is no fixed terminology for referring to a contract, agreement or (contractual) arrangement. Most lawyers will understand a ‘contract’ to be the written record of a business transaction or legal relationship, but many will argue that an ‘agreement’ does the same. Also, the term ‘agreement’ is commonly understood to mean the parties’ mental being in agreement, having achieved consensus (on all details of) a transaction. Regardless of these somewhat arbitrary definitions, most English language contracts are titled as ‘agreement’ (not ‘contract’).

1.2 How to structure a contract

If a contract may be agreed orally or if no specific statutory formalities are required for the validity of a contract, there are no firm requirements applicable either. However, there are best practices, which are explained in this section.

(i) What to include and what to avoid in the first part of a contract

Contract title. It is good practice to give every contract a name or title. The term ‘agreement’ is more common in a title than the term ‘contract’, but both have the same meaning. The title should simply reflect the nature or central purpose of the agreement, indicating whether it is a licence, confidentiality agreement or other contract. The title should be concise.

For example, rather than ‘Agreement for the Development, Implementation and Maintenance of a Franchise’, simply use ‘Master Franchise Agreement’.

Signing date or effective date. The first line often includes a date. This would be the date that the contract was entered into or the date that the contract will become commercially effective, unless the contract states otherwise.

The contracting parties. Every contract must identify the contracting parties on the first page (or contains a reference on the first page that refers to a schedule in which parties are identified), using their complete names. The section identifying the contracting parties should state the information required under the applicable civil procedural law to be included in a writ of summons.

Business groups or units. There is no need to include a statement that the agreement relates to a particular department or business unit of the contracting entity. Such groupings have no legal capacity to enter into a contract and the statement is superfluous. If you would like to limit the scope of the agreement, express this in the relevant contract provision. The effect will probably be negligible in the event of a dispute, since a claimant will not be precluded from being granted rights over assets of other business groups or business units of the same legal entity.

“Also on behalf of affiliates”. Equally undesirable is a statement that a party also acts on behalf of its affiliates. First, the same statement would also need to be reflected in the signature blocks (for which the affiliates would need to be duly represented). Second, it is questionable whether such a statement is desirable from a liability-limiting perspective. Third, such a statement is ambiguous because the precise scope and meaning is unclear. It would be much more accurate (and adequate) to stipulate a provision to be for the benefit of an affiliate where relevant.

(ii) What to include in the preamble or background clauses

Following the title and identification of parties but before the body text, most contracts contain a group of paragraphs addressing a few key characteristics of the agreement, the related transaction or the parties’ businesses, and they help the reader understand the background. These background clauses are also known as the preamble, the recitals or the whereas provisions.

Best practice. The information provided in the background clauses must be limited to intentions, desires or statements of fact. It is customary to limit these statements to matters that may result in the validity or enforceability of the contract being directly affected. Additionally, background clauses should never contain any obligations, conditions, warranties, policy rules or duties.

Types of background clauses. The background clauses give information about the parties and about the context of the agreement, and they introduce the agreement itself. There are several kinds of clauses:

- **Party-related recitals:** one or more clauses can reflect the relevant business activities of each party.
- **Context or background recitals:** these describe the events or circumstances that led to the transaction. They can be an extension of or elaboration on the contract title – for example, explaining particularities of a sale, specifying the patents or trademarks of a licence, or clarifying why a preceding agreement is amended and restated. Such background recitals may describe, in broad terms, the purpose of the transaction that the parties seek to accomplish.
- **Compliance-related recitals:** in one or more whereas provisions, the parties may want to express that those concerned have complied with certain requirements or prerequisites for entering into the agreement. For example, a whereas clause may express that an external party has approved the transaction or that those concerned have complied with regulatory requirements or works-council regulations.
- **Transaction-structure related recitals:** in non-standard, complex transactions, it is sometimes unavoidable to explain the various steps taken pursuant to the contracts (for instance when a sequence of events is of particular importance).
- **Related-transaction recitals:** a preamble might include one or more recitals regarding agreements being entered into at the same time.
- **A step-up recital:** many contract drafters express a general intention, stating that the parties desire to reflect the preceding considerations in writing. In fact, such a lead-in is redundant and therefore unnecessary.

After the background clauses, the contract formally starts. This is often indicated by a phrase “the parties agree as follows:” (if there are indeed background clauses, the phrase would be preceded by the words “now therefore”). In archaic wording, emphasising that the formalities for a valid contract under common law have been fulfilled, this may also include a statement that there is valuable consideration for the promises made. In a modern approach, adopted by ITC, a simple heading “Operative provisions” or “Agreement” is inserted.

(iii) Preparing the body of a contract (article structure)

After the background clauses, the actual agreement is set out in a series of articles. This is usually called the body of the agreement. A typical structure is as follows:

- Article 1 contains definitions (see section 3.4) and provisions related to interpretation of the agreement (see section 1.3(c));
- Article 2 (if applicable) contains the conditions to the agreement or to the closing of the transaction (see section 4.1);
- Article 3 relates to the scope and main contractual obligations (see Chapter 3);
- Article 4 elaborates the characteristic obligation of the agreement (e.g. delivery and acceptance, service level, specifications, level of exclusivity);
- Articles related to purchase price, purchase price adjustments and payment, aspects of compliance, reporting and product quality;
- Articles containing covenants (see section 4.2);

- Articles on warranties, indemnities and limitations of liability (see sections 4.5 and 4.6); and
- Articles addressing the term and termination of the agreement, the confidentiality of certain information (see section 4.7), notices and miscellaneous provisions including the choice of law and dispute settlement (see sections 4.8 and 4.9).

The core of the agreement is in the scope Article 2 or 3, and the two or three articles that immediately follow. However, some drafters prefer to push elaborate clauses into a schedule. Obviously, this enumeration is just one way of setting out a contract outline. Agreements may well follow a different order.

Prioritization and logical sequencing. To determine the best sequence of articles and contract clauses, efficiency suggests that the following principles should be applied:

- General provisions (e.g. defining scope, desired results and principles) should precede specific provisions (e.g. limiting provisions, procedures, exceptions and carve-outs);
- Important provisions should precede less important provisions;
- Clauses identifying causes of action or triggering events should precede their consequences;
- Substance should be distinguished from form;
- Content should be distinguished from procedure;
- Chronological order should be used (if applicable);
- Provisions with a certain permanency should precede temporary or ad hoc provisions;
- Miscellaneous provisions (boilerplates) should be placed at the end.

(iv) Using schedules, annexes and exhibits in contracts

Some contracts address elements of the agreement in a numbered schedule. These are called schedule, annex, exhibit, annexure, appendix or attachment, all with the same meaning and effect. It is best practice that a consistent naming is adopted for all schedules (i.e. either schedule or annex or other name). Sometimes schedules contain attachments; it is best practice that such attachments to a schedule are referred to differently (e.g. a schedule may contain annexes, exhibits or appendices, but not a schedule to contain schedules).

Schedules are used for the following reasons:

- **Complexity.** The transaction is complex and structuring it into schedules improves the manageability of all the transaction documents.
- **Various sub-transactions.** The transaction in the main agreement includes various smaller transactions, each of which is of a different nature. For example, a contractual alliance or a joint venture will almost invariably encompass a number of other relationships established in relation to it (see section 2.1).
- **Different disciplines involved.** The transaction requires the involvement of different disciplines and different types of contributions. For example, it is undesirable to include technical details of a product-to-be-supplied or the description of a work to be serviced in

a contract (see section 2.3) or to include product specifications or retail pricing in the body of the contract. Those should be negotiated and agreed between the technical or commercial persons, respectively.

- **Separation of facts and obligations.** Effective contract drafters place informative aspects, specifications and technical facts in a separate schedule. This saves the drafter from having to keep track of all changes in technical documents (for which the technical people are responsible).
- **Updateable documents attached.** Several schedules will be updated from time to time: for example, it is easier to update the applicable list prices in an annex from time to time than amending a contract clause (in the body text of the contract) in which such prices are listed.

The body of the agreement should contain a reference to each of the schedules, annexes and exhibits, and the contract should not include any schedules, annexes and exhibits without specifically referencing them in the body of the agreement. It is unnecessary to use the phrase “the provisions of the schedule are incorporated by reference”.

(v) Using an informal format – letter agreements

A letter agreement is a letter that contains the terms of the agreement and is signed by both the sender and the addressee (‘for agreement’ or ‘for acceptance’).

A legal (enforceable) agreement does not necessarily need to be embodied in the traditional structure of a contract (with the parties’ signature block, recitals, words of agreement, numbered articles and sections, and signature formula). Most types of agreements are just as enforceable when they take the form of a letter from one party to the other if they are ‘accepted’ or ‘agreed to’ by the receiving party.

Structure. A letter agreement is typically printed on the letterhead of the sender and contains the following elements:

- the sender’s entity name and address;
- the place and date;
- a subject line (but not a title);
- the addressee’s entity name and address;
- a salutation (e.g. a generic “Dear Madam, Sirs” or to the individual representing the other party);
- an introductory sentence referring to the background of the letter or to an agreement to which it pertains;
- the substantive terms of agreement;
- a closing sentence requesting the addressee to countersign a copy (e.g. “If you agree to the above, please sign one copy of this Letter Agreement and return it to me at the above address”);
- the sender’s signature; and

- the addressee's signature, preceded by the words 'For acceptance' (suggesting that the letter itself is an offer in the legal sense) or 'For agreement' (reflecting the truly mutual nature of the letter agreement).

Special characteristics of this type of agreement. A letter agreement usually refers to the parties as "you" and "we" instead of using a functional reference (Seller, Licensor, Customer) or shortname (e.g. ITC, Weagree) for identifying a party. Unlike a traditional contract, the substantive terms of a letter agreement are usually not subdivided into articles and subsections, although subdividing the text into numbered paragraphs is often helpful. The substantive terms may well include miscellaneous provisions, such as a choice of law and a choice of jurisdiction.

1.3 How to interpret contracts

A drafter should be aware of the meaning that will be attributed to contract wording if it comes to court proceedings. The purpose of this section is to raise awareness of the origins of different points of view and styles of contract drafting.

(a) Legal cultures and factors that determine contract interpretation

Three main approaches to legal practice can be distinguished, each representing the characteristics of a legal culture:

- The Roman legal culture;
- The Germanic legal tradition; and
- The common law.

Roman and Germanic traditions. In both the Roman and the Germanic legal cultures, courts will come to their decisions by reverting to systematic codifications of the law (i.e. a civil or a commercial code), the meaning of which is elaborated on in parliamentary materials, doctrinal opinions and case law. These codifications have a rather abstract character, building on general principles such as good faith, reasonable, fair dealing, justifiable, duty to co-operate, which are familiar tools for each lawyer. These principles require that a party observe standards of proportionality and subsidiary when exercising its rights under a contract.

In both legal traditions, courts are not strictly bound to their precedents and, exceptionally, are even able to set aside unfair consequences of a law or regulation. Lawyers from common law jurisdictions would probably reject such sources of uncertainty about explicit provisions, but the practical consequences are not as sweeping as they may seem.

Both in the Roman and Germanic traditions, in case of breach of contract, remedies are not limited and will typically include specific performance or an otherwise effective remedy.

Subjective versus objective approach. The two legal traditions are fundamentally different regarding contract interpretation (although the difference may seem philosophical or academic rather than practical). In the Roman legal culture, the *subjective* consensus between the parties is determinative for the scope and nature of the parties' mutual obligations. This means that the mental 'common intentions' are relevant and that a written agreement is considered to be only a welcome (albeit important) piece of evidence.

In the Germanic legal tradition, a more *objective* approach prevails in the interpretation of contracts and legal acts. The important question is what, under the circumstances, a reasonable and informed person in the same position would deem to reflect most accurately how the parties are bound. In this approach, as well, the written contract is a good starting point.

Common law. In common law systems, vast codifications of private law have never been developed or, at least, they have never achieved the authority given to their counterpart on the European continent. In the United States, for example, codifications exist for corporate law, partnership law, various types of transactions in movable property (embodied in state codifications of the Uniform Commercial Code), and federal topics such as competition law, intellectual property law, arbitration, securities laws and regulations and bankruptcy law (known as 'Chapter 11').

Subject matters that are not covered by these codifications have often been developed in the common law (i.e. case law). Accordingly, legal concepts such as 'mistake' or 'set-off' are based on court precedents. The influence of legal doctrine is very limited if relevant at all, at least in the state laws of the United States. To state that legal concepts such as 'good faith' and 'fair dealing' can be excluded contractually is exaggerated, but to say that the typical common law attorney is well able to appreciate its scope often contradicts practical experience.

Other than in the Roman and Germanic traditions, the default remedy in common law systems is payment (in cash) of damages. Whether or not an injunction or specific performance may be awarded might depend on the adjudicated court, except that parties can always contractually provide for remedies.

Other legal families. Other important cultures can also be identified, such as the Arab (or Islamic) legal culture, the Hindu tradition, the Scandinavian family, the (former) socialist countries, and various mixtures – the Scottish and South African legal systems are a mixture between common law and civil law; Japanese law has been influenced by both United States common law and German law, Turkish law by the Swiss codification of around 1900, and Russian federal law by several European legal systems including the Dutch civil code of 1992.³

³ Many other classifications have been made (and their classification questioned). See Zweigert, K. & Kötz, H. (1996). (3rd ed.) *Einführung in die Rechtsvergleichung*, JCB Mohr Tübingen. Zimmermann, R. & Reimann, M. (2006). *The Oxford Handbook of Comparative Law*. Oxford University Press.

In Africa the influence of the former colonizer is often recognisable (in many cases either the French or the English legal system has been adopted, but then developed independently). Elsewhere, the British Commonwealth jurisdictions have adopted English common law.

Effect on contract interpretation. The practical relevance of distinguishing between subjective and objective approaches of contracts and contract interpretation has been reduced over the centuries. Case law developed principles that smoothen unintended or unfair results, and further case law equipped courts with the legal instruments with which they could come to the right decision. The UNIDROIT Principles contain the following general principle of contract interpretation:

Article 4.1 (*Intention of the parties*)

- (1) A contract shall be interpreted according to the common intention of the parties.
- (2) If such an intention cannot be established, the contract shall be interpreted according to the meaning that reasonable persons of the same kind as the parties would give to it in the same circumstances.

Article 4.2 (*Interpretation of statements and other conduct*)

- (1) The statements and other conduct of a party shall be interpreted according to that party's intention if the other party knew or could not have been aware of that intention.
- (2) If the preceding paragraph is not applicable, such statements and other conduct shall be interpreted according to the meaning that a reasonable person of the same kind as the other party would give to it in the same circumstances.

Article 4.3 (*Relevant circumstances*)

In applying Articles 4.1 and 4.2, regard shall be had to all the circumstances, including:

- (a) preliminary negotiations between the parties;
- (b) practices which the parties have established between themselves;
- (c) the conduct of the parties subsequent to the conclusion of the contract;
- (d) the nature and purpose of the contract;
- (e) the meaning commonly given to terms and expressions in the trade concerned;
- (f) usages.

The articles cited above provide a well-balanced principle of contract interpretation, which would even encompass English law. It is fair to say that each European jurisdiction is represented in the concepts expressed in these articles, and none is contradicted. Note that the literal meaning of contractual words is not necessarily decisive.

(b) Statutory guidelines on contract interpretation

Lawyers like to provide certainty on how a contract must be (and thus will be) interpreted. For them, several legislatures have provided guidelines for interpreting contracts (or legal acts). Despite the broad consensus that such guidelines are not determinative for a case at hand and

provide no more than some hints for courts to consider, risk-avoidant lawyers have anticipated that these guidelines could nevertheless be detrimental and should therefore be excluded explicitly.

Contra Proferentem (interpretation against the draftsman). The UNIDROIT Principles provide guidelines for contract interpretation. This is consistent with the civil codes of France, Italy, Spain and Belgium in particular, although most countries apply such principles. The main principles of interpretation have been discussed in the previous section but another well-known one is to interpret a contract ‘against the drafter’:

Article 4.6 (*Contra proferentem rule*)

If contract terms supplied by one party are unclear, an interpretation against that party is preferred.

The rule provides a preference in case any negotiations were mainly determined by an economically strong party (in its dealings with a weak counterparty). Despite this context-specific application, the principle has prompted many drafters to include a provision expressing that ‘the parties reviewed and negotiated the entire contract in all its respects’ (and accordingly stating or implying that ‘no provision should be interpreted against the party who drafted it’). Such an approach fails to address the real issue:

- First, the interpretation rule would only apply to stipulations where there is a (reasonable) doubt about the actual meaning of a phrase. If there is no such doubt, the stipulation would be enforced. Whether such doubt could exist may also be measured against another rule, for instance, the fact that the parties are business people and advised by professionals who are keen to understand each oddly phrased provision.
- Second, the principle effectively says that where two interpretations compete, the party who created the ambiguity should not have the benefit. The phrase is preferred and emphasizes that the drafter may explain why a certain meaning should prevail (and thereby ‘win’ the interpretation discussion).

Similar arguments can be made about a dominant party who drafted a contract provision: such party would insist on the inclusion of a particular provision, notably regarding disclaimers or limitation of liabilities. In these cases, there may also be a hint of abuse of power, which is not supported by the law (see also UNIDROIT Principles Article 3.2.7 (gross disparity)).

Other rules on interpretation. A few provisions of the UNIDROIT Principles clarify that negotiation of a clause improves its enforceability. This is understandable because the more comprehensive the discussions about the ins and outs of a clause have been, the more reluctant a court must be to attribute a meaning that is not immediately obvious. Another important rule for interpretation is that a contract provision was presumably always given a meaning or intended effect. If a provision is ambiguous or contains errors, mere reliance on such ambiguity or error without further merit should not be protected if another interpretation provides a meaning for it.

Article 4.4 (Reference to contract or statement as a whole)

Terms and expressions shall be interpreted in the light of the whole contract or statement in which they appear.

Article 4.5 (All terms to be given effect)

Contract terms shall be interpreted so as to give effect to all the terms rather than to deprive some of them of effect.

Overall, the importance of one interpretation rule or another is still a matter of judgement and is not inevitably part of the reasoning given by a court. Where the principles invoke different standards, their actual significance may well differ from country to country or even from judge to judge. Again, this probably also appeals to cultural legal differences.

Drafting tip: introduce mutuality: ensure the contract provisions are mutual to both parties. Contract interpretation principles suggest that a very one-sided contract may be susceptible to being interpreted against the drafter. Two examples can be found in the ITC Model Contracts:⁴

- Confidentiality clauses: despite a clear one-party-gearred interest in continuing confidentiality, this provision is usually drafted to apply mutually.
- Force majeure clauses: although the party that can be affected by an event of force majeure is foreseeably only one of the two, the text of the provision often suggests fairness for both.

(c) Contractual guidelines on interpretation of the contract

Many contracts contain provisions that are standard and abstract. These provisions are typically inserted either in Article 1 (on interpretation and definitions) or at the end of a contract, and either grouped under the header 'miscellaneous' or, in case of the ITC Model Contracts, in short contract articles. As in other provisions, common law-originating contracts seem to elaborate more than in continental European legal systems.

This section addresses contractually stipulated guidelines that specify how certain references in a contract must be interpreted. Such guidelines are often inserted in a general article containing the definitions.

“Written” notice. Many contract provisions require a notice to be given in writing. The obvious intention is to require that a party is firm and accurate about its intentions. A party who needs to notify an event of force majeure will prefer to do so informally rather than putting the other party in a position where a formal response becomes inevitable (e.g. a firm and final warning with a deadline for remedy). In joint ventures, informal communications between the partners are the rule. A question that may arise is whether communications by email or fax are considered to be

⁴ International Trade Centre (2010). *Model contracts for small firms: legal guidance for doing international business*. Geneva.

in writing (and thus satisfy the criterion provided in a contract clause). In view of modern practice, it would be hard to argue that this is not the case, but avoiding any discussion of the matter may still be helpful:

A reference to a communication **in writing** shall be construed so as to include any communication in written form, whether by letter, fax, or a scanned and signed document sent by email;

Article and section references. A meticulous contract drafter may refer to articles and sections of the agreement by adding to each such reference: “of this Agreement”, or “above” or “below”, as the case may be, or “hereof” to each such reference. This is superfluous practice. There might theoretically be confusion about whether a reference may unintentionally point to a provision not in the body of the agreement. To ensure that this is only the case for non-capitalized references, include the following clause:

References to Articles, Sections, Annexes, and Schedules are references to articles or sections of, or annexes or schedules to this Agreement.

Headings and captions. A drafter may sometimes want to ensure that contractual provisions cannot be summarized in the two or three words of an article heading or the caption immediately preceding a contract section. Although it is difficult to argue that one party misunderstood a contract clause because the caption or article heading gave it a certain meaning, the following clause would diminish the possibility of such argument:

Headings in this Agreement and captions to its Sections are provided for convenience only and do not affect its meaning.

Applicable laws and regulations. When a party warrants that it is not in breach of a particular statute or undertakes to continue acting in compliance with a particular act or regulation, the other party may want to ensure that such non-breach or compliance is measured against that statute, act or regulation as in effect at the time in question. The following provision would allow a drafter to accomplish this without adding “as amended” or “supplemented” or “from time to time” after each reference to such a law or regulation:

Except as provided otherwise, a reference to a statute or regulation means that statute or regulation as amended or supplemented from time to time.

Times and time zones. In a multinational context it may be helpful to specify which time zone should be referenced in case the parties fail to identify it. For example:

Except as provided otherwise, a reference to a time of day is a reference to the time in Geneva, Switzerland.

1.4 Pre-contractual agreements

Although the concept is a contradiction, there are agreements that precede agreements. This section discusses two documents that may precede agreements.

Non-disclosure agreement: an agreement that is used to ascertain that information exchanged in the pre-contractual stage of assessment or negotiations on a subsequent agreement and (a) will be used only for the purpose of the anticipated transaction (and not for any other competitive purpose), and (b) that all disclosed (confidential) information will be kept secret.

Memorandum of Understanding (MOU) or letter of intent (LOI): a short document outlining the initial views and (non-binding) intentions of the parties, as well as their preliminary mutual understanding, in order to structure or facilitate subsequent negotiations of a definitive agreement.

(a) Using a non-disclosure agreement

A non-disclosure agreement facilitates the exchange of ideas and confidential or proprietary information by limiting the permitted purpose for which such disclosed information may be used and by imposing secrecy obligations on the receiving party.

Terminology. Non-disclosure agreements are also referred to as confidentiality agreements or secrecy agreements (or simply by the abbreviation NDA or CDA) such as in the Model Contracts.

Protection of confidential information. A non-disclosure agreement enables parties to protect their know-how and technology against misappropriation or abusive use by the other party. It is legally difficult to protect ideas, concepts, know-how, general technology and many software functionalities because these elements fall outside of the standard categories covered by intellectual property law, such as copyrighted works, patented inventions, and certain designs.

Intellectual property rights. The Model Contract contains a simplified provision regarding the intellectual property rights of the disclosing party – any improvement of the disclosed information, even when proposed or suggested by the receiving party, will be owned by the disclosing party. This prevents claims to co-inventorship, co-ownership and other related complications.

Avoid negotiation. A non-disclosure agreement should be signed soon after conversations between the parties starts, to facilitate disclosure and effective negotiations concerning the main contract. The non-disclosure agreement should therefore not contain significant areas of negotiation.

The “Purpose”. One of the key clauses is the formulation of the defined term “Purpose”. The purpose of a non-disclosure agreement determines what a receiving party may and may not do with the disclosed confidential information. The purpose should be formulated accurately and in a sufficiently narrow manner. A narrow definition prevents the receiving party using the confidential information for competitive ends, for example, investigating product specifications with the aim of developing the same technology itself or with another party, or any other undesired purposes. Some appropriate purposes could be, for example:

- “discussing the feasibility of jointly developing product X to be used in market A and exchanging information about certain proprietary, secret technologies, including the possible terms and conditions of a joint development project”;
- “assessing the attractiveness of entering into a contractual alliance related to entering into the market of country B, including discussion on the possible terms and conditions of a contractual alliance”; or
- “Investigating the appropriateness of entering into a long-term supply agreement in relation to products Y and Z to be sold in the region of Southeast Asia, including discussion on the possible terms and conditions of a long-term supply.

Not for pre-patent purposes. The Model Contract is not intended for use where patentable inventions are involved because more care is necessary to prevent claims of co-inventorship or ‘prior use’. Nonetheless, if certain materials (or software source code) are disclosed for testing purposes, it is desirable to expressly provide that the materials or source code may not be analysed or re-engineered (unless analysis or re-engineering is the purpose of the non-disclosure agreement).

Confidential information and competition law. Due care must be exercised in the disclosure of confidential information which triggers concerns from an antitrust or competition law perspective. Although development of new technology is usually exempted, this is usually not the case with respect to information regarding market shares, sales figures or cost price elements (or the parties’ intentions or plans to develop markets, to change pricing or to improve cost price). It is a gross violation of antitrust or competition law to enter into a non-disclosure agreement in the context of price-setting arrangements, competing procurement/tender processes and similar acts.

Duration of confidentiality. Depending on the Purpose of the non-disclosure agreement, the term during which confidential information must be kept secret and treated confidentially with due care might range from (usually) six months (in case of simple product development or assessing a long-term supply relationship) to eight or ten years (in case of joint technology development).

(b) Using a Memorandum of understanding (MOU) or Letter of intent (LOI)

A Memorandum of Understanding (MOU) or letter of intent (LOI) is used between two or more parties for the establishment of intentions or mutual understanding concerning their main agreement.

Terminology can vary. A document reflecting the parties' intentions and (partly) non-binding commitments may equally be called a 'Letter of Intent' (also commonly referred to as an 'LOI'), 'Memorandum of Understanding' (or 'MOU'), 'Heads of Agreement' or 'Term Sheet', depending on industry practice and on the parties' preference to express a binding or less-binding commitment.

Importance and use. A Model 'Contract' MOU or LOI can be particularly useful in a context in which:

- the transaction is too complex or too large to negotiate in one single phase;
- the parties are not yet aligned on the structure or nature of a transaction (i.e. crucial deal elements remain to be determined);
- discussions may have reached a stage where outlining a number of mutually acceptable principles and procedures is possible; or
- certain binding obligations can only be agreed on after preliminary hurdles are overcome, certain milestones have been achieved, or if a prototype has been delivered and accepted.

In particular, an agreement concerning a contractual alliance, a (corporate) joint venture or the manufacturing of a complex product may well be preceded by an MOU.

Non-binding nature. Most (if not all) MOU's are intended to be non-binding, with a limited number of binding terms. The applicable law, however, may impose liability on a party if it terminates negotiations that have become somewhat binding (or if a party could, in good faith, reasonably anticipate that a contract would result from the negotiations). The party terminating such negotiations in bad faith can be held liable for damages towards the other party ('precontractual liability'). This liability may stem from a document such as an LOI or MOU if it contains binding, unconditional obligations. In view of the risk that key arrangements could be missing or overlooked, it may be important for companies to establish a policy that says quotations are also to contain appropriate limitations of liability and any key operational restrictions.

Avoiding binding obligations. The extent to which the terms or conditions in MOU's are binding or non-binding depends on a number of factors:

- conditions or requirements set out in the MOU (see Article 2);
- whether the commitments are dependent on permits or clearances (see paragraph 2.1.1 of the MOU), funding or subsidies (see paragraph 2.1.2 of the MOU), a satisfactory outcome of further investigations (see paragraph 2.1.3 of the MOU), "subject to contract"

(such as a Definitive Agreement – see paragraph 2.1.5 of the MOU) or “subject to approval” (see paragraph 2.1.4 of the MOU);

- whether certain (crucial) terms or conditions are specifically mentioned to be pending negotiations and subject to prior agreement (see Section 3.1 of the MOU); and
- generally, also considering other circumstances, the binding wording of the provisions in the MOU.

Negotiation time schedule and action list. The Model MOU contains provisions organising the process of negotiations: a timetable with deadlines (e.g. for delivering first-draft contracts, specifications or factual details – Article 4 of the MOU); and optionally a period of time during which the parties will negotiate on an exclusive basis (Article 5 of the MOU).

1.5 Legal tech for contract automation and contract lifecycle management

Innovation has arrived in the legal sector. Contracting processes have been automated or at least can be supported by IT solutions. The range of innovative ‘legal tech’ solutions captures the entire lifecycle of contracting, starting with contract automation and leading to contract lifecycle management (CMS or CLM).

(a) Contract automation (automated contract creation)

The contract creation process is almost entirely automated with the use of a contract creation application. A user who needs a tailor-made contract selects the appropriate template and answers an intelligent questionnaire. Based on the answers given during the Q&A, a contract is assembled: optional clauses are left out or inserted, alternative options are inserted as required, the data entered, and the correct schedules and annexes attached. Clauses number neatly and cross-references are correct. Schedules and annexes number correctly and are all cross-referenced in the contract.

Automated contract creation ensures a high-quality contract thanks to a thought-through questionnaire (and any freedom to deviate or modify is in principle limited to the options offered during the Q&A) and allows (and justifies) an organization’s lawyer to delegate a substantial part of the contract creation process to ‘the business’.

Contract automation is also referred to as contract assembly, automated contract creation, document automation, automated contract creation or intelligent contracts.

The business case for contract automation. The competitive advantages of legal tech are significant. Contract automation alone improves the performance and productivity of a legal

counsel by 12 to 18 percent. As a result of improved contract know-how management (i.e. availability and access to model contracts and model clauses) the response time of a legal department may decrease from three weeks to a few days only. With these improvements, many transactions maintain their momentum and are more likely to be closed.

Delegation of (a controlled process of) contract creation to ‘the business’ reduces the response time of a legal professional to zero (or to the time required to approve a created contract). In the reality of many businesses, business managers tended to avoid legal involvement, but with the above improvement of productivity and response time, they may act more responsibly and often the volume of created contracts increases from only a few per year to several hundreds of contracts signed. These improvements also lead to higher legal compliance as more transactions are covered by a formal contract improving clarity about each party’s obligations and reducing risks in case of defective deliveries.

A lawyer may argue that his or her work is too bespoke to be automated. If the contract starting point is still a Word document, then the further development of model contracts remains poor. In order to keep such model contracts workable, the options and alternative clauses will be kept to a minimum (as too many options and all explanatory notes will need to be reviewed each time a contract is created). However, automated contracts are not burdened by workability as a computer can handle infinite options. If the implementation and maintenance of automated contracts is easy, the lawyer’s added value is in formulating and building an effective questionnaire.

Advanced contract automation applications. Simple contract automation tooling may be very time-consuming and model contracts are difficult to keep updated: implementation is a hidden cost factor, if only because specific skills are required for automating the model contracts. Advanced contract automation applications include a clause library which allows the reuse of contract clauses across different templates and enables lawyers to insert any transaction-specific clauses during contract creation. A clause library implies significant future cost savings in the maintenance of contract templates. Advanced applications also provide a WYSIWYG (‘what you see is what you get’) online text editing function to enable users to preview and edit the contract in real time.

Enterprise-oriented contract automation solutions will be able to provide a complete overview of all answers given to one or more of the template questionnaires. For example, a legal department will be able to establish for which territories agents or distributors are proposed (but not necessarily signed yet), in which territories any exclusivity is pending, what payment terms were proposed, how intellectual property rights were proposed to be allocated or owned, and which other specificities (e.g. contract currencies) were proposed. These data will later be exported to other contracting solutions (such as a CLM or an ERP, see below).

Import and integration of data. Data from external sources (e.g. party details, transaction or business-related information) can be imported into the questionnaire or contract automatically. The automated contract can be made part of an automated approval workflow and send approvers and submitters email alerts. Also, in an enterprise setting, the Q&A answers given in one questionnaire can be reused in another template, e.g. a signed letter of intent or term sheet

can be the basis for a definitive agreement; or, in the case of tender contracts, several language versions can be created for bidding parties from different countries.

Export of the contract and contract data. In an enterprise contract creation application, the data entered during the questionnaire can be exported as well to other business applications (e.g. customer relation management CRM, enterprise resource planning software ERP, document management or storage DMS, e-signing applications, contract lifecycle management CLM).

(b) Legal tech and contract negotiations

Once a first-draft contract has been created (see section (a)), the document will be exchanged between the parties until agreement is reached.

Document management and collaborative contracting. Once a first-draft contract is sent to the other party, comments may come back in the form of a 'mark up' (tracked changes identifying modifications proposed by the other party). Usually, this process is done by versioning the document in a document management system (a DMS). All emails and underlying documents related to the transaction will be saved and stored in one central place, making sure that all related data are stored together.

In online negotiation tooling, changes can be traced back automatically to a person (of either party) and accepted as proposed or further changed (counter proposal). Such tooling can be internal, as well as external in which case all parties involved are granted access. Advanced solutions keep track of changes automatically (otherwise, compare versions must be created upon 'checking in' a new contract version). Once a contract is agreed, it will be forwarded for an e-signature or to a contract lifecycle management solution (see below).

Artificial intelligence: contract analysis tools. In context of contracting and legal tech, the terms big data, artificial intelligence ('AI') and machine learning are used to signify the possibility of automatically:

- analysing a contract drafted by the other party for any 'red flags' (issues contrary to the contract recipient's contracting policies), and
- generating a report summarizing the contract (in a format defined by the recipient, which is not necessarily the contract structure provided by the draftsman).

E-signature applications. To ensure that a contract is signed by the persons authorized to represent the contracting party, and to ensure which document is the final and agreed version of the contract (and any related contracts), e-signature or e-signing applications have been developed. These solutions often contain workflow approval functionality enabling the 'e-signing representative' to check whether all stakeholders in their organization have approved the contract. If all approvals are given, the application checks the identity of the e-signing representative and

secures the e-signed version of the contract (preventing inadvertent or fraudulent modifications after signing).

The legal merits of e-signing seem to be acceptable, given that the failure of a pencilled (written) signature does not invalidate a contract in most modern legal systems. But while the certainty suggested by providers of e-signature solutions may seem high, the effectiveness of such e-signing is rather to be found in the compliance aspects of contract approval: the workflow connected to the e-signing process. E-signing as such justifies itself where the validity or precise contents may be disputed (mostly in business-to-consumer transactions).

Approval workflow. Such approval workflow can be invoked at any moment during the precontractual stage (and therefore not necessarily as part of the e-signature application). An efficient approval process relies on preapproved contractual arrangements (preventing that stakeholders are unnecessarily involved) and an effective approval process involves all stakeholders of the transaction:

- the procurement department confirming that the contract fulfils a defined business need and is strategically the best option available in the market;
- a financial controller to check financial viability and creditworthiness, including approval of the agreed payment term;
- tax and treasury departments for the correct fiscal unity and financial feasibility of obligations;
- the patent or trademark attorney or other IP lawyer for proper allocation of IP rights in the contracted work or research or development results;
- the in-house lawyer approving that internal processes had been followed, compliance with legal requirements and ensuring that the correct version will be signed; and
- the responsible business manager reconfirming that they need the contract and will take it in their budget.

Note that many of these approvals do not need to be obtained explicitly if an effective contract automation application is in place: the responsible business manager or in-house legal counsel who creates the contract, will then work with preapproved contract language only, and only a deviation from approved policies would require the relevant stakeholder to approve.

(c) Contract lifecycle management (CMS / CLM)

Once signed, the contract can be managed in a contract lifecycle management (CLM) application. A CLM is the same as a contract management system (CMS); the two acronyms, CLM and CMS can be used interchangeably. A CLM provides all persons involved in the operations or business the contract information they need.

A basic CLM will send timely email alerts (and repeatedly) to staff to take action regarding the contract (e.g. renegotiate prices, decide upon continuation or expiry) and will give a complete

overview of all rights and obligations of the organization. An advanced CLM such as Weagree, provides more and deeper insights:

- overviews of all contract deadlines, including their priority for action;
- management on specific contract parameters, such as:
 - delivery milestones,
 - payment schedules,
 - ownership of intellectual property rights,
 - exclusivity granted in geographical areas or markets,
 - termination rights, and
 - transferability of a contract (incl. change of control clauses);
- immediate access to contract-related files and any amendments;
- reporting functionality, giving team leaders, contract managers and senior management insight in busyness and productivity of individual team members, forthcoming pricing reviews and expiry of contracts; and
- a CLM will automatically be the GDPR register as required by modern personal data legislation.

Integrating with other applications. A contract will have operational consequences: components or raw materials will need to be purchased, personnel allocated, purchase orders prepared and issued (enabling the other party's invoicing) etc. The contracting-related applications should be able to exchange data with enterprise resource planning (ERP) software, for example.

Smart contracts. Developments in artificial intelligence may improve contract analysis tooling: they may provide for sets of contractual arrangements that automatically trigger agreed contractual effects upon the occurrence of certain events. For example, the payment of pensions upon a person's 67th birthday or the automatic payment under a letter of credit (L/C) if the advising or confirming bank approves the proper receipt of documents required by the L/C (compare section 5.4(b)).

Such 'smart contracts' are included in a 'blockchain' which ensures that the agreed terms will not be modified without the approval of all contracting parties. Their implementation may not give much room for contract interpretation (see section 1.2). Smart contract technology may be suitable for commodity trade and mass consumer contracts.

(d) Collaboration ITC and Weagree to develop a contract automation platform

ITC has entered into a collaboration with Weagree, a leading innovator of the legal sector, to establish an online platform on which organizations can tailor and manage free of charge any of the ITC Model Contracts to their specific transaction or a legal relationship. It is an open platform, at precontractual.com.

Chapter 2. USING THE ITC MODEL CONTRACTS

The ITC and leading legal experts have developed eight generic contract templates that incorporate internationally recognized standards and laws for most small business situations. The contract templates provide practical ways to secure international deals for small firms and bridge many legal and cultural traditions by harmonizing recurring legal provisions common to most international contracts.

These templates are for key trade activities such as the sale of goods, distribution, provision of services, joint ventures, and more. They were originally published in 2010 by the ITC.

It is important to emphasize that several contract clauses are interchangeable among the Model Contracts, in particular the miscellaneous provisions which appear in every contract.

2.1 Forming alliances and joint ventures

Cooperation: strategic objectives. The basic aim of an alliance or a joint venture is strategic. Activities that are of significant importance to an organization's core business and that cannot be performed at the required quality level or with the necessary efficiency by the company itself 'must' be partnered (unless cooperation is a first step towards divestment of existing business, starting with the joinder of a fifty percent 'partner' and followed by a full-swing sale of the other fifty percent to that party). If the required activities are not a company's core business and if undertaking such activities does not add significant value, or the core business is not crucially dependent on the activities, a company should not enter into cooperation but instead consider outsourcing.

Cooperation may facilitate any of the organization's (core) activities including the joint purchasing of raw materials, inventories or services, the outsourcing of a key discipline to a partner, the development of new technology or products, or a joint exploration or exploitation of a market segment, territory or product market. Also, an alliance may provide access to the partner's network or technology, create learning opportunities (e.g. as regards the partner's way of working), allow for cost savings (e.g. joint purchasing or production), result in risk sharing, or grant access to new markets and distribution channels, expanding the customer base.

Terminology. An alliance or joint venture may be given various titles including joint venture, collaboration, consortium, teaming, cooperation, joint development, joint operation, joint exploration, or even partnership. Its legal qualification, as well as the accentuation in legal consequences or prerequisites, will always be made on the basis of the actual setup.

Alliance or incorporated joint venture? The choice in favour of a contractual alliance, instead of an (incorporated) joint venture, is often based on one or more of the following considerations:

- **Informal character** – a contractual alliance structure is more informal than an incorporated joint venture with its mandatory management organization and formal decision-making requirements. In addition, setting up or dissolving a legal entity involve the completion of various formalities.
- **Taxation, accounting and fiscal transparency** – in a contractual alliance or partnership, each partner fully consolidates the results of the alliance in its financial results.
- **Limited scope or duration** – by its informal character, the alliance is typically also easier to terminate and unwind, and therefore more suited for collaboration with limited duration.
- **Limitation of liability** being less relevant – a corporate joint venture structure might be preferable if the alliance should deliver products or provide services to third parties.
- **No joint (cash) investments** to be made – when the alliance can operate without (cash) investments by a party in a jointly owned business, a contractual structure may be preferable. However, an incorporated joint venture may be preferable when two parties jointly enter a national market in which neither of them is present and establishing a legal entity is desirable (e.g. for taxation purposes).
- **No creation or acquisition of joint property** – but if a new product is developed, its joint exploitation may be easier in an incorporated joint venture.
- **No realistic profit-making potential** – if cooperation is a cost factor and not profitable, its costs and losses can be fully consolidated by both parties if it is set up as a contractual alliance or as a partnership.

The above considerations are mere indicators. Recent legislative developments and the increasing number of tax treaties between countries have lessened the differences between informal contractual alliances and incorporated joint ventures. In each case, it may be important to provide for an appropriate exit scenario in case of deadlock. If know-how and intellectual property are involved or created, it is essential that the entitlement to such know-how and intellectual property rights are clear.

Interchangeability of provisions. It is important to note that all the provisions in the ITC's Model Alliance Agreement⁵ are well suited to be copied into the Model Contract for an International Corporate Joint Venture. This applies in particular to the following articles:

- Article 1 (objectives and key principles for future decision making).
- Article 4 (joint projects, for exploring new business opportunities).
- Article 6 (intellectual property rights).
- Article 7 (preferred supplier arrangements).
- Article 8 (secondment of the parties' personnel to the alliance).

Conversely, the provisions in the Corporate Joint Venture Contract may be added to the Alliance Contract:

⁵ <http://www.intracen.org/itc/exporters/model-contracts/>

- Article 5 (capital and further finance).
- Article 6 (directors and management).
- Article 7 (reserved matters for important decisions).
- Article 9 (additional contributions).
- Article 13 (restrictions on the parties).
- Article 14 (deadlock and termination).

Transaction documents. Alliances and joint ventures will typically require more than just one contract. Once the main principles of the collaboration are agreed, it may be worthwhile to involve more people from both parties' organisations and work on the various aspects involved. If the alliance or joint venture is complex, consider starting with a letter of intent (LOI) or memorandum of understanding (MOU) setting forth the high-level principles of the collaboration (see section 1.4(b)).

The multiple documents that result from preparatory discussions will be included in the alliance contract or joint venture agreement, which will then contain one or more schedules. Using more than one document makes it easier to separate facts and legal arrangements, or the involvement of different disciplines (each working on their own document). If the alliance or joint venture triggers several legal relationships, then it is important to establish each arrangement in separate contracts. For example:

- A joint venture agreement will typically include one or more business arrangements – such as a technology or trademark licence, a long-term supply of products or raw materials – in addition to a (one off) contribution to the joint venture itself. Each can be reflected in its own contract, and all of them should be attached to the main joint venture agreement.
- A joint development agreement may require that one party provides certain tools or equipment on loan, in which case the goods on loan will be dealt with in a separate contract.
- An alliance aimed at the joint development of a product, service or technology typically contains a *statement of work* or 'SOW' (a technical document specifying various aspects of the work to be developed, such as product specifications, testing criteria and acceptance procedures, deliverables and milestones, go/no-go decision-making points, budget allocations, persons involved in the various stages). See also remarks on the ITC Model Contract for an International Supply of Services (section 2.3(a)).
- A joint venture agreement will typically contain a description of the joint venture's business. As sharpening the scope of the business does not require a full document to be circulated each time, separating this into a one-page schedule may facilitate the discussions.
- Similarly, a joint venture agreement will normally contain a business plan for the collaboration. The business plan may be a PowerPoint presentation, or an Excel spreadsheet. A contract, however, should not contain spreadsheets or presentations.

(a) Drafting an international alliance agreement

Contractual alliance. The contractual alliance contract is a framework for an alliance or collaboration between two parties where no separate, jointly-owned corporate entity is created. The alliance is based solely on contractual arrangements between the parties.



Required tailoring. Each contractual alliance or collaboration is different, and the ITC Model Alliance Agreement provides a range of possibilities, depending on the purpose of the alliance. Of course, provisions that are not relevant to the particular alliance should be deleted. Moreover, if the context of the contemplated collaboration makes it desirable to provide for a different arrangement, then this different configuration should be negotiated or adopted. After all, contract law facilitates flexibility and autonomy for the parties to tailor their relationship.

Costs and benefits. The ITC Model Contract anticipates that the two parties will share pro rata in the costs of the alliance. It is important to establish explicitly what types of costs are to be shared, especially to the extent that this would require cash payments from the parties. If a party is to be paid for its work or other contribution, the basis for remuneration should be clearly established at the beginning or through the management committee. Appropriate compensation schemes can be time-based (i.e. per hour, day or month), fixed pricing (e.g. one lump sum compensation or divided into milestones), or a commission or a pro rata sharing of revenues (e.g. a percentage of turnover or net sales).

Organization and decision-making. The ITC Model Contract envisages the formation of a *management committee*, on which the two parties are jointly represented. In this regard, it may be appropriate in some cases to (i) spell out the authority of particular individuals or subcommittees, or (ii) ensure that certain “reserved matters” require unanimous decision. See also the related provisions in the ITC Model Contract for an International Corporate Joint Venture (Articles 6, 7 and 8). It is important that issues involving ownership, (strategic) business scope, non-compete and intellectual property rights remain subject to consensus (i.e. unanimity). If more parties are involved, these issues might be subject to a veto or qualified vote.

Defining party contributions. In the ITC Model Contract, Article 3 contemplates that each party will have areas of responsibility to contribute towards the success of the alliance. In some cases, these will be expressed in general terms and not involve formal legal commitment (see examples in Articles 3.3.1, 3.2.1 and 3.3.2). In other cases, specific legally-binding commitments will be appropriate. In larger or complex alliances, it is common to subdivide the agreements and the alliance agreement becomes an umbrella for adjacent (project) agreements. Article 3 would refer to those agreements, which are attached as a schedule. For example:

- Commitments related to promotion and sales of alliance products could be based on the ITC Model Contracts for an International Commercial Agency or International Distribution of Goods;
- Commitments to supply certain goods to the alliance (or to another party) can follow the format of the ITC Model Contract for the International Long-term Supply of Goods;
- The provision of services, the joint development of a ‘work’, a product or component can be inspired by the ITC Model Contract for the International Supply of Services;

Joint development. If the alliance is a joint development agreement, Article 4 (*joint projects*) is helpful. The organization established in Article 2 is attributed the authority to define and monitor the joint development work, and the parties commit to fund such joint projects. In many cases, it is indispensable to specify technical requirements, technical tolerances of results and external licences in a separate statement of work to be attached as a schedule, as well. If the joint activities include an exchange of staff or key personnel, Article 8 establishes a few safeguards.

Intellectual property rights (IPR). Article 6 sets out provisions for a relatively straightforward sharing of know-how and technical development. The ITC Model Contract provides a framework of key points. It envisages that specific IPR developed under the alliance will be jointly owned and that ‘going to market’ will require the consent of both parties. Clarity is important regarding rights after termination of the alliance. In many cases, more detailed licence agreements will be appropriate to cover the IPR arrangements, particularly where one party’s IPR is made available for use by the other party under the alliance.

Preferred supplier. In many cases, one of the parties is likely to be appointed a preferred supplier or distributor of products developed under the alliance. In such cases, Article 7 suggests an arrangement, which grants a first opportunity (or, alternatively, a *right of first refusal*) to one party to supply the other party, subject to price, specification, quality and delivery times being agreed and no less favourable than other potential and comparable suppliers. It must be noted that

preferred supplier arrangements may constitute an infringement of competition law in the countries where the party's suppliers are established or where the alliance will become operative.

Non-compete clause. Many alliances contain a clause restricting the parties' freedom to undertake activities competing with those of the alliance. This may take the form of a non-compete clause (see Article 10.1 of the ITC Model Contract), as well as a certain level of exclusivity of the cooperation (Article 10.2). Usually, the scope and duration of these clauses are heavily negotiated. It is therefore important to be accurate as to what is prohibited and what is permitted. It is common (and generally not subject to competition law restrictions) to provide for a non-solicitation clause as well: Article 10.3 prohibits the partners from enticing away each other's (key) employees.

The duration of such restrictions is often extended beyond the term of the alliance agreement. This prevents one party from opportunistically terminating the alliance when it appears that cooperating requires the efforts of a struggling marriage, but key skills or learning points of the other party seem replaceable. While a post-termination continuation of a non-compete is justifiable for the viability of an alliance, competition law also limits how long that continuation may last.

Duration. Establish the duration of the alliance. Most alliances are related to the term of a certain project. Once the project has been completed or when the results appear unachievable, the parties may either consider extending the scope of the initial project or separate. In the ITC Model Contract, Article 12 provides for the case where the alliance will continue indefinitely subject to a party's right to terminate – either unilaterally by giving notice or in specified circumstances. Alternatively, the alliance parties might agree on a specific term with subsequent renewal requiring mutual agreement.

One termination ground is particularly common for alliances and close co-operations: termination upon a 'change of control' over the other party. The reason behind it is based on the personal nature of cooperation and the mutual trust required in collaborations. This mutual trust would be diminished if the partner has been taken over by a competitor or if the commitment of the partner's management is in doubt following replacement of the people most directly involved.

Tax and liability implications. A contractual alliance does not usually involve the creation of a separate, profit-making business in which the parties share profits as well as costs. If the arrangements do involve income or profit-sharing, it is important to note the potential liabilities that might arise. An alliance might fiscally or legally be qualified as a 'partnership' that:

- triggers tax filing obligations and specific tax treatment; and
- entails the considerable risk if the alliance conducts business with third parties, in which case each party could become jointly liable to third parties for any claims arising out of the activities of either party in the alliance.

Formalized partnership status. If the venture does involve a separate profit-making business, this will normally require a more formal partnership agreement or the creation of a corporate joint venture. Such a formal partnership agreement can be based on the ITC Model Contract for an International Corporate Joint Venture (where the terms shareholder, director and JVC should be replaced, respectively, by the terms ‘partner’, ‘managing partner’ and ‘alliance’).

(b) Drafting a joint venture agreement (JVC to be incorporated)

When parties incorporate their alliance or cooperation into a legal entity (other than a general partnership), it is common to talk in terms of joint venture and refer to the legal entity as the joint venture company (JVC). The ITC Model Contract for an International Corporate Joint Venture provides a general framework for a joint venture that is to be jointly owned by two parties.⁶



⁶ If more complex arrangements are involved or a wider range of options is needed, consult the (long-form) ITC Model Contract for International Corporate Joint ventures.

(i) Establishment of the JVC

Equality or majority. The ITC Model Contract is designed for 50 /50 participation by two parties. Occasionally, for psychological, tax or accounting reasons, the parties may need to establish a 49/51 or 48/52 participation ratio. The ITC Model Contract can also be used for those cases. If there are more than two parties, or if one is to have an articulated majority share, the provisions will need to be adapted⁷. In multi-party joint ventures, the dynamics of JVC management, decision making, deadlock resolution and termination differ considerably.

The JVC business and business plan. Establishing a JVC requires a match of objectives among the parties, most importantly its financial and business aspects. Although mutual trust between the parties is an essential element for successful cooperation, it is crucial to align business aims and intentions as well. The parties should carefully determine the scope of the JVC. A few guidelines:

- identify the nature of the JVC's business, its commercial environment (e.g. internet-related, target groups), specific products or services, and production methods;
- identify what falls within the JVC's scope, perhaps by clearly identifying what is outside its scope (competitive business, competitors, excluded business);
- define the functionality of the JVC business and application of the joint venture production processes and products;
- identify the JVC's field of activities, which can be delimited geographically as well as by sector or industry;
- describe how synergetic effects are expected to be realised;
- understand how can or should the JVC develop or vary over time. Relevant factors may include targets reached, changes in market circumstances, discontinuance of any activities by the parties, and new technologies.

It is good practice to agree on a business plan at the outset. A business plan can take any form – from a PowerPoint presentation to a simple Excel sheet with forecasted sales projections. The business plan could be attached to (or at least identified in) the joint venture contract.

Conditions. In the context of a joint venture contract, certain 'conditions precedent' may need to be satisfied before the collaboration can actually be launched. Such conditions may include regulatory approvals (e.g. from competition authorities or other market supervisory bodies), the establishment of the JVC legal entity, or the grant of government subsidies (ITC Model Contract, Article 3).

Establishment of the JVC company. A corporate JVC must be formed in a particular jurisdiction. Usually, this will also determine the governing law of the joint venture contract. It will be necessary to prepare articles of association, bylaws or other constitutional documents in that jurisdiction, and these documents must be consistent with the joint venture contract. It is good practice to ensure that the joint venture contract includes key items as a matter of contract between the parties.

⁷ <http://www.intracen.org/itc/exporters/model-contracts/>

In other words, what is essential (or crucial) for each partner to apply within the JVC, or to be achieved by the collaboration (in terms of business or strategically) must be reflected in the contract.

If there are conditions to be satisfied, or if the JVC will be established after the joint venture contract is signed, a number of actions must be postponed. To avoid a renegotiation of terms, the key aspects of such actions should be agreed and listed in the contract. While the actual establishment of a JVC is called 'closing' or 'completion', such a list is often referred to as the 'closing agenda' (ITC Model Contract, Article 4).

