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Determining Fundamental Breach in International Sale of Goods: Taming the Unruly Horse?

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ABSTRACT

The remedy of 'avoidance' under CISG is not available for every breach of contract, except for a fundamental one. Many commentators are of the view that the meaning of "fundamental breach" is vague and uncertain. The present paper analyses the dual elements of 'fundamental breach' on the basis of interpretative tools of the Convention, legislative history and an in-depth survey of judicial decisions from various countries. The paper finds that it is too drastic to say that the meaning of fundamental breach is vague but on the contrary the meaning can be refined through judicial interpretation. The paper concludes that though it will take time for case law to completely cover most situations of fundamental breach, it is clear at this stage that a number of basic principles for the determination of fundamental breach are well settled and established.

Keywords: CISG, foreseeability, fundamental breach, remedy of avoidance, substantial detriment

INTRODUCTION

In view of the often harsh consequences of unilateral declaration of termination of contract, the United Nations Convention on Contracts for the International Sale of Goods (CISG) 1980 provides for rather far-reaching and strict requirements for the remedy of avoidance. A party may resort to the remedy of avoidance only if the other party has committed a "fundamental breach. A simple or non-fundamental breach of contract does not entitle the aggrieved party to avoid the contract. It is the uniform conclusion of courts (*Bundesgerichtshof*, Germany, 1996, CLOUT Case No. 171) and doctrine (Honnold, 1999, p. 314) that "avoidance under the CISG is a remedy of last resort, or an *ultima ratio* remedy, which should not be granted easily."

The main objective of this paper is to investigate the claim that the true meaning of fundamental breach under CISG is vague

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and uncertain. Following this introduction, the paper digs deeper into the concept of fundamental breach and continues with an analysis of the CISG interpretative tools. The paper also evaluates the legislative history of fundamental breach as it appears in article 25 of the CISG. The key contribution of the paper is its thorough analysis of case law on fundamental breach in the light of CLOUT and Pace University database on CISG.

THE CONCEPT OF FUNDAMENTAL BREACH

In the CISG, "avoidance" is not available for every breach. A party may avoid the contract only when the other party commits a "fundamental breach." Why is it limited so? The reason lies in the underlying objective of CISG to maintain as much as possible the successful performance of the contract and also the fact that avoidance may create unnecessary and unproductive costs (Pauly, 2000). Some commentators are of the view that the definition of fundamental breach in article 25 is vague (Graffi, 2003b). Will (1987) predicted that "as a fruit of world-wide compromise, the definition of fundamental breach may not always be easy to apply both for the parties and the judges, and foreseeably may give rise to divergent interpretation and continuous controversy". Zeller (2007), however, disagrees with this criticism. Ferrari (2006) holds the view that "it is possible to define the concept of fundamental breach on the basis of the elements by which it is characterized." As rightly put by Ferrari (2006), the elements of fundamental breach can be interpreted by courts and tribunals of the Contracting States by applying the interpretative tools provided in the Convention.

CISG INTERPRETATIVE TOOLS

There are two types of interpretative tools under CISG: interpretation of CISG provisions (article 7) and interpretation of the contract (article 8). In respect of the rules concerning the Convention's interpretation, there are three primary rules of interpretation enshrined in article 7, namely: (i) the "international character" of the CISG; (ii) the promotion of "uniformity in application"; and (iii) the observance of "good faith in international trade."

Rules on contract interpretation enshrined in article 8 are of utmost importance for the determination of "fundamental breach." This is due to the fact that before such a determination can be made, it is necessary for courts and tribunals to ensure whether there is a substantial deprivation of what the injured party is entitled to expect under the contract (Zeller, 2007). Article 8 puts forward two sets of criteria: subjective and objective. According to the subjective interpretation, "statements made by, and other conduct of, a party are to be interpreted according to his intent, where the other party knew or could not have been unaware what that intent was" [article 8(1)]. The objective interpretation is that if the parties have a different understanding of the meaning of the contract, the language of the contract has to be interpreted "according to the understanding that a reasonable person of the same kind as the other party would

have had in the same circumstances" [article 8(2)]. In so doing, due consideration is to be given to all "relevant circumstances of the case, including the negotiations, any practices which the parties have established between themselves, usages and any subsequent conduct of the parties" [article 8(3)].

