The Vienna Sales Convention and the financial markets

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Key points

- The Vienna Sales Convention has been adopted by many countries, including the United States, since it emerged in 1980. Should the UK accede to it?
- The Convention attempts an international code for sale of goods contracts. But it clearly extends beyond ordinary sale of goods cases and includes at least derivative transactions which provide for physical delivery.
- This article considers the Convention's scope and how far it extends into the field of financial instruments.
- Is the requirement in Article 7 of 'good faith' in the execution of contracts covered by the Convention consistent with English law or, if not, is it desirable, especially where the wholesale markets are concerned?

1. Introduction and summary of conclusions

Introduction

The Vienna Sales Convention (the 'Convention') provides a uniform law for international sales of goods. It establishes a series of rules to govern the formation of sale of goods contracts and contains substantive rights and obligations of seller and buyer arising from the contract. The Convention was adopted by diplomatic conference in Vienna in 1980 and came into force on 1 January 1988. Since then, it has received ratification from 70 countries worldwide, including a number of UK's major trade partners. The UK is currently not a party to the Convention. Most European Union (EU) countries, the United States, China, Canada and Australia have adopted the Convention and Japan is also about to ratify.[1]

The UK Government has for some time been considering the possible implementation of the Vienna Sales Convention in the UK. The Department of Trade and Industry undertook an informal consultation in 1980 and two formal consultations in 1989 and 1997, respectively, relating to possible implementation of the Convention. Following these consultations, a decision was taken in 1998 to legislate to implement the Convention. However, due to a series of unforeseen circumstances, momentum for implementation was lost. In July 2007, the Government considered that the time was right to resume the process

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1 The CISG passed the House of Representatives (lower house) in the Japanese Diet on 20 May 2008. There was no opposition; deliberations at the House of Councillors (upper house) will begin shortly.

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of consultation and accordingly has been seeking to gauge stake-holder views to determine the level of support for and against the implementation of the Convention.

With future ratification of the Convention looking increasingly possible for the UK there is a real need for the UK Government and financial market participants to be aware of the potential difficulties that such a move could bring to the financial markets. This paper provides a legal assessment of the problems that may arise and a discussion of potential solutions.

Summary of conclusions

In summary, whilst the raison d'être behind the Convention is laudable and its success internationally is unquestionable, the potential, unforeseen practical implications of implementation in the UK could present some cause for concern in relation to business-to-business contracts.

> It is clear that the scope of the Convention extends beyond simple contracts for the sale of goods. In my opinion, the Convention will apply to derivative contracts where there is provision for physical delivery, and that without any authority to indicate otherwise, it could also extend to cover other financial instruments falling within the category of *choses in action*.

My own view is that certain parts of the Convention, in particular the good faith requirement under Article 7(1), when applied to international financial market contracts could present significant disincentives to the conduct of business if found to be applicable.

If implementation of the Convention is to occur in the UK care must be taken to clarify the extent to which financial instruments will be covered. UK authorities should also consider restricted implementation options as well as the possibility of promoting the introduction of standard form opt out clauses in certain financial markets master agreements to restrict the application of the Convention to areas where it would be undesirable.

2. Convention on contracts for the international sale of goods—context and purpose

Background to the Convention

The origins of the Convention can be traced back as far as 1930 when, with the support of the League of Nations, the International Institute for the Unification of Private Law (UNIDROIT) made a decision to develop uniform international sale of goods legislation. The tumult of the late 1930s and 1940s temporarily placed the unification effort on hold but it was reignited following the war, eventually resulting, in 1964, in the development of two uniform laws, one on the international sale of goods and the other on the formation of contracts for international sales which were annexed to two corresponding international conventions (the '1964 Hague Conventions').[2]

2 The two conventions were ratified by nine States: Belgium, Germany (Federal Republic), Gambia, Israel, Italy, Luxembourg, The Netherlands, San Marino and the UK. The CISG antecedent conventions were denounced by those states who subsequently ratified the CISG.

