Contract Validity and the CISG: Closing the Loophole

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[1] Introduction:

The United Nations Convention on Contracts for the International Sale of Goods (CISG) was created as an answer to the question of how to create uniformity in the business practices of parties in different countries. Work was begun on the CISG in 1968 by the United Nations Commission on International Trade Law (UNCITRAL). A Working Group, made up of representatives of the member countries in UNCITRAL, was commissioned to prepare a document that would "facilitate acceptance by countries of different legal, social and economic systems."[3] The draft was completed by 1978, and in 1980, a Diplomatic Conference representing 62 States finalized the text in Vienna.[4] As of July 17, 2007, seventy-one states have ratified the convention.

The Preamble to the Convention expresses the drafters' position that "the adoption of uniform rules which govern contracts for the international sale of goods and take into account the different social, economic and legal systems would contribute to the removal of legal barriers in international trade and promote the development of international trade." It is with this hope that the drafters went on to detail the requirements to be met in forming a sales contract, as well as the rights and obligations of the seller and buyer. However, it is in spite of this stated purpose that the Convention leaves open a loophole, which is the source of conflict among signatory parties.

[2] Ambiguity Created by Article 4(a):

Part I of the CISG lays out the parameters of the Convention's application- which issues it covers and which it does not. One such issue is validity, which is excluded from the CISG in Article 4(a):

> ***This Convention governs only the formation of the contract of sale and the rights and obligations of the seller and the buyer arising from such a contract. In particular, except as otherwise expressly provided in this Convention, it is not concerned with:***
>
> > ***(a) the validity of the contract or of any of its provisions or of any usage***

From looking at the drafting history of Article 4(a), it is evident that the validity exception was included in order to protect the differing interests that are safeguarded by different domestic laws.[5] The history shows that the drafters designed Article 4(a) to "serve as a loophole which could stretch to fit the needs of each domestic legal system."[6] However, the article which was supposed to provide flexibility to an otherwise rigid set of rules in order to allow for international differences has sprouted further complications. Because Article 4 does not define validity, the task of determining when a cause of invalidity exists and what its consequences are is left to the various domestic legal systems.[7] Because these legal systems have no central formula to rely on, "the very reason for excluding issues of validity- the differing and strongly felt national traditions- suggests that judges and arbitrators will be tempted to enforce domestic rules of validity."[8] For example, on nations law may allow the use of parole evidence, while another may not. In light of the Convention's stated goals of achieving uniform rules to promote international trade, the issue becomes "to what extent [does] applying non-uniform domestic rules of validity to contracts for the international sale of goods seriously [handicap] the CISG's potential for achieving its goals?"[9]

While it may be argued that performing a simple conflict of laws analysis to determine which state's validity rules apply circumvents the ambiguity created by Article 4(a), a problem arises when the causes of invalidity proscribed by domestic law deal with circumstances that also give rise to remedies under the CISG.[10] For example, some domestic laws state that the absence of a definite price term voids the contract "since agreement on the price is regarded as one of the "essentialia" of a contract of sale."[11] According to Article 55 of the CISG, however, if there is no definite price term, "the parties are considered…, to have impliedly made reference to the price generally charged at the time of the conclusion of the contract for such goods sold under comparable circumstances in the trade concerned." While a consensus exists regarding certain validity issues, such as duress, in this instance, it is evident that an issue labeled as one of validity by domestic law may merit different consideration in the international context.[12] This fact has been the subject of great debate over how to resolve the ambiguity created by Article 4(a).

[3] Different Approaches in Interpreting Article 4(a :

In beginning one's analysis of the ambiguity, a good first step is to look at the drafting history of the article in order to gain some insight as to why the article was drafted the way it was. The history of Article 4(a) suggests that the drafters purposely worded the clause ambiguously. The Working Group did consider several proposals for validity provisions to be included in the Convention, but ultimately decided against incorporating them.[13] The drafting history indicates that fear of an inability to reach agreement or

substantial delays resulting from debate led the drafters to postpone discussing validity; their vehicle for the postponement was the ambiguous wording of Article 4(a).[14] The drafters did not dismiss the validity issue completely; they simply "deferred it to those who would later interpret the Convention."[15] However, the history also reveals that the CISG drafters did not intend for the validity exception to provide carte blanche for applying domestic public policy laws to international transactions.[16] It is for this reason that it is important to create uniform guidelines regarding the interpretation of Article 4(a).

