THE UN CONVENTION FOR THE INTERNATIONAL SALE OF GOODS: IMPLICATIONS FOR HONG KONG AND CHINA

by

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MANY of you will no doubt be aware that in the medieval ages there existed a body of customary international law known as the *lex mercatoria* or law merchant. The law merchant was a collection of well-established and widely recognised customs and practices which regulated trade between merchants from different feudal localities. The law merchant was, in medieval times, the means by which uniformity of practice in international trade transactions could be and was in fact achieved. The uniform practices and principles of the law merchant inevitably facilitated the free flow of international commerce and diminished the likelihood of contractual disputes. It also had the effect of significantly curtailing the influence of peculiarly local customs on the conduct of international trade.

However, with the rise of the nation-state in the sixteenth and seventeenth centuries, and the subsequent importance attached to the notion of national sovereignty, the law merchant was subsumed within the national legal systems of the European states. This localisation of the law merchant, a phenomenon which has continued to this day, produced a legal vacuum as regards the international regulation of trade. In place of international regulation, national commercial laws have come to govern international sales contracts through the complicated and unpredictable medium of national conflict-of-laws rules.

The 1980 UN Convention on Contracts for the International Sale of Goods ('CISG') represents a truly global effort to re-establish a modern *lex mercatoria*. The culmination of fifty years

of consultation and drafting by UNIDROIT and UNCITRAL, CISG is a comprehensive uniform code regulating the major aspects of formation and performance of international sales contracts. The product of cooperative endeavour involving UNCITRAL delegates from Western developed states, the socialist states and the developing states of the Third World, CISG represents a synthesis of both common and civil law principles in respect to contracts and commercial sales. Like its ancient predecessor the law merchant CISG will, if adopted by enough states, establish a uniformity of practice in the conduct of international trade that will lead to freer trade among nations. In time, CISG may supplant the national commercial laws which currently regulate international commerce and we will, as a culture, have come full circle.

The UN Convention has already begun to move down this historic path. CISG entered into force on January 1 of this year, one year after the United States, the People's Republic of China and Italy deposited their instruments of ratification with the United Nations. This joint action by representative states of the three major legal systems in the world (common law, socialist law and civil law respectively) brought the number of ratifications to eleven, one more than the ten required to bring the convention into force in accordance with article 99. Besides the US, China and Italy, other contracting states at present include France, Argentina and Yugoslavia. Twenty-one other nations have signed but not ratified the convention, including the Federal Republic of Germany, Sweden, the Netherlands and Singapore. It is anticipated that these signatory states will, in the near future, ratify the convention as well. Australia has also begun the process of accession to the convention. Noteworthy is the absence of the United Kingdom. At present, the UK is neither a party nor a signatory to CISG and, consequently, CISG may only have relevance for the Hong Kong practitioner in certain limited situations. In due course, I shall identify those situations in which the convention may be of relevance to lawyers in Hong Kong.

As the title of the convention makes plain, the scope of application of CISG is limited to contracts for the international

sale of goods. Articles 1–3 of CISG deal with the scope of application of the convention.

First, the contract must be of an international character or as article 1(1) puts it: the contract must be 'between parties whose places of business are in different States.' In most contexts, the 'internationality' standard set forth in article 1(1) will not present any problems. An arms-length sales transaction between a US seller and a PRC buyer will clearly qualify as an international sale to be governed by the terms of CISG. However, problems may arise in certain contexts. First, the US seller may have *multiple* 'places of business'—including a representative office in Beijing, for example. In that case, internationality may be obviated because the US and PRC parties to the contract have places of business in the same State. To deal with this problem, article 10(a) of the CISG provides that the relevant 'place of business' is the one which has 'the closest relationship to the contract and its *performance*.' Article 10(a) stresses the *place of performance* of the contract as the relevant place of business for the purpose of determining the internationality of the contract. This approach is eminently practical in that the place of procurement or production of the goods is normally more important to both parties than the place where the contract is negotiated and signed. Thus, in our case of the Beijing representative office, which merely negotiates and signs the contract on behalf of the US parent corporation, the representative office would be disregarded as a place of business for the purpose of determining the applicability of the UN Convention.

Another related problem would involve the use of a PRC commercial agent to engage, say, in purchases of Chinese goods at the Guangzhou Trade Fair for a US principal. If the US principal is undisclosed, then the question arises as to whether the transaction is actually an international sale. Article 1(2) of CISG provides that the fact that the parties have their places of business in different states is to be disregarded whenever this fact does not appear either from the contract or any course of dealings prior to the conclusion of the contract. In the case of

an undisclosed US principal CISG, according to Article 1(2), could not apply.

