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A Guide to Navigating the International Commercial Terms

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The international sale of goods usually involves transporting those same goods from the premises of the seller to a location selected by the buyer. This transportation can take place in multiple ways: road, rail, sea, air or a combination thereof. But transportation inherently involves risk — the goods could be lost, stolen or damaged, or they could arrive late. Further, transportation inherently involves costs: freight, loading, unloading and insurance.

The purpose of the International Commercial Terms, or Incoterms, a series of shorthand shipping terms developed by the International Chamber of Commerce, is to specify which of the risks of transportation are to be borne by the seller and which by the buyer, as well as which costs of transportation are to be borne by the seller and which by the buyer. The terms also specify who is responsible for import and export clearance.

The terms have been revised several times since first being issued in 1936; the current version is the Incoterms 2010. The current set of Incoterms incorporates 11 different terms, meant to reflect the realities of modern transportation practices, particularly the containerization of manufactured goods in transit:

EXW: Ex-Works
FCA: Free Carrier
FAS: Free Alongside Ship
FOB: Free On Board
CPT: Carriage Paid To
CIP: Carriage and Insurance Paid To
CFR: Cost and Freight

Authors

Maureen E. Thorson
Partner
202.719.7272
mthorson@wiley.law

Practice Areas

International Trade

CIF: Cost Insurance and Freight
DAT: Delivered at Terminal
DAP: Delivered at Place
DDP: Duty Delivered Paid

The Incoterms are used widely by international contracting parties to specify the delivery terms for merchandise. The primary value of the Incoterms is that they permit the buyers and sellers to quickly, and without having to write lengthy descriptions into their contracts or invoices, understand which of them has which responsibilities with respect to transport.

However, problems arise when one of the parties has misconceptions about the meaning of the individual terms selected, or misconceptions as to what issues the Incoterms, as a whole, cover. Below, I explain what the Incoterms can and cannot do, with respect to the risks and costs of international transportation. I also point out some of the issue areas that most commonly result in misunderstanding among contracting parties, namely a failure of the parties to mutually understand which set of terms they are using, using terms that are inconsistent with the method of shipment, failing to properly understand (and define) the place of delivery and the place of destination, misunderstanding insurance obligations and failing to take into account the parties' relative ability to undertake the obligations required of them by their chosen term.

What Incoterms Can and Cannot Do

As noted above, the Incoterms provide parties with a shorthand for the apportionment of the risks and costs involved in moving goods from one place to another. In other words, parties can use them to establish whether buyer or seller will have to pay for freight, and to what location, whether buyer or seller will have to clear the goods for export and/or import, and who is responsible, at least nominally, for insuring the goods. Further, the Incoterms can be used for both international and domestic shipments.

Two things that the Incoterms do not do, however, is govern title transfer and the consequences of breach of contract.

While the terms can, and do establish, when the risk of loss passes from buyer to seller, and when the costs of transport pass from buyer to seller, they do not establish when the title in the goods themselves actually passes between the parties. This, instead, will be governed by other aspects of the sales agreement between the parties — for example, by the contract itself, as reinforced by any letter of credit and, finally, if it comes to it, by the law of the jurisdiction that the parties have agreed should govern their contract.

For example, consider a German manufacturer that sells a computer numerical control milling machine to a machine shop operator in Canada. The parties agree to FOB selling terms, under which both the risk of loss and the costs of transport shift from seller to buyer once the machine has been loaded onto the ship selected by the buyer, with the seller responsible for clearing the goods for export from Germany. Does this mean that the title transfers once the machine is loaded on the ship and cleared for export? It's simply not clear—Incoterms do not, in of themselves, tell us anything about ownership rights.