(ii) Party contributions and management of the JVC

Contributions in kind. Many joint ventures involve a contribution by a party of assets, property, technology or services, or associated distributorship or supply arrangements. These will often require "ancillary contracts" to spell out detailed terms (e.g. price, specification, limitation of liability). In a simple joint venture, contributions 'in kind' can be included in the joint venture agreement (ITC Model Contract, Article 9). However, in most cases, it is more appropriate to provide for these in separate contracts and other ITC Model Contracts can be used for this purpose.

If a postponed closing or completion is planned, it is important to agree on the key items of such ancillary contracts at the time of signing the joint venture contract (and attach them in 'agreed form', see ITC Model Contract, Article 4.4). The JVC and the appropriate party or parties will then sign on the closing date.

Cash contributions. In many JVCs, each party makes an initial financial contribution to the capital of the JVC. The amount may differ per party – a large contribution in kind by one party can be balanced by additional cash from the other party. It is important to stipulate whether or not a party will have any subsequent obligation to provide further finance to the JVC. Article 5 envisages that any future finance requires mutual consent.

JVC management. Overall direction and management of the JVC is usually in the hands of the JVC board of directors – an executive team of representatives from each of the joint venture partners. They will manage any conflicting interests among the partners and ascertain that the partners do what they have agreed to do. They coordinate the parties' performance, represent their appointing party within the JVC, and manage the JVC (like a business unit of a company). This list of responsibilities makes it clear that the board of directors has a complex task.

Decision making. It is impossible (if even desirable) to foresee in advance and include in the joint venture contract everything that will eventually need to be settled. Nevertheless, it is important to clarify at the outset the balance of decision-making power. Decision making within a JVC affects the parties as shareholders, the board and the individual executives of the JVC. It is common to specify that certain "Reserved Matters" will require the mutual consent of the parties, either as shareholders or on the board.

The shareholders are not necessarily deciding business-related matters, but this is almost inevitably the case for actions or policies affecting:

- financial commitments and obligations of each party (including applicable accounting policies, especially if the JVC is consolidated in the accounts of one or both parties);
- creditworthiness of the JVC;
- shareholding percentage;
- freedom of a party to compete and the freedom of the JVC to enter new markets and territories;
- litigation (affecting the name or reputation of a party);
- key employee-related aspects; and
- JVC's freedom to merge, take over other companies, initiate reorganizations and to apply for insolvency proceedings.

(iii) Termination of the JVC

Overview. Most joint ventures will cease to exist within the first year of their existence. The main reasons include the incompatibility of the parties' organizations or operational functioning, differences in internal (decision-making) culture, a change of strategy by one of the parties, a material breach of contract or even a dispute regarding interpretation of contractual obligations. A sale by a party of its shares in the JVC can, under the ITC Model Contract, only be made with mutual consent.

A loss of mutual trust will typically lead to a deadlock in decision making. Therefore, it is appropriate not to include an exhaustive list of possible termination situations but simply to provide for 'deadlock' as a ground for termination. If a party wishes to bring the joint venture to an end, this usually requires mutual agreement. In the ITC Model Contract, Article 14.3 says that (after an amicable settlement attempt) a party can call for a winding up of the JVC in certain circumstances of breakdown or deadlock.

Russian roulette, Texas shoot-out etc. It is not uncommon to provide for an alternative termination mechanism. In many joint venture configurations, the sale of JVC shares to a third party or to only one of the parties is not acceptable. Sometimes, the parties may foresee which of the two would be the most appropriate buyer of the JVC shares. The key issue in such cases is the valuation of the shares at a reasonable price. The contract clauses providing for a valuation or mechanism to appoint the buyer have been given exotic names such as Russian roulette or Texas shoot-out. A brief description of three common mechanisms is given below.

1. Russian roulette (two-party JVC's). When it is uncertain who will buy out the other party, a common mechanism provides for an internal auction.⁸ Both parties should indicate whether they want to buy or sell, and at what price. If one party wants to sell and the other wants to buy, then the latter must buy at the price proposed by the former party.

⁸ This mechanism matches the auction principle developed by Nobel Prize winner William Vickrey.

If both parties want to sell, then the highest bidding party must buy at the lowest offered price (and vice versa in case of two willing buyers). The combination of these two outcomes embodies an implicit incentive for the willing seller to offer at an appropriate price (i.e. if it offers at a too high price, it would become the buyer; and there is no reason to anticipate an offer at a below-value price).

2. Texas shootout (multiparty JVC's). When it is uncertain who will buy out the other party, another common mechanism can be applied in a multi-party JVC. An independent person who will facilitate the process must propose a share price for the JVC. All parties will indicate whether they are willing to buy or sell at that price. The indicated sellers will sell at that price; if more than one party wants to buy, the process is repeated among the willing buyers at a bid price increased by 5 or 10 percent, until there is one buyer left. If at some point all the remaining willing buyers turn into willing sellers, the price is decreased by 1 percent (and goes down until there is one buyer). The prices to be paid by the buyer will be the prices at which the relevant seller was still willing to buy. If the first round provides only sellers, instead of increasing, the price will decrease by 5 or 10 percent (and if the reference price goes down each time, the mechanism works in the same manner).

3. One pre-appointed acquirer. If one particular party must eventually acquire all the shares, the bidding mechanisms described above do not work. Instead, the valuation must be more rigorous. A termination mechanism would require each of the parties to propose a valuation of the JVC shares (including a breakdown and explanation as to how the valuation has been calculated). If there is a difference between them, the parties will discuss both valuations and deviations. If after a period of 60 days (for example), no consensus is reached on the price, each party may require the appointment of an independent accountant, and it is therefore important that the joint venture agreement provides for an appointing authority in case the parties fail to agree on one person or firm. The appointed independent accountant will establish the price at which the prospected seller must sell, and the anticipated buyer must acquire. The mechanism might contain instructions about the valuation method (but in many cases, it is best not to include such instructions).

2.2 Sales and supply contracts

Among the most important ITC Model Contracts are the International Commercial Sale of Goods contract and the International Long-term Supply of Goods agreement. The former is designed for one-off sales contracts (i.e. a single sale transaction) and the latter establishes a framework for a continuous supply of goods.

(a) Drafting an international sale of goods agreement

This ITC Model Contract can be viewed as a general framework for numerous types of sales contracts in international trade. For implementation, the parties should adapt it to the nature of each particular sales contract as well as to the specific requirements of the applicable law, where such requirements exist.



Scope. The contract contains the substantive rules for an international sales contract, i.e. the main rights and obligations of the parties, the remedies for breach of contract by the buyer; the remedies for breach of contract by the seller; and general rules that apply equally to both parties. It also contains the standard or boilerplate clauses broadly accepted in international commercial contracts.

Structure. The contract is divided into four parts:

1. key obligations related to the goods – delivery term, price, payment conditions, and documents to be provided;
2. the remedies of the seller in case of non-payment at the agreed time, the remedies of the buyer in case of non-delivery of goods at the agreed time, lack of conformity of goods, transfer of property and defects;
3. avoidance (i.e. termination) of contract and damages: termination grounds, avoidance procedure, effects of avoidance, restitution, damages and mitigation of harm; and

4. standard (boilerplate) provisions – for more about these clauses, see the sections 4.3 (Change of circumstances), 4.4 (*Force majeure*), 4.8 (Miscellaneous (boilerplate) clauses), 4.9(a) (Applicable law), and 4.9(c) (Dispute resolution).

CISG-based. The ITC Model Contract is greatly influenced by the United Nations Convention on Contracts for the International Sale of Goods (CISG, also known as the ‘Vienna Convention’ of 1980), which is widely accepted by lawyers of different traditions and backgrounds. The contract articulates practical requirements arising from commercial practice within the general rules of the Vienna Convention – for the Vienna Convention see section 5.2.

Sale of perishable goods. The ITC Model Contract may not be suitable for the sale of perishable goods. Apart from the fact that perishable goods are often sold by reference to branch-established trading terms and conditions, such goods require a different and more concise conformity criterion, short periods of time for notifying non-compliance, and a specialized quality inspection procedure.

Short versus standard version. The ITC Model Contract is presented in two versions – a standard and short version. The standard version contains definitions of relevant notions (e.g. lack of conformity), special comments (e.g. on the notice of non-conformity), explanations and warnings to the parties (e.g. on the limitation of the seller’s liability or on the validity of the agreed interest clause). The short version is more practice-oriented, covering the main rights and obligations of the parties with no special explanations. In addition, the short version contains only selected boilerplate clauses, whereas the standard version provides all the relevant boilerplate clauses included in the other ITC Model Contracts.

Delivery terms (INCOTERMS⁹). Many cross-border sales transactions require transportation. Questions then arise as to which party should do what, who should bear the risk of the various means of transportation, who should arrange for insurance and for customs clearance. This introduces a wide range of possible combinations of responsibilities, but in practice the parties will seek a combination in which those risks and responsibilities match. Commonly used combinations are reflected in the Incoterms, contractual devices for delivery of goods. See section 5.3 for more information.

Payment conditions. In cross-border sales where the parties do not hand over the goods, payment also entails an allocation of risk. Banks play an important trade-facilitating role in such cases. The parties may opt for various payment mechanisms, each of which presents a different allocation of risks for non-compliance. The allocation of risk may also engage the bank or banks involved, which affects the cost of the payment mechanism. Common payment mechanisms, provided for in the ITC Model Contract, are:

- payment in advance: the buyer pays (part of) the purchase price into the seller’s bank account;

⁹ The Incoterms or International Commercial Terms are a series of pre-defined commercial terms published by the International Chamber of Commerce (ICC) relating to international commercial law. This topic is developed in detail in Chapter 5.3.

- documentary collection, involving documents against payment (D/P) or documents against acceptance (D/A): a simple mechanism and suitable if the buyer considers the seller to be a trustworthy party, and if the seller would probably be able to sell the delivered goods to third parties in case of fundamental breach;
- irrevocable documentary credit, pursuant to an L/C, under the UCP600: this mechanism provides optimum security for both parties;
- payment supported by a bank guarantee; or
- another specified payment mechanism (or combination of mechanisms).

Section 5.4 provides more information about each of these mechanisms.

Documents. When a party arranges for transportation, insurance or customs clearance, it receives documentary evidence. Those documents should be identified, and the desired contents may also be specified, in the sales contract. Article 5 of the ITC Model Contract serves as a stepping stone for such specifications. Even when a seller draws up a document alone they must not omit information required to be reflected in that document. This ensures that all documents contain the relevant information for all parties in the transportation and delivery chain. For example, the invoice may need to reflect the value-added tax (otherwise the buyer may not be able to reclaim the tax or apply for exemption), and levies charged in connection with exportation may be recoverable under international treaties. Furthermore, a bank engaged in an L/C payment will not verify if the goods are indeed the ones agreed in the contract, but it will investigate whether the certificate of origin, a certificate of inspection or a date of shipment are reflected in the way the parties agreed in the contract.

Types of commonly agreed documents are:

- commercial documents (e.g. invoice, packing list);
- shipping or transport documents (e.g. bill of lading (ocean, multi-modal or charter party), airway bill, lorry or truck receipt, railway receipt, forwarder cargo receipt);
- official documents (e.g. customs documents, import permits, export permits, license, embassy legalization, certificate of origin, certificate of inspection, phytosanitary certificate);
- financial documents (e.g. bill of exchange, co-accepted draft); and
- insurance documents (e.g. insurance policy or certificate).

Under a UCP600-governed L/C payment transaction, the standard of examination to be applied by a bank is elaborated in UCP600 articles 18 to 28. These articles provide, for example, that:

- the start date of an insurance policy must be no later than the date of shipment, unless it is clear that the insurance coverage is retroactive (Article 28(e));
- a bill of lading may be given any title (Article 20(a)) but must indicate, *inter alia*, the name of the vessel (Article 20(a)(ii)) and contain terms and conditions of carriage, even though the bank will not examine such terms and conditions (Article 20(a)(v));
- an invoice must be expressed in the currency of the L/C (Article 18(a)(iii)).

Late payment and charging interest. A seller would like to ensure that the buyer will pay its invoice in due time. Although the applicable law may provide for an entitlement to charge interest on late payments, it is psychologically stronger to be able to refer to precise contract terms stating that interest will accrue on late payments. Moreover, the statutory interest rate may be too low to justify collection proceedings in court.

In the ITC Model Contract, Article 6.2 provides for the seller's right to demand interest on late payments. However, it is important to note that an interest rate per day or per month will also be 'compounded' daily or monthly (resulting in interest over interest and hence in a rapidly increasing percentage per year). If this effect is excessive over a relatively short period of time, many courts are inclined to adjust (or even set aside) an exaggerated high interest rate. If the applicable law nullifies excessive interest rates, a court will also likely disregard a stipulation such as "unless the applicable law prohibits such interest rate, in which case the highest permitted rate will apply". The specified interest rate should at least cover the interest that the seller would pay if it had to borrow the same amount from a bank.

Penalty or liquidated damages for delayed delivery. The buyer may also wish to agree on a firm incentive for the seller to perform in a timely manner. Article 7.2 of the ITC Model Contract provides an option to include such an incentive in the form of a penalty or liquidated damages clause. To be valid and fully enforceable, the agreed amount of liquidated damages should roughly correspond to the damages likely to fall upon the buyer. As liquidated damages are estimated damages, the actual (exposure to) damages must be sufficiently uncertain at the time of contracting to warrant this option.

In common law contracts, the term 'penalty' should be avoided. As a matter of principle, courts will reject the concept of a penalty for non-performance, delay or inadequate performance; it will, however, permit a party's contractual entitlement to genuine estimate damages. In respect of such 'liquidated damages' clauses, and courts outside common law tend to take the same approach regarding a contractual penalty, a court will seek to achieve a fair result and therefore not enforce a term, with the penalty based on an estimate, that leads to an unjust enrichment of the enforcing party. The proper term under common law is liquidated damages and justified by clarifying that it is an incentive to perform duly and timely (and that the amount of the liquidated damages is an "accurate estimate of the damages" in case of undue or late performance).

Because a penalty or liquidated damages clause contains only an estimate, the actual damages suffered by the buyer may be much higher. However, under common law and in other jurisdictions, including a specified penalty excludes the right to claim actual damages (and in some jurisdictions, even the right to invoke other remedies). It is therefore important to add a phrase such as "without prejudice to the Buyer's right to claim damages" or similar wording.

Lack of conformity of goods. The ITC Model Contract adopts the CISG concept of lack of conformity. This concept is wider than the concept of material defects (traditionally adopted in civil law countries) and includes differences in quality, as well as differences in quantity, delivery of goods of different kinds, and defects in packing.

Nevertheless, specific cases of non-conformity defined under the Vienna Convention largely correspond to how material defects are defined in civil law countries. Such cases include unsuitability of the goods for their *ordinary purpose* or *for a particular purpose*, as well as non-conformity with a *sample or model* (see also sections 5.2(d) and 3.4(u)).

The liability of the seller for non-conformity under the Vienna Convention is dealt with almost identically under most national rules dealing with liability of the seller for material defects. Furthermore, in the Vienna Convention, ‘non-delivery’ and ‘lack of conformity’ are strictly separate forms of breach of contract. The same system is adopted in the ITC Model Contract, specifying special rules on the remedies of the buyer in case of non-delivery at the agreed time; special rules on the remedies of the buyer in case of non-conformity of goods; and general rules on avoidance due to non-performance of contractual obligations.

Expertise procedure. To mitigate the risk of lasting controversies about an alleged non-conformity in the quality of delivered goods, the parties could provide for an expertise procedure. This procedure prevents such controversies from becoming endless and ensures that one party will not engage a third-party expert whose expertise or independence may be questionable. Article 9 of the ITC Model Contract provides for this kind of expert procedure (see also section 4.9(c)(iv)).

Warranty disclaimer. Instead of the Model Contract’s Article 8 (lack of conformity), a seller may propose a limited warranty and complete disclaimer of any implied or express properties of the goods sold under the contract. An example of such a disclaimer is:

The Goods are provided ‘AS IS’ and the Seller makes no other warranties regarding the Goods. The Seller expressly disclaims all representations and warranties, express and implied, including any warranties of merchantability, fitness for a particular purpose and non-infringement of any third-party rights.

If this choice is made, the provision should replace Sections 8.1 to 8.3, in particular, in the Model Contract. Including this kind of disclaimer reduces to a minimum the scope and relevance of Sections 8.4 to 8.5.

Transfer of property. The ownership of goods transfers in accordance with the law applicable to the transfer of movable goods. In most jurisdictions, in the absence of express stipulations (e.g. a retention of title clause), ownership transfers when the seller ‘delivers’ the goods to the buyer because the risk transfers to the buyer. In cross-border sales transactions, this would be at the moment (and the place) determined by the agreed International Commercial Terms (INCOTERM) and may vary. See section 5.3 for more information.

Retention of title clause. A seller with some negotiating power will ensure that ownership of the delivered goods does not transfer to the buyer before the purchase price has been paid (see optional Article 10.1 of the ITC Model Contract). A transfer of ownership obviously reduces the seller’s right to reverse the sales transaction in case the buyer goes bankrupt or enters into suspension-of-payment proceedings. Ownership might also transfer by mixing the goods

delivered with other similar goods (e.g. if the sale concerns generic products such as bricks, steel bars, pencils, raw materials or components). Therefore, it is important to complement a retention of title clause with an obligation to keep the goods under contract separate from the buyer's other goods.

Avoidance (termination) of contract. The ITC Model Contract uses the term 'avoidance' of contract, also taken from the Vienna Convention, to mean contract termination. It adopts the Vienna Convention concept of fundamental breach of contract, but with significant modifications. First, the ITC Model Contract defines cases that constitute a breach of contract (where a party fails to perform any of its obligations under the contract, including defective, partial or late performance). Next, and on that basis, the ITC Model Contract establishes rules for two different situations:

- **Fundamental breach.** A breach of contract amounts to a 'fundamental breach' in cases where strict compliance of the obligation that has not been performed is of the essence under the contract, or where non-performance substantially deprives the aggrieved party of what it was reasonably entitled to expect. The ITC Model Contract allows the parties to specify cases that are to be considered as a fundamental breach (e.g. late payment, late delivery, non-conformity). In case of fundamental breach, the ITC Model Contract allows the aggrieved party to declare the contract void, without fixing an additional period of time to perform what is specified in the contract.
- **Other (material) breaches of contract.** In all other situations, where a breach of contract does not amount to a fundamental breach, the aggrieved party is obliged to fix an additional period of time for performance. Only when the other party fails to perform the obligation within that period, may the aggrieved party declare the contract void. The ITC Model Contract adopts the following CISG rule – a declaration of avoidance is effective only if made by giving notice to the other party.

'Material breach' as a reason for termination. Many contracts provide for a termination right in case of material breach. In this context, courts will give the term 'material' a meaning corresponding to 'significant from the perspective of the aggrieved party'. This implies an assessment as to whether the breach in question has a serious adverse effect on the party that has been deprived of performance or compliance with the contract. The assessment does not require such a breach to be fundamental, but the effect may well be the same.

Given that providing for an assessment leaves uncertainty about what kind of breach will be deemed material, it is worth considering whether to expressly identify the specific breaches that will give rise to a right to terminate (as opposed to generic wording that each delay in payment or delivery, or every non-compliance with specifications, is material).

Restitution. Once a sales contract is avoided (terminated), the parties' performances (if any) must be reversed. Given that the transaction crossed borders, there may be practical implications and additional costs to be incurred by either party. In the ITC Model Contract, Article 13 provides for restitution that can be adjusted to meet the particularities of the case.

Damages. Article 14 of the ITC Model Contract contains an elaborate arrangement for claiming damages in case of non-performance (which includes non-conformity of delivered goods). First, paragraph 14.1 states the general principle that, except for cases of *force majeure*, any non-performance entitles the aggrieved party to damages. Second, the damages eligible for compensation are limited to those reasonably foreseeable at the time of contracting ('which the breaching party ought to have foreseen'). In case of avoidance, such damages will be calculated by reference to the replacement costs of the contract goods, increased by any additional expenses incurred (paragraphs 14.2 to 14.5). This provision substantially reflects Articles 74 to 76 of the Vienna Convention.

Limitation of liability. The ITC Model Contract does limit the extent of liability by specifying the type of damages. The effect is that the buyer faces a discussion as to what 'ought to have been foreseen' by the seller. This eliminates opportunistic claims and, given the probable complex discussion of 'foreseeability', may discourage the buyer from submitting a claim (a phenomenon that is also called the 'nuisance value' of pursuing the claim into court with the related uncertainties).

In practice, the parties may seek more certainty. The seller will exclude its liability and the parties will negotiate a limitation that matches the circumstances. For a more detailed discussion of the dynamics of such negotiations, see section 4.6.

Mitigation of harm. In the ITC Model Contract, Article 15 expresses a general principle of law – even an aggrieved party must take such measures as may reasonably be expected in the circumstances to prevent that any damages or losses unnecessarily increase (also in CISG Article 77, and the same principle is expressed in UNIDROIT Principles Article 7.4.8.) The scope and extent of such measures must be proportionate to the harm suffered if the measures are not taken. Potentially, this may even require the aggrieved party to incur considerable costs. Those expenses are recoverable, however, as part of the damages.

Applicable law. Article 23 of the ITC Model Contract is specific to the international commercial sale of goods. It stipulates that questions not regulated by the contract itself are governed by the Vienna Convention; and questions not covered by the Vienna Convention are governed by the UNIDROIT Principles; and to the extent that such questions are not covered by the UNIDROIT Principles, they are governed by reference to the national law chosen by the parties. The parties may agree on rules that modify, replace or supplement those of the Vienna Convention or the chosen applicable law.

Regulatory framework. The main sources of uniform contract law that were used in drafting the ITC Model Contract are the:

- Vienna Convention (CISG);
- Uniform Law on the International Sale of Goods;
- UNIDROIT Principles;
- Principles of European Contract Law (PECL);¹⁰

¹⁰ Currently extended as the European Draft Common Frame of Reference (DCFR).

- ITC Model Contract for the International Commercial Sale of Perishable Goods;
- International Chamber of Commerce (ICC) Model International Sale Contract – Manufactured Goods Intended for Resale.

(b) Drafting a long-term supply agreement

If the parties enter into a continuous relationship for the supply of goods, it is helpful to reflect this in a long-term supply agreement. The ITC Model Contract on the International Long-term Supply of Goods¹¹ is intended for use in connection with manufactured goods, rather than commodities, which have their own special features and are often sold on standard forms provided by associations of producers or dealers. The Model Contract is not intended for use in cases where goods are supplied for resale by a distributor (for those cases, see the ITC Model Contract for the International Distribution of Goods).



Purpose. While a contract for a long-term supply of goods would mainly be a sales contract, the parties can focus on various relational elements to improve the quality of logistics, delivery and the goods themselves. The larger contracted sales volumes give the parties more freedom to tailor their relationship. The purpose of such a contract is not only to arrange for the sales-related aspects, but also to improve the supply relationship by providing for:

¹¹ <http://www.intracen.org/itc/exporters/model-contracts/>

- continuity of supply;
- logistical aspects of supply aimed at a shortened lead time (the time between order and delivery);
- improvement of product quality;
- continuity in product specifications (and a mechanism for changing product specifications in case of technical developments, a change in raw materials or other developments);
- flexibility in modifying the applicable Incoterm;
- fluctuations in purchase prices (including price developments related to raw materials or components);
- flexibility about payment (i.e. no costly L/C or other payment mechanism is required);
- a limitation of liability by reference to the (long) duration of the contract;
- permissible events of force majeure, tailored to the particularities.

How to decide which contract – supply or manufacturing. A supplier may or may not be the manufacturer of the goods under contract. If the manufacturing aspect is predominant, it is recommended to use the ITC Model International Contract Manufacture Agreement.

Change of specifications. In a long-term supply relationship, it is probably inevitable that each party should have a right to change the specifications of the goods. The customer may need such changes for its own products (which may be subject to change) or to meet the end-users' desire to buy a state-of-the-art product. The supplier may require flexibility because it might need to shift to other suppliers; cope with varying quality of raw materials or components; or want to cease old production methods or processes. In this ITC Model Contract, Articles 1.2 and 1.3 provide for a mechanism to change the product specifications, subject to reasonable notice and price adjustments. The parties may even agree on a product roadmap reflecting improvements to be made to the contracted goods.

Minimum volume commitment. The more volume (i.e. certainty) a customer can commit to in its estimated purchases, the higher a discount a supplier can offer. This is reflected in minimum purchase commitments (see the ITC Model Contract's optional Article 1.4). For large customers, such commitments effectively imply more exclusivity (and less opportunism) regarding the supplier that will be chosen. A long-term supply relationship allows the parties to alleviate any undesired effects of minimum volume commitments: circumstances of force majeure and shortfalls in any year can be compensated in subsequent years.

Framework-character and ordering. A long-term supply agreement is normally an umbrella agreement where the framework for ordering and delivering the goods is established in the contract, but actual deliveries are subject to a purchase order that must be accepted by the supplier. This mechanism does not reflect the contract formation procedure of the Vienna Convention (see Articles 14 to 24 about offers, counter-offers, modified-acceptance and similar negotiation stages). Rather, it is meant to ascertain that the customer is firm in its wish to purchase a certain quantity and quality of goods, to ensure that the supplier has received such an order, and to fix the moment in time as of which both parties are bound to a single delivery of goods. The (software) accounting and enterprise resource planning (ERP) systems work this way.

Forecasting product need. In cases involving complex products, a supplier needs to purchase raw materials and components, and manufacturing may depend on the availability of fine-tuned production lines. To optimize the production process for the supplier, and allow it to acquire raw materials or components at a discount, the ITC Model Contract contains a so-called forecasting mechanism. Every month, quarter or year, the customer is requested to submit a good faith estimate of its product requirement for the forthcoming periods, without being bound to actually purchase such estimated volume.

Inventory management and discontinuation of products. The advantage of a forecasting mechanism is that it enhances a supplier's ability to improve the product lead time – the time between receipt of a purchase order and delivery of the ordered goods. Although reflected weakly, the ITC Model Contract's Article 2.9 provides that the supplier will make commercially reasonable endeavours to meet its obligations (expeditiously). The same article provides for a discontinuation of goods if technological developments, decreasing order volumes or other efficiency-decreasing factors force a supplier to stop supplying a product. In such cases, the supplier must give written notice (allowing the customer to submit an 'end-of-life purchase order').

Intellectual property rights. If the contract triggers or involves the creation or divulgence of any intellectual property rights or know-how, it is strongly recommended that this issue be addressed in the agreement. By default, IP rights are owned by the creating party but if the creation was partly or entirely paid for by the other party, a reallocation of ownership or the grant of a licence may be necessary. Note that the ITC Model International Contract Manufacture Agreement serves a similar purpose but focuses on product and manufacturing process improvement. Various articles from that contract can be used in a long-term supply agreement.

Flexibility in pricing. A change of specifications or other circumstances may lead to an increase (or decrease) of purchase prices and may justify price adjustments. The ITC Model Contract provides for a few options (in Article 3.3 and 3.4) to adjust purchase prices following considerable cost-price increases. Obviously, the question of whether to include these clauses is typically subject to heavy negotiation, in connection with which objective standards would be introduced to protect the interests of the customer. One objective reference could be a national price index or other indicator of inflation. It is appropriate to provide for a minimum notice period and to subject any purchase price increase to a stipulated maximum. Any excessive price increase should entitle the customer to terminate the long-term supply agreement.

Mitigated exclusivity (price comparison of products). Contractual devices that can strengthen the customer's loyalty and order increased volumes for products include an exclusive purchase arrangement, a minimum purchase volume commitment, volume discounts and improved supply chain arrangements. However, such devices demand a certain freedom for the customer to benchmark the prices imposed by the supplier. In the ITC Model Contract, optional Article 3.5 provides the customer with a right to compare prices offered by competitors.

Warranties – no third-party rights. The supplier must deliver goods free from third-party ownership rights (reflected in the warranty in Article 5.1.1). But, consistent with the Vienna Convention (Article 42), the delivered goods should also not infringe the intellectual property

rights of third parties. This would make the goods useless for the customer. In various industries, it is virtually impossible to avoid all infringements (and fortunately, in those industry sectors, monitoring of infringements is often limited to successful products only). The parties may compromise by starting the warranty in Article 5.1.2 with the phrase “to the supplier’s knowledge after due and careful investigation” or, even less strictly, “to the supplier’s knowledge” (see also section 5.2(f)).

Limitation of liability. The ITC Model Contract for Long-term Supply Agreement does not contain an extensive limitation of liability for the supplier. Article 7 optionally excludes the supplier’s liability for any indirect, consequential losses or damages (but product liability-related claims resulting in death or personal injury are not excluded). In long-term relationships, a broader limitation of liability would be very appropriate (see section 4.6).

Duration. The ITC Model Contract also examines duration. As so many considerations could be taken into account, it is not possible to provide for all possibilities. Commonly, a contract of this type will cover several years, sometimes including the right of one party or both parties to terminate earlier either for convenience, breach of contract or insolvency of the other party. A maximum period may be imposed by applicable law, depending on circumstances (see Article 8). Also, a maximum duration of up to five years (with express, not automatic, extension) may be required by virtue of competition law (if the supplier or the customer is in a dominant market position with, indicative, a market share in excess of 30 percent).

Consequences of termination. In cases involving termination of a long-term supply agreement, both parties have an interest to provide for the period after termination. The supplier may want to dispose of excess inventory (or even raw materials, components and spare parts) while the customer may wish to avoid a situation where such goods are dumped by the supplier at market-deteriorating prices.

Miscellaneous provisions and no subcontracting. Standard provisions have been included in the ITC Model Contract, including change of circumstances (hardship) (Article 9), and *force majeure* (Article 10). Article 15 is worth mentioning separately. In a long-term supply agreement, the customer relies on a relationship with the supplier and will therefore prohibit that the supply, as agreed in the contract (whether or not it includes manufacturing), be subcontracted or (partly) delegated to third parties. For more elaborate discussion of these type of clauses, see Chapter 3.

General terms and conditions. In some cases, a long-term supply agreement is used in connection with the supplier’s standard terms of sale or with the customer’s standard terms of purchase. In cases where these do not exist or are not intended to apply, the ITC Model Contract includes a set of simple additional terms of supply (Schedule 4).

2.3 International provision of services

This section addresses two ITC Model Contracts for the provision of services:

- ITC Model Contract for an International Supply of Services.
- ITC Model Contract for the International Contract Manufacture Agreement.

Although manufacturing is often equivalent to the long-term supply of goods, the manufacture of goods may also constitute the provision of 'manufacturing services'.

Mixed types of contracts. If an arrangement between two parties has a mixed character – with elements of a sales transaction but also the provision of services – it is recommended to draw up a contract for the international sale of goods and copy-paste into it the relevant clauses addressing service-related aspects.

(a) Drafting a services agreement

The ITC Model Contract for the International Supply of Services¹² is a framework for the provision of services, in other words, an agreement under the terms of which a client requests that a service provider (the supplier) furnish certain services.

The type of service may vary widely, for example:

- advice (professional consultancy);
- storage (in a warehouse);
- transportation (although this is heavily regulated by law);
- construction work;
- processing (manufacturing) work;
- treatment;
- design;
- research or development services;
- headhunting (acquisition and selection of personnel);
- 'hands' (making personnel available, e.g. by way of secondment);
- brokering and commissioning services;
- mediation services.

Each type of service has its own particularities and requires its own specificities in a supply of services contract. It is important to consider what can go wrong and take preventative action by providing relevant obligations, incentives or remedies.

¹² <http://www.intracen.org/itc/exporters/model-contracts/>

Framework with tailored options. The ITC Model Contract is a general framework only and must be tailored to the circumstances of the particular collaboration. Like most of the ITC Model Contracts discussed in this handbook, this template provides a series of possibilities depending



on the background and the nature of the agreement. Many provisions may not be relevant to any one particular contract and should be deleted.

Change of specifications versus extra work. In Article 1.7, the Model Contract envisages that the client may give instructions, with details or specifications on how the services must be implemented. The provision is fairly simple and limited in scope. However, it is a contractual mechanism that distinguishes between instructions and amendments to specifications, which permits each party to propose and draft amendments that can be controlled by the customer.

In fixed-price projects and in projects where timely delivery is of the essence, this can create a grey area. Are the instructions given by the customer a change of the agreed specifications, or merely a specification within the agreed scope? In the former interpretation, the service provider is likely to charge the difference as 'extra work', but the latter interpretation would have no effect on the agreed service fees. To avoid uncertainty and prevent disputes, in complex fixed-price projects it is recommended that such instructions be given in writing and that the service provider be required to announce any price effects in excess of 10 percent before undertaking the related services.

Statement of Work (SOW). In large or complex projects, the desired results will be outlined in a project plan (also called Statement of Work or abbreviated, an 'SOW'). This is a somewhat technical document in which all aspects of the required services are spelled out in appropriate

detail. For example, high-tech engineering work requires that product quality and any possible permitted purity or contamination are specified, that tolerances for fitting components are listed, and that any uncertainties are identified. Such uncertainties are often expressed as an 'assumption'. For a customer, it is important that those uncertainties and assumptions are reduced as much as possible, as they are the step-up to price increases if the assumptions are incorrect or the uncertainties are expressed negatively.

Steering committee and project management. In most projects, the supply of services is monitored by a project manager. Large and complex projects will normally be managed by a project team (also called steering committee or project board) that includes each party's project manager. If this is the case, consider including a provision addressing the power and authority of the steering committee, e.g. are its members formally entitled to decide on behalf of the party they represent? Which modifications are they entitled to make on behalf of the parties? Article 2 (Payment of fees) is an example of a contract clause that could be used and the subsequent Articles then being renumbered accordingly.

Acceptance testing. A considerable source of disputes is the delivery and acceptance testing of (any milestones and) the results of the services. As with delivery and acceptance of goods, the supplier will be entitled to payment of the services fee (or any success fee or completion bonus) when it provides the services. The client needs to ensure that the deliverables are all in accordance with the agreement (as specified in the Statement of Work). For this purpose, the parties may provide for an acceptance testing procedure, e.g. within a certain period of time after timely delivery by the supplier, the client must test the deliverables and notify any deficiencies.

If the supplier takes responsibility for the deficiencies, it must repair them in due course, otherwise either party should be entitled to invoke expert consultation and engage an independent third person who will establish whether the supplier has indeed delivered according to the specifications or whether the notified deficiencies and other defects must be repaired.

Compensation. Compensation for services is commonly referred to as a services fee. Many services are agreed on a fixed-price basis, but most contracts establish a fee on a 'time and materials basis'. The customer pays on an hourly, daily, weekly or monthly basis and will be compensated for any materials used in relation to the services. Compensation for such materials can be subject to prior written approval or might be allowed if 'reasonable'. The parties are free to agree that the services fees be paid in instalments, for example 10 percent before commencement of the services, 60 percent upon delivery of the contracted results, and the remaining 30 percent after acceptance of the results.

Projects and milestones. Many projects are divided into milestones. It enables the parties to:

- tackle uncertainties and allow for go/no-go decision points;
- monitor progress and evaluate the service provider's performance levels;
- involve or dismiss subcontractors of different disciplines (for parts of the entire project);
- establish payment moments (i.e. upon completion and acceptance of a milestone); and
- facilitate the planning of the entire project.

If the parties wish to provide for milestones, the contract should be rephrased – services should be changed to “the services or any milestone”.

Professional (consultancy) services. Many small service agreements are agreed on a personal basis, with an independent professional or freelancer. The ITC Model Contract is well suited for such purposes. In these cases, consider adding a provision that “the contract is ‘personal’” and “the services shall be performed by Mr or Mrs XYZ”. Many tax authorities monitor these types of arrangements, as they are sometimes used by a client to avoid taxation or by a supplier who forgets to pay its wage taxes. In many countries, the tax legislation entitles the tax authorities to claim such wage taxes from the contractor, i.e. the client. In those cases, the following statements (to be inserted as Article 1.8) and indemnity (as Article 4.4) would be helpful:

1.8 **Independent.** The Supplier is a self-employed person and shall be responsible for all tax, national or health insurance and similar contributions in respect of the service fees payable under this contract to the appropriate tax authorities.

4.4 **Tax indemnity.** The Client shall not be liable in respect of any duty to pay wage or income tax, or employee insurance contributions (including any interest, penalties and costs) pursuant to the Services or the payment of any service fees. The Supplier shall, on first demand, unconditionally indemnify the Client in respect of any claim made or any alleged tax evasion in connection with the foregoing, as well as in respect of any additional tax assessments or tax or employee insurance claims for Supplier’s other services.

Materials belonging to the customer. If performance of the services is dependent on the prior delivery of any materials, components, or equipment from the customer, then the service provider cannot be expected to perform in a timely manner, unless such materials, components and equipment are delivered at the relevant time. It is recommended to include an obligation to this effect:

Supplier shall not be required to commence performance of the Services before receipt from the Client of the agreed (number of) materials, data and other information. In case of a delay in delivery, Supplier shall be entitled to postpone the delivery date according to the duration of such delay or to such later date as necessitated by its planning capabilities.

In the absence of such a clause, the contract (and the context in which the parties have been performing or failing to perform) must be interpreted by taking into account all the circumstances. This may protect the service provider, but it might also be required that the service provider give timely notice to the customer, if required, that it is awaiting a timely performance by the customer and that it is therefore postponing the performance of its own obligations.

Intellectual property rights. If the contract triggers or involves the creation or divulgence of any intellectual property rights or know-how, it is strongly recommended that this be addressed in the contract. By default, intellectual property rights are owned by the creating party, which is likely to be the supplier. If the creation was partly or entirely paid for by the other party (the client), a reallocation of ownership or the grant of a licence may be necessary.

Duration. As concerns the duration of performance, the ITC Model Contract provides for two main schemes (in Article 1.4). In the first option, the services must be provided on a specific date. In the alternative scheme, it is envisaged that the services will be provided on different dates and/or during a certain period of time.

Article 5 also deals with the duration of the contract and must be aligned with the scheme provided in Article 1.4. An additional option (not addressed in the ITC Model Contract) could be to give the contract a specific term with subsequent renewal requiring mutual agreement.

Damages and limitation of liability. As concerns damages (Article 4 in the ITC Model), the parties may wish to include the liability of the supplier for lost profit suffered by the client as a consequence of any breach by the supplier of its obligations under the contract. Article 4.3 should be amended accordingly.

(b) Drafting a manufacturing agreement

The following section presents the ITC Model Contract¹³ that provides a framework for an International Contract Manufacture Agreement. It is only a general framework and must be tailored to specific circumstances. The contract provides a series of options depending on the background and the nature of the production. Many provisions may not be relevant to a particular contract and should be deleted.

Manufacturing versus long-term supply. The set-up and outline of the manufacturing ITC Model Contract differ from the Model Contract for International Long-term Supply Agreement. Although the two ITC Model Contracts are very similar, in the long-term supply agreement the emphasis is on improvement of the product supply chain such as ordering, forecasting, quality assurance, adjustability of specifications and (some) flexibility of pricing. Furthermore, the long-term supply agreement can be used for non-manufacturing related purposes, as well. In the international manufacture agreement, the emphasis is on design and on improvement of the manufactured product and the manufacturing process. Both contracts enable the client to integrate the delivered goods into its own final products or services.

Manufacturing services versus supply (sales). The legal characterization of a manufacturing agreement requires an assessment. Does it entail a sale or supply of goods or is it effectively the provision of a service? Most manufacturing contracts are a mixture of both. When the manufacturer is primarily the party responsible for acquiring raw materials and components; and is also responsible for the adequate quality ('conformity') of those raw materials or components; then the manufacturer assumes the risks and obligations of a seller/supplier. However, if the *customer* procures the raw materials and components and only requires the final product to be compiled or manufactured, then manufacturing can be considered a service. Some legal systems

¹³ <http://www.intracen.org/itc/exporters/model-contracts/>

recognize that a manufacturing agreement may have a mixed character, leading to a differentiated approach regarding each party's rights and obligations.

Unless otherwise specified or agreed, the distinction between manufacturing as sales/supply versus manufacturing as a service can be made as follows:

Manufacturing as a service	Manufacturing as a sale
<ul style="list-style-type: none"> • Obligation to make best efforts. • The client is responsible for timely delivery of raw materials or components. • Prices for raw materials and components are for the risk and account of the customer. • The client is responsible for the conformity of raw materials and components. • IPR in the product is owned by the client. • Implied warranty of good and professional workmanship. • No great level of uniformity in applicable laws worldwide. 	<ul style="list-style-type: none"> • Obligation to deliver a result. • The manufacturer is responsible for timely ordering of raw materials or components. • Prices for raw materials and components are for the risk and account of the manufacturer. • The manufacturer is responsible for the conformity of raw materials and components. • IPR in the product is owned by (or licensed to) the manufacturer. • Implied warranties of fitness for ordinary purpose and conformity. • (Potentially) the Vienna Convention applies.

Toll manufacturing. In practice, a manufacturing services arrangement (i.e. where the service element predominates) is sometimes also referred to as 'toll manufacturing'. Although tolling is a term of art in several industries, across industries there is no common understanding as to what this term actually means.

Interchangeability of contract clauses. Despite the different focus mentioned above in the long-term supply agreement (ordering, lead-time and logistics optimization) as compared to the manufacturing agreement (joint product or production process improvement with emphasis on IP rights), several contract clauses are interchangeable between the two models. The following clauses from the Model Contract for International Long-term Supply Agreement can be copy-pasted into the Model Contract for International Contract Manufacture Agreement:

- ordering and forecasting (Article 2):
 - order acceptance
 - changes to orders
 - flexible Incoterm choice
 - import/export clearance;
- price flexibility and volume discounts (Articles 3.2.2 to 3.4).

The following clauses from the Model Contract for International Distribution of Goods can be copy-pasted into the ITC Model Contract for International Contract Manufacture Agreement:¹⁴

- exclusive, sole or non-exclusive appointment restricting the use of certain developed technology (or the supply of certain manufactured goods) to a:
 - territory
 - market segment;
- training and support (Article 8);
- retention of title (§ 4 of Schedule 4).



Goods on loan. Many manufacturing agreements require specialized equipment or tooling to be used during the manufacturing process. The Model Contract provides for the case that such equipment or tooling is made available by the client to the manufacturer. In such cases, the client will require a higher level of skill and care with the treatment of its equipment or tooling. This possibility of 'goods on loan' is provided for in Article 1.5.

Provision of know-how and responsibility for technology. The Model Contract provides for a basic scheme founded on the assumption that the manufacturer is fully equipped and has the technology to produce conforming goods, in its position as most specialized party. But the Model Contract also provides optionally for cases where the client must transfer parts of its own technology to the manufacturer to enable it to finalize the products (Article 1.4).

¹⁴ The term Supplier must be changed to Manufacturer; and the term Distributor to Client.

Samples and models. In addition, the Contract covers the situation where the parties have agreed that the manufacturer shall submit samples before mass production is launched (Article 1.6).

Quality assurance. The desired level of quality for the goods produced by the manufacturer is ensured in several ways. First, the manufacturer must warrant that the goods comply with the warranties stipulated in Article 4.1 of the ITC Model Contract (compliance to the written specifications of Schedule 1 – free from defects in design, workmanship and materials; and compliance with applicable laws and regulations) during a warranty period to be agreed under Article 4.1.2. Second, the client is given the right to audit the premises of the manufacturer, its permitted subcontractors and its storage warehouses (Article 4.3). Third, the manufacturer undertakes to indemnify the client against third-party claims (Article 4.4).

Intellectual property. Articles 1.4, 5 and 6 of the ITC Model Contract deal with issues related to intellectual property. It is assumed that the relevant intellectual property rights are properly protected by appropriate registration. Moreover, Article 9 imposes a duty of confidentiality upon both parties, which should provide additional protection, particularly if know-how is communicated by one party to the other. It is best to verify that the regime for improvements set out in Article 6 is acceptable in view of any applicable competition (antitrust) law.

If the contract triggers or involves the creation or divulgence of any intellectual property rights or know-how, it is strongly recommended that this be addressed in the contract. By default, intellectual property rights are owned by the creating party and this is often the manufacturer. If the creation was partly or entirely paid for by the other party (the client), a reallocation of ownership or the grant of a licence is necessary.

Cooperation on improvements. In long-term relationships (such as manufacturing contracts) the parties will evaluate each other's performance on a regular basis – depending on the type of goods – annually, quarterly or monthly. The evaluation includes the improvement of the goods (i.e. a product roadmap) and the efficiency or effectiveness of the manufacturing process. In the ITC Model Contract, Article 6.4 provides that (IP rights in) further improvements will be owned by the client. This is because, most often, such improvements will be driven by the efforts of the client. Also, when a client sources its goods from various manufacturers worldwide, all the manufacturers benefit from improvements achieved by any manufacturers engaged by their client.

Duration. For manufacturing, the parties may establish a contract of long duration. The effect may be that each party must consider the other party's reasonable interests. Furthermore, a party cannot freely terminate a contract of long duration without an appropriate termination notice period, especially if the terminated party has made client-specific investments in its equipment and production installations, and the terminating party was aware of these client-specific investments. In such cases, the client can be liable for compensating (the remaining economic value of) the investments. It is therefore important to establish the duration of the agreement (Article 7.1). Another common option (not addressed in the Model Contract) could be to give the contract a specific term with subsequent renewal requiring mutual agreement. Note, however,

that if the manufacturer or the client has a dominant market position, this kind of automatic extension may not exceed five years, in the aggregate.

2.4 The sales channel: distributorships and (commercial) agents

This section describes the contractual aspects for the sales or distribution channel of a company. In addition to the company's own sales activities, it may engage a commercial agent or sell to a distributor, to increase its turnover.

Rationale. One of the main reasons to appoint a distributor or agent is that the supplier is unable to carry out distribution or sales in a particular territory alone or is unwilling to invest in the infrastructure required for distribution. The supplier will wish to be assured that the sales and distribution of the goods will be undertaken in an efficient and vigorous manner.

Agency versus distributorship. It is extremely important to distinguish between a (commercial) agency and a distributorship. A commercial agent is a representative of its principal (who sells to the customers found by the agent), whereas a distributor buys the goods from the supplier and resells them (for the risk and at the account of the distributor itself) to its customers (who are often also the end-users).

Differences between commercial agencies and distributorships

Commercial agency

- An agent does not buy or sell.
- An agent acts for risk of principal.
- A termination indemnity is based on the volume of generated business and goodwill.

Distributorship

- A distributor buys and resells.
- A distributor is a sales channel for the supplier.
- Termination is free, unless the distributor made investments in reasonable reliance on continuation.

Similarities between commercial agencies and distributorships

Commercial agency	Distributorship
<ul style="list-style-type: none"> • An agency is a sales channel for the supplier. • An agency can be exclusive, sole or non-exclusive. • An agency must follow the instructions of the principal (legal duty, contractually reconfirmed). • An agency must use advertisement materials as indicated by the principal. 	<ul style="list-style-type: none"> • A distributorship is a sales channel for the supplier. • A distributorship can be exclusive, sole or non-exclusive. • A distributor must (or should) follow certain instructions of the principal (contractual basis). • A distributor should use advertisement materials as indicated by the principal.

Appointment for a territory or market. The appointment of an agency or distributor is usually limited to a certain geographical area (i.e. a country or part of a country), a specific market segment (e.g. supermarkets, fitness centres, swimming pools, shopping malls, petrol stations), or a type of promotion or customer channel (e.g. general consumers, television broadcasting, printed magazines, luxury brand shops). Note that from a competition (antitrust) law perspective, it is not permitted to restrict a distributor from selling passively to customers from outside the appointed territory, and it is also not permitted to forbid a distributor to sell through the internet.

The principal's key customers. It is important to note that the principal/supplier may wish to exclude certain key customers which have their main place of business outside the territory from the scope granted to the agent or distributor. In commercial agency contracts especially, it is possible that the principal does not want the agent to conduct sales activities with (affiliated companies of) key customers (and become entitled to commission). This is because decisions to buy from a supplier are often made at the corporate (holding) level and it would be inappropriate to reward sales made locally (i.e. pay commission to the agent because, incidentally, the formal buying entity was in its territory).

Exclusivity of appointment. An agent or a distributor will be appointed exclusively, non-exclusively or as sole representative for the principal/supplier. Exclusive means that neither the principal/supplier nor a competitor of the agent/distributor is entitled to be appointed and conduct sales activities in the agreed territory, market segment and customer channel. The distributor or agent will usually seek assurances that its efforts will be protected in some way, possibly by being appointed as the sole or the exclusive distributor, in a given territory. Conversely, a supplier may wish to ensure that the distributor's efforts are concentrated in only the granted territory (Article 1).

Sole appointment. If the appointment concerns a 'sole' agency or distributorship, the principal/supplier may not appoint another agent or distributor for the same territory, market segment or customer channel. Nonetheless, the principal/supplier itself remains entitled to sell into that area. In other words, the appointed agent or distributor will be the only sole agent or distributor for that area but will be operating alongside the principal/supplier.

Important incompatibilities. Both exclusive and non-exclusive arrangements may severely restrict the freedom of the principal or supplier in undertaking sales activities or appointing potentially more successful agents or distributors because:

- The appointment of an *exclusive* distributor for a certain market segment prohibits the subsequent appointment of a *non-exclusive* distributor in the same territory for a broader market;
- The appointment of a *non-exclusive* agency for a certain territory prohibits the subsequent appointment of an exclusive agent in that same territory (even though the former is not de facto active in the market segment or customer channel covered by the latter). In such cases, the second appointment must contain a carve-out permitting the agent appointed first to continue its activities;
- If an agent is appointed with an *exclusivity* arrangement for a term of five years and the agent does not generate any sales, the territory and market segment for which the agent is appointed will effectively be blocked for alternative sales efforts during that period of five years.

Interchangeability of contract clauses. Some clauses in the ITC Model Contract for International Distribution of Goods¹⁵ can be used in the ITC Model Contract for an International Commercial Agency, and vice versa. The following articles can be copied from the ITC Model Contracts¹⁶:

- Article 7 (actions to be taken by the distributor);
- Article 8 (support and training); and
- Article 9 (intellectual property rights).

Conversely, you might want to use the following agency clauses in a distribution contract:¹⁷

- Article 4 (minimum orders); and
- Article 5 (advertising, fairs and exhibitions).

(a) Drafting a distribution agreement

What does a distributor do? It buys goods from a supplier and sells them (for its own risk and account) to its customers in a certain territory, market segment or customer channel. Its customers may be companies who use the goods in their own products, and they may also be retailers (e.g. shopping malls, supermarkets).

¹⁵ <http://www.intracen.org/itc/exporters/model-contracts/>

¹⁶ The term Distributor must be changed to Agent; and the term Supplier to Principal.

¹⁷ The term Agent must be changed to Distributor; and the term Principal to Supplier.

The supplier sells on the terms and conditions of the international distribution of goods contract, and the distributor resells to its customers or to consumers based on – in principle – the general terms and conditions that should be attached to the distribution contract (listed in Schedule 4), applicable by virtue of Article 2.5.



If there is a gap with the terms and conditions invoked by the distributor, this is at the risk of the distributor or, if the supplier is an original equipment manufacturer (OEM), the reputation of the supplier is at risk.

Exclusive distributorship mitigated. If the distributor persists in becoming the exclusive distributor and the supplier nonetheless wishes to undertake independent sales activities, the parties might compromise on a commission to be paid by the supplier to the distributor on all net sales realised by the supplier in that territory (see Article 1.4 in the Model Contract).

Framework-character and ordering. A distribution agreement provides a structural framework for ordering and delivering the goods under contract to the distributor. As in the long-term supply agreement, actual deliveries are subject to a purchase order that must be accepted by the supplier. This mechanism is meant to ensure that the distributor is firm in its wish to purchase a certain quantity and quality of goods and that the supplier has received the order. It also stipulates the moment in time as of which both parties are bound to a single delivery of goods.

Forecasting. Especially in cases involving complex products, a supplier needs to purchase raw materials and components. Also, the manufacturing of a certain product may depend on the availability of (fine-tuned) production lines. For those purposes, to optimise the production

process for the supplier (and allow it to acquire such raw materials or components at a discount), the ITC Model Contract contains a so-called 'forecasting mechanism'. For a lawyer, a forecasting mechanism is a strange animal: every month, quarter or year, the customer is requested to submit a good faith estimate of its product requirement for the forthcoming periods, without being bound to actually purchase the estimated volume.

Inventory management and discontinuation of products. The advantage of a forecasting mechanism is that it enhances a supplier's ability to improve the product lead time – the time it requires between receipt of a purchase order and the actual delivery of the ordered goods. Although reflected weakly, the ITC Model Contract's Article 2.9 provides that the supplier will use its commercially reasonable endeavours to meet its obligations (expeditiously). The same Article provides for a discontinuation of goods: technological developments, decreasing order volumes or other efficiency-decreasing factors may force a supplier to stop supplying a product. In such cases, the supplier must give written notice (allowing the customer to submit an 'end-of-life purchase order').

Competition law restraints. A supplier or manufacturer should not set the resale prices charged by the distributor. However, it may be possible to give *non-binding* price recommendations for the resale prices of branded products, if no direct or indirect pressure is exercised, no incentive is offered to enforce these recommendations and provided that there is no market dominance. Similarly, the supplier may not impose maximum resale prices and should mark all statements regarding resale prices as 'recommended resale prices'.