INTERPRETING FUNDAMENTAL BREACH IN LIGHT OF LEGISLATIVE HISTORY

Article 25 defines 'fundamental breach' with two component elements, namely, substantial detriment and unforeseeability. Legislative history is one important way of ascertaining the meaning of fundamental breach in the light of these two component elements.

The First Element: Substantial Detriment

For a breach to be "fundamental," the breach must cause a "detriment that substantially deprives the non-breaching party of its reasonable expectations under the contract" (CISG, article 25). This detriment concept developed out of the perceived weaknesses of the Uniform Law on the International Sale of Goods (ULIS), which in particular relies entirely on foreseeability test alone. The substantial detriment test remedies those weaknesses.

According to the legislative history of CISG, "[t]he determination whether the injury is substantial must be made in the light of the circumstances of each case, e.g., the monetary value of the contract, the monetary harm caused by the breach, or the extent to which the breach interferes with other activities of the injured party" (Commentary on draft CISG). Huber and Mullis (2007) clearly refer to the '*legitimate interests of the promisee*,' who is a merchant. This '*contractual expectation*' is key on the basis of which courts and tribunals will determine whether there is any substantial detriment (injury) to the non-breaching party to the extent that it amounts to a fundamental breach.

The Second Element: Foreseeability

The 'foreseeability' element of article 25 includes two tests. According to the legislative history of the CISG, the first test, a subjective one, merely requires whether the party in breach actually foresees the detriment that will cause the non-breaching party (Bianca & Bonell, 1987). The second test, an objective one, requires the breaching party to show that "a reasonable person of the same kind in the same circumstances would not have foreseen the detriment to the non-breaching party." Since parties to international sales contracts are presumed to be merchants [CISG article 2(a)], a "reasonable person" may be construed as a reasonable merchant. The phrase "of the same kind" refers to a merchant in the same business as the party in breach (Bianca & Bonell, 1987).

DETERMINING FUNDAMENTAL BREACH IN CASE LAW

Perusing through the case law on article 25 of CISG, the following are the findings.

Case law is categorised into three groups: (1) non-performance of a basic contractual obligation; (2) late performance; and (3) non-conformity of the goods.

Non-Performance: A Complete Failure to Perform a Basic Contractual Obligation

A complete failure to perform a basic contractual obligation is a typical case of a fundamental breach. This may be "non-delivery" in the case of a seller and "non-payment of the price" in the case of a buyer. The total *non-delivery* on the part of the seller is without doubt the most serious and fundamental breach and the buyer has every right to avoid the contract. In case law, however, such a clear-cut situation is a rarity and there is a decided case, which illustrates a *very late* and still a *partial delivery* of the goods. In *Foliopack v. Daniplast* (CLOUT case No. 90, Italy Court of First Instance Parma, 1989), the Italian Court found that considering the statements made by and conduct of the parties, it was the obligation on the part of the seller to deliver the goods in a week. It was held that "the delay by the seller in delivering the goods, together with the fact that two months after the conclusion of the contract, the seller had delivered only one third of the goods sold, amounted to a fundamental breach."

On the other hand, a simple case of *partial non-delivery* is not a fundamental breach. In *Shoes* case (CLOUT case No. 275, Germany, 1997), an Italian manufacturer sold shoes to a German buyer but failed to deliver the agreed quantity. The manufacturer demanded partial payment and the buyer wanted to avoid the contract. The German Appellate Court held that "partial delivery did not lead to a fundamental breach of contract. Non-delivery on the agreed date of performance will amount to a fundamental breach only if the buyer has a special interest in delivery on time by which the seller can foresee that the buyer would prefer non-delivery instead of late performance (for example, in the case of seasonal merchandise)."

Late Performance: Late Delivery or Late Payment

The general rule is that *late performance* by itself is not a fundamental breach of contract, *unless the time is of the essence* by virtue of the terms of the contract or the relevant circumstances of the case. In the context of *late delivery* in *Italdecor v. Yiu'sIndustrie* (1998), Milan Appellate Court, Italy, decided that, "According to article 33 of CISG, the seller must deliver the goods on the date fixed in the contract. In the pending case, taking into account clarifications between the parties in the days following the agreement, there is no doubt that the agreed time of delivery was a fundamental term and that the contract turned on the availability of the goods just before buyer's end of the year sales. However, the seller let the fixed time pass without any excuse; this behaviour is unjustifiable."