In 1966, the United Nations Commission on International Trade Law ('UNCITRAL') was established with the general mandate 'to further the progressive harmonisation and unification of the law of international trade'.[3] It fell to UNCITRAL to set about preparing and promoting a more widely acceptable text than that represented by the Hague Conventions.

It was agreed that the revised text should be introduced directly through an international convention, rather than through further uniform laws, and that only one instrument should be introduced in place of the two previous laws. The United Nations Convention on Contracts for the International Sale of Goods was unanimously adopted by 62 participating states at a UN Conference in Vienna on 10 April 1980.

The Convention is widely perceived as a great success for UNCITRAL and a great legislative achievement, having been accepted throughout the world by countries from every continent with vastly different legal, social and economic backgrounds.

Overriding purpose

Unification

The key objective of the Convention is to establish uniform globally applicable substantive rules to govern the making and interpretation of *international* contracts for the sale of goods as well as providing rules to govern the obligations and remedies of parties to such contracts.

Essentially, the Convention aims to facilitate cross-border buying and selling of manufactured goods, raw materials and commodities. Sale of goods legislation can vary greatly from country to country and it is often difficult to be certain which law should apply to a particular transaction. Choice of law issues are among the most contentious and heavily litigated throughout the world, with both contracting parties generally preferring to apply their own domestic sales law or the law that is most favourable to them wherever possible. There is, accordingly, a wide scope for inefficiency, uncertainty and disputes to arise in this area. The establishment of an international uniform code reduces these risks (and also reduces transactional costs) by introducing internationally accepted substantive rules to fill in any gaps in contract formation. This ensures that there are clear provisions in place on which the contracting parties as well as courts and arbitrators throughout the world are able to rely.

Clarity

A fundamental characteristic of the Convention is its clarity and accessibility. Great efforts were made to draft the text in a clear, simple and practical way, using plain language and ensuring that it remains free from legal jargon. This has enabled the Convention to be read and understood at face value by lay business people throughout the world. The rejection of complex legal terminology and dogma has also helped to

3 General Assembly Resolution 2205 (XXI)—Establishment of the United Nations Commission on International Trade Law—17 December 1966.

minimize any risk of the Convention being susceptible to differing interpretations from country to country, according to the different languages and legal systems.

Flexibility

Part of the appeal of the Convention is that although it seeks to achieve uniformity, it also allows a degree of flexibility to ensure that it can be effectively integrated into as many states as possible. The Convention allows those states that have opted to ratify it ('Contracting States') to take exception to certain articles that may be at odds with aspects of domestic law. This adaptability makes it possible for the uniform law to work on a practical level in every Contracting State, regardless of the existing legislative provisions.

The Convention also provides flexibility by maintaining the fundamental principle of freedom of contract. The Convention explicitly provides that express contractual terms take precedence over the default position under the Convention, thus allowing contracting parties to mould their contracts to their individual specifications: 'The CISG does not pre-empt a private contract between parties; instead, it provides a statutory authority from which contract provisions are interpreted, fills gaps in contract language, and governs issues not addressed by the contract'.[4]

Parties are, therefore, free to specify the terms and governing law they wish to apply to their contract and may expressly exclude the application of the Convention in part, or even completely, if desired.

Application of the Convention

The Convention is not intended to apply to all contracts and the nature of the contract and the location of the contracting parties will determine whether it is to be applicable.

The Convention is only designed to apply to 'sale of goods' contracts and whilst the precise scope of what is covered by the term 'goods' is open to a degree of interpretation, it is clear that the Convention does not extend to contracts for the provision of services. Certain other exceptions are specifically set out in Article 2 of the Convention and include goods bought for personal use, sales by auction or by authority of law, contracts for the sale of ships, aircraft and other vessels and contracts for the sale of electricity. For the purposes of the Financial Markets Law Committee (FMLC), the most important exception is set out in Article 2(d) and relates to intangibles including stocks, shares, investment securities, negotiable instruments or money (see Section 6 below).

Aside from the exceptions above, the Convention will automatically apply to all sale of goods contracts between parties whose respective places of business are in different countries which are both Contracting States, unless the parties opt to specifically exclude its application.