The first of these guidelines has already been created by the drafters of the CISG themselves. Article 7(1) of the Convention states: "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." This article suggests that, even in situations where domestic law is to be applied, it should be applied narrowly in order to "allow the Convention to have the widest possible application consistent with its aim as a unifier of legal rules governing the relationship between parties to an international sale."[17] In other words, the term "validity" must be defined in light of the CISG as a whole.[18]

Keeping in mind the nature of the Convention, commentators have proposed an analysis process to aid in the interpretation of Article 4(a) that is based on the language of the article itself. The "crucial question," according to these commentators, is whether the circumstances invoke both a domestic rule as well as a rule of the Convention.[19] If they do, the "except as otherwise expressly provided" clause in Article 4(a) comes into play; since the Convention expressly provides a rule to apply under the circumstances, domestic law is inapplicable. One example is the CISG rule on form. Article 11 states that "a contract of sale need not be concluded in or evidenced by writing and is not subject to any other requirement as to form." Because the form requirement is expressly excluded from the Convention, tribunals are prohibited from applying domestic writing requirements. Conversely, for issues which are not addressed by any provisions of the Convention, reference must be made to domestic law.[20] Issues falling under this category include illegality, capacity, fraud, mistake, duress, and unconscionability.[21] It is these issues that are held by a consensus of the various domestic legal systems to be issues of validity. One explanation for this fact is that the Convention only covers rights and obligations arising from a contract, and issues such as fraud arise from the process of concluding the contract and not the contract itself.[22]

This analysis referring to the negative rule excluding validity issues in Article 4(a) and the positive rule of "except as otherwise expressly provided" is just one of several theories as to how the validity exception should be interpreted. Another suggested approach is to view all applicable domestic

laws that are considered "mandatory" by the State to be issues of validity.[23] Such an approach may be advocated by critics of the "critical question" method, who feel that "if all issues addressed by the Convention were classified as non-validity issues, the question of validity would never arise", and the "expressly provided" provision would be redundant.[24] The method would also ignore the fact that several provisions of the CISG address issues that are considered validity issues by some domestic legal systems. Furthermore, imposing domestic restrictions on international sales transactions would impose an "unfortunate, if inevitable, conflict between the philosophy of freedom of contract generally enshrined in the Convention and a restriction on that freedom, governed by national law."[25]

[4] CISG Case Law on Article 4(a):

Although there is no uniform rule on contract validity, past court decisions ruling on the issue may serve as a looking glass through which the perspectives of the various legal systems may be observed. One such court decision comes from an Austrian case that dealt with the validity of a specific contractual clause.[26] In this case, the German seller (plaintiff) delivered gravestones to the Austrian buyer (defendant), who later discovered a defect in the product. Upon discovering the defect, the buyer retained his payment and sent one of the stones back for examination. Although he eventually used some of the other stones, the seller filed suit, claiming that the conditions agreed to by the buyer included a clause excluding the buyer's right of retention, even in the case of non-conforming goods. The Austrian Supreme Court ruled on the validity of the non-retention clause, holding that clause validity is an issue of domestic law.[27] While the Court went on to apply German law as per a conflict of rules analysis, it also held that any domestic provisions which contravened the principles upon which the CISG was based would be disregarded. Also, although the Court considered invalidating the German law that excluded a party's right to avoid a contract, it ultimately held that the law granting a party the right to compensatory damages was sufficient.[28] Consequently, the contract clause excluding the right of retention was held to be valid.