Web shops and internet sales. The increasing importance of electronic commerce is a further aspect of distribution that needs to be dealt with in the contract. The ITC Model Contracts provide for it as follows:

The Distributor shall not sell the Goods through any mail order or similar system, or via the Internet or any other electronic means, to customers either in or outside the Territory.

It is important to note that in many legal systems a complete restriction on sales through the Internet or otherwise may not be lawful. Therefore, a more appropriate restriction on web shops and internet sales is proposed as well:

The Distributor shall be entitled to resell the Goods via the Internet, e-mail or any other electronic means, provided that any website, e-mail or other electronic means used for this purpose is not specifically targeted at customers outside the Territory.

What sales activities? A supplier will often wish to ascertain that sales activities undertaken by a distributor correspond to a certain extent to those undertaken elsewhere for the same brand and goods. It may be important to be specific about the particular sales efforts, the dissemination of advertisement materials and provision of after-sales services, because these can be important aspects affecting the customers and end-users' perception of the goods. In the ITC Model Contract, Article 7 deals with the central issue of how the goods are to be distributed and what

level of effort will be required. Article 8 specifies the support and training to be given by the supplier.

Intellectual property rights. Frequently the goods to be distributed will be protected by various forms of IPR, particularly trademarks, that the distributor will need to use during marketing and distribution. These rights are dealt with in Article 9 of the ITC Model Contract.

Miscellaneous clauses. The remaining provisions of the distribution contract are similar to those given in the ITC Model Contract on International Long-term Supply Agreement, except for Article 13 which focuses on the consequences of termination, in terms of the repurchase of stock and related matters.

(b) Drafting a (commercial) agency agreement

The ITC Model Contract for an International Commercial Agency is intended for use in connection with the introduction, promotion, negotiation and conclusion of sales of products or services by an independent agent on behalf of a principal, within a defined territory or market. One of the main reasons to appoint an agent is that the principal is unable to carry out by itself the introduction, promotion, negotiation and conclusion of sales of products or services in that particular territory or market or is not prepared to make the necessary investments required.

Main characteristic. In a commercial agency contract, the principal appoints an agent for a certain territory, market segment or product or customer channel. The agent will conduct business development work, market the principal's goods and facilitate a sales contract with the principal. When a sales contract is facilitated by an agent, it is not the agent who enters into the contract with the customer, it is the principal (represented by the agent) who enters into the sales contract with the customer.

The commercial agent may be a physical person or a company. If the agent is a physical person, under no circumstances can they be considered as an employee of the principal. When an agency contract applies to products, the principal may or may not be the manufacturer of these products. The principal may instead be a distributor, for example.

Activities on behalf of the principal. Although the sales contract is clearly between the principal and the customer, sometimes (but not always) the principal requires that its agent:

- negotiates and signs the sales contract on behalf of the principal;
- takes care of any delivery and installation work;
- collects the purchase price on behalf of the principal; and
- takes care of various kinds of after-sales servicing (including complaints handling).

In such cases, the agent may seem like an employee of the principal, in how they act and as they represent the principal.



Exclusivity. As with distribution contracts, the commercial agency contract may provide that a self-employed agent shall have sole, or exclusive, or sole and exclusive trading rights in a particular territory (ITC Model Contract, Article 1). In this context, the character of the agency is territorial, not personal. The parties may wish to limit the scope of the agency contract to certain categories of customers.

Commission. The agent is normally paid commission on all sales emanating from their territory, whether procured by efforts of their own or of others. The commission is usually based on the price of the goods sold by or through them, sometimes augmented by bonuses or commissions.

Several points require particular attention and should be dealt with in the contract in precise terms, as follows.

Minimum volume commitment. The more volume (i.e. certainty) a customer can commit to in its estimated purchases, the higher a discount a supplier can offer. This is reflected in minimum purchase commitments (see the ITC Model Contract's optional Article 1.4). For large customers, such commitments effectively imply more exclusivity (and less opportunism) regarding the supplier that will be chosen. The long-term character of a supply relationship allows the parties to alleviate any undesired effects of minimum volume commitments: circumstances of force majeure and shortfalls in any year can be compensated in subsequent years.

Commission on orders received directly by the principal. The agent is entitled to commission if the transaction is the direct result of its efforts. The agent cannot claim commission if a customer places an unsolicited order with the principal, or if the order has been obtained by the principal or other agents. These rules are frequently modified by contract parties or a custom of the trade, which may provide that the agent shall be entitled to commission on all transactions emanating from its territory. That arrangement is particularly frequent when an agent is appointed as an exclusive agent for a defined territory.

Repeat orders. Parties often arrange that commission shall be payable on repeat orders. If parties fail to make an express provision on this point, the principle that applies is that if the first order was the result of the agent's efforts, the agent is entitled to commission on repeat orders (because they must be considered as the continued effect of his or her original efforts). It is irrelevant whether these repeat orders are placed with the agent or with the principal directly.

Reimbursement of the agent for expenses. The self-employed sales agent who solicits orders for an exporter cannot claim its trading expenses from the principal, unless this was expressly agreed upon in the contract. If the agent, with the approval of the principal, incurs liabilities in the courts of the country where the customer resides, it is entitled to be indemnified for any losses sustained or liabilities incurred.

Web shops and internet-sales. The increasing importance of electronic commerce is a further aspect of distribution that needs to be dealt with in the contract (see the ITC Model Contract Article 6). The ITC Model Contracts provide for it as follows:

The Agent is not authorized to advertise or promote the sale of the products or its activity as Agent of the Principal on Internet without the Principal's prior written approval.

Although a principal may restrict the agent's freedom to sell through the internet, a more permissive provision on web shops and internet sales could be inspired by the one proposed for distributorships:

The Agent shall be entitled to advertise and promote the Goods via the Internet, e-mail or any other electronic means, provided that any website, e-mail or other electronic means used for this purpose is not specifically targeted at customers outside the Territory.

Del credere agency. In a *del credere* agency, the agent will be responsible for assessing the creditworthiness of the customer and payment of the sales price. A *del credere* agent can be held liable for non-payment, depending on the contract, for amounts up to the:

- sales price;
- commission; or
- part of the commission.

Termination and payment of goodwill. The agent's strength lies in its contacts with customers, and its weakness derives from the fact that its customers 'belong to' the principal. This explains

why, in many countries including the EU Member States, public policy laws work to protect the agent's rights, especially upon the termination of the contract.

Applicable law (and local mandatory law). The parties are subject to mandatory legal provisions of public policy that may apply, regardless of the applicable law chosen by the parties. Thus, an agent may need a level of protection similar in scope and nature as that granted to an employee. Such provisions are binding, meaning that the parties cannot ignore or decide not to apply them. These provisions may restrict the validity of certain provisions in the contract and may allow a court to reduce or extend the obligations of the parties. Before any discussion takes place between the parties, it is therefore strongly recommended to check whether the foreseen agency contract will be affected by such laws.

Quick overview of obligations. The main purpose of a commercial agency contract is to establish the level of each party's obligations towards the other, such as the authority of the agent to commit the principal (Article 2.2), to receive payments on their behalf (Article 2.3), the obligation for the principal to accept the orders transmitted by the agent (Articles 3.4 and 3.5), the information that the principal should pass on to the agent, such as the minimum overall orders, any change in the range of products or services, price, etc. (Articles 3.3 and 3.7), minimum orders (Article 4), advertising, fairs and exhibitions (Article 5), internet sales (Article 6), non-competition (Article 7), trademarks and property rights (Article 9), exclusivity (Article 10), commissions (Articles 11 and 12), consequences on termination (Articles 14 and 15), and assignment and appointment of sub-agents (Article 19).

Detailed description of the agent's duties. If the agent is an individual or a small company that is not necessarily involved in the granted market fully or on a daily basis, it is common to include a detailed list of activities that the principal expects the agent to undertake.

Miscellaneous clauses. Standard provisions have been incorporated into the ITC Model Contract, including the financial responsibility of the agent (optional Article 13), *force majeure* – excuse for non-performance (Article 16) and change of circumstances (hardship) (Article 17).

2.5 Using trademark licence agreements

A trademark licence agreement is for the licensing of a trademark used in connection with certain products. A trademark may be any distinctive, identifying wordmark, symbol, logo or other indicator of a product or service.

As with most ITC Model Contracts, the Model Contract for a Trademark Licence Agreement¹⁸ provides a series of optional possibilities depending on the background and nature of the

¹⁸ For more information: <http://www.intracen.org/>

trademark licence. Many provisions may not be relevant to a particular contract and should therefore not be included.

Scope of the licence. The trademark licence agreement grants the licensee a right to use the trademark on certain products and to *manufacture, promote, import, distribute and sell* such products in an agreed *territory* or *market* segment (or a market segment within an agreed territory).

- **Sub-licences and exhaustion.** Although the licence may exclude the right to grant sub-licences, if the licensee is the seller of the products carrying the trademark, a right to sub-license for such purpose is unnecessary as upon the sale and delivery of the product, the trademark protection is ‘exhausted’. This means that further resale of the products is not considered infringements on the trademark. It is therefore important to be clear, precise and specific about the scope of sub-licensing rights.
- **Sub-licences to affiliates and subcontractors.** The licence may be extended to companies affiliated with the licensee, as well as suppliers (of components or spare parts) of the product, or subcontractors (e.g. responsible for assembling the product for the licensee). The Model Contract contains a number of options to ensure that the scope of sub-licences is not unnecessarily broad.
- **Exclusivity.** The granted licence can be non-exclusive, sole or exclusive (with regards to the territory and market segment). Non-exclusivity means that other persons may be granted a licence as well. A sole licence is where the licensor itself is entitled to use the trademark within the agreed territory or market, next to the licensee. Exclusivity means that also the licensor is **not** entitled to use the trademark for the agreed products in the agreed territory and market segment.

Trademarked products versus services. The trademark licence agreement is written for a trademark used in relation to a product. For services provided under a trademark, references to the ‘Product’ must be replaced by the word ‘Service’ in the Model Contract. Certain provisions typically related to products, product manufacturing, testing or product modifications may be redundant. Instead, it would be desirable to specify the quality and the way in which licensed services are to be performed.

Royalties. Although the Model Contract may be royalty-free or fully paid-up (in which case the articles on royalties and payment can be limited or deleted altogether), most licences provide for a recurring licence fee in the form of a royalty. The Model Contract contains a framework for this.

Usually, the royalty (or licence fee) is linked to the volume of products sold after deducting certain costs which are unrelated to the relevant sale. Sales to affiliated companies, so-called ‘captive sales’, should be excluded (but the sales by those affiliated companies to third parties must be included). Also, the effect of taxes, import duties and other levies should be excluded.

Brand manual and trademark use guidelines. It is important that a trademark owner continuously uses the trademark and is vigilant concerning possible infringements, misuse or genericising signals. One powerful instrument to achieve this is by adopting the trademark

owner's brand manual or trademark use guidelines – a set of detailed instructions as to how and where on the product the trademark must be printed or presented; what type of advertisement materials are permissible; which photographs must be used; what the surrounding style, class or ambience any communication must include; which particular colours, typefaces (fonts) and shapes must be used; and which quality requirements apply to packaging materials or materials on which the trademark is permitted to be printed.

A trademark licence agreement should include the requirement of strict compliance with the brand manual or trademark use guidelines. The agreement could attach the manual or guidelines as an annex (and permit updates from time to time), refer to a website from which the manual or guidelines can be retrieved, or require the licensor's approval of any product or material before it is produced.

The licensee should comply with future changes of the manual or guidelines, at least within a reasonably short period of time. Obviously, as long as the trademark is being 'developed', requiring prior approval for any type of use (i.e. design of merchandising, advertising materials and other communication means) is probably the only practicable way to ensure consistent, distinctive trademark development.

Benefit. A trademark licensor should ensure that 'use' of the trademark 'inures' to the benefit of the owner. If that would not be the case, a licensee who is the only party using the licensed trademark in a territory would (e.g. after five years of being licensed) be able to terminate the licence agreement and prohibit the *licensor* to use the trademark because it had not used the trademark for five years and that conversely, the licensee should be treated as the trademark owner in that territory because it had used it. Although this seems absurd, the general principle is that the party claiming the infringement should *use* the trademark. Therefore, in many countries, including all EU member states, use of the trademark by a licensee (or with the consent of the trademark owner) is deemed to constitute 'use' by the trademark owner. It is helpful to express this in the trademark licence agreement.

The designations TM and ®. Generally, it is not necessary to highlight a trademark by the superscripted letters TM (for non-registered trademarks) or the sign ® (for registered trademarks). The background of this is that some jurisdictions used these designations to distinguish between intentional (or wilful) and unconscious use of a trademark. In those jurisdictions, if the copied trademark is marked by a designation TM or ®, intent on the part of the infringer would be presumed. In that case, the trademark owner would not need to give a prior warning or notice of infringement before it takes action against the infringement. Case law has developed in a less formalistic and a more internationally uniform direction, such that a court will decide on intent with regard to infringement based on the factual circumstances.

Antitrust considerations. Competition (antitrust) laws may considerably restrict a licensor's freedom to control or influence a licensee. Such restrictions apply in particular to the pricing of the products sold under the trademark. Furthermore, competition law may set aside a contractual limitation of the licensee's freedom to challenge the validity of the trademark or nullify a

contractual prohibition of the licensee's ability to market, sell and deliver products to customers (immediately) outside the agreed territory.

Infringement of trademarks. A party using a trademark without a licence might well infringe the trademark. Whether or not there is an infringement, however, is not always clear. The allegedly infringing products may be sold in a different (or merely adjacent) market or the allegedly infringing products might be remotely similar. Relevant criterion is whether the allegedly infringing product or service causes *confusion* of the targeted buyers.

In assessing an alleged infringement, a court will consider:

- strength of the trademark;
- proximity of the products or services;
- whether the trademark is not identical or the further similarity of the trademarks;
- evidence of actual confusion;
- product markets and marketing channels used;
- type of products and the degree of care likely to be exercised by the consumer (or professional buyer), purchaser sophistication;
- the (alleged) infringer's intent in selecting the mark; and
- likelihood of expansion of either party's product line.

Licences and infringement. A trademark licensor will typically require that the licensee promptly notifies it of any infringement which comes to its attention. The reasons for this include (a) the licensor might not immediately be aware of infringements in various places or countries, (b) once the infringing mark is established, the original trademark may lose its distinctiveness (i.e. become genericised and therefore lose protection), (c) the licensor may prefer to act itself and not leave the legal case to be dealt with by the licensee (who might choose a less informed lawyer or make an undesirable argument), and (d) taking prompt action increases the chance to win the case.

Conversely, a licensee of a trademark will typically require that the licensor take prompt action against any infringement. If the licensor would not act (promptly or adequately), the trademark may lose its distinctiveness or goodwill in the market, and the customer might lose its willingness to pay a higher price.

Act promptly versus defence of *laches*. It is important to act promptly against any infringement. Prompt action improves the possibility to prevent sales of infringing products, reduces damages to the goodwill in the trademark, limits the risk of price erosion in the market, and may facilitate the recoverability of damages. More importantly, if the action for trademark infringement is started only after an unreasonable delay (known as *laches*), the trademark owner (or licensee) may have lost all its rights to stop the infringement. Such a defence of *laches* may be successful in case of a delay of even a few days.

In many legal systems, a court will balance the interests of the trademark owner against those of the alleged infringer. If the trademark owner failed to respond promptly against an infringement and the alleged infringer has (in good faith) invested in its mark, many courts will reject a claim to

prohibit use of an 'infringing' mark. The law tends to protect the vigilant, rather than the sleeping party.

Counterfeit products. Counterfeit consumer products (informally also known as knock-offs) are products that inherently infringe the rights of a trademark owner by displaying a trademark which is either identical to a protected trademark or by using an identification mark which cannot be distinguished in its essential aspects from the trademark. Producing, importing or selling counterfeit products is illegal and countries impose increasingly high penalties on such criminal activities. Countries have become increasingly active in fighting counterfeit trade.

Relevant clauses from other ITC Model Contracts. The contract can be expanded with the following provisions from other ITC Model Contracts.

- If a licensor intends to provide training (e.g. on marketing and sales), or customer support related to the products, examples can be found in Article 8 of the ITC Model Contract for the International Distribution of Goods).
- If a licensor wishes to ensure that the quality of a product is sufficiently high and adequately controlled, or if extensive provisions regarding changes of the product specifications are desired, examples can be found in Sections 1.2 and 1.3 of the ITC Model Contract for the International Long-term Supply of Goods or Section 1.6 of the ITC Model Contract for International Manufacture Agreement.
- If a licensor wishes to be more closely involved in the promotion, marketing and sales, specific obligations can be included from Section 7.3 of the ITC Model Contract for the International Distribution of Goods.
- If the development of the trademark and products is undertaken in collaboration with a licensee, a provision addressing implementation of improvements and modifications can be desirable (see Article 6 of the ITC Model Contract for International Manufacture Agreement).
- If the trademark is (or will become) part of a larger framework resembling a franchising network, the contract and the ITC Model Alliance Agreement could be combined. The relevant provisions from ITC Model Alliance Agreement are Articles 1 (Objectives and key principles), 2 (Management Committee), 3 (Contributions of the Parties), 4 (Joint Projects), 5 (Alliance costs), 7 (Preferred supplier/distributor), 8 (Secondments and personnel) and 10 (Restrictions on the Parties).

Chapter 3. HOW TO DRAFT CLEAR AND PRECISE CONTRACTS

3.1 General principles of contract drafting

The task of a contract drafter is to think analytically, create a systematic structure and write logically to ensure that the future implementation of the contract by the parties will not show gaps or reveal an interpretation or results the parties had not intended.

Write with the following principles in mind:

- Contracts should be written in plain language, as clear and as simple as possible.
- Be accurate.
- Be consistent.
- Ambiguity must be avoided.
- Vague terms should be used consciously.

Plain language. A good contract is simple, clear and accurate, and avoids ambiguity by only including important and necessary subjects. Use simple words and phrases of the kind used in a day-to-day context, not archaic 'legalese' and fashionable business jargon. A businessman, the operational people who will work with the contract, must be able to understand the text. The legal aspects of a contract should be limited to what is expressed, not how it is expressed (No tricks!). Old fashioned language makes a contract harder to read and will not serve the interests of the parties.

Using Latin in contract drafting is not archaic as such, but it is best to avoid odd, unnatural terms and phrases that could be stated in more straightforward ways. However, do not use informal language, such as it's, ain't, won't, can't, or owe. Also, a contract must never use a verb expressing an obligation in voluntary terms, such as in "Purchaser should not..."

Accuracy. A contract drafter should distinguish legal, factual, accounting, procedural and legal-procedural concepts from each other, as well as the subtleties in negotiations. Use accurate, straightforward language to increase clarity and avoid ambiguities, gaps and deliberately vague language that could leave them vulnerable later on in a business relationship.

A good drafter protects their interests by determining what is important and necessary in their business relationship. It is important to understand where in the business the real risks or avoidable exposures are, and where the desired performance by a party is not self-evident. Additionally, a drafter must consider whether providing for the risks is necessary; in other words, who carries the burden of any true uncertainty? Often, deleting words or clauses reveals what really matters.

(a) Delete unnecessary words

Dare to delete. Deleting superfluous words makes the final contract more precise, which better protects the parties. Clearly redundant wording can always be deleted.

For example, consider the bracketed phrases below:

- ~~[The Parties agree that]~~ Supplier shall...
- ~~[Seller and Buyer agree that]~~ if...

Here, it is appropriate to delete the bracketed phrases and start these clauses with 'Supplier shall' or 'If'.

Removing unnecessary words and repetitive phrases is more important in contract drafting than in other forms of writing because vague language leads to ambiguity in the final draft. A wordy contract drafter may create ambiguity. Deleting unnecessary or repetitive words and phrases protects the client's interests. A well drafted contract is functional and balanced; each section is crucial to the whole and contains only necessary language. Within the contract, ensure the elaboration of each party's rights and obligations is reasonably balanced.

(b) Consistency

Do not use different words for important terms in the contract. A contract drafter must be consistent, reusing the same terms throughout the contract. Using different terms to express the same thought is a source of ambiguity and confusing in a long contract. Examples of concepts that are sometimes expressed inconsistently include:

- goods, product, equipment, tooling;
- clause, article, section, subsection, paragraph, item ;
- rules, regulations, laws, statutes.

Draft contracts to reflect the reality of the business relationship. Contracts exist to facilitate business relationships. Consistency should not only exist within the contract but also between the contract and its purpose. Ensure the actual performance or action described in the contract is consistent with what was agreed and vice versa. This means that contract provisions need to be consistent with how a debtor, or a creditor, or the industry or business environment in which they perform, actually operate.

This way, many standards of conduct required in contracts are troubling. For example, if there is no internal discipline or enforced policy for marking or treating confidential information, it is inconsistent or overstated if that organization's contractual definitions of Confidential Information strictly require from its business partners that:

...disclosed written information is marked 'confidential' or 'proprietary' (and oral information summarized in writing and identified as 'confidential' within 30 days after its presentation).

Or does one also accept defining Confidential Information to cover “disclosed information, which must reasonably be deemed to be confidential” even if such information was not marked 'confidential' or 'proprietary'?

Practices demanded from a counter-party must not contradict the same practices generally applied in one's own organization. Merely changing the provisions of an agreement will not change organizational discipline into marking documents. A drafter's contracting policy should also be consistent with real life.

(c) Avoid all ambiguity

Two aspects of contract drafting are very important because they are probably the source of most contract interpretation issues disputes: ambiguity and the use of vague terms. A contract drafter must avoid creating ambiguity at all times. The use of vague terms requires care, see section 3.2.

Almost every contract contains ambiguities, if only as a result of the trade-off against the other drafting principles of being concise, using plain language and writing short sentences. This is a paradox because ambiguity is often the result of a drafter's attempt to accurately capture all circumstances and exceptions potentially applicable in the context. Nevertheless, if it is clear that the scope of a provision does not cover a particular fact or event, it is counterproductive to include an exception. Including the exception permits an argument to be made that the scope of the provision is really intended to be broader than it appears; otherwise why would the exception be included?

Sources of ambiguity. There are two important causes of ambiguous language – lengthy sentences (addressing more than two topics) and the use of exceptions. Long sentences can often be avoided by simply splitting them up in several provisions, by deleting unnecessary words or by introducing enumeration. The use of exceptions can be improved by grouping them and by formulating them consistently.

Example of ambiguity. The inconsistent use (or positioning) of exceptions, limitations, and qualifications in one sentence may create ambiguity. For example:

Except as ... X ..., Seller shall not increase the salaries of any employee (other than Y...) above the levels in effect on the Signing Date, provided that increases may be made when ... Z ...

The above sentence contains three positions where exceptions are created. In the case of short exceptions, it will read much better if they are placed at the beginning. Conversely, if there are numerous exceptions, it is better to place the main point of the covenant (i.e. that the Seller shall

not increase salaries) at the beginning, and to place all the exceptions consistently together, in a series at the end or in a separate sentence:

Seller shall not increase the salaries of any employee above the levels in effect on the Signing Date, except that Seller may (a) ... X ..., (b) increase the salary of Y..., and (c) provide for increases when ... Z ...

Visual enumeration is where a series is subdivided into numbered subparagraphs as it is also possible to create exceptions on exceptions. This is often grammatically necessary but subparagraphs tend to be an additional source of ambiguity to a reader.

3.2 How to start drafting or tailoring your contract?

How to translate these principles into contract drafting? A draftsman often deals with the question of how to address a subject of discussion (or agreement) and translate it into clear and unequivocal contract language. Contracts should be drafted in such manner that the future implementation of the contract by the parties will not show lacks or reveal an interpretation the parties had not had in mind, or leads to results different from which the parties intended.

Thinking analytically. To be 'accurate' a drafter may wish to be exhaustive to ensure that a concept is well covered. An important guideline for improving accuracy (and confidence) is to think analytically and to draft 'MECE' (mutually exclusive, collectively exhaustive).¹⁹ In French philosophical terms, this method can be called 'cartesian', consistent with the ideas of Descartes.

Drafting 'MECE' or cartesian. The two related concepts of 'mutually exclusive, collectively exhaustive' can be explained as follows: a description of acts or events is '*collectively exhaustive*' if no other act or event is conceivable. In contract drafting terms: describing a course of action is collectively exhaustive if all variants are captured (under the addressed conditions or circumstances). Subject matters are '*mutually exclusive*' if they exclude each other without any overlap. Applying MECE or cartesian guidelines, drafters cut a larger contractual concept into comprehensible segments that encompass the entire concept, leaving no gaps and with no overlap.

The task of a contract drafter is therefore to think analytically, to create a systematic structure, and to write logically. To avoid missing the smallest relevant details, the drafter may use techniques applying concepts such as:

- substance vs. procedure
- objective elements vs. subjective elements

¹⁹ The MECE-principle (pronounced MEESEE, as in see me) is addressed in two bestsellers by Ethan Rasiel (McKinsey): Rasiel, Ethan M. *The McKinsey way*, McGraw-Hill 1999; and Rasiel, Ethan M. and Friga, Paul N. *The McKinsey mind*, McGraw-Hill 2002 (both are translated into several languages).

- content vs. form
- cause vs. effects
- a concept vs. manifestations of the concept
- (chrono)logical sequence: before and after delivery/closing

By applying these concepts in the case at hand, a drafter may establish a conviction that the entire subject is captured by the contract.

3.3 Using vague terms in contracts

Acceptable use of vague terms. Although contracts must be clear in principle, many obligations are hard to define in an all-encompassing manner. For example, precise criteria may depend on extraneous uncertainties, or the parties may be willing to assume clear (and even stricter) criteria only after a minimum level of mutual trust has been established. In such cases, it may be necessary to use a vague term. It makes sense to elaborate on vague terms by agreeing on conditions or milestones to achieve specificity (and certainty) at a later stage.

Vague terms and gentlemen's agreements. Although vagueness should be avoided, many vague terms serve a useful purpose. As a general principle, a contract should be clear about the obligations of each party. However, clear obligations are not always agreeable between the parties. In such cases, the principals may work based on a gentlemen's agreement reflected by some vague wording of intention, materiality or reasonableness. Remember, however, that if an obligation is not clear, the strongest contracting party will have the benefit of the doubt as to whether it did perform duly.

Examples of vague terms. Some examples of vague or unspecified contract terms are good faith, reasonable, undue delay, material, substantially and properly.

Good faith. Good faith is a subjective state of mind requiring due and sincere consideration. Referring in a contract to good faith essentially introduces a standard of conduct which has yet to be defined and reflects a call for 'good-housekeeping-behaviour-but-not-too-much'. By contrasting it in a particular context to what bad faith entails, it is often possible to define what is **not** good faith (and in international commercial transactions, if behaviour is not continuously in a grey area of bad faith, this may well define an appropriate and acceptable course of acting in good faith).

There is no need to expressly provide that a party "shall act in good faith", although many contract drafters believe that such a reference can be a useful reminder. For example, it is not uncommon to provide that "in the event that XYZ occurs, the parties shall discuss in good faith any adjustments to the price".

Good faith in contracts and the law. The principle of good faith (or ‘good faith and fair dealing’) may be considered one of the fundamental concepts of the Germanic legal family and, although less articulated, the Roman legal systems as well. Lawyers from these legal traditions (and the legal systems based on or inspired by them) will have a good sense of what it means to say that each contracting party must act in accordance with the principles of good faith.

For lawyers from a common law jurisdiction, it is much more difficult to appreciate what is the scope of good faith. They feel uncomfortable with the idea that some undefined, vague cerebral phrase may result in unexpected obligations. They would prefer clear contract wording that outlined a party’s obligations and, in cases where these obligations were not clearly stated that, the principle of freedom of contract should prevail.

For more about the principle of good faith, see section 5.1(b).

(a) Reasonable

The most obvious example of good faith vagueness is the word ‘reasonable’. It introduces an objective standard into the contract. The term ‘reasonable’ places a limit on discretionary power or the effect of overly strict obligations. Where it limits the exercise of discretionary power, it requires that a party be able to explain its performance (or failure to perform as expected). Where the term ‘reasonable’ is included with the aim of reducing the harshness of strict contract clauses, it introduces a common sense approach to a strict interpretation of what may normally be expected from a party’s performance. The standard of reasonableness is usually measured by considering how a well-informed third party with the same expertise would act under the same circumstances.

At a party’s discretion. The opposite of reasonable is indicated in the phrase “at a party’s discretion” or in otherwise strict (and strictly enforced) criteria, although no performance and no exercise of power under a contract should be unreasonable if it adversely affects the other party’s proper interests.

A typical example is where a party has the right to exercise discretion in making a decision under a contract provision, e.g. whether submitted documents satisfy the contractual requirements. The party who has the right to make such a decision will want to be able to make it at its sole discretion. This way, whatever the party decides cannot be disputed by the other party. The other party will push for a less subjective standard of reasonableness, as this would give it the right to obtain an explanation and to question the other party’s decision.

The Draft Common Frame of Reference²⁰ defines reasonable as a concept:

to be objectively ascertained, having regard to the nature and purpose of what is being done, to the circumstances of the case and to any relevant usages and practices.

Qualification of the term reasonable. There is no need to qualify the term reasonableness if a European law would be applicable. All European legal systems impose some standard of reasonableness on the contracting parties exercising their contractual rights. Nevertheless, contracting parties appreciate that a standard of reasonableness be explicitly introduced. This is also prudent in modern common law systems where the general principle of freedom of contract retains considerable support.²¹ An example:

Customer shall reimburse Service Provider's reasonable out-of-pocket expenses incurred in connection with the Services.

The term reasonable clarifies that there is a limit on reimbursable out-of-pocket expenses. It gives the customer a point of departure for addressing excessive declarations. The service provider should be able to explain why the invoiced expenses were made, and the explanation should be understandable or reasonable. The explanation should fit the parties' contractual subjective contexts and the actual circumstances. Because the service provider is dependent on the principal's decision, in hindsight, of its invoice, the service provider will be careful in incurring the expenses.

(b) Using the term material

The concept of materiality (meaning significant or relevant) is used to qualify phrases that would otherwise be too strict. It removes various immaterial or irrelevant elements from the scope covered by the phrase. It is often used in conditions precedent and warranties.

Example of appropriate usage

Supplier has not violated any laws or regulations in a manner that must reasonably be expected to have a material adverse effect on Supplier's business or financial condition.

Inappropriate usage. Materiality qualifications are often inappropriately used, for example:

Supplier has not violated any material laws or regulations.

Q: What about persistent traffic speed violations by employees of the Supplier during work time?

Supplier has not violated any laws or regulations in any material respect.

²⁰ The Common Frame of Reference has been developed under auspices of the European Commission, as a framework for and in anticipation of a possible European Civil Code. The term reasonable is defined in Annex I of the CFR and referred to in Article I-1:103.

²¹ Chitty, *J Chitty on Contracts*, Thomson Reuters (legal) Ltd, 2008., 30th Ed.

Q: What is material?

The qualification 'material' balances out straightforward wording against the potential black-and-white result if no qualification of materiality was used. Like the term 'reasonably', the scope of a materiality qualification would be determined by the party who carries the benefit of the related contract provision. This is usually the stronger contracting party. For example, if the completion of a project is subject to a condition that no material incompliances exist in respect of the project specifications, any doubt about the materiality of incompliances in the project results will be used by the strongest party to the project.

If a party to an agreement defines materiality, for example in an interpretation guideline that applies across the entire contract, and does so by reference to an amount, be very sure that all references to material can meet the threshold.

(c) Using the term substantially

The vague term 'substantially' is often used to allow for some minimal deviations after entering into an agreement. The effect of a qualification 'substantially in the form' is that a party might impose small modifications of a rather immaterial nature on the other party, requiring that the other party should not unreasonably reject such modifications. These may be desirable to adapt the final contract terms to developments during the intermediate period between signing and closing or because immaterial inaccuracies were discovered while preparing the closing. The term 'substantially' then implies that any proposed change may be rejected by the other party if it touches upon material aspects of the contract. The Vienna Convention (Article 19.3) illustrates what may be considered material to accepting an offer to conclude a contract:

...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.

Substantially is also used in meet-or-release and most-favoured-customer clauses. In accordance with contract provisions, a buyer may require price adjustments if the same goods or services can be sourced from a third party on terms and conditions that are substantially the same (or reasonably similar) to those from the seller.

A meet-or-release provision would entitle the buyer to terminate the supply of goods or services if the seller elects not to meet the terms and conditions. A most-favoured-customer provision would entitle the buyer to be charged the lowest price offered by the seller to its other customers (and sometimes even the lowest price available in the market). Enforcement of a most-favoured-customer provision should be secured by a right to audit the seller's books or require an audited best-price-confirmation letter.

3.4 ‘Best efforts’ or ‘reasonable endeavours’ in contract provisions

There is one vague term that is inherent to the nature of the underlying obligation. Traditionally, legal systems distinguish between obligations ‘to achieve a result’ and obligations ‘to endeavour to achieve something’ (without necessarily accomplishing it). If a desired result is not entirely within a contracting party’s control, that party is probably willing to ‘do its best’ but not to guarantee the result.

Other phrases used in place of best efforts. Other than best efforts, drafters also use phrases such as *reasonable endeavours*, *commercially reasonable efforts* and *good faith efforts*. By implication, an obligation to achieve a result is more onerous than any of its best efforts variants. Some lawyers believe that among these variants, best efforts is the most onerous one – in this interpretation, the promisor would be required to do everything in its power to accomplish the goal, even if this leads to its insolvency. Making that distinction implies that a party obliged to make best efforts should do not only everything that may reasonably be expected from it, but also things that cannot reasonably be expected. Such an interpretation is probably not within the scope of either concept. A larger group lawyers would probably reject such a contrast of meanings and may even consider that the practical difference between the variants is negligible. Best efforts certainly does not mean second-best efforts.

Sufficient efforts? Best efforts and its variants imply standards of subsidiarity and proportionality in what may or must be expected from the party concerned. Occasionally, a party may be obliged to make efforts disproportionate to the benefits under the contract. Determining whether a party has made sufficient efforts depends on all facts and circumstances. The minimum standard would probably be that the party has made a good faith effort to achieve the anticipated result.

Guiding legal framework. The UNIDROIT Principles provide a guideline:

Article 5.1.4 (...Duty of best efforts)

2. To the extent that an obligation of a party involves a duty of best efforts in the performance of an activity, that party is bound to make such efforts as would be made by a reasonable person of the same kind in the same circumstances.

Article 5.1.5 (Determination of kind of duty involved)

In determining the extent to which an obligation of a party involves a duty of best efforts in the performance of an activity or a duty to achieve a specific result, regard shall be had, among other factors, to:

- (a) the way in which the obligation is expressed in the contract;
- (b) the contractual price and other terms of the contract;
- (c) the degree of risk normally involved in achieving the expected result;
- (d) the ability of the other party to influence the performance of the obligation.

Strengthening the Model Contract clause. These UNIDROIT Principles can be used in formulating a contractual clause that is stronger (or at least more specific) than the phrase ‘shall make reasonable efforts’. Experience shows that a best efforts provision must have teeth to ensure effectiveness and go beyond what is otherwise a relatively weak concept. Improving the

clause requires clarifying the burden of proof and making more explicit the scope of a party's duty to explain and justify.

To clarify what best efforts entail, the drafter may attempt to rephrase the clause as an obligation to achieve a certain result or to link it to a contractual remedy to manage failure:

Where any obligation is qualified or phrased by reference to use reasonable endeavours, best efforts or wording of a similar nature, it means the efforts that a person desirous of achieving a result would use in similar circumstances to ensure that such result is achieved as expeditious as possible. The Party under such an obligation shall, if a result aimed at is not achieved or achieved after delay, upon the request of a Party explain in writing (a) the actions taken by it in order to fulfil this obligation, (b) any choices made where two or more alternative courses of action would have been reasonably appropriate, and (c) plausibly how any external factors influenced its performance and the achieved result.

3.5 Defined terms and definitions – best practices

Using defined terms and definitions is a powerful tool to improve the readability of a contract. They are used to make the interpretation of a contract easier and reduce any risks of ambiguity. This section identifies and explains best practices commonly found in relation to defined terms and definitions.²²

In common parlance, the terms defined term and definition are somewhat interchangeably referred to as 'definitions'. However, for a better understanding of the concept of definitions in contracts, it is helpful using a strict terminology:

- **Definition** refers to the description, or object, of what is being defined;
- **Defined term** refers to the (capitalised) word or words chosen to refer to that definition.

How does it work? In short, to indicate that a term is defined, its first character is written in upper case (note that sometimes contract drafters put the entire defined term in capitals). Throughout the contract, the draftsperson will consistently use the defined term, wherever the definition is intended to be used (and wherever the same word is not with a first-capital, the word should be interpreted not to have the meaning as defined). In interpreting a contract, the reader must substitute the defined terms by their respective definition. If drafted properly, the definition so substituted will give the contract provision its precise meaning.

Defined terms can be defined in a separate article and in the body text of the contract (or on both places). Where defined, it is best practice to indicate the defined term clearly, by placing the defined term (with initial capitals) between quotation marks or print it bold (or underlined).

In drafting and using defined terms and definitions almost invariably mistakes or drafting flaws are found.

²² Books identifying the same or similar best practices include: W.J.H. Wiggers, *Drafting contracts – Techniques, best practice rules and recommendations related to contract drafting*, Deventer, 2011; Tina L. Stark, *Drafting contracts – How and why lawyers do what they do*, Aspen Publishers, 2007; and Kenneth A. Adams, *A manual of style for contract drafting*, ABA Section of business law, 2017, fourth ed.

(a) Best practices of using defined terms

1) Defined terms and definitions are used to make the interpretation of a contract easier: they make contract provisions concise; whereas the use of defined terms should at all times reduce any risks of ambiguity.

This is the overriding principle that must be taken into account when deciding whether and how to define a term. In interpreting the contract, the defined term must be substituted by the definition of that term.

A defined term should not include “(s)”: where defined, a defined term is either singular or plural. In the body of the contract, both the singular and plural can be used interchangeably regardless of whether the definition refers to the singular or plural term.

2) The first letter of the defined term should be capitalized. If a defined term consists of more words, each word should be capitalized, except for conjunctions and prepositions (e.g. *and, but, or, on, in, under, beside, of, by, for, with, as, about*).

This best practice rule is well-established and prevents that more clarification of how defined terms and definitions work. For example:

- Seller hereby sells the Goods and undertakes to provide the Services...
- Within ten Business Days after each calendar quarter, the Management Board shall...
- Each party may terminate this agreement upon a Change of Control over the other party.

The defined terms are underlined for the sake of clarity only. When a reference is made to an article or section of a statute, regulation or to another contract, write ‘article’ or ‘section’ (without capital).

3) A defined term must be used in the body text (or in definitions) by capitalizing the term as defined.

The contractual provision must be interpreted by substituting the definition for the defined term. If the drafter intentionally avoids the definition, the capitalisation should also be avoided (but mistakes are made all too often); in view of this error sensitivity, the drafter may prefer to use a synonym. Here is an example of correctly using a defined term in combination with an undefined (similar) word:

Distributor shall not sell any products that are equal to or fulfil a similar function as the Products.

Note that in the contract text, where used, the defined term should not be underlined or printed bold (except where it marks the definition – see best practice rule 13).

4) Do not define a term (or a phrase) if its ordinary meaning expresses the concept.

Defined terms are used to make interpretation of the contract easier. That would not be improved by defining terms of which the plain-language meaning is clear. Especially in transactions in which

no sharp line is intended to be drawn between concepts that could either fall within or outside the definition, it is often better to leave the term undefined.

For example, in most contracts it will be superfluous to define what a ‘third party’ is (e.g. whether it includes legal entities that form part of a contracting party’s group), what is captured by clauses referring to a ‘person’ (e.g. in addition to legal entities, does it also include governmental agencies?) or ‘business hours’ (if ‘response time’ or ‘availability of service’ do not affect the economics of the underlying transaction).

Similarly, defining the terms ‘Parties’, this ‘Agreement’ (or ‘Contract’) is generally unnecessary. But it must be admitted that in the specific case of Parties and Agreement, this best practice principle is ignored often.

5) Create only one defined term for each definition and use that term exclusively.

This best practice rule overlaps with the principle under 6. For example, you should not refer both to ‘Product’ and to ‘TV Sets’, if they are both defined as “tv sets as specified in Annex 1”. If a defined term originates from and refers to exactly the same definition in another (related) contract or document, refer to that contract or document; you should not repeat such definition.

6) Use the defined term each time the definition is meant to apply, and do not create a defined term unless it will be used more than once.

It is confusing if a word or concept is defined (e.g. the **G**oods sold under the agreement are “all products listed in the annex”) and the agreement would ‘refer’ to it by using similar words or concepts. In other words, it is confusing if the agreement would interchangeably refer to “Goods”, “the products listed in the annex” and “the goods contemplated by this agreement”. Confusion gives rise to ambiguity and interpretation questions.

In case a word or concept would be used only once in the contract, it is sufficient clarifying that word or concept in a subsequent sentence or paragraph. After all, defined terms and definitions are used to make the interpretation of a contract easier.

7) If a term is defined, do not repeat any part of its definition in connection with the use of the defined term.

For example, do not refer to the “Management Board of the Company” in the contract provisions if the definition of “Management Board” is already defined as “the management board of the Company”; when substituting such incorrectly used defined term, the result would read “the management board of the Company of the Company”. In other words, the principle of substituting a definition into the defined term must be applied strictly.

8) A term defined in the body text should not be used before it is defined.

(b) Best practices for presentation and placing of defined terms

9) If a contract uses more than one defined term in several places and the contract is more than six or seven pages long, bring the definitions together in one article.

Normally, definitions would be listed in the article 1 of a contract. It aligns with best practice rule 8, that defined terms must not be used in the body text before they are defined. If a defined term is used in the preamble, it should be followed by “(as defined in Article 1)”.

Many contract drafters prefer to bring the definitions together at the backend of the contract or in a separate schedule. This prevents the somewhat inconvenient reading a contract (to first go through a list of definitions before reading the core provisions).

10) In the definitions article, defined terms should be ordered alphabetically, a paragraph for each, together with its definition.

If the definitions are defined in a dedicated definitions article, they are almost invariably ordered alphabetically. In the definitions article, the defined terms should not be numbered (a), (b), (c), or 1.1, 1.2, 1.3 etc. As they are ordered alphabetically, it does not make sense to enumerate the list as well.

11) A term defined in the definitions article should not be preceded by an article or a preposition and should be followed, consistently, by the word ‘means’.

If the defined term is a verb and may be confused with a noun, exceptionally, the defined verb can be preceded by “to”, which should not be printed bold and should be placed outside the quotation marks (if used at all).

Note that grammatically, ‘shall’ exclusively refers to an obligation (an action by a person). Accordingly, ‘shall mean’ would be incorrect. A correct example is:

"Products" means the products listed in Annex 1.

12) In the definitions article, never repeat a part of a term that is already defined in the body text and never summarize or rephrase such a definition.

For example, do not use “**Management Board** means the management board of the Company” together with a section “4.1. The Company shall be managed and represented by the management board (the **Management Board**).” What happens in such combination of ‘definitions’ within one contract is that there are two definitions of the same defined term, and both are ascribed a (fundamentally) different meaning. Although the draftsman may not intend to differentiate, the defined term is anyhow ambiguous.

It would be even worse to use the following definition in combination with such section 4.1: “**Management Board** means the Company’s formal body, collectively responsible for the day-to-day affairs of the Company.” Where in the previous example the definition aimed at different elements for identifying the Management Board, in this example, the definitions even collide. A term should be defined completely, either in the definitions article (preferred option) or in the body text.

13) A term defined in the body text should (a) be placed immediately following the concept it defines, (b) be placed between brackets together with an article, (c) be distinguished clearly from the other text, and (d) be marked consistent with the terms defined in the definitions article.

A defined term is clearly distinguishable when printed bold, but traditionally, the term is also put between “citation marks” (it is odd to use ‘single quotes’). It is common practice to mark the defined term in bold where it is defined. For example:

...(the **Products**).

The article “the” is not part of the defined term. For example, do not define products as (“**the Products**”) but instead write (the **Products**), or (the “**Products**”) if citation marks are used. It is unnecessary to indicate that a term is defined elsewhere in the body text, by also inserting words such as ‘hereinafter’, or ‘hereinafter referred to as’.

14) A term defined in the body text must be placed immediately after the definition (taken in its entirety).

The defined term should not be placed halfway through the description it intends to cover. This creates ambiguity. Consider the different scopes of definition of when a notice qualifies as an “Option Notice” in the following examples:

- ...Purchasers, shall give Seller a notice in writing referring to this Agreement and this Article (an “**Option Notice**”), specifying the precise nature, background and details of the Triggering Event and the date on which the Triggering Event occurred, as well as the date on which Purchaser anticipates that the effect of the Triggering Event may reasonably result in...
- ...Purchasers, shall give Seller a notice in writing referring to this Agreement and this Article, specifying the precise nature, background and details of the Triggering Event and the date on which the Triggering Event occurred, as well as the date on which Purchaser anticipates that the effect of the Triggering Event may reasonably result in... (such notice, an “**Option Notice**”).

By the placement of the defined term, the scope of the captured definition differs: in the first example, a mere written notice by the Purchaser to the Sellers pointing at its option under the referred-to Article will already qualify as an Option Notice, with all the effects stipulated in the agreement (for example, the right to exercise the agreed option right may lapse permanently within a stipulated period of time after the Option Notice, or uncertainty may exist regarding the question whether there was a Triggering Event at all).

(c) Best practices for drafting a definition

15) The defined term should correlate with the concept of the definition.

In interpreting the contract, the meaning of the definition (substituted into the defined term) prevails over the (ordinary meaning of) the defined term. Use a term that is concise and yet

informative. The choice of the defined term should preferably reflect what is relevant, to distinguish it from other defined terms. Keep the defined terms short.

When substituting the definition in the body text for the defined term, the meaning of the sentence should be the same and no grammatical errors should occur. For example, the defined term 'Bicycle' would not be suitable to include 'cars, buses, trains and motorcycles' as part of its definition (in such case, rather use 'Means of Transportation').

16) Never include obligations, conditions or warranties in a definition.

This is an important best practice principle. Ignoring this rule frustrates the principle of substituting the defined term by its definition, with all negative consequences. The inclusion of obligations, conditions or warranties creates ambiguity when interpreting the body text in which the defined term is used. A common flaw of such 'error' is, for example:

Specifications means the technical design and related specifications, which shall be developed and owned by Licensor and which are to be provided to the Manufacturers that wish to manufacture the Product meeting those specifications.

Such definition will be problematic when the contract would furthermore stipulate:

"Technical designs and related specifications developed by Licensee in connection with the Specifications will be owned by Licensor."

The complications triggered by including an obligation in the definition are difficult to oversee (and any right to compensation or payment problematic): the definition includes an obligation on the part of Licensor, the contract provision contains an entitlement of Licensor to Licensee's contributions; but what happens if the Licensee requires the Licensor to further develop its design (e.g. to match the requirements of Licensee's technical designs)?

This best practice rule is important; let's repeat it: never include an obligation, a condition or a warranty in the definition.

17) Define a term as narrowly as possible such that it fits everywhere it is used.

Do not use adjectives in the body text to distinguish, qualify or limit certain defined concepts from concepts covered by the same definition, unless substituting the definition into the defined term fits entirely (and without overlap) in the intended meaning of that defined term. For example, do not use "...draft Financial Statements..." if the Financial Statements are defined as "the published financial statements from time to time as certified by the Auditor and approved by the Annual General Meeting".

18) A definition may include a defined term (defined elsewhere).

This phenomenon is referred to as nesting or embedded definitions. Because definitions are ordered alphabetically in the definitions section, do not 'clarify' (e.g. "(as defined below)") that such nested defined term is defined later in that section.

19) Never create circular definitions.

A circular definition is a term directly or indirectly defined by reference to that same term. Circular definitions occur in case of nested definitions or when several defined terms are intertwined. For the sake of clarity, this best practice rule does not apply to the inclusion of the non-capitalised term in the definition. For a correct example:

Licence Agreement means the licence agreement attached as **Schedule 3**.

Such use of the term rather emphasizes that the defined term is well chosen.

20) To exclude a concept that may ordinarily be within the scope of a definition, the defined term, or a part of it, should be followed by ‘excludes’.

Similarly, some drafters believe that if a definition is not intended as an exhaustive description, the defined term should be followed by ‘includes’ (and not ‘means’). For example:

“**Fruits**” means all fruits commercialized by Seller, including mini tomatoes and olives.

“**Products**” means all fruits commercialized by Seller. “Products” exclude peppers, cucumber, peas, string beans, eggplants, avocados, corn, zucchini and beans.

Note that botanically, both the included and the excluded vegetables are actually fruits. Especially if there can be discussion about the scope of the contracted goods, the clarification is helpful. Such discussion may be relevant if also a non-compete clause or exclusivity is.

21) If a definition must also capture any future, yet unknown version, value or amendment, it must qualify the relevant concept by the words “from time to time”.

22) The definition of a (signed) ‘contract’ should identify the title of that contract, its date, the parties and the amendments (if any).

If more than one name can be attributed to the contract, the title as it appears most prominently on the first page, including any subtitles, should be used. If a contract refers to several dates (e.g. because each signatory wrote down a different date of signature), the printed date should be used and failing such date, the first date on which the first signatory of the last signing party should be used. The names of each party should include the type of entity (e.g. GmbH, N.V., Sàrl). In the case of one or more amendments, supplements or addenda, only the dates of those documents should be included (e.g. “as amended on 18 June 2016 and 14 July 2017”).

23) The definition of a person, legal entity or organization should be consistent with the details provided for the parties.

3.6 How to write numbers, refer to a time and to a date

If a transaction involves many figures (amounts, units of measurement, specifications), collect them in a single spreadsheet and double check whether they are correct. If numbers are likely to change, or if they are confidential, keep them out of the initial drafts of the document. However, being the contracting parties' compass, contracts typically contain many numbers, dates and sometimes times. And despite attempts in being accurate and avoiding ambiguity, it appears that writing numbers and referring to time and date is error prone. There are a number of best practices, for which official national or EU legislation style guides, authoritative newspapers' style guides may serve as a good basis.

(a) Best practice rules for drafting numbers

1) Be rigorously consistent in the use of figures or words to express a number.

Generally, a reader comprehends figures more readily than their expression in words. If a provision or contract contains both figures and words, use either figures or words for all the numbers of the same category.

Writing zero and one. Clarification may be necessary in the case of 0 (zero), or if a number in a contract clause is a remarkably low one (e.g. "the purchase price for the Shares is EUR 1 (one euro)").

2) Use words for simple figures from one to ten. Use figures for numbers from 11 upwards and for all figures that include a decimal point or a fraction.

Best practice rules 1 and 2 compete for priority. For example:

One, seven

3, 14, 975 and 6,650 (for consistency reasons, three is written as a figure in this case)

4.25 and 4¼

During the initial three years of the Term, Purchaser shall order at least 4, 8 and 21 containers, respectively.

It may occasionally be desirable to write out round numbers up to twenty, if this can be defended in terms of consistency.

3) Always use figures in percentages, for cross-references and serial numbers, for ranges denoted by a dash, in tables, for statistics and for votes.

For example:

Percentages: 4 percent

Cross references and serial numbers: page 25, Article 9, Section 3, Part 2

Ranges denoted by a dash: sections 3.14 to 3.15

Statistics: 3 managing directors were appointed in 2008, 2 in 2009...

Votes: 6 members were in favour, 3 against, and 2 abstained

Avoid starting a sentence with a figure; write the number in words instead.

4) Best practice rules 1 to 3 also apply to ordinal numbers (e.g. second, fourth, 12th, 51st).

5) In English language contracts, use commas to separate grouped thousands and use full stops to separate round numbers from decimals.

Note that this may be different in other languages. For example:

EUR 2,750.75 plus EUR 1,249.25 equals EUR 4,000.

6) Write out 'hundred' and 'thousand' in words or figures as is required for consistency. For rounded millions or higher use figures, words or their combination.

For example:

500 or five hundred **but not** 5 hundred

EUR 3,000 or three thousand euro **but not** EUR 3 thousand

2.5 million, 3 million, 31 billion

7) Avoid abbreviating millions by M or mln.

In several languages, the abbreviation *M* or *m* is used for thousands (e.g. in French, Italian and Spanish thousand is *mille* or *mil*). Note that in Roman numbering, M indicates one thousand. Do not abbreviate billions (or more).

8) Avoid combining single-digit figures and words by using hyphens but write out the number using a word instead.

For example: a three-year term; a five-door car. But note there are acceptable phrases such as 40-hour week, 24-hour services and 4-wheel drive.

9) Do not add two decimal zeros after round (cardinal) amounts. For figures smaller than 1 add zero before the full stop.

An exception may apply when consistency or precision so requires, for example in tables or when other amounts are not round amounts (and all are part of one calculation). For example:

EUR 2,750.75 plus EUR 6,000.00 plus EUR 1,249.25 equals EUR 10,000.
...the default interest shall be further increased by 0.85.

Do not write out decimals.

10) When two numbers are adjacent, spell out one of them.

Usually, it would be the first number. For example:

Seventy 44-eurocent stamps
140 fifty-kilogram packages

11) In English, compound numbers take a hyphen, when written in words.

In English, numbers below one hundred are compounded. For example: thirty-first; nineteen hundred sixty-six.