Second, the transaction must be a 'contract of sale.' Consequently, gifts, bailments, leases and secured transactions are not within the scope of the convention. Moreover, article 2 of the CISG excludes certain types of sales transactions: (1) consumer sales (ie, 'goods bought for personal, family or household use'), (2) sales by auction and (3) sales on execution or otherwise by operation of law. Article 3 also excludes 'contracts for the supply of goods to be manufactured or produced' if the 'party who orders the goods undertakes to supply a substantial part of the materials necessary for such manufacture or production.' Thus, in the case of a US corporation entering into a compensation trade contract with a PRC manufacturing enterprise in which the US corporation supplies (through a Hong Kong branch office) most of the materials to be processed by the PRC enterprise, subsequent sales of the processed goods to the US corporation would not be considered a 'contract of sale.' Accordingly, most compensation trade contracts with the PRC would not covered by CISG. Article 3(2) also excludes contracts in which the preponderant part of the obligations of the party supplying the goods consists of supply of labour or other services. It is therefore unlikely that technology transfer contracts would fall within the scope of the convention.

Third, the transaction in question must be a sale of 'goods.' The term 'goods' is not defined by the convention. Instead, rules are provided for certain borderline cases. Article 2 provides that sales of investment securities, commercial paper, ships, aircraft, hovercraft and electricity are excluded.

The determination that a particular contract of sale is an 'international contract for the sale of goods' as defined by the convention, does not automatically mean that CISG will govern that contract. An international sale is subject to the convention only if the transaction bears a prescribed relation to one or more contracting states. CISG in articles 1(1)(a) and (b) prescribes two such relationships, either of which will suffice.

The principal criterion for establishing the applicability of the convention is set forth in article 1(1)(a), the so-called

'contracting states' criterion. Article 1(1)(a) states that where the parties have places of business in different states and *both* of those states are contracting states, the convention will apply.

The second criterion for application of the convention is set forth in article 1(1)(b), the so-called 'rules of private international law' criterion. Article 1(1)(b) provides that where the rules of private international law lead to application of the law of a contracting state, the convention will apply. Thus, where the parties' places of business are in different states and one of those states is not a contracting state, the convention will nonetheless apply if the rules of private international law of the forum hearing the case lead to the application of the law of a contracting state.

Owing to the uncertainty of application and potentially wide applicability of the CISG under the article 1(1)(b) criterion, many of the present contracting states have opted not to be bound by this criterion by express reservation under article 95. Both the US and the PRC have made express reservations under article 95. Consequently, the 'rules of private international law' criterion for application of the CISG is of limited practical significance. In most contexts, the only way for the convention to apply to an international sales transaction is under the contracting states' criterion, namely, where the parties have places of business in different contracting states.

Because article 1(1)(a) provides the sole criterion for application of CISG in most cases, the relevance of the convention for Hong Kong is quite limited. As previously mentioned, the United Kingdom is not a party to CISG. Until such time as the United Kingdom accedes to CISG, there is no possibility of the convention applying *ipso facto* to international sales contracts concluded by Hong Kong companies or individuals. Consequently, Hong Kong parties, even when they enter into national sales contracts with parties from contracting states, will not be bound by CISG. There are, however, three situations in which the convention may be relevant for the Hong Kong practitioner.

First, Hong Kong may be the forum for a dispute involving parties from different contracting states. The forum may be the

Hong Kong courts or the Hong Kong International Arbitration Centre. In the interests of brevity, I shall restrict my remarks to the Hong Kong courts.

The Hong Kong courts would not be bound to apply CISG as neither the United Kingdom nor Hong Kong is a party to the convention. Rather, the courts would employ their own conflict-of-laws rules to determine the proper law of the contract. In the event that the conflicts rules led to the application of the law of a contracting state, then CISG would apply.

Of course, at the outset, the Hong Kong courts must have jurisdiction to hear a case involving, inter alia, two companies with places of business outside of the territorial limits of Hong Kong (ie., in contracting states). Jurisdiction over a foreign or oversea company will exist provided that the company is 'present' or 'carrying on business' in Hong Kong. In this regard, section 332 of the Companies Ordinance (cap 32, LHK 1984 ed), provides the relevant test: does the oversea company have an 'established place of business' in Hong Kong? If it does, then by section 338 of the Companies Ordinance, service of a writ on the oversea company is permitted.