Another issue dealt with by courts is consideration, which was the subject of a 2002 United States case.[29] In this case, the New Jersey buyer brought suit against the Canadian seller, alleging breach of contract. Among other things, the defendant argued lack of consideration. In addressing this claim, the Court first stated: "By validity, the CISG refers to any issue by which the domestic law would render the contract void, voidable, or unenforceable."[30] The Court classified the subject of consideration as such an issue. To determine which domestic law would apply, the Court applied a conflict of law analysis, and subsequently determined that there was sufficient consideration under New Jersey law.[31]

[5] Israeli Law Regarding Contract Validity:

As the stated purpose of the CISG is to remove legal barriers in international trade, it would be a logical step to look not only at international court cases, but also at the laws of the various legal systems themselves, as the foundation on which to build uniform law; one such system is that of the State of Israel. While the nation incorporated the CISG into its laws in 1999, it retained its own regulations for contract formation, which are expressed in Contracts Law (General Part), 1973. Subjects that are covered by the Convention, such as offer and acceptance, are discussed, as well as subjects that are not- the most significant being invalidity.

Article thirty of the Contracts Law states that if the content or object of a contract is "illegal, immoral, or contrary to public policy", it is void.[32] Furthermore, articles fourteen through eighteen list factors that, if present, allow a contracting party to rescind the contract: mistake, deceit, duress, extortion. Mistake is defined as a mistake of fact or law which does not include a mistake about the "worthwhileness" of the deal.[33] The article further states that mistake is ground for rescission only if the contract cannot be preserved by rectifying the mistake. Deceit is defined as "the nondisclosure of facts which the other party, according to law, custom or circumstances, should have disclosed," and is grounds for rescission when it has resulted in a mistake by the victim party who entered into the contract only in consequence of that mistake.[34] Duress is grounds for rescission if a person has entered into a contract due to force or threats applied by the other party, subject to the limitation that "a bona fide warning that a right may be exercised does not constitute a threat."[35] Finally, rescission by reason of extortion is allowed if a party or his agent takes advantage of the distress, inexperience, or mental or physical weakness of the other party, and the terms of the contract are unreasonably less favorable than is customary.[36]

[6] Israeli Case Law on Contract Validity:

In order to use Israeli law as a model for creating a uniform law on contract validity, one cannot only look at the law, but must also observe how it has been applied by the Israeli courts. In ***Ben Lulu v. Atrash Elias***[37], the plaintiff and defendant had come to a settlement agreement regarding an accident in which the plaintiff was injured; the agreement barred all future claims. Upon discovering new injuries, the plaintiff again brought suit against the defendant, who claimed that this suit was prohibited by the original agreement. The Supreme Court ruled that a contract is a device for allocating risk and that a court must not interfere with an otherwise valid contract just because the parties included a known certainty when drafting their agreement[38].

While uncertainty is not grounds for invalidation, contracts based on deception have been held by the Israeli Supreme Court to be void. In ***Meir Vofna v. Ogash***, a couple was looking to buy a home in a quiet neighborhood; the seller of a home insisted on showing the buyers the house only on a Saturday, the Jewish day of rest.[39] After signing the agreement, the buyers learned that the house is near a noisy construction zone, and that the seller intentionally deceived them by showing the house on the day that no construction is done. The court annulled the agreement[40].

Duress has also been found to be grounds for contract annulment. In ***Rahamim v. Expomedia Ltd[41],*** a joint venture in a fair sought to annul his joint venture agreement on the grounds that the defendant forced him to invest more money by threatening to end the project before it began. The Israeli Supreme Court ruled that economic pressure is sufficient grounds to annul an agreement.[42] In ***Diyur Laole Ltd. V. Keren***[43], the court held that duress can be found at any point before the agreement is signed, up until the actual signing, but not at any time after that[44].

Finally, in a case where a woman was seeking to annul her marriage contract, the Israeli court referencing Article 30 of Israel's Contract Law in stating that a court can annul a contract which goes against the values, interests, and major vital principles that the legal system was seeking to preserve and develop.[45]

[7] Comparison to Other Legal Systems:

In formulating a uniform law regarding contract validity, it is also important to look at how the laws of specific signatory countries relate to each other. For example, the aforementioned Israeli validity rules are similar to those of China. According to the Contract Law of the Peoples Republic of China, a contract is void if it is created through the use of fraud or coercion, has an illegitimate purpose, is damaging to the public interest, or violates compulsory laws and regulations.[46] Further, a party has the right to request a court to modify or revoke a contract which is the result of a significant misconception, was obviously unfair at the time of its conclusion, or was concluded by exploiting a party's unfavorable position.[47]