4 *Ajax Tool Works, Inc. v Can-Eng Manufacturing* (Northern District, IL, 29 January 2003).

Application of the Convention may also extend to non-Contracting States if the conflict of law rules set out in the contract in question lead to the application of the law of a Contracting State.

3. Impact of the Convention in Europe

Currently 23 of the 27 member states of the EU have ratified the Convention and, accordingly, it has had a positive impact in unifying the rules applicable to cross-border commercial sales contracts within the EU. Some argue, however, that unification throughout Europe is limited by the fact that a small number of Member States, including the UK, are yet to ratify the Convention and that others who have ratified have opted to use the reservations offered to disapply certain parts of the Convention. This situation may not be entirely satisfactory for commercial enterprises operating throughout Europe, who need to remain aware of the potential different sets of rules that could govern inter-European sales transactions. This result appears to be at odds with the fundamental principle of a single European market and could potentially discourage businesses from entering into sales contracts with EU states which rely on internal law rather than the Convention, particularly where such law is not easily accessible.[5]

It is possible to argue that uniform ratification of the Convention throughout Europe is the ideal solution to ensure consistency and a level playing field for all Member States. However, the FMLC notes that uniform direct implementation of the Convention may not be required as there are other instruments already in place which effectively implement the Convention throughout the EU.

The Convention text forms the basis of the UNIDROIT Principles of International Commercial Contracts 1994 and the (Lando) Principles of European Contract Law 1998 both of which emulate the Convention with little substantive modification. Furthermore, the European Directive (the 'Directive') on Consumer Sales (1999/44/EC) has largely adopted the same structure as the Convention. The Directive has been implemented in all EU Member States and, therefore, indirectly the substance of the Convention has, to some extent, already become an integral part of the sales legislation in every EU Member State. Although the Directive is only applicable to consumers, whereas the Convention applies to consumers and non-consumers alike, its implementation throughout Europe, along with the UNIDROIT and Lando Principles, suggests that the substance of the Convention is widely recognized, even in non-Contracting States, which reduces the risks associated with non-uniform implementation throughout the EU.[6]

Wide implementation of the Convention in the EU raises the question of why the UK has not yet ratified. It would appear that the main reason is simply that, with limited Parliamentary time available, ratification of the Convention has not thus far been a

5 It should be noted that this is unlikely to be the case with regard to English Law which is widely used in international contracts and generally perceived to include easily identifiable and accessible provisions.

6 Scandinavian states which also have a separate law of sales for Scandinavian transactions and have consequently made specific reservations when ratifying the CISG are in the process of lifting their reservations.

legislative priority. There is little evidence to demonstrate that the lack of ratification has had any adverse effect on the UK economy and, therefore, many parties, including a number of large and influential commercial organizations, see no point in upsetting the status quo.

> The UK legal system is viewed with high regard and holds a unique position throughout the world. There is, therefore, a view that accession to the Convention could jeopardise this special position and thus be undesirable for the UK. Such a change could bring with it a risk that London would lose its edge in international arbitration and litigation. This, in turn, could have a negative impact upon the attractiveness of London to a number of businesses, most notably in the financial markets, that position themselves in the UK to take advantage of the strength of the legal and commercial infrastructure available. It is particularly important to note that the UK remains the leading centre in worldwide derivatives trading, holding 43% of total turnover for this market in 2007, which contributes significantly to the UK economy.[7] For reasons explicated throughout this paper, ratification of the Convention in the UK could have a very real impact on derivatives markets, as well as a potential impact upon other financial instruments markets. The strength of these markets in the UK and their contribution to the UK economy are all factors to be weighed up against the apparent benefits associated with ratification of the Convention.

4. Provisions of the Convention of particular relevance to the financial markets

I turn to consider which provisions of the Convention (if any) might present difficulties, in particular with respect to legal certainty. The principal problem lies, in my view, in Article 7(1), which provides as follows:

> In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade.

It is plain that the observance of good faith in international trade is at the heart of the Convention. But what does it mean and how is the observance of good faith to be achieved? For the reasons set out in Section 5 below, Article 7(1) may create an element of uncertainty in the performance of contractual obligations, which the Government should take into account in deciding whether or not to accede to the Convention.