To determine whether an oversea company has an 'established place of business' under the Companies Ordinance, the Hong Kong courts have relied on common law decisions which have dealt with the meaning of 'carrying on business.' However, in the wake of *South India Shipping Corporation Ltd v Export-Import Bank of Korea* [1985] 2 All ER 219 (CA) such common law decisions should only constitute a guide, not a set of talismanic requirements, on the issue of whether an oversea company has an 'established place of business' under the Companies Ordinance.

In the case of an international sales transaction involving parties from two contracting states, one of which has a branch office in Hong Kong, jurisdiction of the Hong Kong courts should attach. A Hong Kong branch office would constitute an 'established place of business' so long as the branch has a fixed and definite place of business in Hong Kong. As *South India Shipping* makes abundantly clear, it is not even necessary for the

branch to be authorised to enter into contracts on behalf of the oversea company in order for jurisdiction to attach. In that case, a Korean bank had a branch office in London which merely passed on financial information to the Korean head-quarters.

In the case of an international sales transaction involving parties from different contracting states, one of which has an agent in Hong Kong, the jurisdiction of the Hong Kong courts is more problematic. In *The Artemis* [1983] HKLR 364, a case involving Hong Kong ship agents, the Court of Appeal held that the place of business of a Hong Kong agent may constitute an established place of business of an oversea company provided the Hong Kong agent is 'carrying on the business of the oversea company in Hong Kong' (see also *Okura & Co Ltd v Forsbacka Jernverks Aktiebolag* [1914] 1 KB 715). The criterion of 'carrying on business' will be satisfied in circumstances in which the agent has authority to enter into contracts which are binding on the oversea company (*The Artemis;* see also *Saccharin Corporation Ltd v. Chemische Fabrik von Heyden Aktiengesellschaft* [1911] 2 KB 516).

Thus, in cases in which the foreign defendant has either a branch office or an agent in Hong Kong, that defendant may be deemed 'present' for purposes of jurisdiction and the Hong Kong courts may properly serve out a writ and hear the case.

The power of the Hong Kong courts to hear cases involving oversea companies is not, however, limited only to those cases in which the defendant company is deemed 'present' in Hong Kong. The Hong Kong courts also have 'assumed jurisdiction' in certain specified instances under Order 11 of the Rules of the Supreme Court (cap 4, LHK 1988 ed), which provides for service of writs on defendants outside the jurisdiction or, in other words, not 'present' in Hong Kong.

I do not think it worth our time to dwell on all of the individual rules under Order 11, but I should like to point out two of these rules which are relevant to our discussion.

First, the Hong Kong courts may exercise jurisdiction where the contract 'was made by or through an agent trading or residing within the jurisdiction on behalf of a principal trading or residing out of the jurisdiction.' This ground of jurisdiction

would cover cases in which it is not altogether clear that the agent is 'carrying on the business of the oversea company in Hong Kong.' Indeed, where there is some doubt, it would be better to proceed under Order 11, rather than under the Companies Ordinance. This ground of jurisdiction would also cover those cases in which the agent is not authorised to enter into contracts for the oversea company (ie, where the agent merely solicits orders for the oversea company) (see *National Mortgage and Agency Co of New Zealand v Gosselin* (1922) 38 TLR 832 (CA)).

Second, the Hong Kong courts may exercise jurisdiction where the contract 'contains a term to the effect that the High Court shall have jurisdiction to hear and determine any action in respect of the contract.' This ground of jurisdiction would cover those cases in which a jurisdiction clause is present in the sales contract.

The second specific situation in which the convention may be relevant to the Hong Kong practitioner or, more precisely, those practitioners engaged in China trade, involves international sales transactions conducted by 'enterprises with foreign investment' in the PRC with parties from other contracting states. By 'enterprises with foreign investment' I mean, namely, Sino-foreign equity and contractual joint ventures as well as wholly foreign-owned subsidiaries operating in the PRC.

As previously mentioned, China has ratified CISG, subject to an article 95 reservation. Consequently, all international sales contracts concluded by Chinese parties with parties from other contracting states are to be governed by CISG.

The question as to whether 'enterprises with foreign investment' constitute Chinese parties for purposes of application of CISG is resolved by reference to the *General Principles of Civil Law of the People's Republic of China*. Article 41 of the *General Principles* stipulates that all three types of 'enterprises with foreign investment' upon registration acquire the status of Chinese legal persons. Article 36 of the *General Principles* sets forth the characteristics of a Chinese legal person, among which is the competence to enter into contracts. Accordingly, 'enterprises with foreign investment' in the PRC qualify as Chinese parties

for the purposes of application of CISG. It is critical to note, however, the CISG will only apply when the non-Chinese party has his place of business in a contracting state. This condition must exist because of China's reservation to article 1(1)(b) under article 95 of CISG. In cases in which the Chinese party contracts with a foreign party who has his place of business in a non-contracting state, as in the case of Hong Kong, CISG will *not* apply. In the event that Chinese law is determined to be the proper law of the contract, the applicable law will be the *Foreign Economic Contract Law* of the PRC.