Also similar to Israeli law is European contract law, codified in The Principles of European Contract Law 1998, Parts I and II.[48] According to these principles, a contract may be avoided if it was concluded as a result of fraudulent misrepresentation, fraudulent non-disclosure, an imminent of serious threat, or the other party had excessive benefit or unfair advantage.[49] Specific contract clauses may be avoided if they have not been individually negotiated and cause a significant imbalance in the rights and obligations of the parties.[50]

These three law systems are just a small portion of the seventy-one nations whose interests must be addressed. Comparing the laws of the various signatory countries is key in ensuring that the uniform law on validity, once formulated, will not stray too far from the interests of each nation, and will strike a balance that will suit the stated goals of the CISG.

[8] Conclusion:

When the drafters of the CISG set out to create a uniform law, their stated purpose was to promote the development of international trade while keeping in mind the varying world legal, social, and economic systems. While many issues were addressed and resolved in creating the CISG, the issue of validity has remained a heavily-debated and enigmatic one. Supporters may claim that deferring contract validity to the several domestic systems allows flexibility, but the fact remains that as long as there is no uniform law regarding the subject, different court systems will apply different law, and parties will have no continuity in their expectations. In order to create such a uniform law, one must look to the laws of the various states, such as Israel, and find a consensus among the laws on issues such as mistake, duress, and illegality.

Until this difficult process can be completed however, practicing lawyers are left with the dilemma of how to protect their clients and the contracts to which they are parties; the answer is twofold. First, a prudent attorney drawing up an international contract should consult an attorney from the other party's country, in order to ensure that the agreement's validity will hold up in both forums. Second, since a contract drawn up according to the CISG is subject only to the laws of the CISG, it is crucial to expressly designate the choice of law to be referred to in case an issue arises for which the CISG has no resolution (i.e. contract validity). If these two steps are taken, the potential for conflict between two parties regarding contract validity will be decreased. Until a uniform law or treaty is created, it falls on attorneys to "promote the development of international trade."

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[3] Patrick C. Leyens, *CISG and Mistake:* ***Uniform Law vs. Domestic Law*** *[The Interpretive Challenge of Mistake and the Validity Loophole* (2003)*, available at* http://cisgw3.law.pace.edu/cisg/biblio/leyens.html#con.

[4] *Id.*

[5] Helen Elizabeth Hartnell, *Rousing the Sleeping Dog: The Validity Exception to the Convention on Contracts for the International Sale of Goods*, 18 Yale. J. Int. Law 1-93 (1993), *available at* http://cisgw3.law.pace.edu/cisg/biblio/hartnell.html

[6] *Id.*

[7] Ulrich Drobnig, *Substantive Validity*, 40 Am. J. Comp. L. 635-644 (1992), *available at* http://cisgw3.law.pace.edu/cisg/biblio/drobnig2.html.

[8] John A. Spanogle & Peter Winship, *International Sales Law: A Problem-Oriented Coursebook*, 131-132 (2000).

[9] Hartnell, *supra.*

[10] Drobnig, *supra.*

[11] *Id.*

[12] **Hartnell**, supra.

13 **Christoph R. Heiz**, *Validity of Contracts Under the Untied Nations Convention on Contracts for the International Sale of Goods*, 20 Vand. J. Transnat'l L. 639-663 (1987), *available at:* http://cisgw3.law.pace.edu/cisg/biblio/heiz.html.

[14] Hartnell, *supra.*

[15] *Id.*

[16] *Id.*

[17] *Id.*

[18] Heiz, *supra.*

[19] *Id.*

[20] Spanogle, *supra.*

[21] Dr. Peter Schlechtriem, *Uniform Sales Law - The UN-Convention on Contracts for the International Sale of Goods* (1986), *available at* http://cisgw3.law.pace.edu/cisg/biblio/schlechtriem-04.html.

[22] Heiz, *supra.*

[23] Hartnell, *supra.*

[24] Leyens, *supra.*

[25] Hartnell, *supra.*

[26] **Oberster Gerichtshof**, 8 Ob 22/00v, 7 September 2000.