A second, but less important area of doubt concerns Article 25 of the Convention dealing with breach. This article reads as follows:

> 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.

Article 25 must be read with Article 49(1), which provides that the buyer may declare the contract avoided: ''if the failure by the seller to perform any of his obligations under the contract or this Convention amounts to a fundamental breach of the contract''.

7 See the International Financial Services London Research Paper on Derivatives 2007 (http://www.ifsl.org.uk/upload/CBS_Derivatives_2007.pdf) and the 2008 Research Paper on commodities (http://www.ifsl.org.uk/upload/CBS_Commodities_2008.pdf) for further statistics.

This important definition of the right to avoid the contract of sale seems to us to be significantly less precise than English law currently provides. Whether the breach is or is not 'fundamental' depends upon its effect rather than its quality. The party in breach will not necessarily know whether or not his act or omission will result in the detriment defined in Article 25. English law attempted some 30 years ago to define a concept of 'fundamental breach' in the law of contract but this failed to supplant the idea of repudiatory breach which the House of Lords reaffirmed in *Photo Production Ltd. v Securicor* [1980] AC 827. One reason why it failed was because of the difficulty of knowing whether the breach was or was not fundamental at the time it was committed. Article 25 could introduce an undesirable lack of clarity into our law of sale of goods. In the case of sales of goods to consumers, the lack of clarity may be justified in the interest of consumer protection but the Convention applies to consumers and non-consumers alike and we are concerned as to the effect as between commercial parties. There are, however, a number of decided cases interpreting Articles 25 and 49(1). When Article 25 was first included in the Convention, there were expressions of concern as to what it would mean but we now have a substantial body of case law interpretations.

Thirdly, Article 6 CISG relates to the exclusion of the Convention by the parties and provides: 'The parties may exclude the application of this Convention or, subject to article 12, derogate from or vary the effect of any of its provisions.'

It is general market practice to disapply the Convention to all privately negotiated over-the-counter (OTC) cross-border transactions in physically settled commodity derivatives (provided they are defined as a 'sale of goods' under the CISG) that are documented under non-English law as governing law of the contract. For example, the AIPN Model Form Master LNG Sale and Purchase Agreement (for natural liquefied gas), the EFET General Agreement Concerning the Delivery and Acceptance of Natural Gas, the Globalcoal Standard Coal Trading Agreement (SCoTA), the ISDA US Oil and Refined Petroleum Products Annex, the LEAP Master Agreement for Purchase and Selling Refined Petroleum Products and Crude Oil, include an express CISG waiver.

Those documents whose standard wording does currently not include an express CISG waiver are generally amended bilaterally to include an opt out.

Article 6 CISG provides that parties may exclude the application of this Convention or, subject to Article 12 CISG, derogate from or vary the effect of any of its provisions. The breadth of the parties' freedom to modify the Convention's rules is emphasized by the one exception stated in Article 6—the privilege of an adhering state under Articles 12, 96 CISG to preserve its domestic rules.[8]

The Convention does not say anything about an implicit exclusion. This may be relevant for those transactions whose documentation stays silent on this point. Various commentaries on the CISG seem to be of the view that there is the possibility of implicitly

8 JO Honnold, *Uniform Law for International Sales under the 1980 United Nations Convention* (3rd edn, 1999), Kluwer Law International <www.cisg.law.pace.edu/cisg/biblio/honnold.html> (accessed 21 August 2008) para 74.

excluding the Convention.[9] If the parties wish to safely exclude the application of the Convention, they do so best in agreeing to invoke the law of a specific state under exclusion of the CISG.[10]

Furthermore, in international transactions, the scenario may arise that both the seller and the buyer have their places of business in Contracting States (eg various EU member states, United States, Canada and Australia) but the law governing the contract may be from a non-Contracting State (eg English law) and/or the performance might take place in a non-Contracting State (eg UK). This scenario seems to be reflected in Article 1(1) CISG. Due to rules of private international law, it might not be entirely clear if the Convention is excluded from a transaction, eg a physically settled OTC transaction in commodity derivatives, documented under English law, although the parties might have chosen English law (as a law of a non-contracting state) based on the assumption that such choice would exclude the Convention. English law is generally chosen based on the perception of being 'clear', 'commercially reasonable' and 'not bearing too many surprises for either counterparty'.