12) Use figures in a combination with units of measurement that are denoted by a symbol or an abbreviation.

For example:

250 kW **or** two hundred and fifty kilowatts
205 µg **or** two hundred and five micrograms
5 °C **or** five degrees Celsius

The opposite does not hold. If the units of measurement are spelled out, the numbers may be written as figures: 250 kilowatts, 500 metres.

13) In contract clauses, use the official (ISO) currency abbreviation with the related amounts (that appear in figures).

Examples of the official ISO currency abbreviations are EUR, USD and GBP.²³ Note that the official notation of US Dollars is USD and **not** US\$. Accordingly, do not use the currency symbol (e.g. €, \$, £). For example:

EUR 50 or one hundred euro

²³ The standard official abbreviations are listed in ISO 4217.

If, despite the above best practice rule, you do use the currency symbol, never put it behind the amount unless the national rule so prescribes for that symbol (i.e. **never** write 50€, 134\$ or 13£).

The official plural of euro is euro (i.e. not euros). The official rule is not to capitalise euro (i.e. not Euro).

14) Avoid using fractions. When used, fractions should always be spelled out in words, even when the figures are higher than ten, unless they relate to round numbers.

For example:

a two-thirds increase
increased by two thirds
two-thirds completed, **but not:** $\frac{2}{3}$ completed

Never contrast or compare a fraction with a decimal (i.e. avoid ‘the applicable interest rate shall be $6\frac{1}{4}$ percent instead of 5.1 percent’).

16) When a range of figures is indicated by a dash, do not repeat the symbol or multiple if they do not change. Close up the dash between the figures.

For example: 5,000-6,000, 5-6 percent and 5 billion-6 billion (**not** 5-6 billion).

In running (contract) text, use **to** (5,000 to 6,000 employees).

(b) References to dates

17) Write out the month, preceded by a figure for the day. Use four digits when referring to specific years.

For example:

15 March 1928

The format March 15, 1928 is practice in the United States only. **Never** write a date according to any of the following structures:

...the 15th day of March 1928 (written out)
the fifteenth day of March 1928 (even worse)
15th March 1928 (ordinal day indication)
March 15 1928 (without comma)
March 15th, 1928 (combination ordinal indication and reverse order)

09 March 1928 (zero for days below 10)

Avoid an all-figure style of writing dates, for example, **not** 15-3-1928, and 1966 **not** '66.

18) When referring to decades write 'the 1980s' (without apostrophe).

(c) References to time

19) Use the 24-hour system in preference to the 12-hour system. Include both the hours and the minutes (not the seconds). In cross-border contracts, add the ISO time-zone indicator.

When writing times, use a colon instead of a full stop between hours and minutes. Do not add 'hrs' or 'o'clock', e.g. 11:30 h CET.

It is important to note that a reference to 12:00 p.m. is ambiguous. In view of the risk that a party may rely on an erroneous combination of a.m. used in the 24-hour system, it is strongly recommended that a contract clause either refer to 11:59 a.m. or 00:01 p.m. as a marking point in time.

Chapter 4. EXPLAINING CERTAIN TYPES OF CLAUSES

4.1 Conditions

A contract or a contractual obligation may be made conditional upon the occurrence of a future uncertain event, so that the contract or the contractual obligation only takes effect if the event occurs (suspensive condition) or comes to an end if the event occurs (resolutive condition).²⁴

Relevance of conditions. Conditions are of great importance because their effect can be draconic. If a condition is not satisfied, the related rights or obligations either fall away or become effective, depending on the formulation. This may even apply to the enforceability of the entire agreement.

Conditions should relate to future or uncertain facts or events. Most legal systems require that a condition refer to a future or uncertain fact or event. This distinguishes conditions from the legal concept of mistake (*Irrtum, erreur, dwaling*). The concept of mistake implies that a contract can be terminated if the terminating party made a serious mistake, such that it would have concluded the contract on materially different terms and conditions or would not have concluded the contract at all, and, having regard to the circumstances, the mistake must not reasonably be borne by the mistaken party.

To include a condition that refers to an unknown but existing fact or event (or to a fact or event that is uncertain for the parties but certain for others) is therefore not so much a question of conditionality of the agreement, but rather an agreement between the parties that the referenced fact or event is important enough to trigger a termination. Nevertheless, if a straightforward condition is satisfied but for some apparently insignificant fact or event, the rights or obligations that are the subject of the condition will not come into force. That is the power of a condition.

Conditions as an exit. In many cases, the contracting parties may believe that signing an agreement concludes the deal, when in fact there is still work to be done before the transaction is completed. In those cases, a condition sometimes serves as leverage to renegotiate key deal terms. In other words, a condition is not intended as an exit from the transaction but rather to protect one party against 'hidden defects' (with the possibility to optimize the terms of a final (unconditional) transaction).

Potestative conditions. A condition sometimes provides one party with a relatively large degree of freedom to decide whether it is satisfied. If this freedom means that a party can walk away freely from the transaction or postpone the moment at which it decides to enter into the transaction, this is referred to as a '*potestative condition*'. Effectively, such a 'subjective condition'

²⁴ UNIDROIT Principles Article 5.3.1.

implies that the party has never been truly bound to the 'agreed' transaction since that party has always been free to terminate 'at will'. If that is true, it is questionable whether there was mutual consent or a meeting of minds regarding the object of the agreement. On the European continent, potestative conditions are invalid or ineffective. Depending on the content of the condition, the principle of good faith would impose legal consequences that may, for example, range from the complete ineffectiveness of the condition to a more objective (and reasonable) test of whether the condition is satisfied, or even an obligation on a party to make best efforts to ascertain that the condition is satisfied.

The potestative nature of a condition is not always apparent. For example, the following phrases contain a prevailing subjective element:

- ...in form and substance satisfactory to [one party]...
- ...in form and substance satisfactory to both parties...
- ...[Purchaser] being satisfied in all respects with...
- ...The Parties having entered into an agreement, allocating each Party's rights and obligations in a mutually satisfactory manner.

Overly subjective conditions can be remedied in several ways. Specifying a standard of reasonableness in each of the conditions would mean that the beneficiary of the condition cannot avoid closing the transaction by providing a simple statement that the condition has not been satisfied. The standard of reasonableness implies an objective test or at least a duty to explain (on reasonably plausible grounds) why the condition has not been satisfied. Similarly, the conditions could be phrased more objectively.

In the above examples, the required *form and substance* could refer to market standards or customs or even to the internal policies generally applied by one party. Another good option would be to leave open the determination of whether the condition has been satisfied. Alternatively, a condition could be elaborated upon by attaching an agreed framework or the main terms of such agreement.

Conditions, reasonable efforts and good faith. Most conditions require that one party undertake to perform a certain fact or event. This would imply that the same party also has the power to prevent the satisfaction of a condition. However, this is not true. Many legal systems impose a duty to act in good faith (or a similar concept) on such party, requiring it to make reasonable endeavours to achieve the stipulated results. The specific effects of this principle, and the particular actions required in the context, largely depend on the circumstances of the case.

4.2 Covenants

Covenants are a range of contractual devices ensuring that a party receives the benefits that it negotiated for in the business deal. In other words, covenants support the achievement of the purpose implied by the key provisions in the transaction.

Carve-outs. The scope of a covenant can be limited or qualified. The most important one is to create exceptions or to be specific regarding its scope: a carve-out. A carve-out is formulated as an exception and functions as a removal, or carve-out, of part of the restriction imposed by the covenant. There is no rule for it, as the following examples demonstrate:

The appointment as distributor is exclusive for the territory of South East Asia. However, in Cambodia XYZ is entitled to undertake distribution activities as well.

Licensor warrants that the Technology does not infringe the rights of third parties, except for the rights in the database, which are owned by ABC.

Remedies for breach of a covenant. In most agreements that are subject to a European continental law, it is unnecessary to include a remedy in a covenant. Unlike in civil law jurisdictions, the default remedy under common law for breach of contract is that the harmed party is entitled to damages but not *a priori* to specific performance, which is an equitable remedy granted at the discretion of the court. In the European continental legal systems, the opposite applies – by default, a party can ask for specific performance (and if that is not practicable or adequate, damages can be claimed). As an entitlement to damages often does not protect the harmed party's interests adequately, an agreement under common law usually provides for specific remedies in the event of a breach of a covenant.

Covenants in IP-related agreements. In a patent transfer agreement, the transferring party will transfer its invention. However, the transferee would like to maximize its use of the patented invention and also be made familiar with all know-how connected to the patented invention. Also, a transferor may want to avoid any infringement claims for the use of any remote elements in the patent that do not relate to the transferee's business but were covered by the patented invention (as the patent was applied for in view of the transferor's business): the transferor may seek a non-assertion or licence-back in connection with the transferred patent. Similarly, a licensor of trademarks or other intellectual property rights often requires from its licensees that they notify the licensor promptly of any infringements identified in the markets of such licensees. Such stipulations are covenants.

Covenants in leases and goods-on-loan agreements. In a manufacturing equipment lease, the main objective of the lessor is to ensure that the lessee pays the rent in a timely fashion and that it returns the equipment at the end of the lease. However, a lessor may want the lessee to operate and store the equipment in accordance with the lessor's instructions, to maintain the leased assets, to keep them insured and to allow periodical inspections by the lessor.

The lessor, in addition to its concern regarding the value of the equipment, will want to prevent the lessee from being unable to pay the rent timely. Likewise, the lessor might require that the lessee provides an ongoing security for the lease instalments. If the lease has a potentially significant impact on the lessee's business, the lessor may even require periodical information about the lessee's financial capability to continue paying the rent.

Each of the above examples of deal-related or unrelated purposes is accomplished by covenants that prescribe what the transferor or lessee must do, and cannot do, in respect of the transferred patent or leased equipment, respectively.

Covenants in M&A transactions. In mergers and (company) acquisitions (also M&A transactions), covenants will protect the purchaser's interests prior to completion (i.e. covenants force a seller and the acquired companies to conduct the business in the ordinary course and to obtain the purchaser's approval for important or extraordinary matters) as well as its commercial deal after completion (i.e. the seller is required to take care of transaction-related interests or to continue to disentangle the acquired business) and in a passive sense (i.e. the seller should refrain from using its knowledge or business relationships to compete with the business it sold).

Pre-closing covenants in mergers and acquisitions. During the period between the signing and the closing of an M&A transaction, the business of the acquired companies would typically be continued in the ordinary course of business. Anticipated investments (e.g. the renewal or maintenance of equipment and production installations) may or may not continue as planned. The purchasers will likely want to prepare or further elaborate their business plan for the acquired companies.

Also, suppliers and customers contact their counterparts in the sold business asking for a clarification of the transaction (and certainty about their ongoing position). Some contracts contain change-of-control provisions, which may even trigger renegotiation of the pricing or other terms and conditions. As with everything in life, issues arise in the ordinary course of business. As each issue might affect the value of the acquired companies or the possibility of integrating the acquired business into the business of the purchaser, pre-closing covenants would be agreed, for example:

- **Access to facilities and information rights.** Whereas competition laws often prohibit the implementation of (irreversible) measures, a purchaser would like to have some access rights to the acquired companies' manufacturing facilities. But the purchaser should not interfere with the business activities and must comply with all security and safety measures.
- **Undertaking to conduct the business in the ordinary course.**
- **Approval rights.** Various matters will be subject to the purchaser's prior approval:
 - entering into agreements (distinguishing between ordinary course contracts, non-ordinary course contracts, unusual contracts or commitments under atypical terms and conditions, and contracts with a conflict of interest);
 - matters related to the acquired companies' assets (i.e. no disposals or grants of pledges other than in the ordinary course of business and no unanticipated deviation from capital-expenditure-related investment plans);

- matters related to the corporate structure, taxation and finance (including financial reporting), preventing a transfer of any entities, any amendments to corporate constitutional documents, tax-revaluations etc;
- employment-related matters, such as a change of the terms of employment (including of any collective labour agreements), the removal of (key) employees other than for urgent cause, or the employment of additional personnel;
- IP-related matters (if not addressed otherwise);
- an undertaking not to enter into, amend or terminate any joint ventures, partnerships, licences or important lease agreements; and
- settlement of claims and disputes and the conduct of any pending litigation.
- **A duty to inform.** Obviously, between signing and closing, the purchaser wants to be informed about all matters that might affect the value of the acquired companies, any of the warranties becoming incorrect and generally any business decisions by the acquired companies. It will also want to receive periodical management reports and quarterly or annual financial statements.

Covenants in credit agreements. In their financing practice, banks have been developing great insight into the need to monitor their customers' businesses. Those needs are satisfied by adequate financial covenants. Financial covenants restrict a borrower's freedom to engage in activities that may worsen its financial condition. These include:

- **Incurrence of debt.** More debt means more interest and principal payments.
- **Creation of encumbrances ('negative pledge').** The more assets are pledged or otherwise collateralized, the fewer assets are available to satisfy the borrower's unsecured claims and general obligations in the event of insolvency.
- **Line of business.** Especially in leveraged finance, credit agreements will require that the borrower does not change the essential scope or nature of its business activities.
- **Sale of assets.** Loss of income-generating assets could adversely affect the lessee's cash flow. Sometimes also the assignment of receivables ('factoring') is restricted or prohibited.
- **Dividend distributions ('leakage prevention').** Each euro distributed as dividend to shareholders reduces cash available for payment of interest. Also, intra-company transactions with affiliates that do not participate in the financial arrangement may endanger the leakage of valuable assets or cash out of the reach of the lenders.
- **Investments.** From a lender's standpoint, cash spent on investments would be better spent on repaying amounts due to the lender.

4.3 Change of circumstances (hardship)

The legal context. An area of the law that divides the legal traditions is evident in the concept of force majeure. During the late nineteenth century, the French *Cour de cassation* (supreme court) established the overriding principle that contractual provisions are recognized as a strong force of law. Unless the parties provide for exceptions in the case of hardship or force majeure, the

principle 'contract is contract' (*pacta sunt servanda*) prevails. This principle – you must deliver what you promised – is also essential in common law. Nevertheless, under both systems some circumstances that go beyond the reasonable expectations of the parties may call the binding nature of a contract into question. The occurrences of life are infinite and, accordingly, upon the occurrence of unforeseen circumstances, a contract or a rule of law might provide an unjust result. This makes a hardship or *force majeure* provision very important.²⁵

Examples of cases of hardship. A change of circumstances sufficient to trigger a renegotiation or justify an amendment of the contract should be highly exceptional. Courts are very reluctant to step into such revisions. Obviously, while a hardship clause as such can be desirable, contractually providing for changes of circumstances also lowers the threshold for a party to call upon it.

Cases in which renegotiation or change would be appropriate might be, for instance:

- a pricing formula linked to an electricity price index that starts to increase significantly (e.g. effectively turning the index from a ratio of less than 1 (one) into a factor more than 1 (one); in other words, changing a mathematical divider into a multiplier);
- a purchase price expressed in a currency that has become subject to extreme fluctuations, whereas a period of relatively stable exchange rates prevailed when the contract was entered into;
- delivery requirements for a country that has become inaccessible due to political reasons or because of an international trade embargo;
- minimum purchase requirements or exclusivity arrangements in long-term agreements, where the product (or a key component of it) has been abandoned due to technological developments.

ITC Model Contracts. A contractual device applicable in exceptional cases involving a change of circumstances can be found in the ITC Model Contracts. Such cases would typically include changes of circumstances or hardship that (a) the parties did not already (implicitly) incorporate in the contract by way of risk allocation, (b) should not remain for the risk and account of the affected party (e.g. because the occurred change of circumstance is inherent to its type of business), or (c) could not be influenced by the affected party. For example, in the international long-term supply contract:

9. Change of circumstances (hardship)

9.1 Where the performance of this contract becomes more onerous for one of the Parties, that party is nevertheless bound to perform its obligations subject to the following provisions on change of circumstances (hardship).

9.2 If, however, after the time of conclusion of this contract, events occur which have not been contemplated by the Parties and which fundamentally alter the equilibrium of the present contract, thereby placing an excessive burden on one of the Parties in the

²⁵ An excellent and comprehensive study of the scope and effect of unforeseen circumstances (and hardship, mistake and *force majeure*) in the European Union countries can be found in Hondius, Ewoud and Grigoleit, Hans Christoph, eds. (2011), *Unexpected circumstances in European contract law, The common core of European private law*, Cambridge University Press.

performance of its contractual obligations (hardship), that party shall be entitled to request revision of this contract provided that:

9.2.1 the events could not reasonably have been taken into account by the affected party at the time of conclusion of this contract;

9.2.2 the events are beyond the control of the affected party; and

9.2.3 the risk of the events is not one that, according to this contract, the Party affected should be required to bear.

9.3 Each party shall in good faith consider any proposed revision seriously put forward by the other party in the interests of the relationship between the Parties.

Interference by a third person. The idea behind this kind of clause is that the parties should be free to consult each other in the event of a major change in circumstances – particularly one creating hardship for a particular party. However, a company should only include the option at the end of Article 9.4 (right to refer to the courts/arbitral tribunal to make a revision or to terminate the contract) if the company considers that it is not likely to be used against that party's interests by a party in a stronger tactical position, or if the right to refer to a court/tribunal is already an existing right under the applicable governing law in the event of hardship. In that case:

9.4 If the Parties fail to reach agreement on the requested revision within [specify time limit if appropriate], a party may resort to the dispute resolution procedure provided in Article 18. The [court/arbitral tribunal] shall have the power to make any revision to this contract that it finds just and equitable in the circumstances, or to terminate this contract at a date and on Terms to be fixed.

Legal framework. The UNIDROIT Principles address the issues related to hardship and provide for a sophisticated framework consistent with the solution proposed in the ITC Model Contracts.

Because courts are very reluctant to step into the position of a contracting party, the solution of a case of hardship would apply only in highly exceptional, special circumstances. This principle is taken rather strictly in common law and in French law. In the Germanic legal tradition, a force majeure or hardship provision is not a must-have, because courts will take an objective (more reasonable) approach to the question of whether a party is excused from performance given the occurrence of exceptional circumstances.

4.4 Force majeure

A force majeure clause is a contract provision that allows a party to suspend or terminate the performance of its obligations when certain circumstances beyond their control occur that make performance inadvisable, commercially impractical, illegal, or impossible.

The provision may state either that performance of a contract is terminated if the force majeure event continues for a prolonged period of time or that performance is merely suspended until the event has concluded. The following elements should be addressed in a force majeure clause:

- Definition of force majeure events;
- What happens when an event occurs;
- Who may suspend performance; and
- What happens if the force majeure event continues for more than a specified period of time.

ITC Model Contracts. The ITC Model Contracts provide a contractual framework in case of force majeure. Examples may be found in the international contractual alliance contract (Article 13) and the long-term supply of goods contract (Article 10). In many cases, especially in industries where an event of force majeure is not exceptional, the termination right of the standard ITC Model Contract force majeure clause is too onerous. In such cases, it may be desirable to provide for a less rigorous force majeure clause, as follows:

10.4 If the performance by either party of any of its obligations under this contract is prevented or delayed by force majeure for a continuous period in excess of three [specify any other figure] months, the Parties shall negotiate in good faith, and use their best endeavours to agree upon such amendments to this contract or alternative arrangements as may be fair and reasonable with a view to alleviating its effects, but if they do not agree upon such amendments or arrangements within a further period of 30 [specify any other figure] days, the other party shall be entitled to terminate this contract by giving written notice to the party affected by the force majeure.

The UNIDROIT Principles also reflect a less rigorous standard in their force majeure clause (Article 7.1.7).

Force majeure versus change of circumstances (hardship). The legal concept of hardship deals with highly exceptional, external circumstances that the parties had not foreseen at the time they entered into the agreement. But there are also circumstances that are (objectively) foreseeable but not actually foreseen in the contract. If (a) the change of circumstances is beyond the affected party's control and (b) the affected party ought not reasonably to have taken measures to prevent the effect of such change of circumstances, it would be excused.

Although the legal concept of change of circumstances (hardship) applies only in rather rare, exceptional cases, the legal concept of force majeure may occur more frequently. Also, a change of circumstances (hardship) does not necessarily prevent performance of the contractual obligations – rather, it significantly changes the economic fundamentals of the contract – but a force majeure event prevents a party from performing or functioning properly. In fact, depending on the type of business, in a long-term relationship the occurrence of an event of force majeure may well be a certainty.

As events of force majeure are foreseeable to a relatively larger extent, the scope of force majeure and its consequences can both be described in relatively precise contractual terms. In cases of

hardship, a description is hardly possible because of its exceptional and unforeseeable nature. A case of force majeure provides for a contractual excuse (and no liability) whereas a case of hardship triggers the renegotiation of the contractual equilibrium.

4.5 Warranties (and conformity)

A warranty is a promise of indemnity that a statement of fact is correct.

Allocation of risk. The party making a warranty assumes the risk that if the warranty is incorrect, the other party will have a claim against it or another appropriate remedy under the agreement. Depending on the interpretation of the warranty, a failure in the contractual object may fall within the scope of the warranty (and therefore the customer can make a claim) or it may not (and accordingly, the risk remains for the customer). It may well be that neither party knows whether a warranty is correct, even after comprehensive investigations and testing. Having the seller, service provider, borrower or licensor make the warranty is a simple allocation of risk.

Terminology: warranties, not representations and warranties. The word 'warranties' is very often coupled with the word 'representations', in that the parties do not merely *warrant*, they would *represent and warrant*. Many people argue that representation and warranty signify the same legal concept, and that the use of the one or the other is interchangeable. While this is true for all non-common law systems (where warranties do not have a distinct meaning), within common law – most evidently under English law – the two terms relate to fundamentally different concepts.

Representations under English common law. Under English common law, a representation is a statement of fact made by one party to induce the other party to enter into the contract. Being a statement of fact means that it can relate (and must be drafted to relate) to past or present facts or circumstances only. As in many other legal systems, a misrepresentation (a 'breach' of a representation), by consequence, affects (the appropriateness, validity or cause of) the transaction. A misrepresentation operates the same way the legal concept of '*mistake*' (*erreur*, *Irrtum*, *dwaling*) works in non-common law jurisdictions. Accordingly, the default remedy is that the induced or misled other party may rescind the contract if the misrepresentation so justifies (as is codified for English law in the Misrepresentation Act 1967). An immediate consequence would then also be that, rather than a (contractually qualified and contractually limited) claim under 'contract', such other party would make a claim in tort or 'unjustified enrichment'.

Although one may stipulate representations in the contract, by a representation's very nature (as an inducement to enter into the contract) such written reflection is not necessary. Whether the remedy (rescission of the contract) is justified will be determined regardless of whether the representation was in writing. Having the representation in writing is good evidence.

Warranties under common law. The term warranty has a slightly different meaning. It reflects the promise about (the effects of) the contemplated transaction made by one party to the other,

so about what such other party might expect from performance under the contract. If a warranty appears to be incorrect, the remedy under common law is damages (and not rescission). If the incorrectness is fundamental, the contract can be terminated. However, the default remedy under common law is the payment of damages resulting from the warranty being incorrect.

Unlike a representation, the contract is not undone as though it never existed. A warranty should be drafted such that one can say that it is correct or incorrect. Accordingly, like representations, semantically, a warranty takes the 'structure' of a statement of (past, current or future) facts. Whilst *representations* refer to the particular facts as they are (or would be) at the time of contracting, a *warranty* must be presumed to address a promised future fact, benefit or circumstance measured as of the moment such a warranty is made. On similar grounds, warranties imply a contractual risk allocation mechanism, which is – in view of the remedy (rescission) – not the case with a representation.

'Reps and warranties' in the rest of the world. Outside the common law, one would expect that *representation* is the preferred wording. It matches with the concept of a so-called 'juridical act' (which is 'a statement or declaration that has legal effect as such'). Also, outside common law, a *warranty* has no specific legal meaning. What is relevant is that one party makes a statement of fact and that the party relying on that statement may or may not invoke a contractual or statutory right when that statement happens to be incorrect.

Guarantee? Some European originating contracts may use the terms guarantee (i.e. the verb) or guaranty (i.e. noun, the act itself). This can be explained from the translated concept, e.g. *garantie* (French), *Garantie* (German), *garantie* (Dutch). In the common law, the concept guarantee is much more closely related to a suretyship, the undertaking by one person to stand in for the due and timely performance by another person.

Best practice – written as a statement of fact. A representation and a warranty must be drafted as a statement of fact. A properly drafted warranty is either true (or correct) or not. There should be no room for something in between. A warranty can be partially incorrect, but this implies that the warranty in its entirety is also incorrect. In the English language, it is also appropriate to stipulate that a warranty is accurate (or inaccurate).

Best practice – never include obligations. Like recitals and definitions, a warranty should never contain obligations, remedies or other operative provisions. If the drafter wants to provide for an obligation or a remedy in case a warranty is incorrect, or for any consequences depending on the degree of 'incorrectness' of a warranty, this should be addressed in a separate provision, e.g. a separate article, section or at least its own sentence.

Warranties in all-caps: 'conspicuousness' ? Many contract drafters believe that a disclaimer or limitation of liability must be printed entirely in capital letters. The requirement to capitalize can be found in the United States Uniform Commercial Code (UCC) and only applies to a few nominal types of contracts – the sale of goods, the licence of software, a lease or a warehousing contract. In such contracts, a seller of a product can disclaim implied warranties and limit its exposure to liability *conspicuously*. The UCC defines the conspicuous requirement as something written (i.e.

printed) in such a way that a reasonable person ought to have noticed it.²⁶ Language in the body of a contract would be considered conspicuous if it is in a larger font or other contrasting type or colour (for sales contracts, a broader definition applies). The UCC does not require all-capitals. Whether or not text, as printed, is considered conspicuous is for decision by the court. Finally, since the requirement of conspicuousness has its origins in the UCC, it applies only if the contract is governed by the law of (most) states in the United States. Almost no other country adopted such a conspicuous requirement.

4.6 Limitation of liability clauses

Why limit liability? In many jurisdictions, it is common to limit exposure to liability under a contract. There are good reasons to do so, for example:

- The supplier would otherwise be exposed to liability that may exceed the value of its entire business. In most cases, value added increases considerably as you move through the value chain: a supplier of raw materials receives little payment compared to a vendor who supplies to consumers. For example, a manufacturer receives a few euro for electronic wiring, which interconnects components in a smart phone that may cost hundreds of euro.
- The customer is in a position to manage and mitigate any liability, but this does not apply to the supplier (who usually has no contact with the end customers).
- The customer, who does have direct contact with the end customer, is often in a much better position to provide for solutions or for compensation (e.g. free supplies in kind or a higher service level). Moreover, if prompt action is desirable, a customer may worsen an event that caused liability by doing nothing, whereas failure to act promptly as such is not legally attributable to the customer.
- The customer is also typically in a better position to obtain coverage under insurance policies than its supplier for the type of fact or circumstance leading to the claim.

(i) *Elements for limitation*

A supplier will normally limit its risks and exposure to liability in various respects:

- Scope of damages eligible for compensation:
 - excluding indirect (consequential) damages, only damages individually exceeding a (*de minimis*) threshold and furthermore damages that are not remedied by the buyer;
 - a buyer's own risk, also known as a basket, which must be filled before a first claim can be made;
 - aspects of own fault, mixed causation, claim-related benefits, recourse rights on third parties (e.g. suppliers);

²⁶ UCC, Article 1, General provisions, Section 1-210 (10).

- a cap (an absolute maximum liability).
- Permitted warranty claim period;
- Causation: eligible damages limited to those that are the immediate and adequate consequence of a warranty being incorrect;
- Remedies (e.g. replacement or repair, at the supplier's option, stipulated as the sole remedies available to the customer);
- Management of the claim process:
 - constraints on (notification and) handling of third-party claims that may give rise to a warranty claim;
 - procedures for making warranty claims that must be followed (e.g. not mere notifications of claims interrupting the contractual period of limitation but requiring that legal proceedings are initiated).

Limiting the type of damages. One way to limit the liability of a party is by reducing the scope of damages eligible for compensation. The most common limitation excludes indirect or consequential damages. Although this is a somewhat vague and uncertain legal concept, it is clear that remote consequences of a breach of contract will be excluded from compensation. Whether or not any damages are 'indirect' or 'consequential' may be subject to discussion and may divert the parties to related questions such as the 'foreseeability' of the alleged damages. If the parties agree that only reasonably foreseeable damages incurred by one party are eligible for compensation by the other party, then a framework for discussion is created. This may not be preferable for the party facing the damages (in hindsight), but at least it allows the parties to find a middle ground.

ITC Model Contracts. Parameters for limiting liability mentioned above are reflected in the ITC Model Contract for the International Commercial Sale of Goods (standard version), Article 14.²⁷

General limitation of liability – a cap. Many contracts contain a monetary limitation of liability (a 'cap'). For merger and acquisition agreements, such a cap is typically defined as a percentage of the (preliminary or adjusted) purchase price or simply a fixed amount (agreed by the same token). Normally, a cap should not apply to matters relating to ownership or entitlement to sell because it affects the entire sales transaction (and more). For operational contracts, such a reference is not always readily determinable, or the parties may have reasons to vary.

(ii) Commonly agreed caps on liability

Commonly used limitations of liability are:

- a) a designated amount (perhaps related to the amount ordinarily received under a purchase order);
- b) the amount of the purchase order (under which the defective products were delivered);
- c) the amount actually paid under the agreement during a period of time preceding the claim;
- d) a percentage of the amount indicated under (c);

²⁷ ITC Model contracts for small firms: legal guidance for doing international business. (2010). pp. 53-54.

- e) whichever is higher: (i) a designated amount, or (ii) a reference such as indicated under (b), (c) or (d); or
- f) whichever is lower: (i) or (ii) as indicated under (e).

Types of limitation of liability. The types of liability caps (listed above) serve different purposes. A designated amount has an obvious effect – it provides for at least some substance, preventing a court from establishing that a complete exclusion of liability leads to a void limitation (as this may be the case in various jurisdictions, especially if a party is a relatively small company). The amount can be chosen to correspond to the value of one or more purchase orders, to match the anticipated profit over the expected turnover from the relevant customer or the annual expected turnover from that customer.

A harsh but fairly common limitation of liability is mentioned under (b) in the list above: the customer may expect compensation of its damages but to the amount paid for what it bought. If the parties have an established and continuing commercial relationship, such a reference would be inconsistent with the way they do business (except, of course, if the loyalty of the customer is limited or if the best orders are submitted to competitors).

A cap that is linked to the volume of deliveries between the two parties during a certain period of time is very suitable for both large and small companies and is a fair limitation. In other words, if the customer orders large volumes of product, it is much better protected against damages than customers that buy only occasionally. The period of time is then typically 12 months – one financial year of exposure.

The last two types of caps (e) and (f) serve other purposes. Having a cap defined as whichever is higher, a designated amount or, for example, the amount corresponding to 12 months turnover, would provide substance during the initial period of time or in case of irregular deliveries. Such a cap may induce the customer to start ordering. Having a cap defined as whichever is lower, a designated amount or an amount corresponding to turnover, may be useful if turnover is not an adequate reference value, for example, because the profit margins are low. In such cases, increasingly higher turnover could endanger the supplier. Providing for the lower amount alternative prevents a claim from exceeding the financial capabilities of the supplier. In both alternatives, the referenced amount could be linked to the profit plus a fixed cost element of the anticipated annual supplies to that customer (although disclosing such rationale is often undesirable).

Further differentiating the cap. Any limitation of liability established in accordance with one of the amounts mentioned above will almost invariably be subject to further discussions. A solution may be to further distinguish the risks involved (rather than applying a standard, one-size-fits-all clause). For example:

- three times X for any damages that arise during the first three months after whichever comes later: the Signing Date, or Milestone 1 having been delivered and accepted;
- two times X during the nine months thereafter; and

- one time X thereafter until whichever comes later: 24 months after the Signing Date, or 12 months after Milestone 5 having been delivered and accepted.

In the above example, the factor X could be defined:

- as a fixed amount;
- as the amount actually paid by the customer to the service provider during the 24 months preceding any claim; or
- in any other convenient way.

(iii) Carve-out for essential obligations

In many operational contracts where intellectual property rights are at stake, the limitation of liability clause contains a carve-out for breach of the confidentiality provision and for IP infringement claims. A very common (and, between equal parties, often accepted) carve-out is:

Except in case of a breach of Section [Warranty on no IP-infringement] or Article [Confidentiality clause], Seller's liability shall in no event exceed the amounts actually received by Seller under this Agreement.

In a good commercial relationship, when determining a cap on liability, buyers expect that other supplies between the parties and between their affiliated companies are also considered (i.e. the limitation should not merely refer to amounts paid under the agreement, let alone under a single purchase order).

4.7 Confidentiality clauses

Confidentiality clauses are commonly inserted in any kind of contract. They are quasi-miscellaneous provisions. Even so, a contract drafter should establish whether a confidentiality clause is indeed desirable. In contracts for the sale of bulk products, a confidentiality provision may well be excessive. In product development arrangements (sometimes as part of a sales contract), the developer may prefer to remain free to operate making use of information about the products or product applications of its customer. A confidentiality clause in a patent licence may obstruct registration of the licence in national patent registers (making the licence potentially invalid if the patent is sold and transferred to another party or if the patent owner goes bankrupt).

(i) Define the scope of confidential information

The scope of a confidentiality clause requires some care. It is essential to capture the right information. Some parties prefer to be rigorous and require that information is only considered

confidential information if it is marked as such (and furthermore, in case of oral information, the confidential information must be put in writing and communicated within 30 days of the oral presentation to be covered by the confidentiality provision). A court should be suspicious of whether such a strict approach was indeed intended by the parties. Many companies are less formal.

“Confidential Information” means any information of a non-public, confidential or proprietary nature; whether of a commercial, financial or technical nature; customer, supplier, product or production-related; and otherwise all information exchanged between the parties in the context of [the Purpose][this Agreement][the Project] shall be deemed to be confidential.

Of course, the definition can be extended by adding appropriate examples of confidential information, which may include samples, information relating to raw materials, formulae, recipes, specifications, software source code, patent applications, process designs, process models, catalysts and processed materials. Such additions should be product, sector or industry specific.

Note that the definition of Confidential Information is generic. It does not state that the information is owned by one party. This means that the body text should clarify which party may or must do what, and what rights apply upon disclosure.

Marking obligations. The relaxed approach to defining confidential information is often complemented by an undertaking to mark information as confidential, for example:

Each Party shall use its best efforts to mark the Confidential Information which is disclosed in writing as being confidential. Failure to do so, however, shall leave the other Party's obligations set forth in this Agreement unaffected.

The second sentence in this example is sometimes replaced by the more burdensome statement that orally disclosed information is only deemed to be confidential if it has been identified as such or summarized in a written document (with typically the requirement that it be sent to the Receiving Party within 30 days after the disclosure).

(ii) Scope of use (the “Purpose”) and restrictions

The scope of use of confidential information needs to be properly restricted. The two main provisions of a confidentiality agreement or clause address the disclosing party's right to select or deny a disclosure to the receiving party, and the receiving party's obligation to use disclosed information for a limited purpose only and furthermore to keep it confidential, as follows:

In mutual NDAs:

No obligation to disclose. Each Party may furnish Confidential Information to the other Party as it deems necessary or helpful for the Purpose.

For confidentiality clauses in a contract:

No obligation to disclose. Each Party may furnish Confidential Information to the other Party as it deems necessary or helpful for [the completion of the Project] OR [the performance of the Services] OR [that Party's performance].

Restrictions on use of confidential information. A Receiving Party shall not use Confidential Information of the Disclosing Party for purposes other than in direct relation with the Purpose. The Receiving Party shall treat the Disclosing Party's Confidential Information with at least the same degree of care as it would use in respect of its own confidential information of like importance, but in any event a reasonable level of care.

If a higher level of care is needed, it may be necessary to provide specific guidelines for protecting know-how. A disclosing party should in any case be entitled to rely on a higher level of care professed by the receiving party. Please note the non-capitalization of confidential information in the penultimate line, above.

Expanded scope to affiliated companies and employees. As confidentiality obligations are normally assumed by two or a limited number of formal entities, it is important to expand the scope of confidentiality to people related to those entities. Furthermore, the receiving party should limit expansion only to the extent necessary (albeit that in practice everybody will be aware that the parties are exchanging confidential information).

Related Parties. The Receiving Party shall disclose Confidential Information to its group companies (including subsidiaries and affiliates), directors, officers, employees or other representatives only on a need-to-know basis. Prior to the disclosure of the Disclosing Party's Confidential Information to such persons, the Receiving Party shall inform each such person of the confidential nature of the Confidential Information and shall expressly require that the person agrees to treat the Confidential Information as is provided in this Agreement. Notwithstanding due observance of these requirements, the Receiving Party shall be liable for any breach of the provisions of this Agreement by such person.

Note that subsidiaries and affiliates are not covered, unless they qualify as a group company (normally meaning entities that are fully consolidated in the financial accounts and hence under full control of the receiving party). Employees are, in most jurisdictions, subject to statutory duties of confidentiality, but even when they are subject to such obligations by their employment conditions; it would be unusual not to expressly refer to their obligations. Directors and officers are mentioned separately from employees because in most jurisdictions they are not an employee of the company they serve.

It is appropriate to stipulate that employees will receive confidential information on a need-to-know basis only, which makes it easier for the disclosing party to question unnecessary internal disclosures (and require a higher level of care). Finally, because all these individuals are not themselves contracting parties and probably not even capable of bearing the consequences of a breach, it is important to attribute any such breach to the receiving party (even if the receiving party has implemented proper measures to prevent disclosure).

(iii) Miscellaneous

Exceptions to confidentiality. A properly drafted confidentiality clause also addresses the exceptions, even though they may be presupposed or raised as a defence against a claim for breach. Such clause carves out certain information that is or comes into the public domain, has been developed by the receiving party (as should be evidenced properly), was received from another party (without violating a confidentiality obligation). And a further nuance to such exception may be added for information in the public domain which is not readily relatable to the use or application as disclosed by the disclosing party.

Court-ordered disclosures. Another common exception would apply in case a court orders the receiving party to disclose confidential information, in which case it is best practice to provide that, to the extent possible, the receiving party will permit the disclosing party to prevent or oppose such disclosure by the receiving party (and that the disclosure is only made to the extent strictly necessary to comply with the court's order).

Special exception for intellectual property rights. If disclosures are made in connection with research or development projects or service agreements and intended to be protected under intellectual property rights, it is important to regulate the input or suggestions for improvement. Intellectual property laws protect the creator or inventor's ideas but, if whilst presenting inventions to an adviser or interested customer, that customer gives feedback on the ideas, the latter may claim co-ownership or co-inventor rights. Such effect, co-ownership or co-inventorship merely resulting from feedback is often undesirable (but it is the legal consequence of a failing contractual arrangement to the contrary).

If the receiving party (i.e. the adviser or potential customer) refuses to waive ownership rights on any feedback given, and the disclosing party nevertheless desires to make the disclosure, it may be important to agree on a protocol allocating time and opportunity to make a disclosure in full or to give feedback, respectively. Examples can be found in most software licences or online forums, where modifications and suggestions for improvement or additional functionalities are gratefully appropriated by the licensor.

4.8 Miscellaneous clauses (boilerplates)

A number of clauses, commonly referred to as the 'miscellaneous clauses', or boilerplates are relatively straightforward and almost invariably appear in the last part of the contract. They regulate aspects of the contract which the governing law of the contract does not necessarily address appropriately. Miscellaneous clauses are usually formulated the same way regardless of the contract in which they appear. For example, an Amendments clause will typically be formulated the same way in all contracts in which it is inserted. The composition of the set of miscellaneous clauses varies slightly depending on the type of contract.

This section will discuss the miscellaneous clauses found in the ITC Model Contracts.

(a) Amendments

A provision on amendments should address two elements. First, an amendment should be in writing, to ensure that both parties understand the scope and nature of any contract changes and to be able to keep track of the status of the contract. Second, it should not be possible to amend a contract inadvertently, for example, binding a party to the informal promises of a junior sales representative. Amendments should therefore be considered (and accepted) only by the persons authorized to act on behalf of the relevant party. Consider the following clause:

Amendments. No amendment of this Agreement shall bind a Party unless it is in writing and duly signed by the Parties.

The inclusion of this provision attempts to prevent a business representative of one party making promises they cannot uphold and to prevent such promises from becoming binding because the other party acted in reliance on them. The amendment clause builds in certainty that the management of a company, not an arbitrary employee, is responsible for any assurances made by the company.

Important note. The scope of the provision is not as firm and certain as it appears, because if the same employee starts to repeat his promises and the company appears to support this (or acts accordingly), the company may nevertheless be bound.

(b) Assignment

Many contracts will provide for a prohibition to assign the rights and obligations under the agreement. Normally, each party should be able to negotiate that the other party's approval of an assignment will not be unreasonably withheld or delayed:

Assignment. No Party shall assign its rights or obligations under this Agreement in whole or in part, without the prior written approval of the other Party, which approval shall not be unreasonably withheld, conditioned or delayed.

In many cases, parties would like to make an extra carve-out for intra-group restructurings of activities or performance under the contract by an affiliate, whether for tax-related or other geographical reasons. This would be a typical example involving the applicability of "shall not be unreasonably withheld". However, contracting parties may seek more certainty. Uncertainty becomes particularly problematic when a party prepares a divestment of the business. Obviously, when the new investor is a competitor of the customer, the latter's refusal to unconditionally approve assignment is reasonable. In other cases, the parties may want to be free to assign the

agreement (i.e. the rights and related obligations) as part of a sale of the entire business to which such agreement relates. The uncertainty may be covered by a specific exception:

..., except that Seller may assign its rights and obligations under this Agreement in connection with a sale of all or a substantial part of its business to which such rights and obligations pertain.

Please note that an assignment clause does not relieve the parties to an assignment from fulfilling the requirements of the applicable law regarding the assigned rights and obligations. To give an assignment of rights its full effect (i.e. enforceability against the debtor and an obligation on the debtor to perform regarding the assignee only), most jurisdictions require a written assignment notice to the debtor.

(c) No subcontracting

Many service or supply contracts prohibit subcontracting, either in the miscellaneous chapter or in the article addressing the agreement's scope. The prohibition to subcontract any part of a party's rights and obligations is often mitigated by the phrase "which approval shall not be unreasonably withheld or delayed". A contractual stipulation may also be expanded such that, once approval is granted, specific provisions apply. Examples of subcontracting clauses can be found in the ITC Model Contracts for international corporate joint ventures (Article 20) and international long-term supply of goods (Article 25).

The practical merits of this clause are not as severe as they may appear. The background of this is certainly not limited to a desire to understand or manage a service provider's costs accumulating in the supply chain. Responsible business parties wish to be fully aware of the identity of all their suppliers in the supply chain. A customer often wants to make sure that know-how required for or developed in connection with the services obtained from a service provider does not become diluted over an extensive chain of subcontractors. Also, responsible business parties cautiously monitor the supply chain for generally unacceptable matters, such as child labour, remarkably bad working conditions or environmentally hazardous production methods. Finally, many companies do not want directly or indirectly to incorporate the technology of their competitors into their own products. An effective contractual instrument to monitor and control this would be a no-subcontracting clause.

In many cases, a no-subcontracting clause merely triggers an information requirement, as the customer does not intend to reject a request from the supplier to have certain obligations performed by a third party. Note, however, that the prohibition does imply a veto right – and if the customer established a (dual) supplier policy, the agreed performance is probably assumed to be personal. In other words, the customer may need to rely on this specific supplier or on the technology implemented by qualified, experienced employees of the supplier. In that case, the subcontracting clause will be enforced (or result in ongoing evaluation of the subcontractors).

Finally, if the agreement containing the subcontracting clause contains restrictions or covenants on quality controls, compliance, sharing or confidentiality of information or any specific other aspects, it is recommended that those provisions are forwarded to the subcontractor or that the principal may communicate directly with the subcontractor.

(d) Severability (effect of invalid or unenforceable provisions)

The quick contract drafter will often try to avoid a situation whereby if a contract clause appears to be null or void, for whatever reason, the remainder of the contract remains unaffected. Often, the contract clause addressing such nullity is redundant because a context leading to such null or void agreement is exceptional. Moreover, such an attempt may well overlook the actual consequences and the fact that, typically, European laws provide a much more refined solution.

Legal Framework. The root cause of a contract provision being null or void typically relates to fundamental matters of competition law or regulations on safety, health or environment. If solving the nullity affects the pricing or other essentials of the contract, it affects the entire contract, and the parties may prefer to be able to renegotiate or terminate their arrangement. If a nullity applies to only one jurisdiction, this will not necessarily affect applicability in another jurisdiction. For example, refer to the UNIDROIT Principles Article 3.3.1 (Contracts infringing mandatory rules) and the severability clause below:

Severability. If any provision of this Agreement is found to be invalid or unenforceable in any jurisdiction:

- (a) the validity or enforceability of such provision shall not in any way be affected in respect of any other jurisdiction and the validity and enforceability of the remaining provisions shall not be affected, unless this Agreement reasonably fails in its essential purpose; and
- (b) the Parties shall replace such provision by one or more valid and enforceable provisions approximating the original provision as closely as possible.

However, there are two significant elements that are unlikely to be addressed under national law. First, a cross-border element may be present in a contract but typically not in a national civil code. Second, it is helpful to provide for an active obligation to negotiate a proper replacement clause.

Arbitration clause. If the entire contract ‘falls away’ because a key provision becomes null or void, all modern arbitration laws will deem an arbitration provision to be ‘several’ (valid and enforceable) anyway. Hence, there is no need for specific stipulations in that respect.

(e) Waivers

Most modern laws provide that the failure of a party to claim or enforce its rights does not automatically qualify as a waiver of such rights. Also, if a party does 'waive' its rights in a certain situation, EU Member State laws will not easily presume a blanket waiver. Despite the compulsory nature of that principle and the great reluctance of courts to assume a waiver, many contract drafters still include wording that reflects the law, resulting in something less sophisticated than the law that will apply anyhow. Such inferior wording might be:

Franchisor and Franchisee may by written instrument unilaterally waive or reduce any obligation of the other under this Agreement. Any waiver granted by Franchisor shall be without prejudice to any other rights Franchisor may have and shall be subject to continuing review by Franchisor.

In certain cases, a waiver provision is useful and more adapted to the way things work in real life. For example, if it is more specific in scope or effects:

Waivers. A failure of a Party to enforce strictly a provision of this Agreement shall in no event be considered a waiver of any part of such provision. No waiver by a Party of any breach or default by the other Party shall operate as a waiver of any succeeding breach or other default or breach by such other Party. No waiver shall have any effect unless it is specific, irrevocable and in writing.

This above clause specifies what may or may not be the consequence of a party's behaviour or (informal) remarks.

(f) Entire agreement (or merger) clauses, to exclude preceding arrangements

Often, a contract will replace a preceding contract, a letter of intention or an exchange of emails in which the basics of a possible transaction have been fine-tuned. Also, in many cases, a contract is the end result of a process that began with a 'binding bid', letter of intent, memorandum of understanding ('MOU') or one or more (product or business) presentations. During the negotiations, the parties will no doubt have expressed their intentions as to how they would perform in certain specific cases or how they would generally behave in a certain context. If these preliminaries concern important or otherwise key issues of the transaction, the parties will include them in the final contract. But usually the parties will have acted in a cooperative manner to get the deal done, without necessarily assuming the performance of all promises made. Eventually, they will have identified what is essentially important or necessary to include in a written contract and will probably perform their respective obligations as a result (whether or not they are formally committed to do so), considering the other party's behaviour.

Functional approach. This is why contracting parties limit their contractual obligations to what has been negotiated and written down in the contract itself and why they may wish explicitly to exclude preceding communications and arrangements. Obviously, what will be carved out by entire agreement clauses should be limited to what is necessary (and not also cover unrelated or related arrangements). If a term sheet or letter of intent needs to be terminated, it is preferable to state this explicitly by including all identifiers of a contract. Strictly speaking, to achieve full certainty, it needs to be done by the relevant party to any such letter of intent, but in practice it is acceptable for an affiliated company to do it.

Entire Agreement. This Agreement constitutes the entire agreement between the Parties on the subject matter of this Agreement and supersedes any preceding agreement between the Parties on the subject matter of this Agreement only. In particular, the *Letter of Intent on the Acquisition of all Shares in Johnson Distribution Services Holding GmbH* dated 18 May 2017 between [N] and [C] is hereby terminated.

The binding effect of an entire agreement clause remains somewhat uncertain and always subject to interpretation. The UNIDROIT Principles are more clearly defined as seen in Article 2.1.17 (Merger Clauses) below:

Article 2.1.17 (Merger clauses)

A contract in writing which contains a clause indicating that the writing completely embodies the terms on which the parties have agreed cannot be contradicted or supplemented by evidence of prior statements or agreements. However, such statements or agreements may be used to interpret the writing.

Not always used in alliances or joint ventures. If mutual trust and cooperation are important characteristics of a transaction, the contracting parties should be reluctant to include an entire agreement clause in their contract. The matter may be particularly sensitive if extensive discussions between them have led to various arrangements that have not necessarily been incorporated into the transaction agreements. Of course, if arrangements in a letter of intent have been renegotiated or were the subject of give-and-take regarding other benefits, the exclusion of a specific document is recommended. A drafter should consider the impact of emails and other arrangements in the block notes of one party but not the other.

(g) Further assurance (or duty to cooperate)

The general concept of good faith – a core concept of EU Member State laws (but not under common law jurisdictions) – makes it largely superfluous to include a miscellaneous clause on ‘further assurances’. Nevertheless, sometimes it may be helpful to provide for such ‘duty to cooperate’. For instance, the clause may support a party’s request when it must prove its rights under an agreement versus a third party, or if the enforcement of a party’s rights requires the fulfilment of any legal or practical formality. As an example of such a clause:

Further assurance. Each Party shall cooperate with the other and execute such instruments or documents and take such other actions as may reasonably be requested from time to time in order to carry out, evidence or confirm their rights or obligations or as may be reasonably necessary or helpful to give effect to this Agreement.

Note: if you delete the clause in a mark-up on the other party's first draft, or if the other party deletes your clause, this may convey a sense of unwillingness to cooperate.

(h) Independent contractors ('no partnership established')

Although the categorization of a contract or contractual obligation is a matter of law, certain contracts originating from a common law environment may contain disclaimers such as:

Independent contractors. The Parties are independent contractors. Nothing in this Agreement shall be deemed to constitute a partnership or joint venture between the Parties or constitute any Party to be the agent of the other Party for any purpose.

The purpose of the clause is to avoid the consequences of an unwanted legal relationship. For example, if a contract, obligation or 'legal act' would entail a certain level of dependency, partnership or joint venture; in common law countries, such circumstances may create an unwanted legal structure with undesired (financial or tax) obligations. This imposes important 'duties of loyalty' upon the fiduciary, such as a duty to disclose all conflicts of interest and a duty to subordinate the fiduciary's own interests in favour of those of the other party. However, a contractual denial of the existence of such relationship or facts is not likely to be determinative of the legal effect. At the same time, consider whether the unwanted relationship is realistic at all.

No authority granted. A more valuable miscellaneous clause would be to provide expressly that the contract does not implicitly grant a power or authority for one party to act on behalf of the other party. This is because the agency doctrine of 'apparent authority' may apply. Under this doctrine, a person becomes bound by the acts of someone else, its agent, if after becoming aware of those acts, the former, as (apparent) principal, has been behaving in an acquiescent manner or must otherwise be deemed to have tacitly accepted the consequences of such acts (by its apparent agent). An argument to support the opposite intention is reflected in the following sentence from an 'independent contractors' clause:

No Party shall have any authority to act for or bind the other Party in any way, or to represent that it has such authority.

Note: since the provision is not also addressed to unrelated third parties acting in reliance on the representative's acts, its effectiveness is limited to the internal relationship between the 'apparent principal' and its 'agent'. Typically, a miscellaneous clause on 'independent contractors' is unnecessary. A stipulation that one party shall not represent the other is of limited use.

(i) Time is of the essence

The qualification of 'breach of contract' should be preceded by (or happen concurrently with) the 'default' of a party. However, whether a party is in default is not always clear. Obviously, if the party must deliver work or a product that will be used during the Olympic Games, for example, then a stipulated deadline unequivocally triggers the default if delivery does not take place by the specified date.

Default. A provision that 'time is of the essence' is sometimes included to emphasize that the debtor is in default upon its failure to meet a certain deadline for delivery. An imprecise example:

Time is of the essence. Supplier shall adhere to the time schedule in the Statement of Work. Each date specified in the Statement of Work is of the essence, unless the context clearly and unequivocally allows otherwise. The Parties will notify each other promptly of any circumstances that may adversely affect the time schedule in the Statement of Work, specifying the causes of delay and expected duration of it, as well as all proposed measures to reduce the delay as much as practicable.

If all delivery dates are stated as being 'of the essence', the statement is probably superfluous because whether a timely delivery is indeed 'of the essence' is a factual question based on the circumstances and subject to qualification by the operation of law. Of course, in a commercial services agreement agreed in the context of a larger project, meeting the contractual milestones may well be essential. It is recommended that you ensure that this is understood using facts other than a boilerplate provision such as the above example. In common law jurisdictions, 'time is of the essence' often means that delayed performance permits the affected party to terminate the contract.