The third situation in which CISG may be relevant to the Hong Kong practitioner arises where the parties to an international sales transaction incorporate a CISG choice-of-law clause in their contract. Again, in light of the tremendous volume of import-export trade conducted by Hong Kong with China, this head of discussion may be of most relevance to those practitioners involved in China trade. Indeed, I exhort those of you who have clients engaged in PRC sales and purchase transactions to strongly advise your clients to press for incorporation of a CISG choice-of-law clause in future negotiations. The inclusion of a CISG clause will, in most cases, make the claims settlement process a lot easier for the Hong Kong practitioner in that a comprehensive set of recognizable legal principles will govern the contractual dispute.

In the past, the Chinese foreign trade corporations, with whom most transactions are conducted, have steadfastly refused to include a choice-of-law clause in their standard form sales and purchase contracts specifying foreign law (including Hong Kong law) as the governing law. However, the Chinese may be more willing to agree to a CISG choice-of-law clause since the PRC has ratified the convention thus in effect making it the national law of the People's Republic in all transactions involving Chinese and foreign parties from contracting states. Indeed, last year, before the entry into force of CISG, there was one reported case in which a Guangzhou foreign trade corporation agreed to just such a clause.

The advantages of CISG over the *Foreign Economic Contract Law* of the PRC, which would otherwise govern the contract

(if Chinese law is the proper law of the contract, as is normally the case) are manifold.

Suffice to say, there are many issues not addressed in the *Foreign Economic Contract Law* which are the subject of detailed treatment in CISG. I should like to draw your attention to three important areas in which CISG has distinct advantages over the PRC *Foreign Economic Contract Law* as the governing law of the contract.

(1) *Formation of contract.* The *Foreign Economic Contract Law* provides minimal assistance in the form of one brief article on the formation of contracts, whereas CISG in Part II provides comprehensive rules on offer, counter-offer and acceptance. In particular, CISG provides for formation of contract by means of telex and telegram, a frequently used medium of communication in international trade. The *Foreign Economic Contract Law* is at best ambiguous on this point and does not elaborate rules governing offers or acceptances transmitted by such means.

(2) *Implied warranties as to the quality of the goods.* There are simply no provisions in the *Foreign Economic Contract Law* on this important subject. In fact, to date, implied warranties have not been recognized in PRC foreign trade law or practice. The Hong Kong buyer, however, will be relieved to know that implied warranties form an important part of the seller's obligations under CISG. Article 35(2) includes both implied warranties of merchantability and fitness for a particular purpose. Such implied warranties may provide potent weapons when faced with the all-too-familiar prospect of poor quality Chinese goods.

(3) *Formulae for the measure of damages in the case of fundamental breach.* The *Foreign Economic Contract Law* fails to provide for any functional formula for measuring damages in cases in which there is a fundamental breach of contract and subsequent cancellation of the contract, although clearly damages are recoverable. CISG, by comparison, in articles 75 and 76, sets forth familiar measures in cases of cancellation or 'avoidance' on account of fundamental breach of contract. Article 75

stipulates one measure of damages, namely, the difference between the contract price and the replacement or resale price. Article 76 specifies another: the difference between the contract price and the current market price at the time of avoidance. Moreover, consequential or special damages are also recoverable under article 74, subject to a requirement of foreseeability of loss similar to the rule in *Hadley v Baxendale* (1854) 9 Exch 341. There are, of course, other substantive advantages inherent in the use of CISG as the governing law of the contract instead of the *Foreign Economic Contract Law,* but this brief survey may give you some idea of the benefits to be derived from the inclusion of a CISG choice-of-law clause in Chinese standard sales and purchase contracts.

The merits of a truly international law for contracts for the transnational sale of goods are manifest. The United Kingdom has indicated as much in the passage of the Uniform Law for the International Sale of Goods Act in 1967. As CISG has superseded the 1964 Hague Convention on a Uniform Law for the International Sale of Goods, it would behoove the United Kingdom to seriously consider accession to CISG. Until the United Kingdom accedes to CISG, the many benefits of the UN Convention will remain beyond the reach of both Hong Kong's trading and legal communities.