Fourthly, Article 9 CISG relates to usages and established practices and provides:

> (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 considered, unless otherwise agreed, to have impliedly made applicable to their contract or its formation a usage of which the parties knew or ought to have known and which in international trade is widely known to, and regularly observed by, parties or contracts of the type involved in the particular trade concerned.

As outlined above, cross-border transactions in OTC derivatives involving physical settlement of the underlying are generally done by excluding the Convention in one way or another. In practice, the Convention becomes relevant only with regards to OTC transactions in commodity derivatives (with the exemption of electricity according to Article 2(f) CISG). Physically settled OTC derivatives transactions on underlying other than commodities, eg those defined as a 'sale' of stocks, shares, investment securities, negotiable instruments or money, are not of concern according to Article 2(d).

The vast majority of contracts that are drafted for cross-border use (see the list of standard contracts mentioned above) exclude the Convention, especially when New York law (being a law of the United States as a Contracting State) is chosen. In an English law context (ie involving a law from the UK as a non-Contracting State), it could be argued that the general expectation is that the Convention is disapplied irrespective of the choice of governing law. It may well be that due to the fact that as the UK is not a Contracting State, it is not considered 'necessary' to expressly opt out of the Convention. It is not in the interest of market practice to regard differently the same type of transactions that are entered into under the same conditions worldwide merely because the choice of English law as the law governing the contract may make the transaction subject to the Convention.

9 F Enderlein, D Maskow, *International Sales Law* (1st edn, 1992), Oceana Publications <www.cisg.law.pace.edu/cisg/biblio/enderlein.html> (accessed 21 August 2008) art 6, ch 1.2.
10 Ibid ch 1.3; Honnold (n 8) para 77.

Also, one could argue that a certain usage exists that counterparties to OTC derivatives transactions do not expect these transactions to be subject to the Convention as such a usage is not the general practice between counterparties to such transactions. Such expectations can be established by patterns of conduct between buyer and seller. A certain course of conduct creates an expectation that a specific conduct will be continued and interpreted according to the understanding that a reasonable person of the same kind as the other party would have had in the same circumstance.[11] Without prior notification, no counterparties to OTC derivatives transactions under any governing law would expect the Convention to be applicable.

Therefore, it could be regarded as 'trade usage' to have the Convention excluded also from English law governed transactions in physically settled OTC commodity derivatives. However, it might be considered helpful to expressly opt out of the CISG irrespective of the governing law chosen for the contract, including English law, in order to avoid any uncertainty that might arise out of the fact that the UK is not a Contracting State or in a scenario in which the counterparties might not be aware of the applicability of the CISG for other reasons. Standard provisions to this effect are contained in many standard contracts for OTC commodity derivative transactions.

5. Good faith

Section 6 below considers the extent to which financial products or intangibles could be described as 'goods' and/or are caught by the Convention. Even if they are not caught, however, it is beyond doubt that the Convention does extend beyond a simple contract for the sale of goods. As already noted, there is no limitation to consumers, so that the Convention applies to contracts between sophisticated commercial parties of equal bargaining strength who are dealing on an entirely arm's length basis. Secondly, derivative contracts are clearly caught where there is provision for physical delivery (even if at a future date), rather than cash settlement. Thus, commodity futures, options, forwards and swaps may be caught. This makes it necessary to examine the need for the 'good faith' interpretative provision in Article 7 and its desirability in the case of arm's length commercial contracts.