Again, in *Diversitel v. Glacier* (CLOUT case No. 859, Canada, 2003), the buyer, a Canadian company doing business in

research and development of satellite and terrestrial communications entered into a contract with the seller, an American company. The buyer required delivery of insulation to meet the terms of a pre-existing contract with the Canadian Department of National Defence (DND). As a term of its contract with the seller, the buyer set out a specific schedule of delivery of the insulation by the defendant. The seller failed to deliver on time. The Supreme Court of Ontario found that, "*the parties had made time of the essence* in the contract by their conduct and communications, and held that the seller's failure to perform in time was thus a fundamental breach".

Non-Conformity of the Goods

As we have seen above, total non-performance of the contract is a clear-cut case of a fundamental breach. Nevertheless, the overwhelming majority of cases on CISG are those of non-conformity. The buyer can avoid the contract if defective goods are delivered and if non-conformity can be considered as a fundamental breach of contract under the CISG [article 49(1)(a)]. The question that can be raised here is under what circumstances delivery of non-conforming goods constitutes a fundamental breach.

A difficult question is how to determine the '*substantial deprivation of contractual expectation*'. According to Schlechtriem and Schwenzer (2010), a buyer, who can make use of the goods (even if it is not the use which is intended at the time of the conclusion of the contract), ought to retain the goods and claim instead a price reduction or damages or both. It is a fact that when goods have been shipped across national frontiers, the cost of sending them back to the seller definitely will be too expensive and cumbersome. At the same time, it will be too harsh on a buyer to be told that he will have to keep the goods and, at some considerable cost and with unreliable prospects of recovering damages, sue a distant and uncooperative seller (Bridge, 2010). The question is how to strike a balance and at what point serious become very serious.

A careful analysis of the case law indicates that non-conformity in relation to quality is merely a *non-fundamental breach* unless it can be shown that the buyer – "without unreasonable inconvenience - *can use the goods or resell them even at a discount*."

In the *Meat case* (CLOUT case No. 248, Switzerland, 1998), the German sellers delivered frozen meat by ship to Egypt and Jordan for a Swiss buyer. The buyer claimed lack of conformity of the goods. The Supreme Court of Switzerland found that "the difference in quality between that as had been agreed and that as was delivered was not significant enough to give the buyer the right to declare the contract avoided even though experts estimated that the decrease in value of the goods, which was too fat and too wet, amounted to 25.5%". The Court held that "since the buyer had had such alternatives as to otherwise process the goods or to sell them, ithad no right to declare the contract avoided. The buyer

could merely avail itself of a reduction in price of 25.5%".

The above analysis of case law demonstrates the following principles in determining a fundamental breach:

(a) As reaffirmed by the Swiss Federal Supreme Court in '*Packing Machine*' case: "[T]he term fundamental breach is to be interpreted narrowly. If it is doubtful, it should generally be assumed that no fundamental breach is existent".

(b) The requirement of 'contractual expectation' must be ascertained through objective standards, while mere subjective expectations are immaterial (*Packaging machine case*).

(c) In most cases, courts rely on interpretative tools in article 8 of CISG, taking into account not only the contract itself but all relevant circumstances of the case in order to decide on the severity of the deprivation of contractual expectation of the injured party (*Packaging machine case Foliopack v. Daniplast*; Garden *flowers case*).

(d) In the case of non-conformity, it must be a substantially serious one, which cannot be remedied within reasonable time and by reasonable efforts to the effect that the goods are practically useless, unmerchantable, or cannot be appropriately resold" (*Packaging machine case*; *Meat case*).

CONCLUSION

Article 25 of CISG defines fundamental breach; nonetheless, there are commentators who maintain that the notion of fundamental breach expressed in article 25 is uncertain and rather controversial. The present paper argues that although the components of the definition of fundamental breach (e.g., 'substantial detriment' and 'contractual expectations') appear to be a bit strange for many people, it is not fair to conclude that they are vague and uncertain. There are a growing number of judicial decisions (not less than 56 decisions) on the application of fundamental breach. These decisions have in one way or another contributed to the development of consistent judicial interpretation of the concept, leading towards the unification of laws governing international sale of goods, which is the stated objective of CISG.

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