A useful element to include in the same provision is the agreed remedy in case a delivery date cannot be met. In ongoing relationships, the people involved will contact each other and explain regardless. Without a contractual remedy, however, it may be more difficult to ensure that the defaulting party notifies promptly, let alone expect a collaborative approach from the defaulting party.

(j) Contract language (translations)

If a contract is translated into another language (e.g. because the local law requires that contracts be drawn up in an officially recognized language for the contract to be valid and enforceable), it is important to state this and to determine which version will prevail in case of inconsistencies or contradictions between the two. An example of a clause providing for the prevailing version in such circumstances:

Language. This Agreement has been drawn up in the English language. In case of discrepancies between the English text version of this Agreement and any translation, the English version shall prevail.

The first sentence may sound superfluous, but a translator should not translate the word English, for example, into the characters for Chinese. In that case, the reader of the Chinese version must be alert that another text version might be slightly different.

The UNIDROIT Principles provide:

Article 4.7 (*Linguistic discrepancies*)

Where a contract is drawn up in two or more language versions which are equally authoritative there is, in case of discrepancy between the versions, a preference for the interpretation according to a version in which the contract was originally drawn up.

(k) Counterparts

The counterparts clause is one of the most remarkable miscellaneous provisions in modern common law practice. Even though over the past century it has become almost completely unnecessary, it is still inserted into most contracts originating from those jurisdictions. For legal systems other than those based on the common law, the clause is superfluous.

Background. In common law countries,²⁸ 350 years ago, a defendant in court may require a claimant to provide evidence of the existence of a valid contract by handing over the original documents. If an original with the signatures of both parties or a counterpart with the signature of the other party could not be shown, a court would have decided that no valid or enforceable contract had been entered into. At that time, halfway through the seventeenth century, contracts were drawn up in one of two ways: either as one document reflecting both parties' rights and obligations and signed by each of them (each party received an identical copy, and both copies were considered to be an original); or by the combination of one document reflecting the rights of the lessor or seller (called the original) and another document reflecting any remaining rights and obligations (called the counterpart). The terminology referred to the physical presentation of contracts – the original and the counterpart were separated by a perforation for detaching the two counterparts, and each party signed the other party's counterpart (on which its obligations were reflected). At the turn of the nineteenth century, contracts were typed on paper with carbon copies behind them; the carbon copies were the counterparts of the original. In those days, the need for a statutory countersigning requirement was understandable to prevent fraud.

It would suffice to hand over an original executed by the other party if a contract contains a counterpart's clause such as:

²⁸ More specifically, under the *Statutes of frauds* of those countries.

Counterparts. This Agreement may be executed in one or more counterparts, each of which shall be deemed to be an original, and all of which together shall constitute one and the same agreement.

Modern necessity. For obvious reasons, over the centuries, common law courts have created numerous caveats and exceptions to the burdensome countersigning requirement. The idea behind the requirement was that under the common law *Statutes of Frauds*, strict formal requirements apply to the validity and enforceability of certain types of contract. To understand these requirements better, compare the formalities applicable on the European continent for vesting a right of mortgage or incorporating a company, which are typically subject to the notarial form. But because not all *Statutes of Frauds* have been modernized and case law is still relatively scarce, there is no certainty that courts will reject a party's claim in court if there is no properly executed counterpart. For the last few decades, copiers and printers have produced originals and their counterparts as if both are an original. So the counterparts clause became completely redundant.

Recommendation. Even today, American contract drafting books can spend pages on the uncertainties that various wording can create. When contracting with an American or common law party, the advice is to insert the simple clause suggested above, and if the clause is marked up, accept it as amended.

4.9 Applicable law and dispute resolution clauses

(a) Applicable law (choice-of-law clauses)

Most contracts contain a provision on the applicable law – a clause that determines which law will apply to the transaction or contractual relationship. The effect of a choice of law is that, with only very few exceptions, the contract is governed by the law referred to in that clause.²⁹ A standard and sufficient choice of law provision is:

This Agreement is governed by the laws of [specify the relevant national law].

The ITC Model Contracts approach. The ITC Model Contracts provide an attractive compromise for those who are unable to agree on a national law for this provision. Instead of appointing an applicable national law, a staggered approach is adopted:

Questions relating to this contract which are not settled by the provisions contained in this contract itself shall be governed by the *United Nations Convention on Contracts for the*

²⁹ Article 3 Rome Convention of 1980 on the Law Applicable to Contractual Obligations, entry into force 1 April 1991.

International Sale of Goods (Vienna Convention of 1980, hereafter referred to as CISG) as well as the UNIDROIT *Principles of International Commercial Contracts*, and to the extent that such questions are not covered by CISG or the UNIDROIT Principles, by reference to [specify the relevant national law].

Scope of a choice of law. Even though a choice-of-law clause designates the law that applies to the agreement, the parties may be unable to avoid certain mandatory law provisions of the contracting parties' national laws. By operation of the applicable conflicts of law provisions, a distinction must be made in relation to:

- **non-contractual matters** – subject matters that qualify as a category of private international law, for the parties cannot choose another law other than the *lex causae* – this may be the case in connection with the transfer of ownership of real estate, movable property in a foreign jurisdiction, aspects of company law, insolvency law, securities law, competition law, etc;
- **regulatory matters** – for example regulatory matters designed to protect a local market, such as food, feed and pharmaceutical regulations, regulations relating to the registration or authorization of chemical substances, laws and regulations relating to the financial markets, insurance and provision of financial advice, telecom and energy laws etc;
- **'super-mandatory rules'** – subject matters covered by a 'scope rule' (i.e. a super-mandatory rule that applies regardless of the law governing the contract) – usually matters related to socioeconomic politics (employment law or employee codetermination law) or environmental. These super-mandatory rules are a limitation to the freedom of contract and apply despite the choice of law that the parties may have made;
- **public policy** – a local rule or provision is preferable if the otherwise applicable law would violate or be contrary to social, moral and even religious values of a society;
- **consumers and employees** – in the case of employment agreements and consumer contracts, different choice-of-law rules apply to protect the interests of the weaker party. In some countries, this is considered an extension of public policy;
- **civil procedural law** – the applicable arbitration law (or other law of civil procedure), as an arbitration is governed by the law of the agreed place of arbitration, whereas a choice of court implies a choice for the civil procedural laws applicable in the chosen jurisdiction. If, exceptionally, the parties wish to agree on a particular other arbitration law, they may do so explicitly;³⁰

The law applicable to the subject matters listed above is determined based on provisions of private international law (or public international law, as the case may be) and are different from those of contractual obligations. Of course, they might be subject to the law chosen by the parties, but that would be because the relevant provisions point to the same legal system. The following sections present a few particularities of legal practice.

Which law to choose? In most contracts, the applicable law is chosen by the strongest party. Alternatively, that party may be willing to revert to the law of a neutral country. English common

³⁰ Theoretically, the force and effect of such deviation may be mitigated by the *lex causae* governing the arbitration (i.e. if the otherwise applicable arbitration law does not allow for party autonomy on such choice).

law and Swiss law are popular alternatives. In any case, it is recommended but not mandatory that, if the parties choose a public court (as opposed to arbitration), they also opt for the law of that court's jurisdiction. If the United States is chosen, the clause should specify the state (e.g. New York, California, Florida, Illinois) because contract law is state law in the United States, not federal law.³¹

In this case, if an external law firm has been engaged, the external lawyer will need to stop representing their client, as many professional insurance companies reject coverage for professional liability in such cases. In-house lawyers will be more inclined to compromise, e.g. a large European multinational might opt for the laws of another country from which it could provide legal support (or simply because it believes it should be able to stand for its approach in any modern jurisdiction).

Applicability of Incoterms and UCP600. In principle, the chosen law applies to the contract in its entirety. The parties are free, however, to identify specific parts of their contract (or agreements attached as a schedule or annex) and submit those parts to a different applicable law. This is called *depeçage*. It is also worth mentioning supranational rules and regulations such as the Incoterms and UCP600 in this context.³² The legal status of these rules is not always clear; in some jurisdictions they are considered 'contractual arrangements incorporated into the contract by reference', whereas in other contracts they are seen as a separate body of law. In any case, a proper reference to such rules or regulations could be considered as *depeçage* and be valid and enforceable.

International nature is necessary. For a choice-of-law clause to be effective, a contract must be international. If a contract is **not** international, the effect of the choice-of-law clause is that only the supplementary law (*ius dispositivum*) from the local law of the contracting parties is replaced by the chosen law; the local mandatory law of the contracting parties' jurisdiction cannot be contracted away.

When is it 'international'? A contract is international if an element of some significance in the agreement points to a jurisdiction other than the law that would otherwise be assumed to apply in the usual course of things. This is most obvious if the two parties are established in different jurisdictions but also exists when both contracting parties are from the same jurisdiction and delivery of the goods takes place abroad. A sales contract is generally considered to be 'international'. It is not clear in all jurisdictions when a contract becomes international, but the prevailing opinion is that the criteria are relatively easily met.

Relevant moment. In determining whether a contract is 'international', the relevant time is always the moment of contracting – the time of consensus – between the parties. This implies that if one party subsequently relocates abroad, in principle this does not affect the internationality of the agreement (i.e. the agreement does not become international as a result). Nevertheless, as mentioned above, the threshold for assuming internationality is low – if the parties anticipate a

³¹ But, in the United States, intellectual property law, bankruptcy law, securities law and competition (antitrust) law are (primarily) federal law.

³² UCP600 is the successor of UCP500, a set of rules governing the issuance of and performance under letters of credit. ICC Publication No. 600. ICC Uniform Customs and Practice for Documentary Credits.

relocation, this might be sufficient to expressly choose the applicable law (and accordingly, but subject to the court's assessment, a foreign law can be chosen).

Dispense with the phrase ‘...excluding its conflicts of law provisions’. Choice-of-law clauses regularly contain the phrase ‘excluding its conflicts of law provisions’ (or a similar provision attempting to exclude the operation of principles of private international law). It is used so often and yet is so useless that clarification is desirable.

The phrase ‘excluding its conflicts of law provisions’ attempts to exclude the private international law provisions of the law chosen under that same choice-of-law clause.³³ The phrase is meaningful only if the private international law rules of the chosen law would ‘refer’ the same matter to another law. This is only possible under the (private international law) concept of ‘*renvoi*’.

What is *renvoi*? Many systems of private international law reject *renvoi*, which is understandable because *renvoi* is a source of legal uncertainty, potentially leading to circular or endless referrals. Moreover, *renvoi* would not necessarily lead to an unequivocally acceptable solution. Finally, many legal systems reject *renvoi* because it may introduce inefficiencies into the case at hand. Countries that do accept *renvoi* normally reduce its scope to a minimum. Areas typically excluded from the working sphere of *renvoi* are contractual obligations and areas that permit broad party autonomy (*ius dispositivum*). In essence, the applicability of *renvoi* in a choice-of-law clause, and hence the phrase ‘excluding its conflicts of law provisions’, seems rather exceptional.

Exclude the applicability of the Vienna Convention? Many contracts opt out of the applicability of the Vienna Convention (CISG).³⁴ Most lawyers do this ‘because everyone else does’, and many opt out even if it is not applicable. But there are very good reasons not to exclude the Vienna Convention and hardly any reasons to do so.

Reasons not to exclude CISG. The (international) sale of goods is one of the bodies of law that has become considerably harmonized over the centuries (and being predictable has always been an important factor for trading companies to do business). Even the legal concepts underlying sales contract law are similar or equivalent under various legal systems. The Vienna Convention is not different in this respect. A court is not likely to rule on important questions relating to ‘fitness for purpose,’ ‘conformity,’ ‘free from liens’ or ‘merchantability’ differently under the Vienna Convention from under any applicable national law. In many cases, handbooks on the Vienna Convention provide more details on case law developed in various national courts than any national case law is reasonably capable of addressing. It is commonly considered that opting out of the applicability of the Vienna Convention has to do with getting ‘cold feet’.

Nonetheless, if you wish to exclude the CISG, you may do so as follows:

The *Convention on Contracts for the international sale of goods* (Vienna 1980) does not apply.

³³ Conflict of laws is an area of private international law, which deals with determining the applicable law, as may be appointed by a choice-of-law clause.

³⁴ The Convention on Contracts for the International Sale of Goods (Vienna 1980).

(b) Failing to include a choice of law (the *lex causae*)

Closest connection and characteristic performance. If the parties fail to express a clear choice of law, the rules of private international law bring the contract under a national law. In case of a contract, that will be the jurisdiction with which it has its ‘closest connection’. Thus a contract will be localized in the jurisdiction of the party who has to perform the most characteristic obligation. This principle, which was first formulated under Swiss private international law, has been adopted worldwide, with the most important exception being the United States.

Characteristic performance in the eight ITC Model Contracts. The characteristic performance of each of the ITC Model Contracts may differ from one another.

- In a sale of movable goods contract, the characteristic obligation is the act of sale and delivery of the goods (as opposed to the payment of the purchase price). Accordingly, a contract of sale without a choice of applicable law will normally be governed by the laws of the country where the seller is established. The same applies to a long-term supply agreement, which is essentially a sales contract.
- In a distribution contract (without an express choice of law), the supplier performs the characteristic obligation (not the distributor, since distribution is a species of sales).
- In a commercial agency contract, the situation is slightly more complicated – it is less evident which party’s obligation is more characteristic: most probably the agent’s duties, but agency sometimes resembles an employment relationship. Therefore, (even with an express choice of law) a commercial agent will to a large extent be protected by super-mandatory rules of the jurisdiction where it operates (at least that would be the case in the EU).
- In a manufacturing contract, the manufacturer performs the most characteristic obligation, whether manufacture and sale or the service of manufacturing, so in the absence of a choice of law, the law of the country where the manufacturer is established applies.
- In an incorporated joint venture, the joint venture company’s internal rules would be those of the applicable company law; to avoid uncertainties, a joint venture agreement among shareholders will typically be subjected to the laws of the joint venture company, although exceptionally, the ‘joint venturers’ might have their reasons to opt for another applicable law. If no choice is made, a corporate joint venture agreement and an alliance agreement are difficult to localize. In many collaboration efforts, it appears arbitrary to establish which party performs the most characteristic obligation. In such cases, the more abstract principle of establishing the ‘closest connection’ with a national legal context might provide an answer.

(c) Dispute resolution provisions

It is strongly advised to provide for a dispute resolution mechanism. The following section addresses various drafting issues that arise in this context.

(i) Choosing court or arbitration?

The principal question is whether disputes should be settled in court or by means of arbitration. Many lawyers make their choice based on hearsay or after one or two bad experiences in arbitration.

Decisive factors. The decisive factors for choosing arbitration instead of public court proceedings are:

- **Enforceability of a decision.** Arbitration is almost inevitable if there is no treaty between the countries in which the final decision must be executed and the country of an agreeable court (e.g. a convention on the enforcement of foreign judgments). The New York Convention of 1958, facilitating the enforcement of arbitral awards, has been ratified by an impressive number of countries.
- **Confidentiality.** With arbitration, there is no newspaper coverage of a dispute.
- **Greater expertise of arbitrators.**
- **International approach of a dispute.** In court procedures, the foreign party will likely feel uncomfortable about possible chauvinist attitudes the national court may take. An arbitral tribunal may be more receptive to international standards.
- **Speed (although arbitration is sometimes slower).** It is not generally true that arbitration is slower than court proceedings.
- **Adaptability of the arbitral procedure.**

Whatever the parties agree, they should certainly not provide both for arbitration and a choice of court. Also, if the choice is made for arbitration, it is highly unusual to provide for a right of appeal (not even in court) and the decision not to choose arbitration should not be driven by the lack of such right of appeal.

(ii) Choices of court

Policy decisions. If the parties decide to avoid arbitration or prefer court proceedings, a choice of court provision will be appropriate. In essence, the 'political' questions asked in connection with a choice of court provision in commercial contracts are:

- What is the best choice to ensure as much as possible the continuation of business?
- Should we discourage court proceedings by providing for an unattractive procedure? Alternatively, do we need an expeditious court decision?
- Is a carve-out for certain actions desirable (e.g. the right to seek protection under applicable intellectual property laws in a different jurisdiction)?
- Where should we engage a law firm?

The answers will follow from some very general observations of each party's probable interests and power to settle disputes amicably.

Exclusive jurisdiction. A choice of court is typically made under the assumption that the choice excludes the international jurisdiction of other courts. In Europe, making this explicit is not necessary – both the Brussels Regulation and the Lugano Convention (the regulation's counterpart for non-EU Member States) determine that in the absence of such an express stipulation, jurisdiction of the appointed court over any dispute is exclusive. Since United States courts do not recognize the scope of the Regulation or the Convention, it is recommended that this is made explicit by including the word 'exclusive'.

Relative jurisdiction. Normally, it is not necessary – and potentially a source of confusion – to express which level of court jurisdiction (relative competence) applies. It is unnecessary because local civil procedural law will determine the level (and does not always permit a choice); it can be a source of confusion if at the time of a dispute it appears that the drafter did not intend to choose the relative jurisdiction but rather was trying to be too clever. The parties might find themselves having precluded a right to appeal (e.g. because they appointed a Court of Appeals).

(iii) Arbitration or expert determination?

It is important to distinguish dispute settlement by arbitration from expert-determination proceedings. Arbitration is suitable when the parties have a true dispute, for example differing opinions on the interpretation of a contract, disputes as to whether one party can be held liable, or a deadlock in decision making. In the case of deadlock, a more sophisticated mechanism such as mediation or a dispute board would probably be more desirable. Expert-determination proceedings are relevant in relation to matters that require the establishment of facts. Accordingly, many argue that arbitration relates to legal issues whereas expert determination relates to matters of fact.

Of course, the parties may be in dispute on the establishment of a certain value, amount or quality level, and most disputes can be traced back to questions about how much a party should pay. In practice, it is often best to determine the appropriate procedure based on the issue at hand.

(iv) Expert-determination clauses

When to use experts? The appropriateness of expert determination is often overlooked. Typical examples of matters that can be subjected to expert determination are:

- the determination of the final purchase price (and purchase price-related elements) under a share or business purchase agreement;
- the questions of whether the delivered products or services meet the agreed product specifications;
- the determination of the amount of damages;
- the determination of a root cause of certain damages (e.g. whether a defect in a delivered product was caused by a hidden defect in the product itself or by external circumstances);

- the valuation of important assets or of a business or legal entity in the event of an exit procedure (e.g. if a party terminated a joint venture or if a partnership share needs to be bought out);
- a situation where it is undesirable that a party obtains access to confidential information regarding the other party (e.g. determinative sales or turnover figures in connection with a royalty audit).

What to ask from an expert? The questions for the expert must be rather straightforward and should not involve assessments that may trigger elaborate discussions between the parties or a judgement as to what is reasonable or appropriate under the circumstances. This does not mean, of course, that an expert should not be reasonable or should disregard all circumstances. It also does not mean that an expert's opinion may not contain any speculative elements. Furthermore, a careful expert is likely to give each party an opportunity to explain the case (and respond to explanations from the other party) before reaching a final determination.

Important elements of an experts clause include:

- the expert's involvement is triggered based on clear (objective) criteria;
- the expert's independence from both parties is properly secured, although an expert engaged for auditing the other party's books and records would only need to be reasonably acceptable;
- the expert's appointment should take place expeditiously, implying that the contract should provide for clear deadlines to object or agree on a proposed appointment and, failing consensus, on (the chairman or president of) a named authoritative expert institute that will make the appointment in case of disagreement;
- high-level expert-determination principles, the failure of which may give rise to disputes between the parties, are clarified beforehand (and ideally in the contract itself);
- the expert should have adequate access rights to the information needed for the determination, subject to such information being kept confidential (including, in some instances, regarding the other party). Such information or access should be given promptly;
- it may be desirable to provide for an allocation of the related costs, depending on the outcome of the expert's determination. In case of a royalty audit, it would be appropriate to allow for a threshold for any excusable misstatements or relief.

(v) *Arbitration institute or ad hoc arbitration?*

If arbitration is chosen, the parties should decide to submit to ad hoc arbitration or choose an appropriate arbitration institute. If the potential disputes under a contract are likely to be simple or capable of being resolved relatively easily, it is perfectly fine to provide for ad hoc arbitration. In that case, the arbitration law of the place of arbitration will determine how the arbiter or arbitral tribunal will be appointed, unless the parties have provided for their own appointment mechanism.

Which institute? Normally, the parties will agree on an arbitration institute to administer the arbitration. Arguments regarding specific expertise or the location of the institute's principal office,

as well as a link with the applicable law, might influence the choice. A contract drafter will encounter competition among the major arbitration institutes: ICC, American Arbitration Association (AAA), London Court of International Arbitration (LCIA), the Stockholm or the Swiss chambers of commerce, the NAI, 'Singapore' and CIETAC – each have their particular benefits. It may be helpful if you establish a contracting policy on the arbitration institute you appoint when the agreement 'moves out of your jurisdiction'. In the United States, one would often choose either the ICC or International Centre for Dispute Resolution, the international division of the AAA (pronounced triple A), or JAMS.

Which arbitration clause? After the choice of an arbitration institute, it is recommended to include the model arbitration clause of the elected institute in the contract. If you change the arbitration institute during contract negotiations, the arbitration clause should be amended according to the agreed institute's model clause.

(vi) Drafting an arbitration clause

All model arbitration clauses provide for some options. Normally, it is advisable to include them:

1. The parties should agree on a **place of arbitration**. Although the arbitration rules will provide for a solution, identifying a venue improves the enforceability of an arbitral award. Although the arbitral proceedings would normally be held in the chosen city, this is not a must (the parties may always agree on other places). You should know that all arbitral institutes will allow you to compromise on any place of arbitration;
2. The parties may agree on the **number of arbiters**. Many arbitration laws require that this must be an odd number (one or three);
3. Be aware that in the absence of a **choice-of-law clause** the arbitral tribunal may sometimes be entitled to 'decide *ex aequo et bono*' – instead of settling the dispute in accordance with the rules or law and court precedents, decide according to what is just or appropriate in the specific case. This depends on the applicable arbitration law and thus on the jurisdiction of the place of arbitration. Since nearly all arbitration laws are highly flexible, there is no need to explicitly stipulate that another arbitration law applies. Parties might, however, desire to determine that the arbitral tribunal "shall decide in accordance with the rules of law" or "as *amiable compositeurs*";
4. The parties may or may not want to provide a customised **mechanism for appointment** of the arbitral tribunal. Each arbitration institute has its own rules, but all institutes require that the arbitral tribunal be independent from both parties (even though the parties might have nominated their own 'representatives' on the tribunal);
5. Most arbitration institutes provide for adequate **access to summary proceedings** and provisional measures. If not, the applicable arbitration law will probably allow for it. Nevertheless, you might exceptionally want to say something about such a possibility.

(vii) Mediation and escalation

Mediation. Once it comes to litigation, the termination of the contract is almost inevitable. Therefore, in complex or relational contracts in which unwinding the contract may give rise to another source of dispute, providing for mediation may be desirable.

It is a matter of best practice to link the mediation and arbitration provisions to each other. Normally, you would probably want to have mediations coordinated and administered by the same institute as a subsequent arbitration (if any). Each arbitration institute mentioned above also provides for ADR ('alternative dispute resolution') procedures (and model clauses are available on the respective institutes' websites). Many people believe that mediation has no reasonable chance of success if one of the parties does not sincerely wish to settle the dispute. Therefore, a mediation clause is primarily a voluntary procedure, albeit that the admissibility of an obligatory mediation clause before arbitration may vary. This subtlety depends on the actual wording of the provision.

Escalation clauses. In contractual relationships between major parties that regularly do business with each other, an 'escalation clause' providing for the escalation of a dispute to the principal executive officers would be another means of dispute settlement. The idea behind an escalation clause is that the party who threatens the relationship between the parties should subsequently face internal discussions as to whether and how the senior executives must be involved (including any career-limiting effects of such involvement). In other words, both parties will go up the hierarchical ladder of their organization upon the occurrence of a contractual triggering event. The senior executives selected should not have been directly involved in the dispute but need to have the authority to bind the party they represent.

An escalation clause contains several incentives. The persons directly involved in the dispute may be reluctant to escalate, given the 'shameful' implication that they were not able to settle the matter themselves. Moreover, senior executives will spend only as much time on the matter as their (financial or strategic) interest justifies and will settle as quickly and pragmatically as possible. Such escalation would be effective if they must consider the higher desirability of all relationships between the parties or if they can compromise on other disputes or irregularities as well.

Chapter 5. MAIN LEGAL INSTRUMENTS AND PRINCIPLES

This chapter addresses the key areas and merits of the laws as reflected in the ITC Model Contracts (or as may be triggered by implementing those contracts in real life). The main topics that will be discussed are:

- UNIDROIT Principles of international commercial contracts (section 5.1).
- United Nations Convention on contracts for the international sale of goods (CISG, Vienna 1980) – section 5.2).
- ICC Incoterms 2010 (section 5.3).
- Various cross-border payment conditions and usages (section 5.4).
- Intellectual property rights (section 5.5).
- Competition (antitrust) law (section 5.6).

The following important topics in international contracting will not be addressed because the related rules and regulations are of a technical nature, or because there is little uniformity among national implementations of those rules and regulations:

- **Corporate social responsibility (CSR) in contracts.** Over the past few decades, multinationals have become very keen on the ethics of the people and companies with whom they conduct their business. This attitude has been triggered by scandals, pressure exercised by the public, or a fundamental belief that a business must be conducted responsibly.

Adopting corporate social responsibility means that multinationals refrain from purchasing goods and services from parties engaged in questionable practices or dealings, and they strictly monitor full compliance with the standards. Key focus points of CSR policies typically include the avoidance of:

- child labour;
- violations of human rights;
- substandard employment conditions;
- use of hazardous substances;
- application of environmentally unfriendly materials or practices;
- engagement in bribery or corrupt practices;
- committing a criminal offence or involvement in any illegal business.

Obviously, these multinationals do not only adopt the CSR policies internally but expect them to be applied by all suppliers across the entire supply chain (i.e. also by suppliers to suppliers). Many multinationals take a step further and organize their business in such manner that they serve as an example for their business sector (industry stewardship).

- **Public procurement.** Contracts with governments are typically subject to rules and regulations ensuring fair treatment of market parties. The procurement of goods or services by governmental (or semi-governmental) institutions is well regulated in many countries and include the preparation of specifications and criteria for goods or services to be purchased, contacting potential suppliers, tender and selection. The entire process is subject to many specific rules preventing any unjustified preferential treatment and making sure that the government does not pay too much for its goods or services.
- **Personal data protection.** Companies are not entitled to collect and store personal data from consumers, end-users, potential (individual) customers, or even their employees, unless it serves a proper and legally justified purpose. With the increased relevance and importance of the internet, it is possible to use such personal data for purposes that do not correspond to the intent of the persons concerned. National and international rules have tended to become more and more restrictive, to protect the privacy of each individual.
- **International taxation (VAT, corporate income tax, wage tax).** Taxation is not only a national affair but also an international arena. Governments compete with each other to attract multinationals to establish their business headquarters in one country instead of another. International tax treaties ensure that a company will not be directly or indirectly charged twice for the same taxable income in different tax jurisdictions. The mere existence of these treaties also encourages companies to establish their business in a certain country (and avoid another).
- **Import and export regulations.** Various types of business are subject to import or export restrictions. These restrictions attempt to prevent technology, nuclear materials, chemical or biological substances, or military-technical information from being transferred to certain countries where the information or goods may be abused.

5.1 UNIDROIT Principles of International Commercial Contracts

Throughout this handbook, many generally accepted principles of international contract law – rules of the *Lex Mercatoria* or usages and customs of international trade – have been discussed with reference to specific UNIDROIT Principles.³⁵ In this section, a few high-level concepts underlying international trade will be addressed by referring to the UNIDROIT Principles. These general concepts include freedom of contract, the principle of good faith and fair dealing, and practices and usages of international trade.

Scope. The UNIDROIT Principles set forth general rules basically conceived for international commercial contracts. The concept ‘international’ should be given the broadest possible interpretation, to exclude only those contractual relationships where no international element is involved at all. The term ‘commercial’ is intended to exclude so-called consumer transactions, aimed at protecting the consumer (i.e. a person who enters into a contract other than in the exercise of a trade or a profession).

³⁵ The introduction to the UNIDROIT Principles in this section is largely based on and inspired by the official comments to its preamble and Articles 1.1, 1.7 and 1.9.

The UNIDROIT Principles as the applicable law. Given that the UNIDROIT Principles embody a system of principles and rules of contract law common to existing national legal systems or best adapted to the special requirements of international commercial transactions, there might be good reasons for the parties to choose them expressly as the rules of law governing their contract. In so doing, the parties may refer to the UNIDROIT Principles exclusively or in conjunction with a particular domestic law that applies to issues not covered by the UNIDROIT Principles. The Model Clauses are divided into four categories according to whether their purpose is. For example, choose the UNIDROIT Principles as the rules of law governing the contract;

“This contract is governed by the UNIDROIT Principles of International Commercial Contracts (2010).”

Alternatively, incorporate the UNIDROIT Principles as terms of the contract (in which case the broad array of principles apply to the contractual relationship or transaction. If both the contract and the UNIDROIT Principles leave an issue unresolved, the solution is to be found in the chosen applicable law;

“This contract is governed by the UNIDROIT Principles of International Commercial Contracts (2010) and, with respect to issues not covered by such Principles, by the law of [country].”

UNIDROIT Principles in arbitration. Some public courts might consider that freedom to choose the applicable law is limited to national laws. Therefore, it is recommended that parties who wish to choose the UNIDROIT Principles as the rules of law governing their contract combine this choice of law with an arbitration agreement. Since the UNIDROIT Principles could be considered a mere set of rules, the law applicable to the contract would still have to be determined based on private international law rules. In such approach, the UNIDROIT Principles would bind the parties only to the extent that they do not affect mandatory law. This is different in arbitration. Arbitrators are not necessarily bound by a particular domestic law. This is self-evident if they are authorized by the parties to act as *amiable compositeurs* or *ex aequo et bono*. Moreover, the parties are generally permitted to choose rules of law other than national laws, on which the arbitrators must base their decision. Accordingly, the parties would be free to choose the UNIDROIT Principles as the rules of law according to which the arbitrators must decide a dispute.

UNIDROIT Principles and *Lex Mercatoria*³⁶. Parties to international commercial contracts who cannot agree on the choice of a particular domestic law as the law applicable to their contract sometimes provide that it shall be governed by “general principles of law”, by the “usages and customs of international trade” or – as such general principles or usages and customs are sometimes also called – by the ‘*Lex Mercatoria*’. In such cases, it might be advisable to submit to the UNIDROIT Principles. The UNIDROIT Principles can be considered to reflect the *Lex Mercatoria* (if any such body of law can be identified at all) and certainly reflect the usages and customs of international trade.

³⁶ The term refers to the principles of trading used among merchants in medieval period across Europe.

A rich source of materials, cases and arbitral awards related to a 'codification' in 130 principles of the *Lex Mercatoria* (and referring also to the UNIDROIT Principles) has been collected by Professor Klaus Peter Berger. The collection is available on the Trans-Lex website.³⁷

(a) Freedom of contract

A fundamental principle in international trade. The principle of freedom of contract is of paramount importance in international trade. The principle embodies the freedom to decide to whom a company will offer its goods or services and by whom it wishes to be supplied, as well as the terms and conditions of the related transactions. This is inherent to an open, market-oriented and competitive international economic order.

Exceptions and limitations. Regarding the freedom to conclude contracts with any other person, certain economic sectors are in the public interest excluded from open competition, e.g. military goods and materials, nuclear products, technology, raw materials or ingredients that might be used for chemical or biological weapons. In such cases the goods or services can only be ordered from selected suppliers, subject to terms and conditions consistent with the public interest.

Limitation by mandatory rules. Freedom of contract, to the extent that it relates to the subject matter of an agreement, is further limited by mandatory law – laws and regulations from which the parties may not derogate. Such mandatory law is of a national nature and applies by operation of the conflict of laws principles. Although the contracting parties have a great discretion to avoid mandatory law by making a choice of law for a jurisdiction which is more favourable or familiar to them (or whatever other justification, if any, the parties may have), the rules of private international law may qualify specific laws and regulations to prevail despite such choice of law (e.g. laws requiring a certain level of employment conditions or protecting certain weaker parties such as agents).

(b) Good faith (and fair dealing)

(i) *Good faith as a fundamental legal principle*

The principle of good faith may be considered as one of the fundamental legal concepts underlying the UNIDROIT Principles. The UNIDROIT Principles refer to the concept as “good faith and fair dealing”, as follows:

³⁷ See <http://www.trans-lex.org/principles>.

Article 1.7 (Good faith and fair dealing)

- (1) Each party must act in accordance with good faith and fair dealing in international trade.
- (2) The parties may not exclude or limit this duty.

By stating in general terms that each party must act in accordance with good faith and fair dealing, it is clear that even in the absence of special provisions in the UNIDROIT Principles, the parties' behaviour throughout the lifecycle of a contract – including the negotiation process – is governed by the overriding principle of good faith (and fair dealing).

It is very difficult to grasp an abstract concept such as good faith and fair dealing. This concept is therefore thoroughly illustrated in the comments to the UNIDROIT Principles:

Illustration 1 (enabling the other party to perform duly).

A grants B forty-eight hours as the time within which B may accept its offer. When B, shortly before the expiry of the deadline, decides to accept, it is unable to do so: it is the weekend, the fax at A's office is disconnected and there is no telephone answering machine which can take the message. When on the following Monday A refuses B's acceptance, A acts contrary to good faith since when it fixed the time-limit for acceptance it was for A to ensure that messages could be received at its office throughout the forty-eight-hour period.

Illustration 2 (not avoiding responsibilities transferred to affiliates).

J's contract for the supply and installation of a special production line contains a provision according to which J, the seller, is obliged to communicate to P, the purchaser, any improvements made by J to the technology of that line. After a year P learns of an important improvement of which it had not been informed. J is not excused by the fact that the production of that particular type of production line is no longer its responsibility but that of SAF, a wholly-owned affiliated company of J. It would be against good faith for J to invoke the separate entity of SAF, which was specifically set up to take over this production to avoid J's contractual obligations regarding P.

Illustration 3 (not systematically and unjustifiably exercising discretionary rights).

A, an agent, undertakes on behalf of B, the principal, to promote the sale of B's goods in a given area. Under the contract A's right to compensation arises only after B's approval of the contracts procured by A. While B is free to decide whether to approve the contracts procured by A, a systematic and unjustified refusal to approve any contract procured by A would be against good faith.

Illustration 4 (no sudden and unjustified change in exercising contractual rights).

Under a line of credit agreement between B, a bank, and C, a customer, B suddenly and inexplicably refuses to make further advances to C whose business suffers heavy losses as a consequence. Notwithstanding the fact that the agreement contains a term permitting B to accelerate payment "at will", B's demand for payment in full without prior warning and with no justification would be against good faith.

(ii) Abuse of rights

A typical example of behaviour contrary to the principle of good faith and fair dealing is known in some legal systems (in particular, in the Roman legal systems (and Swiss law), as ‘abuse of rights’. The term refers to a party’s bad faith, opportunistic or unjustifiable behaviour, for example when a party exercises a right merely to damage the other party, or to serve a purpose other than the purpose for which the right had been granted, or when the exercise of a right is disproportionate to the originally intended result.

Illustration 5 (from two options exercising the contractual remedy that is unnecessary and excessively burdensome).

T rents premises from L for the purpose of setting up a retail business. The rental contract is for five years, but when three years later T realizes that business in the area is very poor, it decides to close the business and informs L that it is no longer interested in renting the premises. T’s breach of contract would normally lead to L having the choice of either terminating the contract and claiming damages or requesting specific performance. However, under the circumstances L would be abusing its rights if it required T to pay the rent for the remaining two years of the contract instead of terminating the contract and claiming damages from T for the rent it has lost for the length of time necessary to find a new tenant.

Illustration 6 (requiring a remedy where less burdensome options are available).

R rents premises from L for the purpose of opening a restaurant. During the summer months R sets up a few tables out of doors, but still on the owner’s property. On account of the noise caused by the restaurant’s customers late at night, L has increasing difficulties finding tenants for apartments in the same building. L would be abusing its rights if, instead of requesting R to desist from serving out of doors late at night, it required R not to serve out of doors at all.

(iii) Good faith and fair dealing in international trade

International standard. In the UNIDROIT Principles, the concept of good faith (and fair dealing) should be considered as an internationally general standard of conduct as adopted within different national legal systems. This means that national legal particularities related to the same national-law-based concept of good faith should not be extended to cross-border cases if this is not supported elsewhere. The UNIDROIT Principles reflect a generally accepted international standard for assessing contracting parties’ behaviour.

Adjustment to sector particularities. The concept of ‘good faith and fair dealing’ must also be construed considering the special conditions of international trade. Standards of business practice may indeed vary considerably from one trade sector to another, and even within a given trade sector they may be more or less stringent depending on the socioeconomic environment in which companies operate, their size and technical skill, etc.

Illustration 7 (in making a claim, appropriate care must be given in notifying the nature of a defect in order to permit the other party to properly remedy it).

Under a contract for the sale of high-technology equipment, the purchaser loses the right to rely on any defect in the goods if it does not give notice to the seller specifying the nature of the defect without undue delay after it has discovered or ought to have discovered the defect. B, a buyer operating in a country where such equipment is commonly used, discovers a defect in the equipment after having put it into operation, but in its notice to S, the seller of the equipment, B gives misleading indications as to the nature of the defect. B loses its right to rely on the defect since a more careful examination of the defect would have permitted it to give S the necessary specifications.

Illustration 8 (in noticing defects, the expected level of familiarity in assessing the level of care required from the claiming party).

The facts are the same as in Illustration 7, except that B operates in a country where this type of equipment is so far almost unknown. B does not lose its right to rely on the defect because S, being aware of B's lack of technical knowledge, could not reasonably have expected B properly to identify the nature of the defect.

(iv) The mandatory nature of the principle of good faith and fair dealing

The parties' duty to act in accordance with good faith and fair dealing is of such a fundamental nature that the parties may not contractually exclude or limit it (UNIDROIT Principles Article 1.7 paragraph (2)). On the one hand, the principle of freedom of contract allows the parties to specify which actions are expected or prohibited among them. On the other hand, it is impossible to foresee all possible exceptions that might arise and should reasonably mitigate the scope of an obligation to act (or not to act).

Being more specific. The mandatory nature of a principle becomes more specific, for example, in the similarly overriding principle that no contractual right or obligation is valid or enforceable if it has been invoked or assumed in a context of fraud, threat, gross disparity or illegality (UNIDROIT Principles Article 3.1.4). Also, the parties may have provided that in certain cases, a stipulated amount becomes due or payable, which would generally be enforceable. However, in view of the actual circumstances and a gross disparity between the harm of non-performance, the principle of good faith might demand the agreed amount is mitigated (UNIDROIT Principles Article 7.4.13).

Notwithstanding the somewhat interruptive nature of the principle of good faith, nothing prevents parties from agreeing on a duty to observe stringent standards of behaviour. The more specific the parties are about contractual rights or obligations, the more unlikely any interference should be with reference to a general standard such as good faith and fair dealing (see, for example, Article 5.3.3).

(c) Inconsistent behaviour (*venire contra factum proprium*)

A general principle of contracting that can be considered as an application of good faith and fair dealing is the requirement that parties should not act inconsistently with an understanding that is implied in the contract (UNIDROIT Principles Article 1.8):

Article 1.8 (*Inconsistent behaviour*)

A party cannot act inconsistently with an understanding it has caused the other party to have and upon which that other party reasonably has acted in reliance to its detriment.

This general manifestation of the principle of good faith is called (non) *venire contra factum proprium*. In other words, a contract imposes a responsibility on each party not to cause detriment to another party by acting inconsistently with an understanding concerning their contractual relationship that it has – explicitly, implicitly or by its mere behaviour – caused that other party to have, and upon which that other party has reasonably acted in reliance.

How an ‘understanding reasonably relied upon’ comes into existence. A party may cause the other party to have an understanding concerning their contract, its performance or enforcement in many ways. For example, the understanding may result from a representation made, from conduct, or from silence when a party would reasonably expect the other to speak to correct a known error or misunderstanding that was being relied upon.

Effect of the principle. The prohibition in Article 1.8 might result in the creation of rights, or in the loss, suspension or modification of rights, deviating from those expressly agreed by the parties. This is because the ‘understanding reasonably relied upon’ may itself be inconsistent with the agreed or actual rights of the parties.

As Article 1.8’s impact is rather large, there is an important prerequisite for invoking this principle – the understanding must be one on which, in view of all the circumstances, the other party can and does reasonably rely. Whether such reliance is reasonable (and must be given effect) depends on the communications and conduct of the parties, on the nature and context of the parties’ dealings, and on the expectations they could reasonably have regarding each other. This is best illustrated by examples:

Illustration 1 (*letting the other party take destructive steps in anticipation of a contract that is not entered into*).

A and B have spent lengthy negotiations over a lease contract relating to B’s land under which B is to demolish a building and construct a new one to A’s specification. A communicates with B in terms that induce B reasonably to understand that their contract negotiations have been completed, and that B can begin performance. B then demolishes the building and engages contractors to build the new building. A is aware of this and does nothing to stop it. A later indicates to B that there are additional terms still to be negotiated. A will be precluded from departing from B’s understanding.

Illustration 2 (failing to warn that expected performance should be different).

B mistakenly understands that its contract with A can be performed in a particular way. A is aware of this and stands by while B's performance proceeds. B and A meet regularly. B's performance is discussed but no reference is made by A to B's mistake. A will be precluded from insisting that the performance was not that which was required under the contract.

Illustration 3 (denying that payment is due, now that an affiliate ordered the work).

A regularly uses B to do subcontract work on building sites. That part of A's business and the employees involved in it are taken over by A1, a related business. There is no change in the general course of business by which B obtains its instruction to do work. B continues to provide subcontract services and continues to bill A for work done believing the work is being done for A. A does not inform B of its mistake. A is precluded from denying that B's contract for work done is with it and must pay for the work done.

Illustration 4 (requiring penalties notwithstanding accepted delays in deliveries).

Because of difficulties it is experiencing with its own suppliers, A is unable to make deliveries on time to B under their contract. The contract imposes penalties for late delivery. After being made aware of A's difficulties, B indicates it will not insist on strict compliance with the delivery schedule. A year later, B's business begins to suffer from A's late deliveries. B seeks to recover penalties for the late deliveries to date and to require compliance with the delivery schedule for the future. It will be precluded from recovering the penalties but will be able to insist on compliance with the schedule if reasonable notice is given that compliance is required for the future.

Illustration 5 (failure to claim payment does not preclude a later claim to be paid).

B is indebted to A in the sum of AUD 10,000. Though the debt is due A takes no steps to enforce it. B assumes in consequence that A has pardoned the debt. A has done nothing to indicate that such actually is the case. It later demands payment. B cannot rely on A's inaction to resist that demand.

Detriment and preclusion. Contracting parties must avoid detriment being occasioned in consequence of reasonable reliance. This principle does not necessarily lead to a prohibition or preclusion to act in the detrimental way. Depending on the circumstances, there may be other reasonable means available that can avert the detriment. For example, unreasonable detriment can be diminished by giving reasonable notice before acting inconsistently (see Illustration 4), or by paying for costs or losses incurred by reason of reliance.

Illustration 6 (compensation of non-commissioned but performed work).

A and B are parties to a construction contract which requires that additional works be documented in writing and be certified by the site architect. A's contract manager orally requests B to do specified additional work on a 'time and materials basis' and assures B it will be documented appropriately in due course. B commissions design works for the additional work at which stage A indicates that the work is not required. The cost incurred in commissioning the design work is far less than the cost that would be incurred if the

additional work were to be done. If A pays B the costs incurred by B for the design work, B cannot then complain of A's inconsistent behaviour.

Illustration 7 (continued request for performance precludes a termination right for breach of contract).

A fails to meet on time a prescribed milestone in a software development contract with B. B is entitled under the contract to terminate the contract because of that failure. B continues to require and pay for changes to the software and acts co-operatively with A in continuing the software development programme. A's continued performance is based on B's conduct subsequent to the breach. B will in such circumstances be precluded from exercising its right to terminate for the failure to meet the milestone. However, under the UNIDROIT Principles B will be able to allow A an additional period of time for performance (see Article 7.1.5) and to exercise its right to terminate if the milestone is not met in that period.

(d) Practices and usages

In general, contract parties are bound by practices and usages that they have established among themselves or that are widely known and generally accepted in the industry concerned:

Article 1.9 (Usages and practices)

- (1) The parties are bound by any usage to which they have agreed and by any practices which they have established between themselves.
- (2) The parties are bound by a usage that is widely known to and regularly observed in international trade by parties in the particular trade concerned except where the application of such a usage would be unreasonable.

Practices between the parties. A practice established between the parties is automatically binding, except where the parties have expressly excluded its application. Whether a particular practice must be considered to be 'established' between the parties depends on the circumstances. Obviously, behaviour in the context of only one preceding transaction will not normally suffice.

Illustration 1 (usually permitted claim period in excess of the agreed term).

S, a supplier, has repeatedly accepted claims from C, a customer, for quantitative or qualitative defects in the goods as much as two weeks after their delivery. When C gives another notice of defects after a fortnight, S cannot object that it is too late since the two-weeks' notice amounts to a practice established between S and C which will as such be binding on S.

Agreed usages. The parties may specify all the terms of their contract or for certain questions simply refer to other sources, including usages. In the ITC Model Contract for the International Commercial Sale of Goods, this applies where references are made to the Incoterms and to

international trade usages as regards letters of credit (UCP600), standby practices (ISP98) or demand guarantees (URDG).

Other applicable usages. Concerning the applicability of other trade usages, it is important that the usage is 'widely known to and regularly observed [...] by parties in the particular trade concerned'. The additional qualification 'in international trade' means that usages confined to domestic transactions should not also be invoked in transactions with foreigners. Only exceptionally should usages of a purely local or national origin be applied without any reference thereto by the parties. For example, usages existing on certain commodity exchanges or at ports should apply, provided that would regularly be the case with respect to foreigners. Another exception concerns businesses that have already completed a number of similar contracts and that might be deemed to have become aware of the usages within that country for such contracts.

Illustration 3 (*usages in ports*).

A, a terminal operator, invokes a particular usage of the port where it is located regarding B, a foreign carrier. B is bound by this local usage if the port is normally used by foreigners and the usage in question has been regularly observed with respect to all customers, irrespective of their place of business and of their nationality.

Illustration 4 (*applicability of local discount usages*).

A, a sales agent from Country X, receives a request from B, one of its customers in Country Y, for the customary 10 percent discount upon payment of the price in cash. A may not object to the application of such a usage because of it being restricted to Country Y if A has been doing business in that country for a certain period of time.

Application would be unreasonable. A usage may be regularly observed in a particular trade sector, but its application in a given case may nevertheless be unreasonable. Particular conditions within which a party operates, or the atypical nature of a transaction, may lead to such a conclusion. In that case, the usage should not apply.

Illustration 5 (*adjusted warranty claim right if quality inspection is unreasonably burdensome*).

A usage exists in a commodity trade sector according to which the purchaser may not rely on defects in the goods if they are not duly certified by an internationally recognized inspection agency. When A, a buyer, takes over the goods at the port of destination, the only internationally recognized inspection agency operating in that port is on strike and to call another from the nearest port would be excessively costly. The application of the usage in this case would be unreasonable and A may rely on the defects it has discovered even though they have not been certified by an internationally recognized inspection agency.

5.2 Vienna Convention on contracts for the international sale of goods (CISG)

One of the most important treaties (or, equally, conventions) in international commerce is the United Nations Convention on Contracts for the International Sale of Goods. It was prepared by the United Nations Commission on International Trade Law (UNCITRAL) and adopted in Vienna in 1980.³⁸ In common parlance, the convention is referred to as the Vienna Convention and often abbreviated as CISG.

The CISG is a success. Considering the number of ratifications, the Vienna Convention is a great success. The text has been ratified by over 75 countries worldwide. Important countries that have not (yet) ratified the CISG include the United Kingdom, India, Portugal, South Africa and several countries in the Middle East.³⁹ An up-to-date map can be found on the websites of UNCITRAL⁴⁰ and ITC's LegaCarta⁴¹.

Accessibility and supporting materials. The Vienna Convention has been translated into the six official United Nations languages, as well as German, Italian and Portuguese, among others. This makes the CISG widely accessible. Moreover, there is an abundance of materials explaining the scope and application of the Vienna Convention.⁴²

(a) Scope of application and general provisions

Scope of CISG. The scope of the Vienna Convention is well defined. It is limited to international sales contracts only. It does not apply to licences, service contracts, manufacturing agreements or loans, except to the extent that such contracts contain provisions related to the sale of movable goods. Furthermore, the CISG excludes certain sales contracts because of purpose (i.e. consumer contracts), particular nature (i.e. sales by auction, on execution or otherwise by operation of law) or the nature of the goods (i.e. shares, investment securities, negotiable instruments, money, ships, aircraft, or electricity). Therefore, it is nonsense to exclude its applicability in any of those cases.

Certain matters fall outside the Vienna Convention's scope, such as, for example, the validity of the sales contract, and (passing of) ownership of the goods sold. These matters are typically covered by the law chosen in the sales contract. Whether that is indeed true is a question of

³⁸ U.N. Convention on Contracts for the International Sale of Goods, Vienna, 1 April 1980. It entered into force on 1 January 1988.

³⁹ Note that for the Convention to be applicable, it is sufficient that only one contracting party has its place of business in a contracting State and that the rules of private international law lead to the application of the law of a contracting State (Article 1).

⁴⁰ <http://www.uncitral.org/>

⁴¹ <https://legacarta.intracen.org/>

⁴² See in particular: *Commentary on the Draft Convention for the International Sale of Goods, prepared by the Secretariat* (document A/Conf.97/5), dated 14 March 1979. Available from www.cisg-online.ch.

private international law (more adequately called 'conflict of laws' - see section 4.9). In any case, the Vienna Convention applies if the law of a contracting State is chosen.⁴³

Party autonomy. A key aspect of the Vienna Convention is the recognition of 'freedom of contract' or 'party autonomy'. The parties are free to exclude the application of the Vienna Convention and to modify the scope or effect of any of its provisions. The parties do not have to derogate explicitly from the Vienna Convention: they may instead provide a different rule from the corresponding provision found in the Vienna Convention.

Interpretation of CISG. The Vienna Convention was written to be as clear and easy to understand as possible. In cases involving disputes as to its meaning and application, courts and arbitral tribunals are admonished to observe its international character, to promote a uniform application and to observe good faith in international trade. Nevertheless, the Vienna Convention will respect (i) the statements and conduct of a party in the context of the formation of the contract or its implementation, (ii) usages agreed to by the parties, (iii) practices they have established among themselves, and (iv) industry usages and good practices.

Legal form of a contract. The Vienna Convention does not require that a sales contract be expressed in a certain form. A sales agreement can be entered into orally, in writing, by email or in any other form. Accordingly, any amendment of the agreement does not require a certain form – except, if the contract itself requires that an amendment or a termination be notified in writing, such requirement prevails.⁴⁴ The only exception would be that a party may be precluded by its conduct from asserting such requirement to the extent that the other party has relied on that conduct.

Formation of a sales contract. The second part of the Vienna Convention deals with the formation of the contract, which is concluded by the exchange of offer and acceptance. It is outside the scope of this book to discuss aspects of 'business proposals', 'withdrawal or revocation of offers', 'rejection of an offer', 'counteroffers', 'modified acceptance', 'acceptance' and related topics, and aspects of the applicability of general terms and conditions (also referred to as general business terms or any other recombination of these words).

(b) Passing of ownership and risk

In an international sale of goods, the exact moment at which the risk of loss or damage to the goods passes from the seller to the buyer is of great importance. It determines whether the buyer must pay despite a complete or partial loss of the goods, or whether a seller should replace the goods if they have been damaged during transportation (CISG Article 66). As a rule, the risk passes when the ownership of the goods changes. The parties may address the passing of risk

⁴³ A contracting State means a country that has ratified the Vienna Convention. Note that CISG Article 1 contains a more accurate rule indicating its applicability.

⁴⁴ See CISG Article 29, and ITC Model Contract for the International Commercial Sale of Goods (standard) Article 18.2. However, note that ratifying States whose legislation requires sales contracts to be concluded in or evidenced by writing, may have set aside CISG Article 11, 29 or provisions in Part II, for a seller or buyer that has its place of business in that State (see Article 96).

(or the shift of ownership) in their contract expressly or by implication in the use of an Incoterm (see section 5.3). The ITC Model Contracts provide wording for the choice of an Incoterm, as well as for a transfer of property (i.e. ownership). Failing such a provision, the Vienna Convention sets forth a complete set of rules (see CISG Articles 66-70).

Applicable law. How the ownership of and risk related to the goods under contract pass from the seller to the buyer is a matter for the applicable property law. But property laws will also refer to specific acts or circumstances such as the handing over of the goods and may permit a 'retention of title' (i.e. postponement of transfer of ownership until the purchase price has been paid in full). Those acts or circumstances may still need to be specified. The two situations contemplated by the Vienna Convention are when the sales contract involves carriage of the goods (CISG Article 67) and when the goods are sold while in transit (CISG Article 68). In all other cases, the risk passes to the buyer when it takes over the goods or from the time when the goods are placed at its disposal and it commits a breach of contract by failing to take delivery, whichever comes first (CISG Article 69). In the frequent case when the contract relates to goods that are not then identified, they must be identified as covered by the contract before it can be considered that they have been placed at the disposal of the buyer and that the risk of their loss has passed to the buyer (CISG Article 69(3) and 69(2)).