English law has not accepted a general 'good faith' requirement in the law of contract, despite the early support of Lord Mansfield. Contracts of insurance have adopted it, referring to the principle of 'utmost good faith' but otherwise it has been resisted, most emphatically by the House of Lords in *Walford v Miles* [1992] 2 AC 128. Characteristically, English law has moved incrementally to recognize particular situations where good faith obligations exist rather than (as in France and Germany) laying down a general rule and then applying it. This can be seen from the decisions of the Court of Appeal in *Interfoto Picture Library Ltd. v Stilletto* [1989] 1 QB 433 and *Laceys Footwear v Bowler International* [1997]2 Ll. Rep 369. There, the Courts fashioned a principle that there is an obligation on a party wishing to enforce an unusually onerous term to have

11 Article 8 CISG; see also Honnold (n 8) para 116.

pointed out the term at the time of contract with particular care. It was explained that this did not arise from an a priori good faith requirement but was fashioned to deal with a particular problem encountered in practice. It should be noted that the Courts equated the result with the ultimate effect achieved by civil law jurisdictions.

Before comparing other jurisdictions, it is necessary to be clear what is meant by 'good faith'. The phrase has at least two different meanings. In the English Sale of Goods Act 1979 (reproducing on this point earlier Acts) it is defined as equating to honesty. Section 61(3) of that Act provides that: 'A thing is deemed to be done in good faith within the meaning of the Act when it is in fact done honestly, whether it is done negligently or not'.

Thus, good faith here is simply the converse of dishonesty. Of course, a contractual party must act honestly and it is because of this narrow definition of 'good faith' in the English Sale of Goods Act that no difficulty has been encountered to date. But it is important to note that this is not what is meant by 'good faith' in other contexts. In particular, the concept of good faith introduced from EU law by regulation 5(1) of the Unfair Terms in Consumer Contracts Regulations 1999 is an obligation of 'fair and open dealing, characterised by the need for disclosure and the need not even unconsciously to take advantage of the other party's weaknesses'. This provision does deal only with consumers but it reflects at least one meaning to be given to 'the requirement of good faith', as it was interpreted by the House of Lords in *Director General of Fair Trading v First National Bank* [2002] 1 AC 481. The same provision has been under consideration in the Commercial Court in the recent litigation concerning bank charges.

In the commercial context, the difficulty with 'good faith' if this broader concept is applied is that it may be impossible for a party to be able to judge when entering into its contracts whether or not the relevant terms would ultimately be held to infringe the requirement of good faith. Similar issues arise with regulation 7 of the EU Financial Services (Distance Marketing) Regulations 2004 and Article 2(h) of the EU Unfair Commercial Practices Directive.

If this concept of good faith is also that of the Convention, then it seems clear to us that this would be damaging to the conduct of commercial business because of the high degree of uncertainty and unpredictability introduced. But is it? The Convention does not derive from EU consumer law at all. The similarity is rather to other international instruments, such as the UNIDROIT Principles of International Commercial Contracts, or perhaps to the Principles of European Contract Law (Article 1.201), or again to general provisions in the contract law of leading nations including the United States, France and Germany. Section 1 of the US Uniform Commercial Code provides that '. . . every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement'. Article 1134(3) of the French Civil Code provides that '. . . contracts must be executed or performed in good faith'. Section 242 of the German Civil Code states that '. . . the debtor is bound to effect performance according to the requirements of good faith, giving consideration to common usage'. The US position is particularly

worth noting, since this is another common law jurisdiction, which has acceded to the Convention and does not seem to have had any difficulty with the good faith requirement.

These general provisions of US, French and German law have not had the effect of importing the same legal concept of 'fair and open dealing' into all contracts which regulation 5(1) of the EU Unfair Terms Regulations has introduced in the case of consumers but the position is not as clear cut as under general English law. In France for instance, most commentators have followed the principles of Roman law and adopted a narrow approach to the application of Article 1134(3). According to this majority view, the Article does not apply at all to the formation of contracts or to pre-contractual negotiations but only to performance, although there are dissenting views. Even in respect of performance, Article 1134(3) has played on the whole a modest role, again following the Roman law approach that the good faith requirement only applies to particular 'good faith' types of contract (such as sale, partnership or mandate) and not to 'strict law' contracts (such as stipulation). The problem is again one of certainty and we find the French experience here only partly reassuring. In Germany, Section 242 has been at times somewhat more widely applied, at least in the case of performance, and the ambit of the Article is a matter of much debate. Again, the problem is one of certainty.