Likewise, the Incoterms, with certain very limited exceptions, do not establish the consequences of a failure on either party's part to comply with its obligations under the parties' selling agreement. For example, assume that a Japanese manufacturer of novelty holiday decorations has agreed to supply a U.S. home goods retailer. The parties have agreed to CPT selling terms, which require the seller to arrange and pay for transportation to the place named in the shipping contract. The parties further agree that the goods shall arrive at the port of Long Beach no later than Nov. 30, 2015. However, the goods are dispatched late and do not arrive until Dec. 10, 2015. Does the seller owe the buyer a discount? Does the buyer have any recourse at all? The Incoterms themselves do not say; the parties would need to look to their contract/letter of credit and the underlying law to determine what the consequences are for this breach. (Of course, since the buyer had the responsibility for obtaining insurance under the CPT term, the insurance contract may provide another means by which he can be made "whole." And given the importance of timing to the sale of holiday-themed items, the buyer would have been well-advised to make sure he was fully insured!).

The only instances in which the Incoterms establish the consequences of a contract breach are where the buyer, having agreed to an Incoterms under which he must select a carrier or take delivery at an agreed-upon place, fails to timely inform the seller of the carrier or to take delivery. In such instances, the buyer is responsible for any charges that are incurred as a result of the buyer's late performance of his obligations under the Incoterms.

What Set of Terms Are We Using?

The Incoterms were last updated in 2010; the revision altered the responsibilities and obligations under certain prior existing terms, such as FOB, and removed/replaced other terms, like the former DES and DEQ, altogether. Misunderstandings may arise when the parties use a term that no longer exists or, more problematically, when they agree to use a term that still exists, but one or both of them believe themselves to have agreed to risks and obligations that are in accordance with an outdated version of the term.

Likewise, certain Incoterms, like FAS and FOB, are used in chartering contracts with shipping corporations, but have totally different meanings (usually dependent on the shipping company) than they have within the Incoterms. Further, terms like FOB and CIF are also defined in the Uniform Commercial Code, which is often used by parties to domestic sales transactions in the United States. However, there again the terms have different meanings than they do within the Incoterms 2010.

Parties can avoid the confusion entirely by specifying within their contracts and other shipping documents that they are using the Incoterms 2010 or, to the extent that they would prefer their contract be governed by another set of shipping terms, expressly specifying that in their contracts.

This Term Doesn't Make Sense

Another common problem area for contracting parties is agreeing to an Incoterm that is inconsistent on its face with their proposed transportation method. This most commonly occurs when the FAS, FOB, CFR or CIF terms are used with respect to goods that are being transported by road, rail or air. These four terms, however, are meant only for maritime or inland waterway transport. The FAS term for example, shifts risks and costs from seller to buyer once the goods are placed on a quay or barge "alongside" the ship nominated by the buyer. If there is no ship, and no quay or barge, however, questions may arise as to how or whether the seller has discharged—or ever could discharge — his obligations.

Another common issue is the use of a term that is unsuitable to the realities of containerized merchandise, by continuing the seller's risks and obligations after the merchandise has effectively left his control. For example, the FOB term shifts risks and costs only after the goods have been loaded about the ship selected by the buyer. But the seller is likely to lose effective control over the merchandise (and thus effective control over risk) once he has handed the goods over for containerization in a container yard. The FCA transfers risks from seller to buyer at the point that the goods are handed over to the carrier or another person nominated by the buyer, and thus much better reflects the realities of transporting containerized goods.

Relatedly, parties may find that there is wide variation in the lading and unlading charges associated with specific ports or even specific charter/shipping companies. In using terms that transfer risks and costs at the point where goods are loaded or unloaded (such as FOB or DAT), the parties may be well-advised to specifically indicate which of them is responsible for any such oddball charges. For example, annotating the FOB term with the phrase "stowed and trimmed" will clearly establish that it is the seller's responsibility to pay for all loading costs. Likewise, annotating the DAT term with "Terminal Handling Charges to seller's account" will clear up any ambiguity over which party is liable for unlading charges.

What Is the Place of Delivery and What Is the Place of Destination?