[27] *Id.*

[28] *Id.*

[29] ***Pharmaceuticals Tech. Corp. v. Barr Labs. Inc.*** 201 F.Supp.2d 236 (2002).

[30] *Id.*

[31] *Id.*

[32] Article 30 of the **Israeli Contract (General Part) Law**, 1973.

[33] *Id* at Article 14(d).

[34] *Id* at Article 15.

[35] *Id* at Article 17.

[36] *Id* at Article 18.

[37] Civil appeal 2495/95 ***Hadas Ben Lulu v. Atrash Elias***, Supreme Court Verdicts vol. 51(1), page 583 (1997).

[38] For further verdicts regarding Mistake in Contract see also: Civil appeal 406/82 ***Nahmani V. Galor***, Supreme Court Verdicts vol. 41(1), page 494; Civil appeal 2444/90 ***Aroesti v. Kashi***, Supreme Court Verdicts vol. 48(2), page 513; Civil appeal 8972/00 ***Shlezinger v. Hafenix Hevra Lebituah***, Supreme Court Verdicts vol. 47(4), page 814.

[39] Civil appeal 373/80 ***Meir Vofna v. Dan Ogash***, Supreme Court Verdicts vol. 31(2), page 215 (1981).

[40] For further verdicts regarding Deception in Contract see also: Civil appeal 494/74 ***Hevrat Beit Hashmonaim v. Aharoni***, Supreme Court Verdicts vol. 30(2), page 141; Civil appeal 838/75 ***Spector v. Tzarfati***, Supreme Court Verdicts vol. 32(1), page 231; Civil appeal 488/83 ***Tzan'ani v. Agmon***, Supreme Court Verdicts vol. 38(4), page 141; Civil appeal 373/80 ***Meir Vofna v. Dan Ogash***, Supreme Court Verdicts vol. 31(2), page 215 (1981).

[41] Civil appeal 8/88 ***Shaul Rahamim v. Expomedia Ltd.***, Supreme Court Verdicts vol. 43(4), page 95 (1989).

[42] *Id.*

[43] Civil appeal 5493/95 ***Diyur Laole Ltd. V. Shoshana Keren***, Supreme Court Verdicts vol. 50(4), page 509 (1996). This case involved an agreement by two neighbors to move out of their building. One year after the agreement, they claimed they were forced to sign by their other neighbors.

[44] For further verdicts regarding Duress in Contract see also: Civil appeal 403/80 ***Sassi v. Kikaon***, Supreme Court Verdicts vol. 31(1), page 762; Civil appeal 784/81 ***Shaffir v. MArtin***, Supreme Court Verdicts vol. 39(4), page 149; Civil appeal 4839/02 ***Ganz v. Katz***, Supreme Court Verdicts vol. 48(4), page 749; Civil appeal 1569/93 ***Maya v. Penford***, Supreme Court Verdicts vol. 48(5), page 705; Civil appeal 6234/00 ***SH.A.P Ltd v. Bank Leumi***, Supreme Court Verdicts vol. 37(6), page 769.

[45] Civil appeal 8256/99 ***Jane Doe v. John Doe***, Supreme Court Verdicts vol. 58(2), page 213 (2003). See also Civil appeal 148/77 ***Rot v. Yeshoofe***, Supreme Court Verdicts vol. 33(1), page 617; Civil appeal 661/88 ***Haymov v. Hamid***, Supreme Court Verdicts vol. 44(1), page 75; Civil appeal 139/87 ***Soolimani v. Katz***, Supreme Court Verdicts vol. 43(4), page 705; Supreme Court of Justice case 6051/95 ***Rekent v. Beit Hadin Haartzi***, Supreme Court Verdicts vol. 51(3), page 289; Civil appeal 695/89 ***Shilo v.*** Be'eri, Supreme Court Verdicts vol. 47(4), page 796.

[46] Contract Law of the Peoples Republic of China, *available at:* http://www.law-bridge.net/english/LAW/20064/0222320014345.html.

[47] *Id.*

[48] The Principles of European Contract Law 1998, Parts I and II, *available at:* http://www.jus.uio.no/lm/eu.contract.principles.1998/doc.html#207.

[49] *Id.*

[50] *Id.*