The conclusion is that there are potential risks in Article7(1) of the Convention, in that the introduction of a general objective to promote observance of good faith in international trade opens up the prospect of an unpredictability in commercial activity which is hard to justify in non-consumer dealings. Adequate tools exist in the common law, as supplemented by the particular disclosure requirements of individual markets, to preclude the need to introduce what could be significant disincentives to the conduct of business between market counterparties and other arm's length commercial entities.

Article 7(1) requires that the Convention be interpreted in such a manner that the observance of good faith in international trade is promoted. Although an express reference to the good faith principle is to be found solely in this provision relating to the Convention's interpretation, there are numerous applications of that principle throughout the Convention. Among the manifestations of that principle are the rules contained in the following provisions:

- Article 16(2)(b) on the non-revocability of an offer where it was reasonable for the offeree to rely upon the offer being held open and the offeree acted in reliance on the offer;
- Article 21(2) on the status of a late acceptance which was sent in such circumstances that if its transmission had been normal it would have reached the offeror in due time;
- Article 29(2) in relation to the preclusion of a party from relying on a provision in a contract that modification or abrogation of the contract must be in writing;
- Articles 37 and 46 on the rights of a seller to remedy non-conformities in the goods;
- Article 40 which precludes the seller from relying on the fact that notice of non-conformity has not been given by the buyer in accordance with Articles 38 and 39 if the lack of conformity relates to facts of which the seller knew or could not have been unaware and which he did not disclose to the buyer;
- Articles 47(2), 64(2) and 82 on the loss of the right to declare the contract avoided;
- Articles 85 to 88 which impose on the parties obligations to take steps to preserve the goods.

The language of Article 7(1) suggests that it will not be used for the interpretation of contractual documents, merely for the interpretation of the Convention, but its effect will be felt through the application of the Articles of the Convention, including those listed above.

6. Application of Convention to financial instruments

Two approaches

Part I Chapter I of the Convention concerns its sphere of application. Two different views may be taken of the application of the Convention to financial instruments, depending on whether a functional approach or a formal approach is taken to the interpretation of the provisions of Part I Chapter I.

Two contrasting approaches to legal interpretation are traditionally identified, namely functionalism and formalism. In cases where the letter of a provision appears to be inconsistent with its apparent purpose, formal interpretation has regard to the former and functional interpretation has regard to the latter.

Provisions

Article 1(1) provides *inter alia* that the Convention applies to contracts for the sale of goods. The term 'goods' is not defined in the Convention. The meaning of the term 'goods' in English law is confined to *choses in possession* and excludes *choses in action*.[12] However, it is understood that, under the law of certain contracting states, the term 'goods' may include *choses in action*.

Article 2(d) provides that the Convention does not apply to sales 'of stocks, shares, investment securities, negotiable instruments or money'.

Functional interpretation of provisions

The apparent purpose of these provisions is to create a sphere of application for the Convention that includes chattels but excludes financial instruments. This is consistent with the references in the preamble to the Convention to the promotion of 'international trade'; the natural meaning of that term is trade in physical assets, including commodities, rather than the provision of financial services. No ambition to regulate financial services is suggested by the terms of the Convention. Indeed the wording of article 2(d) is clearly an attempt, made in light of the financial markets as they existed in 1980, to remove financial instruments from its scope.

Thus, the interpretation of the term 'goods' in Article 1(1) to exclude *choses in action* is consistent both with English domestic law and with the apparent purpose of the Convention.

It was indicated in Section 4 paragraph 5, that physically settled commodity derivatives may amount to contracts for the sale of goods for the purposes of Article 1(1). However, the effect of the purposive interpretation indicted in Section 6 paragraph 2, is that all

12 Sale of Goods Act 1979 s. 61(1).

other types of financial instrument, including financial derivatives and cash settled commodity derivatives, are out with the scope of Article 1(1) and therefore of the Convention.

