



# THE INCOTERMS: THEIR USES AND SOME PITFALLS

**Legal Corner** By David Street, TOYSA Legal Counsel

For most international sales transactions, the standard terms developed and defined by the International Chamber of Commerce (“ICC”) are used. These terms and their definitions - - called “INCOTERMS” - - have been developed by the ICC to standardize the interpretation of trade terms throughout the world to facilitate the conduct of international trade. This effort was begun in 1936 and the INCOTERMS have been updated from time to time (most recently, every ten years) since then to keep up with prevailing commercial practices. The most recent publication is INCOTERMS 2000. There are 13 standard INCOTERMS that may be grouped into four basic categories distinguished by the level of obligation assumed by the seller. The terms and the groupings are set forth below:

## **Group E**

Departure	EXW	Ex Works
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## **Group F**

	FCA	Free Carrier
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Main Carriage	FAS	Free Alongside Ship
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Unpaid	FOB	Free On Board
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## **Group C**

	CFR	Cost and Freight
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Main Carriage	CIF	Cost, Insurance and Freight
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Paid	CPT	Carriage Paid To
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	CIP	Carriage and Insurance Paid To
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## **Group D**

	DAF	Delivered At Frontier
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Arrival	DES	Delivered Ex Ship
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DEQ	Delivered Ex Quay
DDU	Delivered Duty Unpaid
DDP	Delivered Duty Paid

The purpose of the INCOTERMS is to inform international buyers and sellers of goods what their obligations are with respect to the carriage and delivery of the goods, export and import clearance, and explain the division of costs and risks between the parties.

The relationships among the terms of sale and the allocation of responsibilities and risks between the seller and the buyer in an international sale of goods may be illustrated through an analysis of one of the most popular of the INCOTERMS – “FOB”, which means “Free on Board.” For example, a transaction for the sale of goods in China to an American buyer denoted “FOB Shanghai” defines the respective obligations of the seller and buyer as follows:

**The Seller must - -**

- (1) deliver the goods in Shanghai in the manner customary at the port of Shanghai on board a vessel nominated by the Buyer;
- (2) meet all export licensing and clearance requirements necessary for the goods to leave China;
- (3) pay all costs relating to the goods (e.g., packing, inland carriage, etc.) prior to delivery;
- (4) bear all risks of loss of or damage to the goods until such time as they have passed over the ship’s rail at Shanghai.

**The Buyer must - -**

- (1) take delivery of the goods when they have been delivered in accordance with the Seller’s obligation;
- (2) contract at its own expense for the carriage of the goods from Shanghai to the United States;

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- (3) meet all import and customs requirements in the United States;
- (4) pay all costs relating to the goods from the time they have passed over the ship's rail in Shanghai;
- (5) give the seller sufficient notice of the vessel name, loading point and required delivery time;
- (6) bear all risks of loss of or damage to the goods **either**
  - from the time they have passed the ship's rail at Shanghai shipment if proper notice was given
  - or**
  - from an agreed date or the expiration date of the agreed period for delivery if it fails to give notice of the time of the vessel arrival or because the vessel nominated by the buyer fails to arrive on time or is unable to take the goods or closes for cargo earlier than the time notified.

The INCOTERMS do a good job of specifying the respective obligations of the seller and buyer, but only in the areas the INCOTERMS are designed to cover. Over time, however, through ignorance or laziness, some parties have attempted to rely on the INCOTERMS to accomplish purposes for which they were not designed.

A primary area in which this has occurred has to do with ownership and passage of title to the goods. In this regard, do not confuse *delivery* of the goods with *passage of title*. Just because goods are sold FOB Shanghai does not mean the Buyer takes ownership of the goods in Shanghai. The INCOTERMS themselves specifically state that they "do not deal with transfer of property rights in the goods." Thus, while you might specify "FOB Shanghai" as the terms of sale in your purchase contract, that alone does not say anything about how the goods or the sale should be treated in some extremely important areas such as the company accounts and inventory. When passage of title and/or ownership occurs is determined under the law applicable to the sales transaction. When, as in the example above, a seller completes delivery of the goods to the American buyer in Shanghai, it is possible that Chinese or American law could apply to the sales agreement. This is one reason why it is important for sales agreements and/or purchase orders to specify the law that will apply to the agreement.

If U.S. law were to apply to our sample sales transaction, the passage of title would typically occur at the point when the seller completes its delivery obligations. In the United States, the law generally applicable to the sale of goods

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is the Uniform Commercial Code (“UCC”), which has been adopted in virtually all of the states. Under the UCC, absent explicit contract provisions to the contrary, the seller’s obligation to deliver the goods determines when title passes. The relevant UCC provision provides:

Unless otherwise explicitly agreed, title passes to the buyer at the time and place at which the seller completes his performance with reference to the physical delivery of the goods, despite any reservation of a security interest and even though a document of title is to be delivered at a different time or place; and in particular and despite any reservation of a security interest by the bill of lading

(a) if the contract requires or authorizes the seller to send the goods to the buyer but does not require him to deliver them at destination, title passes to the buyer at the time and place of shipment; but

(b) if the contract requires delivery at destination, title passes on tender there.