(c) Fundamental breach is required for avoidance (termination)

Delivery of what, where? Generally, a seller is bound to deliver the goods, to hand over any documents relating to the goods, and to transfer the property in the goods, as required by the sales contract (CISG Article 30). In the absence of a contractual arrangement as to when, where and how the seller must perform these obligations, the Vienna Convention supplements the contract (CISG Article 31, 32 and 33). If the seller must hand over documents related to the goods – such as transportation documents, import clearances, certificates of origin or quality, or manuals – the sales contract should provide for when, where and in what form the documents must be delivered (CISG Article 34).

The goods. In cases involving *specific* goods, clearly the seller must deliver exactly those goods identified in the contract. If the seller handed over a *sample* or *model*, the goods must possess the qualities of the sample or model. In cases involving *unidentified* goods, the seller must deliver goods that generally conform to the description agreed to in the contract. For example, if the contract demands delivery of corn, the seller has not delivered if it provides grain. However, the goods are considered as 'delivered' even if they are non-conforming. For example, handing over to the carrier the requisite amount of no. 3 grade corn when no. 2 grade was called for, or handing over to the carrier five tons when ten tons were called for, would constitute delivery of 'the goods'. Of course, even though the goods 'had been' delivered, the buyer would be able to exercise any rights it might have because of the seller's breach of contract.

'Breach' or 'fundamental breach'? The third part of the Vienna Convention deals with the obligations of the parties to the contract. Obligations of the seller include delivering goods in

conformity with the quantity and quality stipulated in the contract, together with related documents, and transferring the property of the goods. If a seller delivers goods that may be considered fit for the general purpose for which they are normally used, but that do not meet the specificities of the contract, the seller is in breach. The same applies if the goods are delivered after the agreed delivery date, or if the seller fails to meet another obligation. Normally, such a breach of contract leads to a reduction of the purchase price, the buyer's entitlement to compensation of damages or another remedy (including specific performance – CISG Article 28 and 46). Remedies may be cumulated to the extent they do not exclude each other by their very nature (CISG Article 45 and 61 paragraph 2). In certain cases, a breach is fundamental:

Article 25

A breach of contract committed by one of the parties is fundamental if it results in such detriment to the other party as substantially to deprive him of what he is entitled to expect under the contract, unless the party in breach did not foresee and a reasonable person of the same kind in the same circumstances would not have foreseen such a result.

Avoidance (termination). In case of fundamental breach, the aggrieved party may avoid (terminate) the sales contract (CISG Article 49 and 64). If a breach is not fundamental, the right to avoid the contract is dependent on whether the goods were delivered at all (if not, the terminating party must first fix a deadline allowing delivery). If the goods were delivered, the right to avoid the contract lapses after a reasonable period of time. Exactly when a reasonable period of time is considered to have lapsed, depends on whether the breach amounted to a delay in delivery or not: specific criteria apply as to the knowledge (or imputed knowledge) of the terminating party (CISG Article 49).

Case law. In many cases, the main question is whether a breach of contract is fundamental or not. To a large extent, this depends on whether any delivered goods were in conformity with the sales contract and fit for their purpose, and whether any non-conformity was discovered and notified in a timely manner (see section (d)). Unilex, an initiative of Professor M.J. Bonell (Rome, Italy), is a collection of hundreds of court decisions and arbitral awards based on the Vienna Convention.⁴⁵ The following cases are particularly illustrative for questions related to fundamental breach (CISG Article 35, whether or not leading to avoidance pursuant to Article 49):

Case: cadmium-contaminated mussels⁴⁶

A Swiss seller and a German buyer concluded a contract for the sale of New Zealand mussels. The buyer refused to pay the purchase price after the mussels were declared not completely safe because of the quantity of cadmium they contained: significantly greater than the advised cadmium levels published by the German Federal Health Department. The buyer notified the seller and requested it to take back the mussels. Six or eight weeks after the delivery, the buyer complained about defects of the packaging. The seller commenced an action claiming payment and interest. At first instance the Court decided in favour of the seller. The buyer's subsequent appeals were unsuccessful.

⁴⁵ See: <http://www.unilex.info/dynasite.cfm?dssid=2376&dsmid=13356&x=35>

⁴⁶ German Bundesgerichtshof 8 March 1995 VIII ZR 159/94 (Unilex): <http://www.unilex.info/case.cfm?pid=1&do=case&id=108>

The Court held that the buyer had to pay the purchase price. It was not entitled to declare the contract avoided under CISG Articles 25 and 49(1)(a) since the seller did not commit a fundamental breach. The Court confirmed the findings of the lower courts, according to which the mussels were conforming to the contract since they were fit for the purposes for which goods of the same description would ordinarily be used (CISG Article 35(2)(a)). The Court did find that the fact that the mussels contained a greater quantity of cadmium than the advised cadmium levels could well affect the merchantability of the goods, provided that the corresponding public law requirements were relevant. However, like the lower courts, the Supreme Court excluded that the seller can generally be expected to observe special regulatory food quality requirements of the buyer's state; it could only be expected to do so: (1) where the same requirements also exist in the seller's country; (2) where the buyer draws the seller's attention to their existence; (3) or, possibly, where the seller knows or should know of those requirements due to special circumstances, such as (i) when the seller has a branch in the buyer's country, (ii) when the parties are in a longstanding business relationship, (iii) when the seller regularly exports to the buyer's country, or (iv) when the seller advertises its own products in the buyer's country.

The Court equally confirmed that the buyer was not entitled to avoid the contract because of non-conformity of the packaging (CISG Article 35(2)(c)). The decisive fact in this respect was that the buyer did not give notice of non-conformity of the packaging in due time (notice was given approximately two months after delivery).

Case: underperforming packaging machine⁴⁷

A Swiss seller and a Spanish buyer concluded a contract for the sale of a packaging machine. The seller undertook to install the machine and prepare its operation at the buyer's factory. A dispute arose between the parties regarding the required performance level of the machine. The buyer asserted that an output of 180 vials per minute had been agreed but the seller contended that this was neither possible nor agreed. On several occasions thereafter, the seller unsuccessfully attempted to increase the performance level. After two years, the buyer declared the contract terminated and claimed restitution of the purchase price plus damages. The seller counterclaimed for the outstanding purchase price along with damages. The seller lost the case in all three instances up to the Swiss Federal Supreme Court.

The Supreme Court stated that the actual performance of the machine delivered by the seller was well below the performance required under the contract. Therefore, the buyer was substantially deprived of what it had been entitled to expect under the contract according to CISG Article 25 and had the right to avoid the contract pursuant to CISG Article 49(1)(a).

As to the seller's allegation that the buyer had forfeited its right to terminate the contract pursuant to the Vienna Convention, the Supreme Court emphasised a 'reasonable' period of time as required by CISG Article 49(2)(b) must be determined in accordance with the circumstances of the case (*inter alia*, nature of the goods and lack of conformity, conduct of the seller subsequent to buyer's notice of non-conformity), as well as the purpose of the provision.

⁴⁷ Swiss Tribunal Federal, 18 May 2009, 4A_68/2009 (Unilex): <http://www.unilex.info/case.cfm?pid=1&do=case&id=1460>

In this case, the buyer had properly notified the lack of conformity pursuant to CISG Article 39(1), since it had done so immediately after the machine had been installed and the first test runs had been conducted. Furthermore, the relevant period of time for declaring the contract avoided had commenced only at a late stage, after the seller had eventually proposed an amicable settlement for a target performance level that would still be well below the performance required by the contract and the buyer became aware of the fundamental breach by the seller. Since the buyer declared the contract avoided approximately one month after the settlement proposal, it acted within a reasonable time.

Regarding the seller's contention that the buyer had lost its right to declare termination of the contract due to its use of the machine (CISG Article 82(1)), the Swiss Supreme Court held that such provision applies only if the condition of the goods has been changing in such manner that it is unreasonable to expect the seller to redeem the goods. This was apparently not the case.

Case: defective pressure cookers⁴⁸

A Portuguese seller and a French buyer concluded a contract for the sale of a stock of pressure cookers to be distributed in a French chain of supermarkets. After delivery, some of the cookers showed a defect that made their use dangerous. In the first instance Court held the contract terminated and condemned the seller to pay damages. Also, it ordered that all items were to be withdrawn from the market. The seller appealed, putting forward that termination should have been limited to those cookers which were defective (identification was possible by their serial number).

The Court rejected the seller's claim. The number of the defective pressure cookers amounted almost to a third of the total number. Therefore, the seller's breach of contract (according to CISG Article 35) was 'fundamental' under CISG Article 49, considering the nature of the goods and the need of security in their use.

Although the seller had stated that the defective items had a differing serial number permitting to limit the scope of a product recall, this did not result from the invoices, referencing to the same number. The seller did not provide for another way to identify the defective items. Partial termination was therefore not admissible.

Analogy with UNIDROIT Principles. The UNIDROIT Principles' Article 7.3.1 uses the same concept of fundamental breach as CISG Article 25, but the UNIDROIT Principles calls it fundamental non-performance. Although the UNIDROIT Principles only apply in connection with the termination of a contract – and not also a claim for specific performance or other remedy – the criteria applied are the same, except that the UNIDROIT Principles are more specific about the circumstances that may be relevant to determine if a breach is fundamental:

SECTION 3: TERMINATION

Article 7.3.1 (*Right to terminate the contract*)

(1) A party may terminate the contract where the failure of the other party to perform an obligation under the contract amounts to a fundamental non-performance.

⁴⁸ Paris Cour d'Appel, 4 June 2004, 2002/18702 (Unilex): <http://www.unilex.info/case.cfm?pid=1&do=case&id=984>.

- (2) In determining whether a failure to perform an obligation amounts to a fundamental non-performance regard shall be had, in particular, to whether:
- (a) the non-performance substantially deprives the aggrieved party of what it was entitled to expect under the contract unless the other party did not foresee and could not reasonably have foreseen such result;
 - (b) strict compliance with the obligation which has not been performed is of essence under the contract;
 - (c) the non-performance is intentional or reckless;
 - (d) the non-performance gives the aggrieved party reason to believe that it cannot rely on the other party's future performance;
 - (e) the non-performing party will suffer disproportionate loss as a result of the preparation or performance if the contract is terminated.

One illustrative arbitral award illustrates how the UNIDROIT Principles must be applied to determine whether a breach of contract is fundamental:

Case: exclusive supply of Mexican squash and cucumbers⁴⁹

Defendant, a Mexican grower, and Claimant, a United States distributor, entered into a one-year exclusive supply agreement according to which Defendant undertook to produce specific quantities of squash and cucumbers and to supply them to Claimant on an exclusive basis. Claimant had to distribute the goods on the Californian market against a commission. Due to a series of extraordinarily heavy rainstorms and flooding caused by the meteorological phenomenon known as *El Niño*, a complete harvest of crops was destroyed.

Claimant brought an action before the *Centro de Arbitraje de México* arguing that Defendant had breached the contract by not providing the agreed goods and by violating the exclusivity clause. The arbitral tribunal rejected the Defendant's defence based on force majeure and hardship. It also established that the exclusivity clause was breached at least in one instance.

Concerning the request for termination, the Arbitral Tribunal pointed out that according to UNIDROIT Principles Article 7.3.1 par. (1), the non-performance by Defendant was fundamental since at least three of the criteria laid down in Article 7.3.1 (2) were met: first, Defendant's failure to deliver the vegetables deprived Claimant of the goods it was entitled to expect under the contract; second, the Defendant's violation of the exclusivity clause was intentional; and, third, these two circumstances were enough to give Claimant reason to believe that it could not rely on Defendant's future performance.

(d) Product conformity, fitness for purpose

The Vienna Convention provides a number of rules for the implementation of the seller's obligations regarding the quality of the goods. In general, the seller must deliver goods that are

⁴⁹ Arbitral Award (Centro de Arbitraje de México), 30 November 2006 (Unilex): <http://www.unilex.info/case.cfm?id=1149>

of the quantity, quality and description required by the contract and that are contained or packaged in the manner required by the contract, as follows:

Article 35 [Conformity of the goods]

1. The seller must deliver goods which are of the quantity, quality and description required by the contract and which are contained or packaged in the manner required by the contract.
2. Except where the parties have agreed otherwise, the goods do not conform with the contract unless they:
 - (a) are fit for the purposes for which goods of the same description would ordinarily be used;
 - (b) are fit for any particular purpose expressly or impliedly made known to the seller at the time of the conclusion of the contract, except where the circumstances show that the buyer did not rely, or that it was unreasonable for him to rely, on the seller's skill and judgement;
 - (c) possess the qualities of goods which the seller has held out to the buyer as a sample or model;
 - (d) are contained or packaged in the manner usual for such goods or, where there is no such manner, in a manner adequate to preserve and protect the goods.
3. The seller is not liable under subparagraphs (a) to (d) of the preceding paragraph for any lack of conformity of the goods if at the time of the conclusion of the contract the buyer knew or could not have been unaware of such lack of conformity.

Conformity. CISG Article 35 sets the standard as to whether a seller has discharged its obligation to deliver goods that conform to the contract. The first sentence emphasizes that the goods must conform to the agreed quantity, quality and description and must be contained or packaged in the agreed manner. It recognizes the prevailing nature of the contract between the parties. The remainder of Article 35 specifies the seller's obligations (as to conformity) that apply, except as otherwise agreed.

Fit for ordinary purposes. Goods are often ordered by general description without any indication to the seller as to the purpose for which those goods will be used. In such a situation, the seller must furnish goods that are fit for all the purposes for which goods of the same description are ordinarily used. The standard of quality implied in the contract must be ascertained in view of the normal expectations of people buying goods of that description. If the goods available to the seller are fit for only some of the purposes for which such goods are ordinarily used, it must ask the buyer to state the particular purposes for which these goods are intended so that it can refuse the order, if necessary.

Re-saleability and merchantability. The scope of the seller's obligation under CISG Article 35(2)(a) is not determined by whether the seller could expect the buyer themselves to use the goods in one of the ways in which such goods are ordinarily used. Rather, the obligation pursuant to Article 35(2)(a) also covers a buyer who has purchased the goods for resale rather than for its own use. For goods to be fit for ordinary purposes, they must be properly re-saleable

in the ordinary course of business. This matches the merchantability criterion used in the United States (see the UCC (*Uniform Commercial Code*), adopted by virtually all states).

Fitness for a particular purpose. Generally, a seller is not bound to deliver goods that are fit for some special purpose that is not a purpose “for which goods of the same description would ordinarily be used” unless the buyer has “expressly or impliedly made known to the seller at the time of the conclusion of the contract” such intended use (CISG Article 35(2)(b)). This issue may arise if the buyer intends to use the goods for a purpose for which goods of this kind are sometimes, but not ‘ordinarily’ used. If the buyer does not provide any indication that it intends to use the goods for such a particular purpose, the seller has no reason to attempt to supply goods appropriate for such a purpose.

Buyers often know that they need goods of a general description to meet some particular purpose, but they may not know enough about the goods to give exact specifications. In such a case, the buyer may specify the desired goods by describing the particular use to which the goods are to be put. If the buyer expressly or impliedly ‘makes known’ to the seller such (particular) purpose, the seller must deliver goods fit for that purpose.

Parties’ duties to inform. To allow a claim for non-conformity of delivered goods, a buyer’s particular purpose for the goods must be known to the seller at the time of entering into the sales contract. The idea is that the seller can refuse to enter the contract if he is unable to furnish goods adequate for that purpose. Except to the extent that the parties agreed otherwise:

...the goods do not conform with the contract unless they ... (b) are fit for any particular purpose expressly or impliedly made known to the seller at the time of the conclusion of the contract, except where the circumstances show that the buyer did not rely, or that it was unreasonable for him to rely, on the seller’s skill and judgement.

Seller’s skill and judgement. In the clause given above, the strong impact of the duty to inform is somewhat qualified or limited. The seller is not liable for failing to deliver goods fit for a particular purpose (even if the particular purpose for which the goods have been purchased has been expressly or impliedly made known to him) if ‘the circumstances show that the buyer did not rely, or that it was unreasonable for him to rely, on the seller’s skill and judgement’. For example, the circumstances may show that the buyer wanted the goods for the brand name or described the desired goods in terms of highly technical specifications. This may support a claim that, in making the purchase, the buyer had not relied on the seller’s skill and judgement. Nevertheless, if the seller knew that the goods ordered by the buyer would not be satisfactory for the particular purpose, it is likely that a seller must disclose this fact to the buyer. Obviously, if the buyer would instead purchase the goods, the buyer can hardly be deemed to have relied on the seller’s skill and judgement. Conversely, it would also be unreasonable for the buyer to rely on the seller’s skill and judgement if the seller did not purport to have any special knowledge regarding the goods in question.

Samples and models. As mentioned above, if the contract was entered into based on a sample or model, the goods delivered must possess the qualities of that sample or model. Of course, this

does not apply if the seller indicates, at the time of entering into the contract, that in certain respects the sample or model differs from the goods that will be delivered. In that case, the goods must have the qualities of the sample or model that the seller claims are possessed by the goods to be delivered.

Packaging. CISG Article 35(2)(d) includes, as one of the seller's obligations regarding conformity of the goods, that they 'are contained or packaged in the manner usual for such goods'. This provision sets forth a minimum standard. Packaging has been the subject of various court proceedings. While it may take time to establish the existence of product defects, damaged packaging and defects caused by improper packaging are easy to establish quickly. That is why courts tend to require particularly short periods of time for inspection upon arrival of the goods.

(e) Goods affected by rights or claims of third parties

Third-party claims in general. A seller must deliver the agreed goods free from any third-party right or claim, unless the buyer agreed to accept the goods subject to that right or claim (CISG Article 41). This obligation is 'implied' – it does not need to be required by the buyer or warranted by the seller to be enforceable. Examples of third-party claims include if materials or components of the delivered goods are still owned by a third party (e.g. if they were delivered under retention of title); if such materials, components, or the goods themselves were stolen from a third party; or if the ownership of such materials or components has not been transferred for any other reason (e.g. they were acquired in violation of mandatory laws).

Rights and claims. The seller has breached his obligation, not only if a third party's claim is valid, but also and already if a third party merely makes a claim about the goods. This is because, once a third party has made a claim and until the claim is resolved, the buyer faces the possibility of litigation with and liability to the third party. Even if the seller asserts that the third-party claim is invalid – or if a good faith buyer can rightfully defend that, under the law applicable to the sales transaction, it will legally be deemed to acquire the goods free of third-party claims (i.e. *possession vaut titre*) – the third party could still engage in time-consuming and expensive litigation against the buyer. Obviously, litigation will delay and disrupt the buyer's use or resale of the goods.

It is the seller who carries the burden of demonstrating, to the satisfaction of the buyer, that a claim is frivolous. If the buyer is not satisfied that the third-party claim is indeed frivolous, the seller must take appropriate action to free the goods from the claim. From a buyer's point of view, this could rarely be achieved within a reasonably short period of time. If that is not likely, the seller must either replace the goods, induce the third party to release the claim, or provide the buyer with an adequate indemnity (i.e. providing for defence in legal proceedings and against all losses arising out of the claim).

Third-party intellectual property rights. A different approach applies, however, to the delivery of goods that are not free from third-party rights or claims because they (allegedly) infringe

intellectual property rights (CISG Article 42). The seller is not always aware of the existence of such IP rights, let alone that there has been an infringement. Therefore, the implied obligation at the time of contracting is qualified by two additional requirements. First, the seller is not liable if the buyer furnished the technical drawings, designs, formulae or other specifications from which the infringement results. Second, the seller must not have known or must not have been unaware of an alleged infringement under the law of the jurisdiction where the goods will be resold or otherwise used. This requirement is further limited: at the time of contracting, the seller must know or may not be unaware of the countries where the goods are intended to be resold or otherwise used. In other words, if a seller is aware of an infringement right or claim by a third party, and the buyer is not aware (and must not be aware) of the infringement right or claim, the seller may not sell the affected goods in the jurisdiction where the IP rights are alleged to be infringed.

International context and resale. In an international transaction, it is not obvious that the seller of goods should be liable to the same degree for all infringements of intellectual property rights. First, the infringement will often occur outside the seller's country. The seller cannot be expected to have as complete knowledge of the status of IP rights that its goods might possibly infringe as it would know in respect of its own country. Second, it is the buyer who selects the countries to which the goods will be sent for use or resale. Therefore, regarding resale, the seller's liability to the buyer for infringements is limited to the countries where the goods were envisaged to be resold (or used) by the parties at the time of contracting. If the parties had not anticipated use or resale in other countries, the seller's liability is limited to infringements only in the jurisdiction where the buyer has its place of business.

(f) Obligations of the buyer

Payment of the purchase price. The general obligations of the buyer are to pay the purchase price of the goods and to accept delivery of them as required by the sales contract or the Vienna Convention. If the contract does not include sufficient details, the Vienna Convention provides supplementary rules, as follows:

1. **Buyer fulfils all requirements.** It is for the buyer to take such steps and comply with such formalities as may be required to effect payment of the purchase price (CISG Article 54).
2. **No price agreed.** If no purchase price has been established (and no clear and unequivocal parameters exist to establish the price), the purchase price is deemed impliedly to be the price generally charged at the time of the conclusion of the contract for such goods sold under comparable circumstances (CISG Article 55).
3. **Net weight.** If the purchase price is based on the weight of the goods, in case of doubt it is to be determined by the net weight (CISG Article 56).
4. **Where to pay.** The buyer must pay the purchase price at the seller's place of business or, if the payment is to be made against delivery of the goods or documents, at the place of such delivery (CISG Article 57(1)).
5. **When to pay.** Failing a specified date of payment, the buyer must pay when the seller places the goods (or documents controlling their disposition) at the buyer's disposal. The

seller may make such payment a condition for handing over the goods or documents (CISG Article 58(1)).

6. **Pay against delivery.** If the sales contract involves transportation of the goods, the seller may dispatch the goods on terms whereby the goods (or documents controlling their disposition) will not be handed over to the buyer except against payment of the full purchase price (CISG Article 58(2)).
7. **Pay after inspection.** The buyer is not bound to pay the price until it has had an opportunity to examine the goods, unless the agreed procedures for delivery or payment are inconsistent with its having such an opportunity (CISG Article 58(3)).
8. **No request required.** The buyer must pay the full purchase price without the need for any request or compliance with any formality on the part of the seller (CISG Article 59).

Non-conformity notice. Regarding the conformity requirement, the Vienna Convention provides that the buyer should inspect the goods. The buyer must give notice of any non-conformity within a reasonable time after it has discovered it (or should have discovered it). Except if the parties agreed otherwise (e.g. a longer warranty period), the right of the buyer to give such a notice lapses, at the latest, two years from the date on which the goods were actually handed over to the buyer.

Buyer's knowledge of non-conformity. The quality requirements of conformity to fitness for ordinary purpose and any particular purpose, to samples or models, or to packaging (CISG Article 35(2)) do not apply to the extent that the buyer, at the time of contracting, 'knew or could not have been unaware of a non-conformity in respect of one of those qualities'. A buyer familiar with defects, failures or failing functionalities cannot claim that it had expected the goods to conform in those respects.

Buyer's inspection and notice. If the buyer has had a reasonable and appropriate opportunity to inspect the goods prior to their shipment, it might lose its right to claim after arrival. The buyer's duty to inspect the goods is particularly important for highly visible aspects such as packaging.⁵⁰ Obviously, if the buyer establishes a non-conformity, it must notify the seller as soon as practicable (CISG Article 39). Especially when the lapse of time might adversely influence the damages or resale price, courts are reluctant to award a buyer any damages in case of late claims. One illustrative example:

Case: damaging paper grinding materials⁵¹

A Swiss buyer purchased from a German seller grinding material to manufacture paper products. The products were resold to another Swiss company and processed into finished goods. After using the grinding material, the buyer ascertained damage to its equipment and to the material itself. About twenty days later, the second Swiss company also complained that the tissues manufactured by using the buyer's paper products were

⁵⁰ See for example: Camara Nacional de Apelaciones en lo Comercial de Buenos Aires, 31 May 2007 (*Sr. Carlos Manuel del Corazón de Jesús Bravo Barros v. Salvador Martínez Gares*): <http://www.unilex.info/case.cfm?id=1197> or Oberlandesgericht Düsseldorf, 8 January 1993, 17 U 82/92: <http://www.unilex.info/case.cfm?id=17>.

⁵¹ German Bundesgerichtshof, 3 November 1999, VIII ZR 287/98 (Unilex): <http://www.unilex.info/case.cfm?id=447>.

defective. An expert examination was then ordered. Upon receiving the expert report, the buyer notified the seller of the defects in the delivered material.

The Supreme Court reversed the decisions of the courts in first and second instance and held that the notice of lack of conformity had been timely given. The buyer could not have discovered the defect by an ordinary examination of the purchased goods either upon delivery, or at any time before damage ensued. In this case, the buyer could be allowed a period of one week from discovery of the damage to consider possible remedies. To this the two-week period of the expert examination is to be added, followed by the reasonable time for notice, which, according to the Court, usually amounts to one month. Therefore, seven weeks after discovery of the damage was considered to be still reasonable.

Finally, the Court determined that the buyer's notice sufficiently precise about the nature of the non-conformity (CISG Article 39(1)): in case of machineries and technical equipment it is enough to describe the defects without the need to specify their root cause.

(g) Remedies for breach of contract

Relevant CISG Articles. The remedies of the buyer for breach of contract by the seller are addressed in connection with CISG Chapter II *Obligations of the seller* (CISG Articles 45-52), and the remedies of the seller for breach of contract by the buyer are addressed in connection with CISG Chapter III *Obligations of the buyer* (CISG Articles 61-65). The same principles apply for both: if all required conditions are fulfilled, the aggrieved party may require performance of the other party's obligations, claim damages, or avoid (terminate) the contract. In addition, the buyer may reduce the price if the delivered goods do not conform to the contract.

Specific performance. The foremost principle in case of breach of contract is that the buyer is permitted to require 'specific performance' (unless it has resorted to a remedy that is inconsistent, such as termination of the contract – CISG Articles 28 and 46). Specific performance means that the seller must perform 'in kind' – deliver the goods. Especially in the common law, this is inconsistent with the historic belief that a public court should refrain from interfering in private relationships. From this perspective, a court's order to perform duly would also introduce complications related to the question of how such performance has to be effected. Since modern times, however – and particularly regarding sales contracts – common law courts have become less reluctant and have accepted the principle. In civil law countries, legislators have always considered such order of specific performance (instead of damages) to be the default remedy. In several jurisdictions, a court's judgement might even operate as an instrument reflecting the contractual rights (e.g. as an instrument for effecting transfer of ownership).

Replacement. A buyer can require the delivery of substitute goods only if the goods delivered were not in conformity with the contract and the lack of conformity constituted a fundamental breach of contract (CISG Article 46(2)).

Force majeure. A party in breach of its obligations might excuse itself (and be exempted from liability) based on an event of force majeure (CISG Article 79). To be excused successfully, the

failure must be due to an impediment 'beyond its control' (external) that the party could 'not reasonably have been expected' to take into account (reasonably unforeseeable) at the time of the conclusion of the contract, and that it could 'not have avoided or overcome' (no alternative for due performance).

Such event of force majeure exempts that party from the consequences of its failure to perform, including the payment of any damages. This exemption may also be invoked by a subcontractor. Furthermore, a successful claim of *force majeure* does not preclude either party from invoking any other remedy (e.g. a reduction of the purchase price if the goods contained defects) – see also section 4.4.

A key criterion to benefit from the force majeure exemption is that the party notifies the other party within a reasonable period of time. Otherwise, the other party is entitled to compensation of its damages to the extent that these could have been prevented but for the lapse of such additional time.

Suspension of performance and anticipatory breach. If, before the date on which performance is due, it becomes apparent that a party will not perform a substantial part of its obligations or will commit a fundamental breach, two scenarios are available to the (potentially) aggrieved party:

- it may suspend performance in cases involving a failure to perform a substantial part of the other party's obligations, if such failure results from that party's inability to perform or its lack of creditworthiness, or if such failure becomes apparent from that party's conduct in preparing to perform (or the performance itself) (CISG Article 71); or
- it may avoid (terminate) the contract once it becomes clear that the other party will commit a fundamental breach of contract (CISG Article 72).

Preservation of the goods. The Vienna Convention imposes on both parties a duty to preserve any goods in their possession that belong to the other party (CISG Articles 85-88). This duty is particularly important in view of the international nature of the contract where the other party is from abroad and might not have representatives in the country where the goods are located. The party in possession of the goods may sell them, or may even be required to sell them, if circumstances so require. In such cases, the selling party is entitled to retain part of the sales price as a compensation for reasonable expenses incurred in preserving the goods and selling them. Obviously, it must account to the other party for the balance (CISG Article 88).

5.3 Incoterms 2010

International Commercial Terms (Incoterms) are a series of pre-defined commercial terms published by the ICC. They are usually abbreviated to three letters (e.g. FOB, CIF, DDP, EXW) and are primarily intended to clearly communicate the tasks, costs and risks associated with the

transportation and delivery of goods. Incoterm rules are generally accepted worldwide for the interpretation of the most commonly used sets of terms and conditions.

An Incoterm operates as a set of predefined parameters related to transportation, transfer of risk, insurance and delivery of sold goods. A contractual reference to an Incoterm implies the incorporation (by reference) of the parameters of the chosen Incoterm into the sales contract. If the parties provide differently about one or more of those parameters, this can be deemed to overrule the relevant parameters of the Incoterm.

Delivery and risk. A key aspect of the Incoterms is to give a precise definition of the contractual place of delivery of the sold goods. Under the Incoterms, the place of delivery is also the place (under the sales contract) where the risk of loss of or damage to the goods transfers from the seller to the buyer. Paragraph A4 of each Incoterm specifies the place of delivery.

Point of delivery. By incorporating an Incoterm into a sales contract, the parties clarify precisely where the seller performs its obligation to deliver the goods. For an Incoterm to work properly, it is essential to identify a precise location as the place of delivery. Under most Incoterms, delivery takes place when the goods are handed over, not directly to the buyer, but to a third party (e.g. a carrier) at a pre-determined place. The practicalities for handing over goods to carriers may vary, depending on the location. Clearly identifying the place of delivery will make it impossible for different possible applicable laws to assign the passage of risk to different locations.

Cost implications. Choosing an Incoterm determines not only the transportation and delivery obligations of the parties, but also the answer to the question – ‘who bears which costs?’. Accordingly, to the extent that the seller takes responsibility for transportation and delivery costs, those costs are presumed to be incorporated into the purchase price of the goods.

Application. The Incoterms have traditionally been used for *international* sale contracts even though some geographical areas, such as the EU (or even the World Trade Organization), have minimized import formalities. Incoterms 2010 can now also be used for domestic sales. This change may encourage greater use of the Incoterms in the United States.

(a) History

Versions. The idea for the Incoterms goes back to 1921, and the ICC published the first set in 1936. The current version is Incoterms 2010, published on 1 January 2011, which updates (albeit to a limited extent) Incoterms 2000.

Refer to the right version. Because changes are made to Incoterms from time to time, it is important to ensure that an express reference is made to the then-current version of the Incoterms wherever the parties incorporate Incoterms into their contract. This may easily be overlooked when, for example, a reference has been made to an earlier version in standard contract forms or in order forms used by merchants. A failure to refer to the current version may then result in

disputes as to whether the parties intended to incorporate that version or an earlier version into their contract. Merchants wishing to use Incoterms 2000 should therefore clearly specify that their contract is governed by Incoterms 2000.

(b) Structure of the Incoterms

Incoterms 2010 defines 11 terms (down from the 13 terms used in Incoterms 2000). There are two new terms (*“Delivered at Terminal”*, DAT; and *“Delivered at Place”*, DAP), which replace four terms in Incoterms 2000 (i.e. *“Delivered at Frontier”*, DAF; *“Delivered Ex Ship”*, DES; *“Delivered Ex Quay”*, DEQ; and *“Delivered Duty Unpaid”*, DDU).

Categorization according to the letter. In Incoterms 2000, a categorization was made based on the place of delivery. Although this approach has now been abandoned, the categorization still helps in distinguishing the Incoterms from one another.

The **“E”-term** (departure contracts) is the term under which the seller’s obligation is at its minimum: the seller has to do no more than place the goods at the disposal of the buyer at the agreed location – usually a distribution centre or the factory or assembler of the seller.

The **“F”-terms** (main carriage unpaid contracts) require the seller to deliver the goods for carriage as instructed by the buyer. The delivery point under FOB is the same under CFR and CIF.

The **“C”-terms** (main carriage paid contracts) require the seller to contract for carriage on usual terms at its own expense. Therefore, a point up to which they would have to pay transport costs must necessarily be indicated after the respective “C”-term.⁵² Under the CIF and CIP terms, the seller also must take out insurance and bear the insurance cost. The “C”-terms contain two critical points (not one, as opposed to the other Incoterms): one indicating the point to which the seller must arrange and bear the costs of a contract of carriage, and another indicating the point for transfer of the risk. A characteristic of the “C”-terms is that the seller is relieved of any further cost and risk once it has discharged its obligations by contracting for transportation, handing over the goods to the carrier, and, in case of CIF or CIP, by providing for insurance. Accordingly, adding obligations of the seller to the “C”-terms, which extend its responsibility beyond the point of transfer of the risk, requires great caution.

The **“D”-terms** (arrival contracts) are essentially different from the “C”-terms, because under the “D”-terms the seller is responsible for the arrival of the goods at the agreed place (or at a destination at the border or within the country of import). The seller must bear all costs and risk in bringing the goods there. Hence, the “D”-terms signify arrival contracts, while the “C”-terms denote departure (shipment) contracts.

⁵² Since the point for the division of costs is fixed at a point in the country of destination, the “C”-terms are frequently mistakenly believed to be ‘arrival contracts’, in which the seller would bear all risks and costs until the goods have actually arrived at the agreed point. It must be emphasized, however, that the “C”-terms are of the same nature as the “F”-terms: the seller fulfils the contract in the country of shipment or dispatch.

Categorization in INCOTERMS 2010⁵³. In International Commercial Terms (INCOTERMS) 2010, the 11 Incoterms are subdivided into two categories based only on method of delivery. The larger group of rules applies regardless of the method of transport, but the smaller group of four is applicable only to sales that solely involve transportation over water.

Subdivision from A1 to B10. Each Incoterm is systematically structured, dividing all the elements of delivery into ten numbered entries, each of which is sub-labelled “A” for the seller’s obligations or “B” for the buyer’s obligations. Accordingly, each Incoterm contains the following captions:

A1	Provision of goods in conformity with the contract
B1	Payment of the price
A2 & B2	Licences, authorizations and formalities
A3 & B3	Contracts of carriage and insurance
A4	Delivery
B4	Taking delivery
A5 & B5	Transfer of risks
A6 & B6	Division of costs
A7	Notice to the buyer
B7	Notice to the seller
A8 & B8	Proof of delivery, transport document or equivalent electronic message
A9	Checking – packaging – marking
B9	Inspection of goods
A10 & B10	Other obligations

(i) Incoterms for any mode of transportation.

The seven terms defined by Incoterms 2010 for any mode(s) of transportation are:

EXW: Ex works (named place of delivery)

The Ex Works Incoterm is typically used in an initial quotation for the goods without any costs included. The seller makes the goods available at its premises. This term places the maximum obligation on the buyer and minimum obligation on the seller. EXW means that on the agreed date, the seller makes the goods available at its premises (factory, warehouse, plant). To put it simply, the seller opens the doors of its premises. The buyer pays for transportation and bears the risks for taking the goods to their final destination. The seller does not load the goods on collecting vehicles and does not clear them for export. If the seller does load the goods, it does so at the buyer’s risk and cost. If the seller should be responsible for loading the goods on departure and bear the costs and risk of such loading, this must be made explicit in the sales contract.

⁵³ The Incoterms or International Commercial Terms are a series of pre-defined commercial terms published by the International Chamber of Commerce (ICC) relating to international commercial law.

FCA: Free carrier (*named place of delivery*)

The seller hands over the goods, cleared for export, putting them at the disposal of the first carrier (named by the buyer) at the named place. The seller pays for carriage to the named point of delivery, and risk passes when the goods are handed over to the first carrier.

CPT: Carriage paid to (*named place of destination*)

The seller pays for carriage. Risk transfers to the buyer upon handing goods over to the first carrier.

CIP: Carriage and insurance paid to (*named place of destination*)

CIP is the containerized transport or multimodal equivalent of CIF. The seller pays for carriage and insurance to the named destination point, but risk passes when the goods are handed over to the first carrier.

DAT: Delivered at terminal (*named terminal at port or place of destination*)

The seller pays for carriage to the terminal, except for costs related to import clearance, and assumes all risks up to the point that the goods are unloaded at the terminal.

DAP: Delivered at place (*named place of destination*)

The seller pays for carriage to the named place, except for costs related to import clearance, and assumes all risks prior to the point that the goods are ready for unloading by the buyer.

DDP: Delivered duty paid (*named place of destination*)

The seller is responsible for delivering the goods to the named place in the country of the buyer and bears all the costs in bringing the goods to the destination, including import duties and taxes. This Incoterm places the maximum obligation on the seller.

(ii) Rules for sea and inland waterway transport

The four terms defined by Incoterms 2010 for international trade where transportation is entirely conducted over water are:

FAS: Free alongside ship (*named port of shipment*)

The seller must place the goods alongside the ship at the named port. The seller must clear the goods for export. FAS is suitable only for maritime transport but **not** for multimodal sea transport in containers. This term is typically used for heavy-lift or bulk cargo.

FOB: Free on board (*named port of shipment*)

The seller must load the goods on board the vessel named by the buyer. Cost and risk shift to the buyer once the goods are actually loaded on board the vessel. The seller must clear the goods for export. The term is applicable for maritime and inland waterway transport only but **not** for multimodal sea transport in containers. The buyer must instruct the seller as to the details of the vessel and the port where the goods are to be loaded, and there is no reference to, or provision

for, the use of a carrier or forwarder. This term has been greatly misused over the past three decades, ever since Incoterms 1980 explained that FCA should be used for container shipments.

CFR: Cost and freight (*named port of destination*)

The seller must pay the costs to transport the goods to the port of destination. The risk transfers to the buyer once the goods are loaded on the vessel (this is a clarification of Incoterms 2000). Maritime transport only and insurance for the goods is **not** included. This term is formerly known as CNF (C&F).

CIF: Cost, insurance and freight (*named port of destination*)

The term is same as CFR, except that the seller must in addition arrange (and pay) for insurance.

(c) Obligations of the parties visualised

The differences among Incoterms are best understood when depicted in a table. Table 1 below shows which action (if applicable) must be undertaken by the seller and which by the buyer. Obviously, this is a cost/price influencing element. However, the choice of one or another Incoterm is often determined by the more practical question – which party is more used to arranging for transportation or insurance, or more familiar with local particularities.

Table 1: Incoterms used to outline the obligations (and actions) of buyers and sellers

	Loading on truck (carrier)	Export-Customs declaration	Carriage to port of export	Unloading truck in port of export	Loading in port of export	Carriage to port of import	Unloading in port of import	Loading on truck in port of import	Carriage to place of destination	Insurance	Import customs clearance	Import taxes
EXW	Buyer	Buyer	Buyer	Buyer	Buyer	Buyer	Buyer	Buyer	Buyer	N/A	Buyer	Buyer
FCA	Seller	Seller	Seller	Buyer	Buyer	Buyer	Buyer	Buyer	Buyer	N/A	Buyer	Buyer
FAS	Seller	Seller	Seller	Seller	Buyer	Buyer	Buyer	Buyer	Buyer	N/A	Buyer	Buyer
FOB	Seller	Seller	Seller	Seller	Seller	Buyer	Buyer	Buyer	Buyer	N/A	Buyer	Buyer
CFR	Seller	Seller	Seller	Seller	Seller	Seller	Buyer	Buyer	Buyer	N/A	Buyer	Buyer
CIF	Seller	Seller	Seller	Seller	Seller	Seller	Buyer	Buyer	Buyer	Seller	Buyer	Buyer
DAT	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Buyer	Buyer	N/A	Buyer	Buyer
DAP	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller	N/A	Buyer	Buyer
CPT	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller	N/A	Buyer	Buyer
CIP	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Buyer	Buyer
DDP	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller	Seller	N/A	Seller	Seller

(d) A few particularities

Ship's rail as delivery point. In Incoterms 2010, the ship's rail as the point of delivery has been omitted in favour of the goods being considered as delivered when they are 'on board'. This more accurately reflects commercial reality and avoids the rather dated image of the risk transferring across an imaginary line.

Terminal handling charges. The carriage costs sometimes include handling and moving the goods within a port or container terminal facility. The carrier or terminal operator may well charge these costs to the buyer who receives the goods. In these cases, the buyer must not be obliged to pay twice for the same service: once to the seller (as part of the total selling price) and once independently to the carrier or the terminal operator. The Incoterms 2010 rules seek to avoid this by clearly allocating these costs in paragraphs A6/B6 of the applicable Incoterm.

Electronic communication. Articles A1/B1 of Incoterms 2010 give electronic means of communication the same effect as paper communication, if the parties so agree, or where such communication is customary.

5.4 Payment by documentary collection, letter of credit, or bank guarantee

This section will discuss the common payment arrangements together with the legal framework typically chosen. The ICC has adopted authoritative rules to answer the questions that arise in each of the arrangements.

If goods or services are to be delivered, the parties agree on a price to be paid, the moment and method of payment regarding delivery. Normally, a sales transaction is effected by handing over the goods and payment (either in cash or upon receipt of an invoice). The customer can see what it is buying, and the supplier is relatively certain about obtaining payment. In an international context, this implied level of trust is often absent. In those circumstances, the parties need a payment arrangement that corresponds to their interest and their power of negotiation.

Common arrangements. Commonly used payment arrangements are payment in advance, payment by documentary collection, and payment by documentary credit. Certainty of payment can be improved by a bank guarantee or a standby letter of credit. The effectiveness of these arrangements varies and depends on the risk assumed by the bank involved. Furthermore, the higher the risk carried by the bank, the higher the cost of the arrangement will be.

(a) Uniform Rules of Collection (URC 522) for documentary collection

Documentary collection is a process for collecting payment. A bank in the country of the buyer plays a key role in the arrangement, acting as a collecting agent for the *seller*. The bank (the *presenting bank*) delivers the agreed documents to the buyer in accordance with the collection instruction provided by the seller, against payment or acceptance.

Why choose documentary collection? Documentary collection is useful if the parties fail to agree on payment in the country of the seller, but the buyer needs the documents to clear customs or prove ownership of the goods in its own country (or its own customers). In most cross-border transactions, the goods must be transported, transport should often be insured, and frequently the goods must be exported and imported (i.e. cleared for customs). The related actions are reflected or evidenced in various documents.⁵⁴ Possessing those documents (e.g. a negotiable bill of lading) implies a great level of control over the corresponding goods.

Risks involved. The seller usually ships the goods before receiving payment and therefore bears the risk that the buyer will not accept the goods, will not take delivery, or will refuse to pay. Moreover, if the goods are defined as delivered at the premises of the buyer, as is often the case in air, truck and rail shipment, the buyer simply obtains possession of the goods. Finally, the seller also bears the risk of the buyer's insolvency. In an opposite scenario with a strong seller, the buyer must pay a demand draft or accept a draft before the goods are delivered (or are even available for inspection). The buyer may examine the documents before the payment, but nevertheless bears the risk of delivery of damaged or non-conforming goods. This risk can be diminished if the seller also provides inspection and insurance certificates. Involving banks to interchange documents against payment facilitates the transaction. If the seller is generally reliable (e.g. the seller has a good reputation and standing) and if the seller is not particularly concerned about the buyer's failure to take delivery (e.g. the goods may alternatively be sold to a third party), documentary collection is an appropriate payment arrangement.

Types of collection. The most common types of documentary collection are:

- **documents against payment (D/P)**, also called cash against documents (C/D) – a type of documentary collection whereby the presenting bank will deliver the documents only upon receipt of the agreed price; and
- **documents against acceptance (D/A)** – a type of documentary collection whereby the presenting bank will deliver the documents only upon acceptance of the bill of exchange by the buyer.

Terminology. If the parties have stipulated documents against acceptance, the presenting bank demands payment by presenting a 'bill of exchange' (also called a 'draft'). The bill of exchange, often a cheque, is a written demand for payment of a specified amount addressed to the 'drawee'.

⁵⁴ See the ITC Model Contract for the International Commercial Sale of Goods (standard version) Article 4.3, requiring a specification of the documents-to-be-presented in Article 5 (Documents). See also the ITC Model Contract for the International Commercial Sale of Goods (short version) Articles 4 and 5, the ITC Model Contract for the International Long-term Supply of Goods Article 4.3 (option 2), and the ITC Model Contract for International Distribution of Goods, Article 5.3 (option 2).

Payment may be demanded upon presentation (i.e. 'at sight') or on a certain specified maturity date such as a number of days after sight (e.g. 30 days after sight), or a number of days after another date (e.g. 30 days after the bill of lading date). Such deferred payment is in fact a credit from the seller to the buyer. Typically, a bill of exchange specifies a party to be paid (the 'payee'). Nevertheless, most bills of exchange are also 'negotiable'. This means that the payee's right to payment may be transferred to another party.

Regulatory framework of URC 522. The most authoritative legal framework for documentary collection is the Uniform Rules for Collections (URC) published by the ICC (**URC 522**).⁵⁵ URC 522 applies only if this is stated in the collection instruction. Also, the parties must stipulate in the sales agreement that "the payment by documentary collection is subject to the *Uniform Rules for Collections*".⁵⁶

Collection instruction. In connection with the documents sent for collection, the seller must provide a "collection instruction". The collection instruction must indicate that the collection is subject to URC 522 and give complete and precise instructions. Collecting banks will only act according to the collection instruction. A bank will not look elsewhere for instructions and is not obliged to examine documents for instructions. Therefore, a seller (or a remitting bank, i.e. the seller's own bank responsible for communications with the presenting bank) must ensure that all necessary information and instructions are provided in the collection instruction. Usually, a bank would ask its customer to use a specific form.

The collection instruction should:⁵⁷

- state the amount and currency to be collected;
- enclose the list of accompanying documents;
- state the terms and conditions upon which the payment or acceptance is to be obtained;
- specify the terms of the delivery of the documents (D/P, D/A or other terms or conditions);
- stipulate the method of payment and instructions in case of non-payment, non-acceptance or non-compliance with other instructions.

The collection instruction may specify aspects of protest (or objection rights) in the event of non-payment or non-acceptance.⁵⁸ If it does not, the bank will have no obligation to allow the buyer to refuse payment or acceptance. Finally, the parties may consider including instructions in the collection instruction if the documents are not taken by the buyer, for example, if the goods then need to be transported to a warehouse and insured.

⁵⁵ ICC Publication No. 522, Uniform Rules For Collection (URC) 522 came into effect on 01 January 1996.

⁵⁶ URC 522 Article 4(a)(i).

⁵⁷ URC 522 Article 4(b).

⁵⁸ URC 522 Article 24.

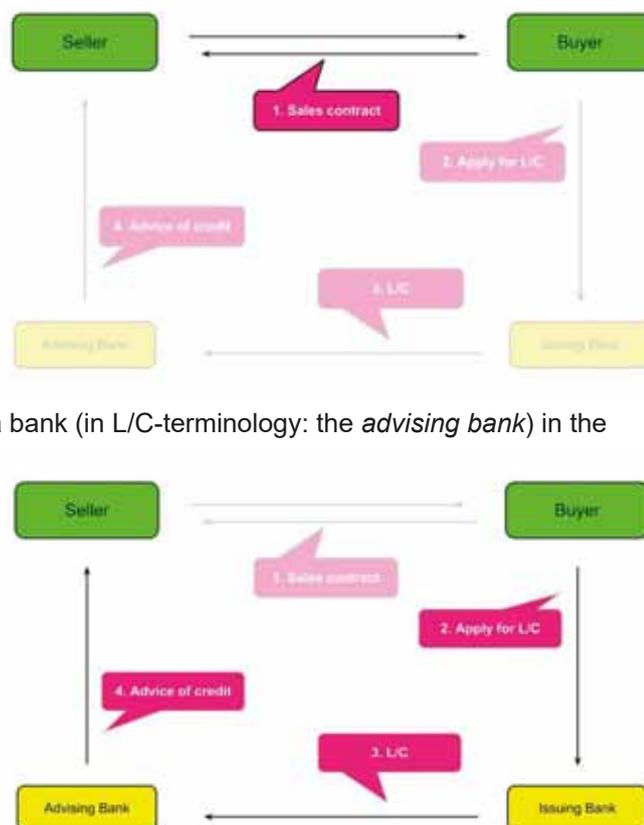
(b) Uniform Customs and Practice for Documentary Credits (UCP600): letters of credit (L/Cs)

General. In many sales contracts, the buyer is required to arrange for payment of the contract price to be made by a bank (normally at the supplier's location). The buyer will seek certainty that it will actually receive the contracted goods or services. In international transactions, where physical exchange of price against goods is rare, a high level of certainty can be achieved by requiring a presentation of documents (usually including an invoice, an insurance policy and a bill of lading or other transport document). Letters of credit (usually abbreviated as "L/C") are a very common and reliable method of payment for goods in cross-border sales transactions.⁵⁹

The parties involved. The parties involved in an L/C are the *seller* (referred to as the *beneficiary*) and the *issuing bank* (usually the buyer's own bank). In the context of an irrevocable L/C, the issuing bank undertakes to pay the purchase price to the beneficiary, provided that the seller submits the correct documents before the expiry of the credit. In many cases, the beneficiary's own bank will also be involved (and be referred to as the *advising bank*).

Overview of a transaction. Visualising the steps of a sales transaction and related payment clarifies how an L/C works:

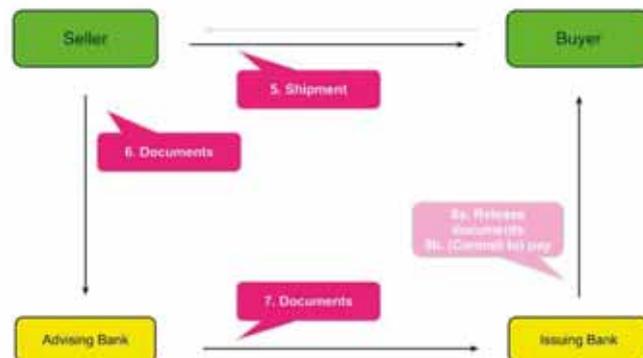
- 1) The buyer and the seller enter into a sales contract.
- 2) The buyer (in L/C terminology: *applicant*) submits a completed L/C-application form to a bank (in L/C-terminology: the *issuing bank*), usually its own bank in its own country.
- 3) The issuing bank approves the application, and sends the L/C to a bank (in L/C-terminology: the *advising bank*) in the country of the seller (in L/C-terminology: the *beneficiary*), often the seller's bank.
- 4) The advising bank authenticates the L/C and sends the beneficiary the details. The beneficiary reviews the L/C: (a) to ascertain that L/C-terms match the provisions of the sales contract; and (b) to make sure that all L/C-conditions can be



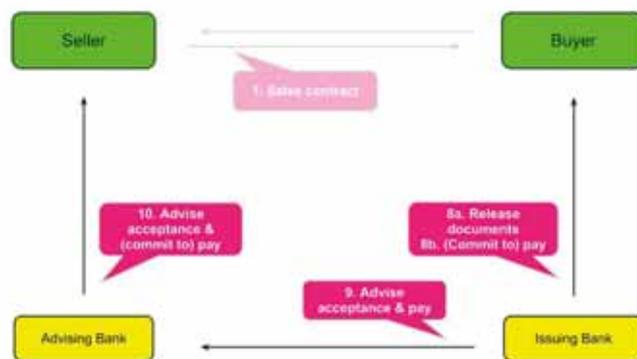
⁵⁹ L/Cs are also called documentary credits or bankers commercial credits.

met. If necessary, the seller/beneficiary contacts the buyer/applicant to request an amendment.

- 5) The seller insures the goods (if agreed) and ships the goods (for which the carrier, freight forwarder or transporter issues the relevant transportation documents) and (if agreed) clears the goods for export and import (as reflected in customs forms).



- 6) The seller submits the agreed documents to the advising bank, which examines the documents against the terms of the L/C.
- 7) If the documents are correct ('compliant'), the advising bank sends the documents to the issuing bank for acceptance.⁶⁰
- 8) The issuing bank examines documents received from the advising bank, and if the documents are in order, pays the amount agreed in the L/C, "at sight" or on the date agreed in the L/C.⁶¹ The issuing bank forwards the documents to the buyer (who can now collect the goods), and debits/settles the L/C amount.



- 9) The issuing bank pays to the advising bank (or will pay on the date agreed in the L/C).
- 10) The advising bank credits the bank account of the seller.