The list in Article 2(d) by no means exhausts the wide range of financial instruments traded today. However, it must be remembered that the provision was drafted over a quarter of a century ago, during which time the financial markets have undergone unprecedented innovation and growth, which has led to the development of financial instruments not within Article 2(d). It must be remembered that "... a rule is hostage to future developments which render the application of the rule uncertain.... Rules thus need a sympathetic audience if they are to be interpreted and applied in a way which will further the purpose for which they were formed; rule maker and rule applier are to this extent in a reciprocal relationship."[13]

The existence of the exclusion in Article 2(d) is consistent with the interpretation indicated in Section 6 paragraph 2, on the basis that the Convention was drafted before the dematerialization of financial instruments became widespread. Bearer securities and negotiable instruments in traditional form were still in customary use; these are categorized as *choses in possession* and therefore fall *prima facie* within the scope of article 1(1). This explains the need for the specific exclusion in Article 2(d).

A functional approach to interpretation is now prevailing over formalism in many branches of English law, including the interpretation of implementing EU legislation,[14] statutory interpretation more generally,[15] financial services regulation[16] and the interpretation of contracts.[17] A purposive approach is also taken in accounting standards.[18] Thus, the trend is towards functionalism[19] and the better view is that the Convention should be taken not to apply to intangibles.

Formal interpretation of provisions

However, a formal approach cannot be ruled out entirely. One possible formal interpretation of the provisions would be:

(i) to take 'goods' in Article 1(1) to include *choses in action*[20] and

13 J Black, *Rules and Regulators* (Clarendon Press, Oxford 1997) 12.

14 *DG of Fair Trading v First National Bank* Plc [2002] 1 AC 481; see also *Alfa Telecom Turkey Limited v Cukurova Financial International Limited and Cukurova Holdings A.S., Cukurova Finance International Limited* and *Cukurova Holdings A.S. v Alfa Telecom Turkey Limited*, The High Court of the British Virgin Islands, 2007, Claim Nos 072, 119.

15 *Pepper (Inspector of Taxes) v Hart* [1993] AC 593.

16 FSA Handbook, GEN 2.2.1.

17 *Investor Compensation Scheme v West Bromwich Building Society* [1998] 1 All ER 97.

18 FRS 5, Accounting Standards Board, 14.

19 '...we are not legislating in the clouds, but for actual human events that happen in the community....' *Gould v Curtis (Surveyor of Taxes)* [1913] 3 KB 84, per Kennedy LJ at 98.

20 The decision in *Cukurova* refers to three principles for the interpretation of EU implementing legislation, which might be applied by analogy to the implementation of the Convention. 'The first concept is that of "autonomous meaning", which is that terms in legislation implementing European Union/Community directives can have a meaning different from the meaning of those terms in national law. In other words, phrases and concepts will be interpreted in a way which may not be consistent with how they may be interpreted in national law; the courts will give them a meaning which can be applied uniformly in all member states'. at para 28. Thus, 'goods' in art 1(1) might be taken to include *choses in action* because that is how it is interpreted in the domestic law of a number of contracting states and the fact that it does not have this meaning under English law is not necessarily conclusive.

(ii) to take the list of excluded financial instruments in article 2(d) to be exhaustive.

The result of such a formal interpretation would be that certain financial instruments are not covered by the exclusion, ie included within the scope of the Convention.

An important example is credit claims. While the rights of lenders under bank loans of course existed when the Convention was drafted, active secondary markets for the sale and purchase of such claims had not developed as they have today. The size, typical liquidity and economic importance of the contemporary secondary loan, securitization and credit derivatives markets cannot be over-emphasized. They attract considerable regulatory attention, particularly in the light of the current credit crunch. These markets are already experiencing stress and the introduction of the uncertainties outlined in Section 4 above would be regrettable.

In order to address this risk, it is important that any implementing legislation should clarify that it does not apply to financial instruments other than physically settled commodity derivatives. It is not within the intended scope of the Convention that it should apply to financial instruments other than the physically settled commodity derivatives we have mentioned. It is therefore entirely legitimate, and indeed important, for this to be made express in any legislation enacted in order to implement the Convention, if and when that time arises.