Under the Incoterms, risks transfer at the place of "delivery" and costs transfer at the place of "destination." These are not always the same place. For example, under the CIP term, the seller is responsible for arranging and paying for carriage of the goods to a place of destination included in the contract (and ideally specified in close proximity to the Incoterm). But the risk of loss transfers from seller to buyer prior to the goods' arrival at the destination. Instead, they transfer at the point where the seller hands the goods over to the carrier. This is the place of "delivery."

For certain Incoterms, the place where risks and costs transfer is the same, such that the place of delivery and the place of destination are also coterminous. But as the above example shows, this is not always the case. If the parties are unaware of this when they make their contract, one or both could be severely — and unpleasantly — surprised to find out later that they have undertaken risks or obligations that they never meant to have, or which would simply have been borne more sensibly by the other party.

Further, parties would always do well to name, as specifically as possible, both the place of delivery and the place of destination within their contracts. For example, the term "CIP Houston" leaves it ambiguous as to where in Houston, exactly, the goods are destined. Further, it does not indicate where, specifically, the goods are to be handed off to the carrier, leaving this entirely up to the seller's discretion.

Insurance Obligations

One of the responsibilities that the Incoterms deal with is insurance. Six of the Incoterms (EXW, FCA, FAS, FOB, CPT and CFR) specify that the buyer is responsible for insurance from the place of delivery to the place of destination, while the five remaining Incoterms (CIP, CIF, DAT, DAP and DDP) make such insurance the responsibility of the seller.

In reality, however, buyers are well-advised to consider whether any of the Incoterms provide for sufficient insurance cover, particularly if the goods at issue are manufactured items. Consider that the five terms that make insurance the responsibility of the seller only require the seller to provide for "minimum cover" — the purchase price plus 10 percent. The buyer, however, may face ramifications from loss or damage (or even lateness) that far outweigh this amount. Delay in receiving a critical part may lead the buyer to be unable to complete orders for his own goods, leading to angry customers and canceled purchases. The value of the goods may itself be dependent on timing—a container of Christmas cards that arrives on Dec. 26 has far less resale value than if it arrived on Nov. 26.

Further, although one might naturally assume that, regardless of the Incoterm at issue, sellers always insure goods up to the point of risk transfer (i.e., delivery), this assumption may be in error. For example, under the FOB term, the seller bears the risk of loss until the goods are loaded onto the vessel selected by the buyer. A prudent seller would be well-advised to insure the goods up through that point. But the seller might not do so, either because it is not standard practice to obtain insurance for domestic shipments in the seller's country, or because he prefers to cross his fingers and hope that nothing goes wrong. If something does go wrong, of course, it would be the seller's responsibility, but the buyer might find it difficult to enforce that responsibility. Rather than face the possibility of having to sue the seller in a foreign jurisdiction, the buyer might consider simply buying its own insurance that covers the goods outright.

It Turns Out I Can't Do That

Because the Incoterms apportion not just risks but costs — that is, responsibilities — it is important that the parties not take on obligations that they cannot actually discharge. The classic example would be a seller agreeing to DDP terms, which require him to clear the goods for import into the buyer's country, when the laws of that country prohibit nonresident corporations from making entry. While there might be ways for the seller to work around this (like hiring a resident corporation to make the entry), they could implicate costs that the seller did not contemplate bearing at the time of contract.

Further, parties of different sizes and bargaining power may have access to different freight rates, preferential terminal access, etc. Awareness of such differential access may lead the parties to select different selling terms than they would if they were meeting on truly neutral ground, or to agree to selling terms only with the understanding that one of the parties will assist the other in discharging its obligations by, for example, prevailing on an ocean shipping company to extend a preferential rate to the party responsible for ocean freight.

Conclusion

The Incoterms can greatly simplify many of the issues associated with sale of goods, but only if both the seller and buyer know exactly what their chosen Incoterm signifies. Each individual Incoterm has its own benefits and detractions, as well as quirks of usage, which can be influenced by the parties' own commercial positions. In selecting an Incoterm, therefore, parties should ensure that they take these factors into account, and take steps to forestall any obvious problems.