Advising versus confirming bank. An advising bank may *confirm* the L/C opened by the issuing bank. In such cases, if the credit is confirmed, the advising bank (now called confirming bank) also undertakes to pay the amount of the L/C. The beneficiary will then be entitled to take recourse on either the issuing bank or the confirming bank. This confirmation, as such, is sometimes requested and paid by the beneficiary (seller's confirmation).⁶²

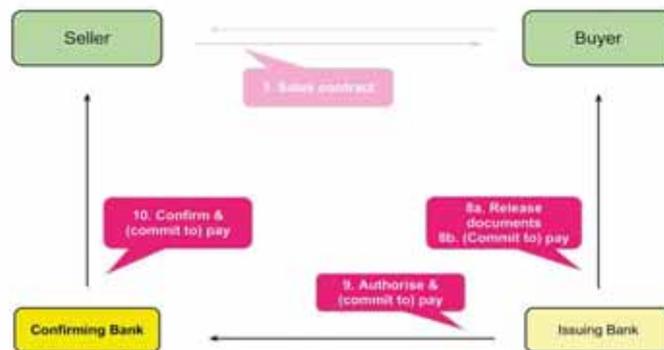
⁶⁰ If the details are not correct, the advising bank informs the beneficiary and waits for corrected documents or the beneficiary instructs the advising bank to forward the documents.

⁶¹ If documents are not correct, the issuing bank contacts the buyer for authorization to accept documents. If the buyer accepts, the issuing bank pays when promised; if buyer refuses, the issuing bank notifies the advising bank.

⁶² See Article 4 (fourth paragraph) of the ITC Model Contract for the International Commercial Sale of Goods (standard version), which contains the seller's confirmation.

In this case, the illustrations change slightly, in that the advising bank has become confirming bank, and the confirming bank does not 'advise' the L/C but 'confirms' it.

Date of payment. Upon presentation of the documents, the bank pays the purchase price according to the L/C, by at sight payment, deferred payment, by acceptance or by negotiation. The L/C states which of the four settlement methods has been chosen. In case of a payment at sight, the advising bank is instructed to pay to the seller on mere presentation of the documents. This is a case of 'payment against documents'.



L/C expiry date. A letter of credit must stipulate an expiry date, on or before which documents must be presented by the seller.

Documents that the parties commonly agree to have submitted under an L/C are:

- **commercial documents** (e.g. invoice, packing list);
- **shipping or transport documents** (e.g. bill of lading (ocean or multi-modal or charter party), airway bill, lorry or truck receipt, railway receipt, forwarder cargo receipt);
- **official documents** (e.g. customs documents, import permits, export permit, licences, embassy legalization, certificates of origin, certificates of inspection, phytosanitary certificates);
- **financial documents** (e.g. bill of exchange, co-accepted draft);
- **insurance documents** (e.g. insurance policy or certificate).

Regulatory framework: UCP600. The common international practice of letters of credit is reflected in the Uniform Customs and Practice for Documentary Credits (UCP600).⁶³ The UCP600's provisions explain the required actions to be taken by each of the parties, their responsibilities and liabilities. UCP600 also elaborates on the verification of the submitted documents. Finally, it contains provisions related to the presentation of documents in electronic (or part-electronic) form (eUCP). UCP600 applies only if the parties have expressly referred to it in the sales contract (see UCP600 Article 1).⁶⁴

Two fundamental principles apply to letters of credit – the principle of autonomy of the L/C and the doctrine of strict compliance.

⁶³ International Chamber of Commerce (2006). *Uniform Customs and Practice for Documentary Credits*. ICC Publication No. 600. Paris, ICC.

⁶⁴ See Article 4 of the ITC Model Contract for the International Commercial Sale of Goods (standard version and short version), Article 4.3 (option 2) of the ITC Model Contract for the International Long-term Supply of Goods, and Article 5.3 (option 2) of the ITC Model Contract for the International Distribution of Goods.

Autonomy of the L/C: independent undertaking. The undertakings by the issuing and confirming banks to pay the beneficiary are separate and independent from the buyer's actual willingness or ability to pay. This characterizes a letter of credit. Accordingly, an issuing bank and a confirming bank will refuse to accept instructions from the buyer not to pay a beneficiary that has satisfied the conditions of the L/C. Similarly, an issuing bank will not accept a revocation of the L/C. A bank that operates an L/C is concerned only whether the documents provided by the beneficiary correspond to those specified in the instructions. This principle of the *autonomy of the L/C* is stated in UCP600, Articles 4 and 5.

Doctrine of strict compliance: document verification. The *doctrine of strict compliance* means that the bank is entitled to reject the documents if they do not strictly conform to the terms of the L/C. In this respect, the bank examines the documents and determines, based on the documents alone, whether the documents appear 'on their face' to constitute a complying presentation (UCP600 Article 14(a)). According to the commentary on UCP600, the concept 'on their face' requires a review of data within a document, to determine that a presentation complies with international standard banking practice and UCP600.⁶⁵ A bank is not obliged to go beyond 'the face' of a document to establish if a document complies with a requirement in the L/C or UCP600.

Which examination criteria? For the important types of documents commonly submitted in connection with an L/C, UCP600 Articles 18 to 28 identify: (a) the required details and information; (b) the assumptions that a bank will make; (c) which information will be ignored by a bank; and (d) what level of verification it undertakes. If the presented documents do not conform to the L/C, the refusing bank will notify the presenter (UCP600 Article 16).

Fraud. The bank may only refuse to pay if it is proved that: (a) the documents (even though they are apparently in order 'on their face') are fraudulent; and (b) the beneficiary was involved in the fraud. This differs from the case where the documents appear not to conform to the L/C (since a discrepancy would entitle the bank to refuse payment based on non-compliance). Examples of alleged fraud include cases where the seller/beneficiary shipped worthless junk or no goods at all, or where documents were forged or fraudulent (e.g. antedated bills of lading, reflecting an earlier date of shipment than the actual date of shipment, to meet the contractual requirements). In addition, the applicable law may require that the seller be aware of the fraud, to entitle a bank to refuse payment. Although this is a matter of the law applicable to the L/C, cases in which fraud was committed by an intermediary (e.g. the carrier or a freight forwarder), for example, should not affect the payment obligation of the bank. The logic behind this is that fraud by an intermediary should not affect the obligation of the bank but should be dealt with in the relationship with that intermediary (e.g. the transportation or freight handling agreement). It must be emphasized that the fraud-exception is a matter for the law applicable to the L/C.

Different types of L/Cs. There are various types of L/Cs. The most important distinctions are made between revocable and irrevocable L/Cs and between confirmed and unconfirmed L/Cs.

⁶⁵ International Chamber of Commerce (2007). *Commentary on UCP 600 – Article by Article Analysis by the UCP600 Drafting Group*. ICC Publication No. 680. Paris, ICC.

Revocable versus irrevocable L/Cs. L/Cs can be revocable or irrevocable. The distinction refers to the obligation of the issuing bank to the beneficiary. Revocable L/Cs are relatively uncommon. UCP600 addresses irrevocable L/Cs.⁶⁶ By definition, under an irrevocable L/C, an issuing bank cannot revoke its undertaking to the beneficiary.

Confirmed versus unconfirmed L/Cs. L/Cs can be confirmed or unconfirmed. This distinction refers to the obligation of the advising bank to the beneficiary. UCP600 Article 2 defines confirmation as “a definite undertaking of the confirming bank, in addition to that of the issuing bank, to honour or negotiate a complying presentation.” Unconfirmed L/Cs are less expensive than confirmed credits, because the advising bank undertakes a separate payment obligation regarding the beneficiary. However, their disadvantage is that the performance of the sales contract is not entirely located in the seller's country. This implies that if the advising bank refuses to pay, the beneficiary might need to start payment collection proceedings in the country of the buyer.

Irrevocable and confirmed credits are most favourable to the seller/beneficiary. The conforming bank cannot withdraw from its liability to the beneficiary even if instructed by the buyer to cancel the credit.

(c) ISP98: Standby practices

A standby letter of credit (standby) is an undertaking by one party, usually a bank, to pay a beneficiary or to accept bills of exchange drawn on it. This payment is made once the beneficiary has demanded it and has satisfied the conditions stated in the standby (e.g. presents certain documents).

Standby versus L/C: A standby differs from the ordinary L/C. The L/C is a payment instrument, which normally obliges the beneficiary to provide transport documents whereas the standby is intended to protect the beneficiary in the event of non-performance by its counterparty in the underlying contract. The standby obligation may be triggered by a document of any description (such as a mere statement that the counterparty is in default) and not necessarily the presentation of any official documents referred to in the previous section.) Standby practice originated in the United States to circumvent rules that prevent a bank from giving guarantees.

Practical use. Standbys are commonly named descriptively. For example:

- **performance standby** supports an obligation to perform other than to pay money, including to cover losses arising from partial or non-performance of the applicant in the underlying contract;
- **advance payment standby** supports an obligation to make an advance payment;

⁶⁶ See UCP600 Article 2 (definition of Credit) and Article 3 (second sentence). See, accordingly, Article 4 of the ITC Model Contract for the International Commercial Sale of Goods (standard version and short version), Article 4.3 (option 2) of the ITC Model Contract for the International Long-term Supply of Goods, and Article 5.3 (option 2) of the ITC Model Contract for the International Distribution of Goods.

- **bid bond** or **tender bond standby** supports an obligation to negotiate and enter into a contract if the applicant is awarded a bid;
- **financial standby** supports an obligation to pay money (or repay under a loan);
- **counter standby** supports the issuance of a separate standby *by the beneficiary* of the *countered* standby;
- **direct pay standby** supports payment when due of an underlying payment obligation;
- **insurance standby** supports an insurance or reinsurance obligation of the applicant;
- **commercial standby** supports the obligations of an applicant to pay for goods or services in the event of non-payment by ordinary payment methods.

Regulatory framework: International Standby Practices (ISP98). Standby practice triggers many questions. ISP98 provides a clear and authoritative framework for addressing them and has become the industry standard for the use of standbys in international transactions.⁶⁷ For it to apply, however, the contract must express that the standby is subject to the ICC's International Standby Practices (or, in short, ISP98).

ISP98 vs. UCP600. UCP600 reinforced the independence and documentary character of the standby. It provides standards for examination and 'notice of dishonour' and an authoritative basis to resist pressures to issue a standby without expiration date. In many cases, however, UCP600 is not appropriate for standbys. Even simple standbys may pose problems not addressed by UCP600. More complex standbys such as those involving longer terms or automatic extensions; transfer on demand; requests that the beneficiary issue its own undertaking to another, for example, require more specialized rules of practice. ISP98 fills these needs.

ISP98 is accepted not only by bankers and merchants (as is UCP600), but also by a broader range of businesses (e.g. project managers, corporate treasurers, rating agencies, government agencies). As standbys are often intended to be available in the event of disputes or applicant insolvency, their texts are subject to a degree of scrutiny not encountered in the context of (the typical UCP600-governed) L/C's. There are basic similarities between ISP98 and UCP600 because standby and commercial practices are fundamentally the same. Nevertheless, ISP98 is more precise, expressly stating the intent 'implied' in the UCP600 rule. Like UCP600 (and demand guarantees), ISP98 will apply to any independent undertaking issued subject to it.

United Nations Convention. ISP98 has been developed as a complement to the United Nations Convention on Independent Guarantees and Standby Letters of Credit.⁶⁸ The Convention facilitates the use of independent guarantees and standby letters of credit and reflects their basic principles.

⁶⁷ Initially developed by the Institute of International Banking Law and Practice and adopted by the ICC (ICC Publication No. 590, 1998 Edition). ISP 98 came into effect on 1 January 1999.

⁶⁸ General Assembly 11 December 1995, entered into force on 1 January 2000. Eight countries have ratified the Convention: Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama and Tunisia. The text of the Convention is available at: http://www.uncitral.org/uncitral/en/uncitral_texts/payments/1995Convention_guarantees_credit.html.

(d) Demand guarantees

An adequate alternative to a confirmed L/C is a (bank) guarantee.⁶⁹ A guarantee provides a higher level of certainty about the other party's performance. It can be procured by both parties. If a buyer procures the bank guarantee, its aim is to secure the payment of the contract price (that would normally be paid by the buyer itself). If a supplier procures the bank guarantee, its aim is to secure repayment of any paid contract price, or of any damages caused by non-conformity or delayed performance.

Usage. Guarantees are used in various types of risky, often complex transactions. Such transactions include:

- in a sale of goods transaction, payment upon a seller's default (e.g. non-conformity or delayed delivery);
- in a service contract or construction contract, security for due performance; or
- in joint venture agreements, underwriting the liability of the partners by their respective parent companies.

Terminology. A demand guarantee (a bank guarantee, when issued by a bank) is also referred to as a 'first demand guarantee', an 'independent guarantee' or an 'abstract guarantee'. These are all designations of the same concept, emphasizing the essential characteristic of a guarantee – a separate undertaking by the guarantor to answer for the duty of another, should the other default. The trigger for a (demand) guarantee is contractual non-performance (or poor or delayed performance). To what extent the breach of contract must be proven regarding the guarantor is a matter of negotiation. A less abstract guarantee that requires a more comprehensive inquiry into the validity of the documents submitted by the beneficiary, or into compliance with the underlying contract, is sometimes also called an 'accessory guarantee'.

First pay then talk. A bank guarantee ensures that the harmed customer must start court proceedings to recover damages (it cannot withhold payment). The effect of a bank guarantee is "first pay then talk". If the customer procures the bank guarantee, the effect of calling on the bank guarantee is that the contract price is paid by operation of the bank guarantee. If the supplier procures the bank guarantee, any damages suffered by the customer are compensated by operation of the bank guarantee. When there is discussion whether a claim under the bank guarantee is justified, such discussion would take place *after* payment under the bank guarantee. Accordingly, a bank guarantee diminishes the risks that either party would otherwise assume.

Abstract (or independent) character. Normally, a guarantee is an 'absolute' ('primary and independent') undertaking by a bank – the guarantor – to pay if the conditions of the guarantee are satisfied. The issuing bank is not concerned as to whether there has been any actual default by the applicant. Obviously, a bank issuing a guarantee will require that the applicant (or a third

⁶⁹ See the ITC Model Contract for the International Commercial Sale of Goods (standard and short versions), Article 4.3; the ITC Model Contract for the International Long-term Supply of Goods, Article 4.3; and the ITC Model Contract for the International Distribution of Goods, Article 5.3.

party, such as an affiliated or parent company) counter-guarantee due performance in relation to the bank.

The conditions of a guarantee are stipulated in a separate agreement with the guarantor, which is called the guarantee. The applicant should ascertain that the underlying contract and the guarantee match: the underlying contract should not require a guarantee that is hardly obtainable (or excessively expensive); and the guarantee should not require documents or evidence that will never exist in the framework of the underlying contract. If any documents or evidence must be submitted to the guarantor, the guarantor will examine the required documents and evidence 'on their face', i.e. by interpreting the context of the presented document, the guarantee and the applicable rules. If they reasonably appear to meet the requirements, the bank (or guarantor) will pay.

If the guarantee does not require any document or evidence, a mere statement that there is a breach of contract is sufficient for the guaranteeing bank to pay. The guarantee may expressly stipulate that no such statement is required at all.⁷⁰

Bank guarantees versus L/C's. In practice, demand guarantees, performance guarantees, performance bonds and standby L/C's have a similar legal character and resemble documentary credits – they are 'primary' (independent or abstract) and typically conditional only upon a written demand for payment, accompanied by any stipulated documents or evidence. The principle of *autonomy* of the bank's undertaking and the *doctrine of strict compliance* apply to bank guarantees just as they do to L/C's. Moreover, the fraud exception may be invoked in respect of a guarantee.

Regulatory framework: Uniform Rules for Demand Guarantees (URDG). The international standard practice for use of demand guarantees is reflected in the URDG published by the ICC (current version URDG 758).⁷¹ URDG 758 applies to any demand guarantee or counter-guarantee (whatever name is given to it), provided that this is expressly indicated in the provisions of the guarantee (and the counter-guarantee). A guarantee is irrevocable even if it does not state that this is so.

(e) Payment in advance and milestone payments

A seller may be able to negotiate that the purchase price of the goods be paid in advance. The reasons for payment in advance are obvious – the seller requires a way of funding its deliverables, or it desires a high level of certainty that it will be paid by the buyer. Conversely, in such cases, the buyer carries the risk of a possible non-conformity or non-delivery of the goods and the risk of the seller's insolvency.

⁷⁰ URDG Article 15(a) and (c).

⁷¹ URDG 758 is a complete revision of URDG 458, and effective as of 1 July 2010.

Milestones. A common alternative in international trade practice is that the parties agree on milestone payments. This is particularly common in services agreements (e.g. for product development work or for the construction of a building or infrastructure). The amount of each milestone payment may vary, as well. For example, it is appropriate to agree on:

- a) prepayment of 40 percent of the contract price after signing the contract, allowing the supplier to purchase raw materials or components and to pay the salaries of its employees;
- b) payment of another 40 percent upon delivery (or the delivery of a first batch); and
- c) payment of the remaining 10 percent after correction of any initial defects and unconditional acceptance.

Combination of arrangements. The payment arrangements mentioned above can, of course, be combined with any other payment arrangement for the payment of a remaining part of the purchase price, such as documentary credit or documentary collection.

5.5 Intellectual property law

'Intellectual property' refers to 'creations of the mind' – inventions; literary and artistic works; know-how; technology; and symbols, names, images and designs used in commerce. Traditionally, intellectual property embraces two categories: *copyright*, which includes literary and artistic works in the broad sense of the word, whether regarded as art or used in commerce; and *industrial property*, all other creations including patents, trademarks, industrial designs and geographic indications of a source.

Terminology: IP, IPR and IP rights. In practice, the term intellectual property is commonly referred to as IP, and intellectual property rights as IPR or IP-rights.

International nature. One of the most international fields of law is IP law. Not only do intangible goods move as fast across borders as email, but also the law of IP across the world has developed in the same direction. One reason for this is because IP law was unified at a very early stage of its development through widely ratified multilateral treaties.⁷² The infrastructure for international legislative and administrative assistance has been strengthened by the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). However, local regulations must always be studied because there might be limitations or additional regulations that may affect IPR.

World Intellectual Property Organization (WIPO). The WIPO (in French: OMPI) is a United Nations agency dedicated to the use of IP and has contributed significantly to the unification of IP law. WIPO's mission is to promote innovation and creativity for the economic, social and cultural

⁷² The main IP-conventions are the Paris Convention for the protection of industrial property (1883); the Berne Convention for the protection of literary and artistic works (1886); the Madrid Agreement concerning the international registration of marks (1891); the Nice Agreement concerning the international classification of goods and services for the purposes of the registration of marks (1957); and of more recent date: the Patent Cooperation Treaty (PCT, 1970); the Trademark Law Treaty (1994); the WIPO Copyright Treaty (1996); and the Patent Law Treaty (2000).

development of all countries through a balanced and effective international IP system. Accordingly, WIPO administers numerous IP treaties, provides IP-related educational materials and guidance, promulgates the importance and usefulness of intellectual property, and works continuously on the further development and unification of IP laws.⁷³

Scope. In this section the most important intellectual property rights for small and medium-sized enterprises will be introduced – trademarks, copyright, trade secrets (know-how and other confidential information) and patents. Rights in software with features of patentable inventions, copyrighted works and confidential information will be addressed as well. Considering its importance, a separate section 5.5(g) is dedicated to IP licensing.

IPR that will **not** be addressed include:

- **Trade names.** Very similar to *trademarks* but limited to the name or designation of a business. IP protection of trade names means that a company cannot use the same commercial or trade name of an existing company that is using that name already. In addition, a name or designation *similar* to the trade name may not be used if there is a likelihood of misleading the public.
- **Domain names.** The law of domain names not only addresses ownership and transfer requirements, but more importantly, the abusive or bad faith registration of domain names that include trademarks. This practice is known as cybersquatting.
- **Neighbouring rights.** Certain persons or companies contribute to making copyrighted works available to the public, or they produce subject matters that, while not qualifying as a ‘work’ under copyright law, justify protection of their copyright-like right. Typically, these ‘related rights’ or ‘neighbouring rights’ are conferred upon performers, producers of music and broadcasting organizations.
- **Databases.** An electronic collection of data is usually stored in a database, a virtual card-index box where data is structured, linked, and made retrievable in different forms. Database law regulates who owns the data in a database, the data retrieved from it and the database as a framework. The laws on (the management and protection of) personal data has also influenced the development of database law.
- **Plant breeder’s rights.** The availability of new or improved plant varieties is important to the agricultural sector in all countries. The business of producing a crop and its attractiveness to consumers can dramatically be affected by improved disease resistance, higher yields, sustainable agricultural production, food security generally and improvements of other properties of plants. New plant varieties, developed after years of patience, efforts and heavy investment, could easily be reproduced by anyone. Protection of these efforts and investments justifies this specific IP right.
- **Semiconductor layouts (topography).** Integrated circuits (also called chips, processors or ICs) are used in many products of everyday use such as mobile phones, computers, TV sets, household equipment and cars. Integrated circuits are manufactured in accordance with very detailed layout designs. Creating a new layout design for an integrated circuit

⁷³ See <http://www.wipo.int>. This website contains most IP-related materials, including many publications explaining in detail how intellectual property is or can be protected.

involves a major investment and copying such a layout design is extremely cheap and easy. This led to the establishment of specific IP protection.

- **Designs and models.** Industrial design is the ornamental or visual aspect of a product, including its shape, pattern or colour. The design must have visual appeal and contribute to the product's use and must be capable of being reproduced by industrial means. When the functional differences between available products are relatively arbitrary, consumer decisions are based on price and visual appeal. Industrial design protection serves as an incentive to invest resources in the design element of production.
- **Portrait rights.** In principle, private individuals are entitled to privacy. Portrait rights are an individual's rights in a portrait of him or her (i.e. other than the copyright of the photographer who made the portrait). An example of portrait rights is the publication of someone's picture in a magazine. The person portrayed can oppose such publication to the extent that he or she has a reasonable interest in doing so.

(a) General concepts in intellectual property law

'Creator is the owner'. The general principle in IP law is that the creator of intellectual property is considered to be the owner of it. The effect of this principle can be significant. Unless the commissioner and the creator of a work or invention agreed otherwise in writing, the author or inventor can prohibit all use of it. Accordingly, a service provider who developed a technology can prevent that the customer uses such technology for purposes other than (expressly) permitted.

IP created by service providers. The default principle that the creator of intellectual property becomes the owner of that IP has an important consequence. If no contract clause on IP ownership is included in the services agreement, the created IP will be owned by the service provider and not by the customer. In most cases, this is not problematic. For example, IP ownership disputes hardly ever arise if the provided services do not result in a 'work of authorship', if a created work is not replicated or distributed as part of a product, or if the customer is the only user of the results of the service.

This may be different if the customer resells the result of a service in the conduct of its business or product portfolio. Whilst this is often overlooked, in a strict sense, the service provider could require its customer to pay a royalty over the customer's sales to third parties in addition to the service fees. To avoid this often-unanticipated effect, the customer should contractually stipulate that it will own all the IP. Alternatively, the services agreement could stipulate that the customer does not have to pay any additional fees and is free 'to use and have used' the services and solutions created by the service provider (with a right to grant sub-licences).

Employees. Since the creator is the owner of the creation, it is important to realize that employees should agree in their employment agreement that instead, the employer (and not the creator-employee) will be the owner of all works created in the context of the employment relationship or the fulfilment of the employee's work (regardless whether the work was performed during normal business hours).

In many jurisdictions the law provides that, by default, the employer owns any creations made by an employee in the day-to-day course of the employment. To avoid abuse by the employees, it typically also includes anything that may reasonably be expected to have been made pursuant to the employment relationship. In other words, the employee is not permitted the easy escape that a certain invention or work was created outside working hours.

This default ownership-allocation is different in the United States, Canada and Australia. In these jurisdictions, the employer should explicitly stipulate in the employment agreement that the employer becomes the owner of all created in the context of the employment relation. If it is not addressed in the employment conditions, it may well result in the employer lawfully being required to pay a royalty to the employee.

Moral rights. The individual who created a copyrighted work has several personal rights: the right that his or her name is mentioned, the right to have the work published anonymously or under pseudonym, and the right to the integrity of the work. The ‘integrity of a work’ means that the work may not be modified, distorted or mutilated. Moral rights are distinct from the IP ownership and licensing rights: even if the copyright in a work has been transferred, the creator may still enforce the moral rights in the work. Therefore, if permitted under the applicable law, employees should also be required to waive their moral rights under works created as part of their day-to-day employment.

Derivative works. The owner of intellectual property is entitled to ‘control’ the use of it. In particular, if the owner has not expressly provided otherwise, nobody is entitled to modify, translate or transform the created work or to create a work that builds on the original creation without its permission. Such a modification, addition or translation is called a ‘derivative work’. Accordingly, a licensee is usually prohibited to modify the created work, unless the owner has permitted the modifications. In other words:

“**Derivative Works**” means any work or creation based on existing Intellectual Property Rights, such as a modification, improvement, reconfiguration, expansion, compilation or translation.

Background and foreground IP. It rarely occurs that merely one person creates technology at one moment in time. Technology is typically a result of several combined technological developments, test results and components. If a company wishes to improve the technology or to add functionalities to its products, it might engage an external consultant, who usually builds on existing technology.

Whilst the customer is willing to pay for the development costs, the expert might want to charge more for using its already *existing* technology. The customer may want to be the owner of the technology, but such ownership allocation is probably impossible in respect of the consultant’s pre-existing technology (which might be owned by or licensed to third parties as well). Such pre-existing technology may be acquired from a third party who is entitled to royalties each time the

technology is used or applied. It works the same way with respect to spare parts, components or half products used in end-products.

Many contracts distinguish between pre-existing technology and new technology developed in the context of the contracted project. The terms used are background IP for pre-existing technology and foreground IP for the technology developed in the framework of the commissioned work (or background know-how, background patents and their counterparts). They can be defined as follows:

“Background IPR” means, by reference to a Party, all intellectual property rights, excluding Foreground IPR, (a) owned by such Party or any of its Affiliates, or (b) licensed or made available by a third party to such Party and under which that Party is authorized to grant licences.

“Foreground IPR” means, by reference to a Party, all intellectual property rights which arise as a result of, or in the context of, any activity pursuant to this Agreement.

Distinguish fields of business. The provisions of a contract involving the development or use of IP should address the owners of the specific IPR and designate which party must grant a licence to the other party. It might also be necessary to obtain a licence from a third party. It is not uncommon to come to a compromise that if the customer becomes the owner of any foreground IPR, the service provider is licensed to use (and to grant sub-licences under) foreground IPR in fields of business outside the scope for which the customer uses the same technology. Such licence for a particular field of business could be exclusive.

Joint development and joint ownership. If parties work together on and contribute to the development of intellectual property, they ‘co-create’ a solution. Like tangible goods, intellectual property can be co-owned by two or more persons or legal entities. This could happen in an alliance or a joint development agreement, where the parties collaborate and merge their contributions into inseparable or interdependent parts of a unitary whole. For co-ownership to come into existence, it is not necessary that the parties’ contributions are equal in effort or nature, or that they be made simultaneously, as long as the parties were collaborating. It is also not necessary that both parties contributed to every aspect of the resulting work or invention.

In view of the complications of joint ownership, registration and exploitation of the IPR, it is important that the parties agree on the specific rights and obligations of the parties in respect of the developed IPR. In many cases, the contracting parties’ respective fields of activity are so different that joint inventions or joint know-how are relatively easy to avoid and unlikely to be problematic. Generally, IP arrangements therefore permit each contributing party to act as the sole owner of the IPR related to its own core business. Alternatively, the parties could leave certain joint-IP-ownership aspects unaddressed, whilst focusing on the exploitation of the (background and) foreground IPR.

Nonetheless, if the parties are active in the same field of business and undertake to jointly develop a solution, they should agree on a number of contractual mechanisms, preferably in advance:

- **Determination of joint IPR:**
 - whether and to which extent any joint IP has indeed been developed;
 - dispute resolution mechanism to avoid lengthy discussions (e.g. escalation to senior managers or directors);
- **Registration:**
 - description of the IPR;
 - specify in which jurisdictions the IPR will be registered;
 - decision making on discontinuation of a registration;
 - mutual rights in case of no registration;
- **Exploitation of the IPR:**
 - in case of joint exploitation, the parties' obligations regarding commercializing and licensing;
 - sub-licensing rights (including to affiliated companies);
 - infringement by third parties of the joint IPR;
 - infringement by the parties of the IPR of a third party (joint defence, decision-making on settlements, mutual indemnity, joint and several liability);
 - entitlement to proceeds (i.e. royalties or recovered damages).

As the above list shows, it is often more efficient to agree on a clear separation of IP-rights (and allow one party to use the other party's foreground IP) than to establish the elaborate framework required in case of jointly owned IPR.

(b) Trademarks

Purpose and characteristics. A trademark is a symbol, logo, word or other indicator to identify a certain product or service and to distinguish it from other (similar) products and services. A trademark serves to identify the commercial source of origin of a product or service, and distinguishes such source of origin from other suppliers. Many people attribute much broader purposes to trademarks, such as a means of communication with consumers or customers (e.g. by creating a 'limited edition' of their products by combining it with an icon of style or quality) or as a means for people to communicate with each other (e.g. by wearing certain clothing or icons of class). Also courts generally acknowledge that trademarks contribute to brand positioning and encourage businesses to invest in high quality of products by awarding high infringement damages, taking into account the inherent goodwill.

From a legal point of view, where trademarks include *word marks* and *service marks*; their protection and enforcement follow the same rules. In a trademark licence, the licensed word mark is usually identified in uppercase: PRECONTRACTUAL, MDLCNTRCTS, WEAGREE, etc. A slogan can also qualify as a trademark. Non-traditional marks such as colours, sounds, fragrances and tastes are increasingly accepted as trademarks.

One trademark may reflect both a product and a service at the same time, and a trademark may be both a word mark and (its design as) a logo. Similarly, a trademark will often coincide with a trade *name*.

Requirements for trademark protection. For a symbol, logo, word or other indicator to be protected under trademark law, it must be ‘distinctive’. Usually, several degrees of distinctiveness are identified, ranging from inherently distinctive (readily distinguishable as a mark) to a generic or descriptive indicator (without legal protection):

- **Inherently distinctive** marks are readily protectable because they are:
 - **arbitrary marks:** usually a common word used in an unrelated context (e.g. Apple for computers). Arbitrary marks consist of words or images which have a particular (dictionary) meaning, but which are used in connection with products or services unrelated to that dictionary meaning. For example, Salty would be an arbitrary mark if it is used in connection with telephones such as Salty Phones, as the term salt has no particular connection with telephones.
 - **fanciful marks** comprise a word that is entirely made up or invented to be used as a trademark. For example, Kodak had no meaning before it was adopted and used as a trademark for photographic and other goods.
 - **suggestive marks** invoke the consumer’s perceptive imagination. Suggestive marks tend to indicate the nature, quality or characteristics of the product or service, but do not describe this characteristic and therefore require imagination from the consumer to identify the specific characteristic. An example is Blu-ray, a technology used for high-capacity data storage.
- **Acquired distinctiveness (not merely descriptive):** if the mark’s descriptive element and the related product or service is less remote, the mark is only protected if the mark has acquired distinctiveness in the relevant market. As per the above example: if Salty is used for saltine crackers or anchovies, it is not protected as a trademark unless it can be shown that a distinctive character has been established through extensive use in the marketplace.
- **Not a generic word:** if a mark indicates a category of products (rather than a particular supplier or a specific product in that category) it is not distinctive and therefore not protected as a trademark. For example, the mark ‘salt’ in connection with sodium chloride is not capable of distinguishing the products or services of a business from the products or services of other businesses.
Some examples of such genericized (eroded) trademarks are aspirin, yo-yo, zipper, thermos, heroin, escalator and kerosene.

In many jurisdictions, a trademark must be registered with the (national) trademark office to receive the desired protection or to intervene when others infringe the trademark.

Classification. Upon registration, the application should specify the class under which the trademark falls according to the Nice Agreement.⁷⁴ This classification serves to differentiate

⁷⁴ Agreement concerning the international classification of goods and services for the purposes of the registration of marks (Nice, France, 15 June 1957), as revised and amended.

trademarks according to the types of goods or services. A trademark can fall in more than one class. The Nice classification, which has been adopted by 148 countries, consists of 45 classes (34 classes of products and 11 classes of services).

Geographical indications. Consistent with the agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS convention), the EU restricts the use of geographical indications for certain 'protected designations of origin'.⁷⁵ In principle, a geographical indication cannot qualify as a trademark because it does not identify a specific company as the producer of goods. Nonetheless, the EU recognized the distinctive nature which a consumer may attribute to a product coming from a specific geographical area and therefore decided to grant protection. This is somewhat controversial because a geographical indication may have already been registered as a trademark elsewhere. Well-known examples of geographical protection in the EU are wines (e.g. Bordeaux, Champagne and port) and cheeses (e.g. Gouda, Roquefort, Parmesan and Feta).

Duration. Other than patents and copyrights, a trademark does not expire or end after a specific term. Although the registration of the trademark may expire, the trademark itself would not be affected. Nonetheless, for a trademark to remain valid and enforceable, it must continue to be used in the relevant market (and not become genericised).

Use and exhaustion. A trademark must be used to maintain the protection. Many jurisdictions require that a trademark owner (or its licensees) must genuinely use a trademark within five years after registration, unless there are valid reasons for non-use. Although many trademark laws provide that the use of the trademark by a licensee accrues to the benefit of the licensor/owner of the trademark, it might be helpful to provide that such use does not accrue to the licensee. If it did, that would enable the licensee to terminate the trademark licence and start using the trademark itself without any obligations towards the licensor, or even with a right to prohibit the licensor to use the trademark in the licensee's territory.

After a product with a trademark has been 'put into circulation' on the market, the intellectual property rights in the trademark are 'exhausted'. This means that the trademark owner cannot take action against the way the subsequent vendor (e.g. of second hand products or outlet stores of past-year products) presents the trademark.

Dilution and blurring effects. One of the most treacherous effects of poor trademark management is dilution or blurring of the trademark: when a trademark loses its distinctiveness. There may be several causes for dilution, a few can be prevented contractually and most require alert and adequate action. A trademark may lose its distinctiveness because:

- it is used or presented inconsistently;
- colours of the trademark are not always exactly the same (or contrast differently depending on surrounding colours), shapes of the trademark are similar across the product portfolio

⁷⁵ The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), Annex 1c to the Agreement Establishing the World Trade Organization). Article 22 provides for a protection of geographical indications about the origin of goods in a way (and based on criteria) similar to trademarks.

but not exactly the same, fonts used in connection with the trademark differ (e.g. Times New Roman versus Garamond, or Arial versus Helvetica or Verdana);

- the emotion or personality attributable to the trademark varies in a confusing manner (e.g. used in intimate contexts as well as aggressive statements, or both in a picture of a natural landscape and in a city nightlife setting, or to convey a sense of exclusiveness and basic cheapness at the same time).

If a licence does not contain quality controls regarding the presentation of the trademark or the way it is presented in advertising and promotional materials, such licence is referred to as a 'naked licence'. Lack of such quality control by the licensor entails a serious risk of dilution (i.e. loss of the trademark).

(c) Franchising

Licensing a concept. Franchise arrangements are very similar to trademark licences. Franchising concerns the licensing by a franchisor of a 'concept' or 'system' to one or more franchisees. The concept usually consists of a trade name, trademark, use of an internet domain name, and trade secrets (see section 5.5(d)) in connection with a product and service, accompanied by detailed instructions or a manual regarding the production, marketing, sales and business model of the product and service. Some examples of franchising are hotel chains and fast food restaurants (e.g. Hilton, Meridien, NH Hotels, McDonalds, 7-Eleven, Subway, Burger King, Wendy's, Kentucky Fried Chicken). Any combination of products or services and set of instructions to ascertain uniformity and recognizability is capable of being franchised.

A franchise often consists of several layers: the main franchisor licences the franchise concept to a limited number of franchisees, with typically one or two franchisees per geographical area. The franchisees, in turn, will have the right to grant sub-licences to sub-franchisees (in parts of the franchise territory). This is a common way to delegate the exploitation of the franchise concept to local entrepreneurs and to limit the management time required to instruct and supervise the sub-franchisees.

Compliance with the concept. More than with trademark licences, a franchise agreement requires strict compliance with the licensed concept and the often detailed instructions in the operations manual. For example, upon entering such franchise restaurant, the staff will approach customers each time exactly the same way, often with exactly the same sentence ("Is there anything else I can do for you?") or with prohibited phrases (such as never say "No problem" after the customer said "Thank you"). Such uniform approach reinforces the consumer's positive perception and recognition of the trademark.

Developing the concept. A franchised concept usually develops continuously. Compliance with the concept therefore includes a contractual obligation to adopt all the changes in the franchised concept as they are adopted by the franchisor and communicated to the franchisees. Usually only

the timing of adopting changes and the contribution by the franchisor in the costs of such changes are (to a limited extent) open to negotiation.

Collaborative element. To streamline the feedback of customers and to optimize the franchised concept, many franchise arrangements contain a committee of franchisees (or geographically oriented sub-committees of franchisees). Such committees enable large numbers of franchisees to communicate with the franchisor and to jointly improve the franchised concept.

(d) Copyright⁷⁶

Technological and economic development of a country or business depends significantly on the creativity of individuals. If the result of creativity were not protected by law, the incentive to develop creative works would be limited. Copyright law protects an owner of intellectual property against those who copy the work. It also encourages the publication and dissemination of creative works because it provides legal remedies enabling the copyright owner to derive benefits from the work.

Scope of copyright. It is important to note that copyright protection also covers technological creations of the mind such as computer programmes and electronic databases, as well as the results of provided services. Furthermore, non-artistic works such as technical guides, engineering drawings, maps, product manuals and user guides are protected by copyright. In many jurisdictions, laws and regulations, as well as official decisions and judgments, are considered to be in the public domain and cannot therefore be copyrighted.

'Work'. Copyright protection relates to creations of the mind, also called *works of authorship*. This is a very wide concept and includes the following:

- literary works (e.g. books, text on a website, manuals);
- pictures, graphics and sculptures (including illustrations, plans and sketches);
- software source code;
- architectural works;
- sound and video recordings (e.g. music and films); and
- any collection of the above (i.e. a selection as such may be a work).

'Ideas' excluded. The physical representation in which the copyrighted creation is expressed is protected. Copyright law does not protect the intangible creation, other than with patented inventions, copyright law protects only the 'form of expression' of an idea, not the idea itself. The creativity in the choice and arrangement of words, sounds, colours or shapes is the object of protection under copyright law.

⁷⁶ In many languages, *copyright* is translated and known as *author's right*. The term copyright refers to the regulations regarding copying a protected work made by the author or with his/her authorization. The expression author's rights emphasizes the central position of the creator and his or her rights with respect to the created work.

Originality. It is not necessary that the ideas expressed in the work are new or original. What is crucial is whether the 'form' in which the idea is expressed (written or otherwise) is an original creation of the author. To be copyright protected, a work must be distinctly original and reflect the personal contribution of the author. It is unnecessary that the work meets a certain level of imaginativeness, or inventiveness. Also, the copyright exists regardless of whether the creation is beautiful, useful or of certain quality.

Copyright and service agreements. Whilst most service providers will not consider that their work for a particular customer justifies extra licence fees for using the work (in addition to the service fees for creating it), nevertheless if the services resulted in a work of authorship and is original, a claim for licence fees would be justified.

Two types of protection. Copyright law distinguishes two types of protection. Moral rights allow the author to preserve the personal reference to the work. Economic rights allow the copyright owner to demand financial benefits (e.g. royalties) from others who use the work. The copyright owner can prohibit or authorize:

- use;
- reproduction;
- import, export or distribution (resale) of copies;
- in an increasing number of jurisdictions, rental (lease);
- public performance;
- broadcasting or other communication to the public;
- translation or adaptation.

Translations and adaptations. A copyright includes the right to translate a work into another language or to adapt it. Adaptation or modification of a work is generally understood as creating another work. An adaptation includes extending a work or combining it with other products. Furthermore, extending or combining two non-original works may result in an original (copyright protected) work. Using or copying a translation or adaptation requires the approval from the copyright owners of the original work and of the translation or adaptation.

Fair use (limitation of rights). There are limits to the restrictions a copyright owner may impose on others who use a work. Whilst copyright encourages creativity and economic development, a limited use of (parts of) copyrighted works facilitates honourable purposes such as criticism (especially parodies), comment, news reporting, education and research. Such use is not an infringement of the copyright. Similarly, most copyright laws permit individuals to make a single copy of the original work for private, personal and non-commercial purposes.

Duration of copyright. Copyright does not continue indefinitely. The term of a copyright begins when the work is created (under some national laws, when it is expressed in a tangible form). The copyright usually continues for at least 50 years after the death of the author (EU, United States and several other countries adopted a 70-year period). Local regulations must be consulted because local and international legislation is continuously under modification or discussion.

(e) Know-how and trade secrets

In many countries, 'trade secrets' (e.g. know-how) have a special legal status.

'Trade secrets'. Trade secrets relate to *confidential information* that is not generally known or reasonably ascertainable, and by which a company can obtain an economic advantage over competitors or customers. This economic advantage must derive particularly from the fact that the trade secret is not publicly known, and not merely from the value of the information itself. Other than the term trade secret suggests, the legal concept is fairly broad. It includes formulas, practices, processes, designs, instruments, patterns, and compilations of information.

Protection: non-disclosure agreements. For a trade secret to enjoy legal protection, the owner must make reasonable efforts to maintain its secrecy. Such efforts include adoption of common technological security measures, non-compete arrangements in employment contracts, and non-disclosure agreements (NDAs) with (potential) business partners and suppliers.

Scope of non-disclosure agreements. Two key elements of a standard NDA are: (a) a prohibition to disclose any part of the received confidential information to third parties; and (b) restrictions on the scope of use of the confidential information (i.e. use only for the specified authorized 'Purpose' of the NDA and sharing only amongst employees and affiliated companies on a need-to-know basis). Usually a penalty (liquidated damages) clause in case of a breach of confidentiality is not included. However, in some industries such clauses can be found. See also sections 1.4(a) and 4.7.

Trade secrets versus patents. To obtain patent protection, a significant amount of information about the process or product must be submitted with the patent application and this information will become publicly accessible. After expiration of the patent, anybody can use the method or product. The temporary monopoly on the underlying invention is considered to be a trade-off for disclosing the information to the public. Obviously, this is not the case with trade secrets.

Licensing trade secrets. In the context of a know-how licence (also called 'technology licence') the licensor can impose or agree on obligations other than those strictly necessary to protect the secrecy, such as the following:

- the licensee can be prohibited to re-engineer or decompile the trade secrets (e.g. if the trade secrets involve software);
- the licensee can be prohibited to analyse its composition (e.g. if the trade secret is a chemical substance, the disclosing party may seek tests of the substance's properties but wishes to prevent that the precise composition is discovered through analysis);
- the payment of a royalty for using the technology, even after the underlying patent has expired;
- sharing of know-how and experience in using or applying the know-how, or access to the licensee's network or customer base;
- exclusive ownership by the licensor of derivative works (and modifications or improvements to the initial technology) that result from communications between the licensor and licensee;

- a right to audit (verification) to ascertain compliance with the licence terms;
- an obligation to notify the licensor in case of any identified infringements by others;
- an agreement that disclosure by the licensor blocks the licensee from using the disclosed confidential information for other purposes than those explicitly agreed.

Trade secrets and technology licences. In the framework of *patent and know-how licence agreements*, the licensed patent expires after 20 years and the licensed know-how continues. Note that any royalties payable after the licensed patent expires should probably be adjusted to only cover compensation for the know-how provided by the licensor. Nevertheless, one may wonder whether continuation of the licence agreement for the sole purpose of using the know-how related to the (expired) patented invention is even desirable at all after the patent expired (when probably all competitors developed the know-how).

(f) Patents⁷⁷

(i) *Inventions and patent criteria*

Patentability. A patent can be granted for:

- any invention;
- which is susceptible to industrial application (it must be of practical use);
- which is new; and
- which involves an inventive step.

An invention is new (i.e. meets novelty criterion) if it does *not* form part of the ‘state of the art’. The state of the art (or state of technology) comprises everything in the public domain, whether made available by publication, oral description, use or in any other way before the date of filing of the patent application. An invention involves an ‘inventive step’ if, in view of the state of the art, the invention is *not obvious* to a person skilled in the art.

Patented inventions versus copyrighted works. Inventions are considered new ideas or solutions to technical problems. Unlike protection of inventions, copyright law protects only the form of expression of ideas, not the ideas themselves. The creativity protected by copyright law is in the choice and arrangement of words, musical notes, colours and shapes.

Given this basic difference between inventions and works of authorship, it follows that also the legal protection differs. Because a patent gives a monopoly right to exploit the invention, such protection is shorter in duration (usually 20 years). The essentials of the invention must be disclosed publicly in an official register. Because the protection of a work of authorship only

⁷⁷ Note that the particularities of concepts discussed in this section, such as patentability, the scope of patent protection, prior art, prior use, co-inventorship and utility patents may vary per country. For example, whether an invention is patentable is described here by reference to the criteria of the European Patent Convention (EPC); in other conventions (substantially) the same criteria apply.

prevents unauthorized use of the 'expressions' of an idea, the term of protection is much longer, without any risk of damage to the public interest. Also, because copyright law entitles the author of a work to prohibit other persons from copying or otherwise using the work: (a) the work is protected as soon as it is created, and (b) a public register of copyright protected works is unnecessary.

Scope of the patent. The scope of the patent is determined based on the 'claims' in the patent registration. The patent claims are accompanied by descriptions (e.g. specifications, explanations, illustrations, calculations, examples, drawings) supporting the interpretation of the patent claims. The scope of patent protection is usually a strict, literal interpretation of the wording of the claims. The purpose of the descriptions is to resolve any ambiguity in the claims. The claim does not serve as a guideline for the descriptions.

Scope of patent protection. The scope of patent law protection is a matter of the national patent law of a state in which the patent is granted. Generally, the patent owner's exclusive rights consist of the following:

- in case of a patent for a product, the right to prevent third parties (non-licensees) from making, using, offering for sale, selling, distributing or importing the product;
- in case of a patent for a process, the right to prevent third parties (non-licensees) from:
 - applying or using the process; and
 - making, using, offering for sale, selling, distributing or importing products which are created directly by that process.

If a patent has been granted in a particular jurisdiction, others who wish to exploit the invention in that jurisdiction must obtain the authorization (e.g. a licence) from the patent owner (or from a licensee of the patent owner who has the right to grant sub-licences). Unauthorized and non-licensed use or application constitutes a crime.

Encouraging inventions. Many large technological companies have an internal association of inventors. Many companies have adopted a policy to reward employees who make an invention. Such a policy facilitates the revelation of inventive ideas within the company and prevents that inventive ideas remain unprotected. In large organizations, this is often the result of a lack of awareness about the existence of inventions or the inventors' failing to acknowledge the importance of their creations. Also, it incentivizes an employee to report a potentially patentable invention and thereby earn a bonus. Such policy could also be extended to external suppliers (whose inventions are even less visible).

Identifying a patent. Every patent is registered with a unique number (European patents are preceded by the letters EP). In a patent licence or deed of patent transfer, it is common to include the title which the patent has been given, as well as the date as of which the patent was requested or granted. There are numerous websites with search engines including national patent registers worldwide. Although not strictly necessary, a (licensed or transferred) patent is usually identified by the following catch-all phrase:

“**Patent**” means the patent [*application*] registered under no. [_____] (and entitled [_____] with priority date [_____] including [*national patents issued on such application and*] any continuations, continuations-in-part, divisions or additions thereof, reissues, renewals, revalidations, re-examinations, substitutions, extensions and any immediate foreign equivalents of them.

Infringement. Contrary to trademark infringements, any action is typically taken after an infringing party has used the patented invention for some time. In a high-tech market where companies file hundreds or thousands of patent applications per year, patent infringements are numerous, often not easy to prove and relatively costly to identify and challenge.

(ii) **Temporal aspects (prior art, grace period, prior use and patent duration)**

Novelty and prior art. Sometimes, two companies make the same invention around the same time. The inventor who files the patent application first will be granted the patent.⁷⁸ Accordingly, in the investigation of the novelty of the invention, the date of filing is determinative. To be considered new, nobody may have published about the invention (taken in its entirety, with all elements of the invention together in the publication) or otherwise made it available to the public. When assessing ‘prior art’, a global approach is taken – if an inventor elsewhere in the world was first, that preceding invention determines state of the art.

A common (but expensive) mistake is if the inventor proclaims the invention in newspapers or on internet before filing for patent protection. Disclosures made to third persons or external organizations only safeguard patent protection if each person or organization signs a non-disclosure agreement (if only retroactively effective).

Priority year (grace period). In view of the prior art criterion, if someone files an application in a country which is party to the Paris Convention for the protection of industrial property, the applicant has six or twelve months after the first application to file for a patent in another state party as well. Publications about the invention or a sale or transfer of the patentable invention during those six or twelve months will be disregarded when determining whether an invention is new and involves an inventive step. This ‘*grace period*’ (or priority year) implies a right of priority over technological developments that take place in that period. Many patent offices publish the application 18 months after the priority date or filing date (the actual patent grant may take much more time).

Duration of patent examination. An inventor normally selects a few jurisdictions to file a patent application. Usually, these are large jurisdictions in which the impact of the patent will be considerable (e.g. United States, United Kingdom, Germany, France, China, Japan) or jurisdictions in which the judicial patent system operates efficiently and professionally (e.g. the

⁷⁸ Including the United States since the Leahy-Smith America Invents Act 2011 (AIA) of 16 March 2013. As of that date, the first-to-invent system was replaced by the first-to-file system, which has been adopted everywhere in the world.

Netherlands, Taiwan Province of China). After filing a patent, a national or supranational agency⁷⁹ examines whether the invention is new, involves an inventive step and is of industrial utility. If the examiner has any doubts, the institute will issue an 'office action' after which the applicant may further substantiate, withdraw, abandon, modify or pursue the patent claims. In many cases, the office action leads to narrowing down the scope of the claimed invention. Also, third persons (such as competitors) may oppose the patentability. Usually such doubts are decided in the applicant's favour because a final and less-abstract judgment on the validity or scope of a patent is possible in court (whilst the alternative, rejection of the patent, precludes all protection).

The application and examination procedure takes several years. Depending on the jurisdiction and the technical discipline involved (e.g. chemistry, biotechnology, pharmaceuticals, electronics), a final decision may take three to five years, or much longer. Once the registration is complete, the patent protection has retroactive effect from the date of filing.

Duration. A registered patent typically lasts 20 years after the date of filing the application. The owner of the patent may prohibit others to use the patented invention in any product or to use the patented process. Extension of the duration of the patent is not possible. However, in relation to pharmaceutical patents, where clinical trials impose a further limitation of the effective duration of a patent, some countries permit a limited extension or a certain period of exclusive commercialization of the patent.

Prior use defence. If an invention was patented by one company but already invented and used by another, most jurisdictions permit the defence of 'prior use' against a claim of infringement by the patent owner. Prior use is exempted from patent infringement claims if the alleged infringer can clearly and convincingly prove that it used the patented invention in a commercial setting. Obviously, the date of such prior use must precede both the patent filing and the publication.⁸⁰ Understandably, such a 'grandfather right' does not apply if the former invention had been derived from the subsequent inventor. To prevent circumvention (or parallel trade), a prior user's right is limited in scope and transferability.

Co-inventorship. A risk associated with patents is that a third party involved in the research or development work leading to the patent may claim co-inventorship. For example, a customer or manufacturer of a research-focused supplier-inventor who was invited (a) to test the invention, and (b) to assist in improving certain practical aspects of the invention. The customer or manufacturer might claim that it made a substantial contribution to the invention, which could result in co-ownership. Often, the customer or manufacturer is granted another benefit for its assistance, such as exclusive distribution or manufacturing rights during a certain period of time.

⁷⁹ In the EU, whilst the technical examination (of novelty and inventiveness) is conducted by a pan-European institute, a 'European patent' does not exist yet. After determination as to whether an invention is patentable, the applicant must choose in which EU member states it wishes to obtain patent registration (and in order to achieve this, certified translations of the selected member states must be prepared). European patents are therefore national patents.

⁸⁰ In the US America Invents Act (2013), the scope of excusable prior use defence is more extensive. The patented invention has to have been used at least within one year prior to the earliest effective date.

(iii) Utility patents

Some countries, such as Germany, France, Spain, Italy, Japan, China and Australia,⁸¹ have introduced a system with a lighter degree of protection for ‘inventions’, known as the utility model.⁸²

Utility model versus patents. A utility model also provides a monopoly right for an invention. The owner of a utility model can prevent an infringer from exploiting the invention in the territory for which the utility model was granted. Normally, the same remedies for infringement available under a patent are available for infringement of a utility model.

Differences between utility models and patents. A utility model is different in that the requirements are typically less burdensome. For a patent to be granted, the invention must be both novel and inventive. For a utility model, the ‘prior art’ in assessing novelty is often more limited (absolute novelty is not always required), and an ‘inventive step’ has a considerably lower threshold and is sometimes not even required. Most jurisdictions will only grant utility models for products, and not for methods or processes. The first utility model laws actually limited protection to mechanical innovations. Furthermore, the term of protection of utility models is shorter, and a utility model is much cheaper to obtain.