Article 2-401. Thus, under this provision, a sale of goods “FOB Shanghai” would, unless the purchase contract provided otherwise, pass title under U.S. law to the buyer at the point when the vendor fulfills its delivery obligations in Shanghai, i.e., when they pass over the ship’s rail.

What if the Buyer wishes to delay taking the goods into his inventory until after they arrive in the United States? Assuming that, for accounting purposes, goods should be taken into inventory when the buyer assumes ownership of them<sup>1</sup>, there are a number of options to handle this situation. One would be to deal with this in the INCOTERMS and the sales agreement by specifying application of U.S. law and using an INCOTERM providing for delivery to the buyer in the United States. For goods shipped by ocean vessel, the most appropriate terms of sale calling for the seller to effect delivery in the United States would be either DES (Delivered Ex Ship) or DEQ (Delivered Ex Quay). The primary difference between these terms is that the DES term obligates the vendor to deliver the goods to the buyer before they are unloaded from the vessel, whereas the DEQ term obligates the vendor to unload the goods from the vessel and deliver them to the buyer on the named wharf at the named port of destination. Under either of these terms, the risk of loss of or damage to the goods remains with the seller until delivery and, under the UCC, title would pass to the buyer at the point of delivery.

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<sup>1</sup> Obviously, the question of when goods should be taken into inventory is ultimately an accounting issue, which is not dealt with in this article. *The contents of this article do not constitute legal advice. You should always consult an experienced attorney about legal issues that arise from particular situations as the individual facts may warrant different legal conclusions in a given case. Mr. Street is a partner at the law firm of GKG Law, P.C and has served as Toysa’s legal counsel since 1991.*

Alternatively, the parties could continue to use the “FOB Shanghai” INCOTERM but make it explicit in the purchase agreement that title to the goods passes upon entering the United States. The UCC allows parties to adopt provisions in their contracts specifying when title will pass, notwithstanding the provisions of Article 2-401 discussed above. This is made clear in the section itself, which is introduced by the phrase; “Unless otherwise explicitly agreed. . .,” and in Article 1-102(3) of the UCC, which provides that:

The effect of provisions of this Act may be varied by agreement, except as otherwise provided in this Act except that the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement . . .

See also, *House of Lloyd, Inc. v. Director of Revenue, State of Missouri*, 824 S.W. 2<sup>d</sup> 914, 923 (Supreme Court, 1992) (“The parties have the right to control the time and place that passage of title occurs by their express intent... However, these intentions control only when the parties ‘otherwise explicitly agreed’ when title will pass. . . ‘Explicitly agreed’ means that which is so clearly stated or distinctly set forth that there is no doubt as to its meaning.”)

Another problem that some parties run into with the INCOTERMS is using a term that is not appropriate for the commercial and physical environment in which they will be acting. Here again, the “FOB” INCOTERM provides a lesson. As noted above, FOB means “free on board,” which refers to the cargo being physically loaded on board the vessel. In the old days, that is exactly what happened. A seller would deliver the cargo to the dock where it would be carried on board the vessel by a man or a machine. That is why the FOB INCOTERM specifies that the seller’s obligation is to deliver the goods “over the ship’s rail.” The advent of containerization, however, has radically changed the way cargo is handled. Now, sellers load containers at their factory or warehouse and send the container to the carrier’s yard, where it may sit for a substantial length of time before the carrier actually loads it on the vessel. In this situation, use of the “FOB” term may not be appropriate because the seller will continue to bear the risk of loss while the goods are sitting in the yard of the carrier chosen by the buyer. A more appropriate term in this instance would be “FCA,” which means “free carrier at the place named.” According to the FCA term, the seller’s responsibilities and risk of loss terminate upon delivery to the carrier at the place named rather than over the ship’s rail. Thus, use of “FCA Shanghai” would mean that the seller’s obligations would end when he gives the containerized shipment to the carrier or the carrier’s drayage company. Why don’t we see more use of the FCA term for sale of goods transported in containers? It may be that people are simply not thinking through the meaning of the FOB term. It may be that they think the FOB term has something to do with transfer of title, in which case two mistakes would compound each other. Or, it may be that they don’t fully appreciate the meanings of and distinctions among the various INCOTERMS.

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In sum, the INCOTERMS provide a useful tool for buyers and sellers in international trade to specify their respective rights and responsibilities in a widely understood and accepted shorthand. But, like all tools, the INCOTERMS can be misused. Before using or relying upon an INCOTERM in your next sales transaction, make sure you completely understand what the INCOTERM means, and that it fully matches your expectations for the transaction. That way, if something goes wrong with the transaction, you won't be in for a potentially nasty surprise.

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