Importance of utility models. In view of the shorter term of protection, utility models can be useful for products with a relatively short product lifecycle. Since the novelty and inventive step criteria are less stringent, utility models can be useful in connection with incremental research and development, where only small changes to existing inventions are made and therefore might not meet the requirement of an inventive step for a patent. Since utility models are granted much more expeditiously than a patent, they are effective in acting against an infringer in a timely manner. Furthermore, the lower costs for obtaining utility models make them particularly attractive for SME’s.

If an inventor has published about its invention, and thus a patent cannot be granted anymore, some jurisdictions such as Germany, allow a grace period. This grace period permits the inventor to obtain a utility model despite it being part of the state of the art.

Duration. Whereas a patent provides protection of up to 20 years, a utility model provides protection for a shorter term. The exact term depends on the jurisdiction but is usually between 7 and 10 years.

Application procedure. Utility model applications can be filed at the patent offices of countries that acknowledge or grant utility models. Similar to a patent application, an application for a utility

⁸¹ Utility models (or similar IP-rights with a different name) are available in Albania, Angola, Argentina, African Regional Intellectual Property Organization, Armenia, Aruba, Australia, Austria, Azerbaijan, Belarus, Belize, Brazil, Bolivia, Bulgaria, Chile, China (including Hong Kong and Macau), Colombia, Costa Rica, Czech Republic, Denmark, Ecuador, Estonia, Ethiopia, Finland, France, Georgia, Germany, Greece, Guatemala, Honduras, Hungary, Indonesia, Ireland, Italy, Japan, Kazakhstan, Kuwait, Kyrgyzstan, Laos, Malaysia, Mexico, African Intellectual Property Organisation, Peru, Philippines, Poland, Portugal, Republic of Korea, Republic of Moldova, Russian Federation, Slovakia, Spain, Taiwan, Tajikistan, Trinidad & Tobago, Turkey, Ukraine, Uruguay and Uzbekistan.

⁸² Utility models are also referred to as an innovation patent, utility innovation or petty patent.

model should include a description, explanations, drawings and claims. Utility model applications are usually not examined before being granted and are therefore granted much sooner (the average time approximating six months).

Conversion into a utility model. Many countries allow the conversion of a patent application into a utility model application. Some countries provide a time limit for such conversion. If a patent application is refused, some countries allow the patent application to be converted into a utility model within a certain period after the refusal.

In some countries, such as Germany, it is possible to obtain both a patent and a utility model for the same invention.

(g) Software

Software: copyright or patentable invention? Software is considered a ‘work of authorship’ and is therefore protected under copyright. This means that it is prohibited to copy, publish or otherwise reproduce software unless there is permission of the owner. The same applies to creating derivative works.

Occasionally, the creation of a software module could be considered an invention. If the invention meets all the requirements for patent protection, the owner is entitled to apply for patent registration. This principle applies to all inventions, and thus also software.

(i) What is software?

Source code versus object code. Software is a somewhat imprecise word for source code or object code. Typically, software is distributed in the form of object code, also called binary code: machine-readable algorithmic instructions in the form of bits and bytes. For example, object code could look like this:

```
PrintDocument (file name, number of copies, which pages, colour, page resizing)
if X=50, then do Y, else go to Zx and do Zy
```

Source code is a set of computer instructions written by software programmers in a particular programming language, with statements such as:

```
PrintDocument (file name, number of copies, which pages, colour, page resizing)
if X=50, then do Y, else go to Zx and do Zy
```

For the computer to understand these algorithmic instructions, the source code must first be compiled (i.e. converted) into object code. Whilst a computer cannot execute mere statements such as ‘if..., then..., else...’, human beings cannot understand object code.

Open source. Whilst software is subject to copyright and the source code is a trade secret, the software programmer could make it available to others under a so-called ‘open source licence’. This means that everyone would have access to and be entitled to use, change and redistribute the software. The rationale is that other developers are more willing to improve the open source software and that improvements are realized much quicker than the owner of proprietary software would be able to achieve. The initial software developer will benefit from being the most informed and best-suited party to realize the wishes from the software users (and such development work is often paid).

Open source software is typically distributed under the terms and conditions of a defined standard. Some widely used standards include the GNU General Public License (GPL) or Lesser GPL (LGPL), Artistic License (e.g. Perl), Mozilla Public License, Common Public License, Sun Community Source License (SCSL), Sun Industry Standards Source License (SISSL), Sun Industry Standards License (SISL) and the Open Software License.

These open source licence terms require for the user or developer, as a condition for use, modification or distribution of the software (or other software incorporated into, derived from or distributed with such software):

- the making available of source code or design information regarding the software (or such other software);
- the grant of permission for creating derivative works of the software (or such other software); or
- the grant of a royalty-free licence to any party under intellectual property rights regarding the software (or such other software).

(ii) Software licence models, SaaS

There are two common licence models: a perpetual licence and ‘software as a service’ (SaaS), with the related question where the application (and inserted data) are hosted.

Perpetual licences. A perpetual licence grants the user, subject to the licence restrictions, a right to use the software permanently without paying additional fees (except for software upgrades). In addition to the perpetual licence, the licensee might optionally enter into a maintenance and support agreement for receiving bug fixes, incremental software improvements and minor new functionalities.

When software is purchased in a box or as a package to be installed on a computer, this is typically a perpetual licence: after payment of the licence fee, the user may use it without restrictions in time. Any ‘updates’ or ‘patches’ are delivered under a maintenance and support agreement, which may be fully paid in advance in order to prevent the high costs associated with the maintenance of countless versions being developed (see section (iv) below).

Software as a service (SaaS). The second and increasingly popular model is SaaS ('software as a service'): the licensee pays a subscription fee and hosting of the software is provided by the licensor. The software functionalities are provided by way of 'service' through the internet rather than by way of a user licence. Likewise, the SaaS agreement takes the form of a service agreement instead of a licence (granting a right), and the terminology changes from licensor and licensee into service provider and customer.

Hosting. Increasingly, software applications become web-based. This means that the software operates somewhere on a server or website and the functionalities are used through an internet browser. A major advantage of web-based accessibility is that it considerably reduces error-sensitivity and installation issues. This means that web-based software is installed on the servers of the licensee's organization or on the servers of the licensor, and accessed through the intranet of the licensee or through the internet via a secure connection.

Hosting by the licensor (or service provider) triggers questions related to data security (possibility to access and protection of the software against third parties seeking access to the data managed through the software) and personal data protection (access and use of personal data, including the names of companies and individuals). The right to store and access depends from country to country, and the law governing such data is determined by the physical location where such data are collected and stored in a data centre. Therefore, it is crucial for many organizations to control where their data are stored (or where the data centre is located).

Subscription licences. If the licensee cannot finance a perpetual licence or wishes to remain free to step over to alternative solutions, a subscription licence could be attractive: the licensee pays a periodical fee and receives all bug fixes and support in exchange for the service fee. In many cases, the breakeven costs compared to a perpetual licence is at five years, the term for amortisation of software (and after which the perpetual licence would have been more beneficial). In a pure subscription scenario, the software would be 'hosted' on the servers of the licensee itself.

(iii) Software licences

To be authorized to use software (in object code form), a user must obtain a licence. In software licences, there are several points of attention:

- The scope of the licence must permit the licensee to use the software in accordance with its requirements (and match its needs and expected use);
- The licence can be limited to named users, a number of concurrently active users, an enterprise, a type or method of use (e.g. light users or for a specific subtask within a greater package of functionalities), the frequency of use, an installation on one device, or to any other licence criteria;
- If parts of the software depend on third-party software, such third-party software must be licensed as well (or at least, an adequate licence can be obtained on reasonable conditions). For example, certain business applications may not only require the installation

of a certain server operating system but also the (licensed) availability of applications for data processing or spreadsheets;

- The software is likely to be accompanied by manuals, documentation and other materials explaining the functionalities. At least formally, a copyright licence to use the manuals, documentation and materials should be granted as well.

Common software licence restrictions. To modify the software, software programmers must have access to the source code. To obtain source code, the object code could be 'decompiled' or 'reverse-engineered'. If the software has a complex structure, reverse engineering is often impossible or at least rather burdensome and does not result in the original source code. Despite its complications or impossibilities, software licence agreements typically prohibit copying and reverse engineering. An example of a 'licence restriction' is:

Except as expressly permitted in Article [2], Licensee shall not, and shall not permit any third party to:

- (a) copy, publish or disseminate the Licensed Software;
- (b) modify, translate or otherwise create Derivative Works of any part of the Licensed Software;
- (c) create its own version of the Licensed Software;
- (d) assign, sub-licence, lease, rent, loan, transfer, disclose or otherwise make available the Licensed Software; or
- (e) reverse assemble, decompile, disassemble or otherwise attempt to circumvent any protection of the Licensed Software.

Implementation and consultation. Often, software requires more than just a licence for use. It is important to identify the additional services necessary to launch the software or to make the software effectively operational. If the software is not very user-friendly, making it work might require impactful change management projects (changing an organization's traditional way of working and adopting the software). The services accompanying software are often called 'consultancy' and these may include software programming work. Embedding the software in the existing software environment of the licensee is commonly referred to as 'integration' or 'implementation'. Finally, a software application might require monitoring by a system administrator, who will most likely need specific training.

The impact of consultation, implementation and training services is often underestimated. At the same time, whilst the software industry matures, the impact of introducing new software solutions should not be overestimated either. These services are often a hidden cost element, the effect of which can remain unidentified in a licence agreement.

(iv) Maintenance and support (M&S)

Typically, software requires continuous development and:

- contains a fault or flaw, or causes a failure (or 'bug') or otherwise ill-functioning components;
- may be susceptible to security issues;
- can be improved, if only to a limited extent;
- probably needs to be tailored to the particular technical and use requirements of the licensee's organisation;
- is dependent on compatibility with hardware;
- is dependent on the performance of other software (e.g. supported office applications are often upgraded every three or four years and internet browser versions may be incompatible with previous versions); and
- is typically provided with a warranty period of no more than 90 days.

After the initial warranty period, there is almost invariably a need to continue receiving bug-fixes, software improvements, improved compatibility with internet browsers and solutions for changes in the environment in which the software operates. For such purpose, the licensee should enter into a maintenance and support (M&S) agreement with the software provider. The M&S agreement defines which software updates a licensee will receive, which service level a licensee can expect and specify the period of time in which bugs must be fixed.

'Updates' and 'upgrades'. Bug-fixes, security solutions, minor software improvements and other changes delivered during the warranty period or in the framework of a maintenance and support agreement are provided in the form of a software 'update'. Usually, they are numbered (e.g. versions 3.2.1, 3.2.2 and 3.2.3; or versions 2.0, 2.1 and 2.2).

Many software licences distinguish updates from 'upgrades': an upgrade would contain significant additional functionalities or features compared to the previous version (and are often numbered by whole number increments: 1.0, 2.0 etc.). These upgrades of software normally justify a renewed licence (and licence fee). An update, on the other hand, would be covered by the maintenance and support.

Error and support levels. Depending on the seriousness or 'severity' of any failure of the software, the parties would agree on an error-support level: the licensor's or service provider's obligation to fix errors that occur during the licensee's or customer's use of the software. Common severity error classifications are:

1. **Critical errors** cause the software or even the computer to stop working. These errors require both immediate action and an immediate solution or implementation of a fall-back scenario;
2. **Major errors** have a significant impact on the software functionalities but do not block its key functions. These require immediate action and a solution must be available as soon as reasonably possible;
3. **Normal errors** do not disturb the normal operation of the software but require appropriate action;
4. **Minor errors** do not disturb the normal operation of the software and a solution should become available when the software provider's course of updating allows.

The severity of a software error determines the priority a licensor or service provider must give to reproduce, describe and confirm such error (response time), as well as the time it is permitted to fix it. Depending on the importance of the software for the licensee or customer, these severity levels, priorities and required efforts are agreed in a service level agreement (SLA).

(h) Licensing intellectual property

The previous sections dealt with the scope of the most common types of intellectual property rights. The owner of an IP right may grant licences to third parties to use those IP rights in one way or another. In such licences, a licensee sometimes has the right to grant sub-licences. In this section, licensing of IP rights will be discussed.

(i) Core licence clause

The essence of a licence is usually reflected in one key licence provision and, if necessary, elaborated in subsequent clauses. In the licence clause, probably more than in any other type of agreement, the key elements of the agreement are identified.

Subject to the terms of this Agreement, Licensor hereby grants Licensee, and Licensee hereby accepts a perpetual, non-exclusive, royalty-bearing licence, without the right to grant sub-licences, to use the Licensed Trademark in the Territory in connection with Licensed Products only.

The licence provision contains the following elements:

- **Licence grant.** The wording reflects the grant of licensed rights (“hereby grants”, “hereby accepts”). The word hereby is essential since it prevents that an additional written licence grant must be signed (as is typically required in connection with intangible rights);
- **The licensed object.** For example, a trademark, patent, copyrighted work, know-how, software;
- **The scope could include:**
 - type of *use* (e.g. manufacture, import, export, market, sell, distribute, use);
 - territory restrictions (this could be a specified region, country, or worldwide);
 - exclusivity (sole or non-exclusive);
 - market segment restrictions (e.g. fitness-shops, shopping malls, supermarkets, web shop);
 - the right to grant sub-licences; and
 - duration (perpetual or irrevocable, or a specified time limit).
- **Licence fees** (i.e. royalty bearing, royalty-free or fully paid-up).

Differentiation in licensed uses. If the licence differentiates for the various uses, the above core licence clause becomes a matrix of several licences, each of which apply to a different scope and each subject to varying conditions. For instance, the above example could differentiate between the types of permitted uses as to degree of exclusivity, geographical reach, right to sub-license and royalty:

Licence. Subject to the terms of this Agreement, Licensor hereby grants to Licensee and Licensee hereby accepts:

- (a) a non-exclusive, royalty-free licence, without the right to grant sub-licences, to demonstrate the Licensed Trademark in connection with Licensed Products only; and
- (b) an exclusive, royalty-bearing licence, with the right to grant sub-licences, to make and have made the Licensed Trademark in connection with Licensed Products only.
- (c) a non-exclusive, royalty-bearing licence, without the right to grant sub-licences, to market, have marketed, offer for sale, have offered for sale, sell, have sold, or otherwise distribute or have distributed, the Licensed Trademark in the Territory in connection with Licensed Products only.

Note that the verb ‘to use’ is omitted in all subparagraphs. Instead, each subparagraph includes a specific type of use. Item (c) demonstrates that the possible differentiation in licensed uses might be very specific.

(ii) Licence elements

Geographical and market-related scope. A licence involving the sale of a patented product or a product or service under a trademark is often limited to a certain geographical area (i.e. a region, a country or part of a country), and sometimes also to a specific market segment (e.g. supermarkets, petrol stations, bars or restaurants), or a type of promotion or customer channel (e.g. general consumers, TV broadcasting, printed magazines, or luxury brand shops). See also sections 2.4, lead-in, (a) and (b).

Regarding patents, the licence should not cover geographical areas in which no patent was granted. Furthermore, a licence must be considered to be a technology licence. However, the licensee may argue that the licensor failed to deliver what was agreed: a patented invention.

Exclusivity. A licence is either exclusive or non-exclusive. “Exclusive” means that nobody is entitled to use the licensed IP in the agreed territory, market segment and customer channel, not even the licensor. If the licence is a sole licence, the licensor may not grant a licence to another in the same territory, market segment or customer channel. Nevertheless, the licensor itself remains entitled to distribute in that area. In other words, the licensee will be the only (sole) licensee for that area, operating alongside the licensor. See also sections 2.4, lead-in, (a) and (b).

Important incompatibilities. Both an exclusive and a non-exclusive arrangement may severely restrict the licensor in its freedom to undertake sales activities or to appoint other potential licensees who may be more successful:

- The appointment of an *exclusive* licence for a certain market segment in a certain territory prohibits the subsequent appointment of a (even non-exclusive) licence in the same territory for a broader market;
- The appointment of a *non-exclusive* licence for a certain territory prohibits the subsequent appointment of an *exclusive* licence in that same territory (even though the former is not de facto active in the market segment or customer channel covered by the latter). In such case, the second licence must contain a carve-out permitting the first licensee to continue its activities;
- If a licensee is appointed with an *exclusivity* arrangement for a term of five years and the licensee does not generate any sales, the territory and market segment for which the licensee is appointed will effectively be blocked for alternative sales efforts during those five years.

Temporal scope. Most licences are either perpetual or have a specific term. If the licence clause includes the word perpetual, there is no further need to provide for a termination mechanism. A term licence would be limited by the time period of the agreement. It is uncommon to address this in the licence clause and is usually stipulated in an article on 'term and termination'. The agreed term should enable the licensee to recover its investments made in relation to the licensed IP (and make profit).

Occasionally, a licence is granted for the duration of a project. For example, if a party agrees to provide certain services with which it makes use of proprietary technology of the customer or a supplier of the customer, the service provider would need a licence to carry out the agreed services. Similarly, if parties enter into a joint development agreement, one or both parties might need a licence to complete their part of the agreed development work. Such licence might be implied by the scope of the agreement, but an express project-licence emphasizes the proprietary nature of the IP involved and might bring to light which limitations ought to apply to such project-licence.

Right to sub-licence. In some cases, a right to grant sub-licences is desirable. For example, if the licensee is granted a licence in respect of a territory whilst it cannot (or will not) exploit the full capabilities of the licensed IP alone. In such case, whilst the licensee might be in a better position to obtain the maximum potential of the market, it would be appropriate to grant sub-licensing rights. In sub-licensing, the licensor usually requires the licensee to assume a larger responsibility in case of IP infringements by third parties in that territory.

More common situations in which sub-licences are necessary relate to the use of the IP by (a) companies affiliated to the licensee, and (b) subcontractors of the licensee. An example of a clause permitting such sub-licences:

Permitted sub-licences. Subject to the limitations applicable to Licensee, Licensee is entitled to grant sub-licences to:

- (a) its Affiliates, which are not also an Affiliate of a third party, with the limited right to [use] the Trademark, provided that such sub-licence terminates (i) upon termination of this Agreement, or (ii) upon such sub-licensed Affiliate ceasing to be an 'Affiliate' of Licensee;
- (b) its suppliers and subcontractors, with the limited right to use the Trademark for Licensee's exclusive benefit, provided that the sub-licence shall be no more extensive than is strictly required for providing such subcontractor's services to Licensee, and provided furthermore that such sub-licence terminates (i) upon termination of this Agreement, or (ii) upon such subcontractor ceasing to be a subcontractor of Licensee for the sub-licensed type of services. Each sub-licence as referred to in this paragraph (b) shall be subject to the prior written approval of Licensor, which approval shall not unreasonably be withheld or delayed.

Competition law restrictions. In patent and know-how licence agreements, the parties should be free to compete with their own developed products, improvements or new applications of the technology to the extent that these are independent from the licensee's initial know-how. It is permitted to oblige the licensee to grant a non-exclusive licence to the licensor for improvements and new applications of the licensed technology. Important prohibitions, see section 5.6(b).

Irrelevant licence elements. In the core licence clause, it is generally not necessary to stipulate matters which are otherwise implied by (contract or IP) law. Such words, as they are occasionally used, include:

- **Non-transferability** or **non-assignability** of the licence. The general contract law principles for transferability of the licence agreement apply. This means that, to be legally effective, such a transfer requires the consent of all the parties to the licence agreement, which means that the licensor has the right to refuse and thereby prevent any transfer.
- **Irrevocability** of the licence. General contract law provides that contracting parties are bound by the terms of their agreement. Revocation of the licence is only possible on grounds provided by the applicable law which justify a term licensor for improvements inaction of the licence (e.g. rescission in case of material breach or termination by a receiver in bankruptcy) or grounds expressly stipulated in the licence agreement (e.g. in cases of material breach, bankruptcy or change of ownership over the licensee).
- **Personal** nature. This is the same as the non-transferability of the licence and a statement that the licence is personal is therefore redundant. Every contract is personal to the parties involved.

(iii) Royalties

Licences are fully paid-up, royalty-free or royalty-bearing. A royalty-free licence is common in joint development projects and for service providers in the context of their provided services. Also, the right to give demonstrations or to hand out free (complimentary or testing) samples of a product is often free of charge.

Fully paid-up. If the licence is fully paid-up, it means that the licensee acquires the rights to use, as stipulated in the licence agreement, after a one-off (lump sum) payment. This licence fee structure is usually applied if the parties want to materialize the licence in one settlement, or more commonly, if the payment in periodical instalments is impracticable (e.g. in case of a broadly defined patent, if the licensee is active in a different industry and not amongst the usual customers of the licensor) or if the collection of licence fees is undesirably burdensome (e.g. in case of consumers or large numbers of users).

Royalty-bearing. Royalty-bearing licences take countless forms. A royalty implies the payment of a (recurring) licence fee, the amount of which is often dependent on the volume of 'net sales' (turnover) of the product in which the IP is used or applied. It is important to define what the royalty amount covers. A common reference figure is a percentage of the net sales of the products on which the trademark is used or for which the manufacture of the licenced patent or know-how is used:

Net Sales definition. In patent or technology licences:

Net Sales means the aggregate amount of sales prices of the Products received by the Licensee and its affiliated companies, excluding:

- (a) taxes and duties paid by the Licensee for the sale of any Products;
- (b) insurance, packaging and transportation expenses of Products;
- (c) deliveries of Products to Licensee's affiliated companies to the extent that such deliveries are also included in such affiliated companies' aggregated sales prices; and
- (d) normal discounts, returns and rebates to Licensee's customers.

In trademark licences, the above item (c) should be replaced by:

- (c) deliveries of Products to Licensee's affiliated companies for internal use by such affiliated companies only;

In both definitions, certain product-unrelated pricing elements, relating to delivery, logistics and insurance, are taken out of the net sales definition. The two definitions are different:

- In patent and technology licences it is important to capture (in case of a process-related patent) all processes where the licensee applies the patented invention or (in case of a product-resulting patent) all products sold by the licensee and its affiliates (even if there is no sub-licensing right). Any captive product sales (i.e. internally to affiliated companies) should be included at the Net Sales amounts received by that affiliated company from its customers (deducting the captive transfer price) but should be calculated at an arm's length price.
- In trademark licences, internal sales are irrelevant and only the sales realized by the licensee and its affiliated companies regarding their customers is relevant. The brand does not operate as a unique selling point.

A percentage of net sales results in zero (nil) royalties if the licensee makes no sales efforts at all. Therefore, in many turnover-related licences, the licensor requires a minimum sales effort from the licensee by agreeing on a minimum royalty commitment: regardless of whether the licensee achieves the agreed minimum level of net sales, it must still pay for it ('take or pay').

NRE. In some industries, it is common to pay a part of the licence fees in an upfront lump sum amount. Such non-recoverable or non-recurring engineering fee is also known as NRE. This is useful if the licensor must undertake development work to fit its product with the licensed IP into a given environment. The results of the development can be licensed to other parties as well. The possibility to relicense the IP justifies that the licensor assumes the costs of the investment, whilst the upfront payment is a way of financing the development work.

Royalty reporting. If any part of the licence fees is directly linked to (sales) amounts realised by the licensee, it is inevitable that the licensee reports on its sales. Accordingly, the licensor will require that the licensee maintains accurate bookkeeping and its records must enable the calculation of royalties by reference to the sales. In other words, the licensee must be able to account for the precise number of products in which the licensed IP was used (and the sales prices received for each product).

It is common to require quarterly reporting, although monthly reporting (in case of questionable debtors or high volumes of sales) and annual reporting (in case of low sales volumes or long lead times) also are agreed on. Royalty reports should be submitted within a few days after the end of the reporting period. Payment of the royalty should be made shortly thereafter (sometimes after the issuance of an invoice).

Royalty audits. If royalties are dependent on a variable, such as fluctuating sales amounts, it is appropriate to provide for an audit right – a right of the licensor (or its independent auditing firm) to verify the accuracy of the licensee's royalty reports. In many industries, a royalty audit is considered to be a step-up to terminating the licence. Nonetheless, an audit clause usually addresses the maximum frequency of permitted audits (if previous audits revealed no irregularities), that an audit must be announced in advance, that it must take place during working hours, as well as a penalty mechanism for settling misreported royalties. An example of a royalty audit clause is included in the model international trademark licence agreement⁸³.

5.6 Competition ('antitrust') law

The aim of this section is to introduce the scope and impact of competition law, in particular in the EU and the United States. Especially due to the fact that the regulatory legal framework is so extensive and somewhat technical, this section will mainly identify the prohibitions and permitted actions. A violation of competition (or antitrust) law may result in extremely high penalties.

⁸³ <http://www.intracen.org>

Application of competition law. It is widely believed that the best economic and social results are achieved in an environment where businesses can freely compete against each other. Accordingly, competition law prohibits unfair restraints on competition and acts of monopolization. Agreements that may (adversely) affect trade between EU member states, within the United States or other economic free trade areas and which prevent, restrict or distort competition are therefore prohibited. Agreements that create sufficient benefits that outweigh the anti-competitive effects are exempted from this prohibition.

Competition versus antitrust law. Whereas the European terminology refers to ‘competition law’, in the United States, the term ‘antitrust laws’ is more commonly used.

Violations in the EU. The European Commission may impose penalties up to 10 percent of the annual worldwide turnover of the company involved, periodic penalty payments as well as state aid recovery decisions or 30 percent of the company’s annual sales to which the infringement relates, multiplied by the number of years of participation in the infringement. Under EU law, anticompetitive agreements are automatically void, and competitors and consumers can take damage actions.

Violations in the United States. For a violation of United States antitrust law, a company may be subject to very substantial penalties, including criminal penalties, of up to hundreds of millions US dollars (and higher). Private parties may also sue for damages. In addition, a violation of competition law may also enable consumers or competitors to initiate court proceedings, resulting in substantial liability claims. In some states, successful plaintiffs may be awarded triple the amount of their damages plus court costs and attorney fees. A violation of competition law can result in an exclusion of the company from public procurement (tender) procedures.

Criminal offence. Next to penalty fines, a violation of national competition laws can also constitute a criminal offence by the corporate offender, such as a director or employee. These individuals can be fined or sentenced to imprisonment.

(a) Horizontal agreements (arrangements between competitors)

Collaboration in the form of arrangements or agreements between competitors which affect trade and aim to or result in preventing, restricting or distorting competition raise very serious competition law concerns.

Collusive behaviour. The form of the ‘anticompetitive arrangement’ is irrelevant. Not only written agreements but also oral commitments are prohibited. Such arrangements may even be presumed to exist in cases of suspicious behaviour of market parties. ‘Unexplainable’ anticompetitive behaviour or failure to act may even constitute evidence of concerted or coordinated practices (i.e. collaboration between companies with a view to eliminate or restrict competition in a certain geographical area or market segment). This includes behaviour that would

not be seen as rational under normal competitive market conditions. Whenever competitors communicate and interact with each other, special attention is required to ensure that their external behaviour cannot be understood as anticompetitive.

The activities and behaviour described in the following subsections might seem very attractive for a business, but should carefully be monitored, discouraged or – in most cases – actively suppressed.

(i) Price-fixing and imposing conditions on supply

A supplier or manufacturer is free to establish and change the prices of its products and services. In doing so, it usually observes and reacts to the decisions of its competitors. However, it is a gross violation of competition law to agree or coordinate in any way with competitors to fix or stabilize prices. The mere conduct that suggests that competitors have coordinated their pricing can constitute a violation of competition law.

Prohibitions amongst competitors include:

- Jointly establishing selling or purchase prices;
- Jointly establishing price increases;
- Jointly setting minimum or maximum prices (or price ranges);
- Jointly agreeing rebates, discounts and other conditions of supply;
- Exchanging cost or price-related information followed by fixing similar pricing;
- Jointly limiting or controlling production, markets, technical development, or investment.

It is strictly prohibited to fix any price-related terms with competitors. Companies may not discuss any aspects of cost price or pricing with their competitors unless the parameters of exchange are carefully constructed (and documented) and this exchange take place for pro-competitive reasons.

(ii) Market partitioning (market allocation)

Any form of agreement among competitors to share or allocate markets (whether geographical or sectoral) or customers is prohibited.

Prohibited actions:

- Sharing or allocating markets between competitors in respect of specific territories, products, customers or sources of supply;
- Fixing volumes of production and volumes of products bought and sold between competitors.

Companies should be careful not to make any market sharing arrangements or arrangements allocating markets (whether geographical or sectoral) between themselves and their competitors.

(iii) Joint ventures and alliances

Joint venture and alliance agreements between competitors may lead to useful efficiencies but may also (adversely) affect competition. Therefore, alliances and joint venture agreements amongst competitors should be scrutinized before they are entered into. Seeking legal advice is strongly recommended before entering into an (alliance or joint venture) agreement with a competitor on joint manufacturing, research and development, marketing or distribution.

(iv) Customer or supplier boycotts

It is prohibited for a group of competitors to agree to refuse to do business with one or more customers or suppliers to the extent that it would disrupt the latter from conducting business in a market.

For example, the following agreements between competitors are prohibited:

- **Not** to supply to certain customers;
- **Not** to purchase from certain suppliers;
- To make the supply or purchase of goods subject to certain mutually agreed conditions.

Instructions to a supplier or customer to behave in these ways is equally prohibited if such instructions are coordinated with competitors.

(v) Participation in trade associations

Participating in a trade association or association of companies (where competitors meet) is generally permissible. Nonetheless, meetings or other activities in which competitors share information poses significant risks of violating competition laws. For example, in the context of any such meeting or activity, it is prohibited to share information concerning prices, discounts, rebates, conditions of supply, profit margins, cost structures, calculation practice versus distribution practices, territories, customers, or new products. Despite these restrictions, companies are permitted to agree on industry standards, joint petitioning, representations to governments and similar topics.

Prohibition and care. Companies may not exchange competitively sensitive information with their competitors. If such information is exchanged at a trade association, a company should immediately leave the meeting and seek legal advice. A company's participation in these associations or meetings must be monitored carefully and it is therefore desirable to set a clear agenda for every meeting and to take detailed minutes.

(b) Vertical agreements

Agreements for the sale of goods or the provision of services between companies operating at different levels of the production or distribution chain are subject to a higher level of scrutiny regarding their anticompetitive effects. Typical examples of vertical agreements are distribution contracts, manufacturing contracts, long-term supply agreements and commercial agency contracts.

Vertical restraints. Normally, vertical agreements that simply determine the price and quantity for a specific sales transaction or for a specific period of time do not restrict competition. However, if a contract contains restraints on the supplier or the customer, it may be deemed to have anticompetitive effects. These '*vertical restraints*' may also have positive effects.

For example, in context affecting the EU market, vertical restraints may be justified for a limited period in the following cases:

- A manufacturer wants to enter a new geographic market and thereby requires certain upfront investments by the distributor to establish the brand in the market;
- Transfer of know-how because it cannot be taken back once it has been provided, and the provider of it may not want it to be used for, or by, its competitors;
- To achieve economies of scale and low retail prices, a manufacturer may need to concentrate the resale of its product on a limited number of distributors;
- Client-specific investments which must be made by either the supplier or buyer, such as investments in special equipment or training;
- A manufacturer increases sales by imposing a certain measure of uniformity and quality standardization on its distributors or franchisees. This enables it to create a brand image and attract consumers.

EU competition law aims to prevent the following negative effects on the market that may result from vertical restraints:

- Anticompetitive foreclosure of other suppliers or other buyers;
- Reduction of competition or facilitation of collusion between the supplier and its competitors;
- Reduction of competition or facilitation of collusion between the buyer and its competitors;
- Limitations on the freedom of consumers to buy goods or services in another EU member state.

Example 1: alternatives. Agreements of an exclusive nature are generally worse for competition than non-exclusive arrangements. For example, under a non-compete obligation the buyer would be permitted to purchase only one brand. Alternatively, a minimum purchase requirement may permit a buyer to purchase competing goods, which reduces the degree of foreclosure.

Example 2: brands versus white-label products. Vertical restraints agreed for white-label products are in general less harmful than restraints affecting the distribution of branded products. The distinction between non-branded and branded products will often coincide with the distinction between intermediate products and final products.

(i) Common vertical restraints

The most common vertical restraints in the EU according to the European Commission's Guidelines on Vertical Restraints are:

- **Single branding.** Single branding results from an obligation or incentive that makes the buyer place all its orders for particular products with only one supplier. It does not mean that the buyer can only buy directly from the supplier but rather that it will not buy and resell competing goods or services.

The anticompetitive risks resulting from single branding include:

- Foreclosure of the market to competing and potential suppliers;
 - Facilitation of collusion between suppliers;
 - If the buyer is a retailer (selling to consumers), a loss of in-store inter-brand competition.
- **Exclusive distribution or exclusive (long-term) supply.** In an exclusive distribution contract, the supplier agrees to sell its products only to one distributor for resale in a particular territory, a market segment or a particular category of customers. Often, the distributor is also itself limited in its active selling efforts on other territories or markets.⁸⁴ The anticompetitive risks include reduced intra-brand competition and market partitioning, which may, in particular, facilitate price discrimination.
- **Selective distribution.** Like exclusive distribution agreements, selective distribution agreements restrict both the number of authorized distributors and their possibilities of resale. Unlike with exclusive distribution agreements, selective distribution:
 - does not restrict the number of dealers based on the number of territories, but selects based on the nature of the product;
 - it is not a restriction on active selling into a territory but rather a restriction on any sales to non-authorized distributors;
 - selective distribution is almost always used to distribute branded products through appointed dealers and targeted customers; and

⁸⁴ Active sales mean actively approaching individual customers inside another distributor's exclusive territory or exclusive customer group for example by direct mail or visits, or actively approaching a specific customer group or customers in a specific territory allocated exclusively to another distributor through advertisement in media or other promotions specifically targeted at that customer group or targeted at customers in that territory; or establishing a warehouse or distribution outlet in another distributor's exclusive territory.

- the anticompetitive risks include reduced intra-brand competition and, especially in case of cumulative effect, foreclosure of a certain type or types of distributors and facilitation of collusion between suppliers or buyers.
- **Franchising.** Typically, franchise agreements entail a licence of IP Rights including trademarks, logos and know-how for the use and distribution of goods or services. In addition to the licence, the franchisor usually provides the franchisee with commercial and technical assistance. The licence and the assistance are integral components of the business concept being franchised. Franchising enables the franchisor to establish, with limited investments, a uniform distribution network.

The anticompetitive risks include the agreement on several vertical restraints concerning the products being distributed (e.g. selective distribution, non-compete clauses and exclusive distribution).

- **Exclusive supply.** Exclusive supply means that there is only one buyer in the territory to which the supplier may sell a particular final product. For intermediate goods or services, exclusive supply means that there is only one buyer in the agreed territory or that there is only one buyer in the territory for the purposes of a specific use. The anticompetitive risk of exclusive supply is the foreclosure of other buyers.
- **Tying.** See section 5.6(d).
- **Recommended and maximum resale prices:** When a supplier influences a buyer or distributor, possibly through an incentive, not to resell below a recommended price or below a maximum price, this is considered equivalent to fixed or minimum prices, and therefore prohibited. The anticompetitive risk is that such pricing policies operate as a focal point for resellers and might be followed by most or all of them. They may then facilitate collusion between suppliers.

Whether a vertical agreement indeed restricts competition and whether the benefits outweigh the anti-competitive effects requires an assessment of the facts and circumstances of the case at hand. The criteria and benchmarks to be applied in the EU are discussed in section 5.6(b)(iii).

(ii) Common violations in vertical agreements

A number of common violations in vertical agreements are identified below. Due to the fact that United States antitrust law does not clearly define various categories, the emphasis will be on EU competition law. Nevertheless, the result of an assessment under United States antitrust law will often be the same.

Non-compete clauses. Under certain circumstances it may be possible to prohibit a distributor or licensee to sell or manufacture competing products. Local regulations must be consulted. For

instance, in the EU, this is possible during the first five years of a distribution or licence agreement. Therefore, parties may not agree to prohibit the following:

- The manufacture and sale of competing products in a distribution agreement for the duration of more than five years from the effective date of the agreement;
- The manufacture and sale of competing products or services in a licence agreement including the distribution of the licensed products for the duration of more than five years from the effective date of the agreement;
- The manufacture and sale of competing products or services beyond the duration of the agreement.

In the United States, the authorities have also been acting against non-compete obligations in the acquisition and joint venture context between competitors. Non-compete clauses are always evaluated under the rule of reason, which involves an assessment and balancing of the pro- and anticompetitive effects in the case at hand.

(Long-term) supply agreements. Most provisions in a (long-term) supply or manufacturing agreement do not affect free competition. However, the following should be kept in mind. In the EU it is prohibited to:

- Conclude an exclusive supply agreement if the buyer is a dominant market party (as regards the supplied product);
- Agree on exclusive supply of products if the supplier is capable of producing the product without the support and know-how (including intellectual property rights) of the customer;
- Forbid the customer or supplier to compete with their own developed products, improvements or new applications of the relevant technology to the extent that these are severable from the know-how of the supplied product;
- Influence (contractually or de facto) the resale prices charged by the customer.

It is permitted to:

- Agree on exclusive supply if the buyer's market share is below 30 percent;
- Establish requirements relating to quality, quality control, specifications, raw materials, packing materials, quantities and terms of delivery;
- Forbid the supplier to use the know-how or technical means for other purposes than for supplying the customer, as long as the protection of the customer's know-how is the sole purpose of such prohibition.

Distributorships: resale pricing. In addition to the various prohibitions mentioned in section 5.6(a)(i), a supplier or manufacturer may not set the resale prices charged by the distributor. In the EU, it is prohibited to:

- Set the resale prices of any product for distributors or dealers;
- State resale prices in price lists, catalogues, order forms, displays, price labels, packings, brochures, etc;

- Require the distributor to adhere to a recommended resale price;
- Coordinate the price policy with the distributor according to the market situation;
- Prohibit the distributor from granting rebates or discounts;
- Provide the distributor with formulas to calculate prices;
- State the profit margin of the distributor;
- Prescribe minimum resale prices;
- Systematically monitor the resale prices of the distributor;
- Terminate the agreement with a distributor because of its refusal to adhere to recommended resale prices.

The following is permitted:

- Giving non-binding price recommendations for resale prices of branded products, if no direct or indirect pressure is exercised or any incentive is offered to enforce such recommendation, and provided that there is no market dominance;
- Impose maximum resale prices;
- Mark all statements of resale prices as 'recommended resale prices'.⁸⁵

Businesses should refrain from imposing resale prices and undertaking any resale price maintenance initiative.

Patent, trademark and copyright licenses. Patent, copyright, know-how or trademark licences in the EU are subject to various limitations. It is prohibited to:

- Contractually exclude the possibility of the licensee to challenge the secrecy of the licensed know-how, trademarks or patents;
- Contractually exclude the possibility of the licensee to challenge the validity of the licensed patent;
- Set the sales price for the licensee's product.

In patent and know-how licence agreements, parties should be free to compete with their own developed products, improvements or new applications of the technology to the extent that these are independent from the licensee's initial know-how. Nevertheless, it is prohibited to:

- Oblige the licensee to grant an exclusive licence to the licensor or a third party for any own severable improvement and new application of the licensed technology;
- Restrict either party from competing with the other party in research and development, manufacture, use or sale of any own developed product, improvement and new application of the technology in question.

It is permitted to oblige the *licensee* to grant a non-exclusive licence to the *licensor* for improvements and new applications of the licensed technology.

⁸⁵ Such non-binding price recommendations may, under certain circumstances, be prohibited under Swiss or other national competition law.

Refusal to sell. Exclusivity of the distributor, customer, franchisee or licensee might appear from facts unrelated to a non-exclusive supply agreement. A refusal to sell to another distributor or customer may raise anticompetitive concerns and might constitute an abuse of a dominant market position. A supplier or manufacturer should not apply (entirely) subjectively motivated criteria for excluding certain (groups of) distributors or customers. Similar customers should be treated equally. It is prohibited to:

- Refuse to sell to a customer that meets the same requirements as other customers;
- Reduce supplies to comparable customers in different ways without an objective justification.

It is, on the other hand, allowed to refuse to sell to:

- Existing or new customers provided that such refusal is reasonable and proportionate to protect commercial interests;
- A customer due to insufficient capacity or an event of force majeure in production.

Export bans and parallel trade. Parallel trade is a consequence of free trade within a given territory. In the EU, the following is prohibited:

- Imposing export bans, unless this is required by law;
- Prescribing the partner not to export the product upon an inquiry by a customer from outside the territory;
- Refusing orders from partners exporting the products due to territory restrictions.

It is permitted to:

- Prohibit an active marketing policy outside the agreed territory (internet advertising should not be prohibited) if the company's market share is below 30 percent;
- Inform the other party about country differences affecting the product's acceptance in another country or other legal requirements in another country;
- Unilaterally limit the number of products sold to a partner due to capacity reasons.

(iii) EU assessment criteria of possible violation (market dominancy)

Whether a vertical agreement in fact restricts competition or whether the benefits outweigh the anticompetitive effects requires an assessment of the case at hand.⁸⁶ The EU adopted the Block Exemption Regulation which determines that certain categories of vertical agreements as well as license agreements on technology transfer do not violate EU competition law if certain requirements are met.⁸⁷

⁸⁶ Treatment of certain vertical agreements in the United States differs from that of the EU.

⁸⁷ Regulation (EU) No 330/2010.

Dominant market party. The assessment whether a vertical agreement violates competition law requires a comparison of the effects of the agreement compared to the likely market situation without such contractual restraints. Anticompetitive effects are likely to occur when a party has or obtains some degree of market power and the agreement contributes to the creation, maintenance or strengthening of that market power or allows the parties to exploit such market power.

Definition of relevant market. The contracting parties need to define the relevant market to establish the market share of the supplier or the buyer. Determination of the relevant market requires a combination of the product market and the geographic market.⁸⁸

- **Product market.** The relevant product market comprises all products and services that are considered interchangeable or substitutable by the consumer due to their functionalities, prices and intended use. All relevant market conditions should be considered including the recent past, results of studies on the elasticity of demand, the views of customers and competitors, consumer preferences, barriers and costs associated with switching demand to other products, and different categories of customer and price discrimination.
- **Geographic market.** The relevant geographic market comprises the area in which the companies concerned are involved in the supply of products or services and in which the conditions of competition are sufficiently homogeneous. It may, for example, cover the world, several continents, a single continent, several countries (e.g. the EU or EEA), a single country and even parts of a country.

Assessment of relevant market. The relevant market must be assessed on a case-by-case basis. The geographic market is to be determined by looking at the market shares of the relevant parties, the prices charged and any price differentials. Market shares provide a useful indication of the market power of a company. Low market shares are generally a good indicator for the absence of substantial market power –: with market shares below 30 percent, dominance is unlikely. The demand-side substitutability (i.e. of customers) also plays a role – can customers readily switch to a similar product in response to a small but permanent price increase (between 5 and 10 percent)? The supply-side substitutability (i.e. of suppliers) should also be assessed – can other suppliers readily switch production to the relevant products and sell these on the relevant market?

The Block Exemption Regulation. The EU Block Exemption Regulation contains certain conditions under which vertical agreements are exempted from the prohibitions stipulated in EU competition law.⁸⁹ The first requirement is that the agreement does not contain any of the hardcore restrictions mentioned below. The second requirement concerns a market share cap of 30 percent for both suppliers and buyers. Finally, the Block Exemption Regulation contains conditions relating to three specific restrictions (see below).

Hardcore restrictions. The Block Exemption Regulation contains hardcore restrictions that lead to the exclusion of the whole agreement from benefitting from the exemptions of the Block

⁸⁸ See also Guidance on the Commission's enforcement priorities in applying Article 82 EC Treaty to abusive exclusionary conduct by dominant undertakings.

⁸⁹ Article 101(1) Treaty on the Functioning of the European Union.

Exemption Regulation, even if the market shares are below 30 percent. Hardcore restrictions are considered to severely restrict competition because of the likelihood of harm caused to consumers. They are prohibited at all times:

- **Price setting.** The first hardcore restriction concerns resale price maintenance (RPM): a supplier is not allowed to fix the (minimum) price at which distributors may resell its products.
- **Market allocation.** The second hardcore restriction concerns contractual provisions that limit the territory on which the buyer may sell or limiting the consumers to whom may be sold. This hardcore restriction relates to *market partitioning* by territory or by category of customers. A distributor must remain free to decide where and to whom it sells. The Block Exemption Regulation contains exceptions to this rule, which, for example, enable companies to operate an *exclusive distribution system* or a *selective distribution system*.
- **Selective or exclusive distribution.** Selected distributors, while being prohibited to sell to unauthorized distributors, cannot be restricted in the end-users to whom they may sell. Furthermore, a distributor must remain free to sell or purchase the contract goods to or from other appointed distributors within the network.
- **Supply of spare parts.** A supply contract between a manufacturer of components or spare parts and a buyer which incorporates these components into its own products may not prevent or restrict sales by the manufacturer of these spare parts to end-users, independent repairers or service providers.

The 30-percent market share cap. The Block Exemption Regulation covers a vertical agreement if neither the buyer nor the supplier (or manufacturer) of the goods or services has a market share exceeding 30 percent. For the supplier (or manufacturer), the market share must be determined based on the relevant *supply market* (i.e. the market on which it sells the goods or services). For the buyer, the market share is determined by reference to the relevant *purchase market* (i.e. the market on which it purchases the goods or services).

The excluded restrictions. The regulation applies to all vertical restraints other than the hardcore restrictions. Three vertical restraints contain specific conditions:

- Non-compete obligations during the contract;
- Non-compete obligations after termination of the contract;
- The exclusion of specific brands in a selective distribution system.

When the conditions are not fulfilled, these vertical restraints cannot benefit from the exemptions. Nevertheless, the Block Exemption Regulation still applies to the remaining part of the vertical agreement if that part is severable (i.e. can operate independently) from the non-exempted vertical restraints.

(c) Abuse of a 'dominant position' (monopolization)

Striving towards (or being in) a dominant market position as such is not prohibited. EU competition law merely prohibits the abuse of such a position and in the United States, the Sherman Act prohibits monopolization, attempts to monopolize and conspiracies to monopolize. A company with a dominant market position may compete on quality of its products. However, it must not hinder effective competition or the growth of competition. For example, it is not permitted to treat distributors, licensees or customers differently without justification. Whether or not behaviour is abusive and prohibited depends on whether the company has a dominant position. This must be assessed as outlined in section 5.6(b)(iii).

(i) *Discrimination and differentiation of sales conditions*

A company with a dominant position may not discriminate in its sales conditions towards similar customers and with comparable circumstances. It is prohibited to grant different sales conditions (e.g. prices, rebates) to distributors or customers with the same characteristics.

It is permitted to grant different sales conditions to distributors providing special services that are not provided by other distributors and to distributors in different stages of the distribution channel (wholesalers – retailers).

Antitrust law in the United States or other countries may differ from the EU. Under United States antitrust law, the Robinson-Patman Act established an elaborate set of rules concerning price discrimination. These principles apply equally to all buyers and sellers.

(ii) *Imposing exclusive or excessive minimum purchase commitments*

Dominant companies are not permitted to substantially restrict access of competitors to customers or dealers through exclusive purchase requirements or excessive terms. In the EU, it is prohibited to agree with customers that all its requirements will be purchased exclusively from one dominant company.

(iii) *Rebates*

Fidelity rebates. Fidelity rebates are granted to buyers on the condition that they buy exclusively from the dominant supplier. In the EU, it is prohibited for a company dominating the market to grant fidelity rebates.

Target rebates. Target rebates are rebates which are granted by a dominant company to buyers under the condition that they reach a certain target sales quantity or turnover. In the EU, it is prohibited for a dominant company to grant target rebates for reaching a specified sales volume or turnover increase.

Aggregated rebates. Generally, it is prohibited to grant aggregated sales rebates which develop a foreclosure or a tying effect in favour of a dominant market party. In the EU, it is prohibited to grant aggregated rebates based on the overall turnover. Nevertheless, it may be possible to grant rebates in return for efficiencies.

(iv) Unfair or predatory pricing

In the EU and the United States, it is prohibited to sell products continuously below the own average avoidable costs or long-run average incremental cost, with the aim or effect of eliminating a competitor. Well-known examples of this are price wars between supermarkets or franchise chains at coffee corners. Furthermore, it is prohibited to establish purchase prices below cost (i.e. use of dumping prices).

(d) Tying and bundling

Tying is when the supplier makes the purchase of one product conditional upon the purchase of another product which, by their nature or according to commercial usage, are not part of one system or have no connection with each other. The first product is referred to as the tying product and the second is referred to as the tied product. It is indifferent whether the tying product and tied products are supplied by the supplier or by someone designated by the supplier.

Bundling is when two or more distinct products are only supplied together in fixed proportions (i.e. pure bundling) or if the products are also sold separately but the aggregate price when sold separately is higher than the bundled price (i.e. mixed bundling).

Tying. If tying is not objectively justified by the nature of the products or commercial usage, such practice may constitute an abuse of a dominant position. Agreements, which effectively (contractually or de facto) make the sale of one product conditional upon the purchase of another distinct product, may therefore violate competition law.

Prohibitions related to tying. A tying clause is prohibited if the supplier is dominant in one of the products or services offered. Examples of prohibited acts of tying include:

- The sale of testing materials required in connection with (testing) instruments or equipment;
- The sale of toner cartridges required for selling printer brands;
- Requiring a bookstore to buy unpopular titles before allowing it to purchase a bestseller;
- The automatic installation of an internet browser in connection with a software operating system.

It is generally prohibited to make the supply of a product:

- Conditional upon the purchase of another product (although there may be exceptions);
- Subject to the obligation to enter into a service agreement.

However, it may be possible to tie:

- A full range of products including accessories;
- Instruments or equipment and a service agreement for reasons of product safety;
- Materials or tools (in licence agreements), which are necessary for a technically satisfactory exploitation of the licence.

Bundling. Bundling adversely affects competition if at least one of the bundled products is dominant. The bundle might foreclose the market for products competing with the single products in the bundle. The prohibitions in the EU include:

- Strategic bundling of two or more products with the sole purpose of excluding competitors and without pursuing innovative, scientific or medical aims;
- Setting a predatory price for a product bundle resulting in foreclosing the market against competitors.

In the EU, it is permitted to bundle two (or more) products:

- When there are strong scientific or medical reasons for the bundle;
- If they are part of a system.

(e) Public procurement and tenders

When participating in a public procurement or tender, a company must make sure that the applicable rules of conduct are observed, including tender law regulations, competition laws and integrity in business regulations.

In any jurisdiction, when involved in a tender process, the following general principles must be observed by any participant during the entire tender process:

- Transparency must be maintained throughout the procurement cycle by adhering to applicable formal procedures;
- Governmental decision makers must be provided with correct and transparent data.

Competition law requirements. The general principles of competition law in dealing with competitors are also applicable to the tender process.

Prohibitions include:

- Discussing tender offer terms such as prices or sales conditions with competitors or other bidders;
- Bid rigging – agreeing on an allocation of tender participation or agreeing with competitors to participate in a tender with a mock offer;
- Withdrawing from a public tender in exchange for compensation from a competitor;
- Fixing the price offered by the contractor in the tender if the contractor participates in a tender process in its own name and at its own business risk;
- Discriminating against other customers when offering low prices for a dominant product;
- Offering dumping prices (prices below cost) when having a dominant market position.

Companies participating should:

- Submit an offer that includes correct and transparent information and figures;
- Autonomously decide to directly participate in a public tender.

Companies may:

- Invite a distributor (or several distributors) to participate in a public tender without fixing or coordinating the prices offered by the distributors;
- Give a non-binding price recommendation for the prices to be offered by the distributors;
- Make an offer below the standard list price for a dominant product to be awarded a tender, provided such offer is not below cost exploitation of the licence.

Integrity in business. Participants in a tender process may not unduly influence the tender process itself or the decision makers involved. Violations of these principles could result in severe sanctions such as exclusion from tender procedures.

It is prohibited to:

- Illicitly influence the content of the tender documents;
- Act as a ghost writer for the tender documents;
- Maintain undue contacts with the decision makers;
- Influence tender decision makers by granting any personal advantage or gift.

It is permissible to provide:

- Existing technical documentation upon inquiry of the tender authority;
- Product specifications to potential customers.

(f) The legal framework

EU competition law. The principal provisions of European competition law are enacted in Articles 101 and 102 (formerly Articles 81 and 82) of the Treaty on the Functioning of the European Union, as well as Articles 103-109. More detailed regulations and guidelines are found in regulations, directives, Commission notices and communications from the Commission. European competition law applies to all companies (undertakings) to the extent that they do business by offering goods or services in the EU internal market and which may affect trade and competition between the member states regardless of whether the company is established in an EU member state or not.

United States antitrust law. In the United States, the relevant laws and regulations are reflected in three federal statutes: the Sherman Antitrust Act, the Federal Trade Commission Act and the Clayton Antitrust Act. United States antitrust law applies to all companies and individuals doing business in the United States or affecting United States commerce.

National competition laws. National competition laws need to be considered when doing business in any country. The scope and effect of national competition laws of EU member states or the competition law of a specific state in the United States is generally similar to EU competition law or United States antitrust law, respectively, but can be more restrictive.

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