WHITE PAPER

The ABCs of International Trade Contracts

The purpose of any contract is to set up an agreement that protects the interests of everyone involved. The way international trade contracts are written is considerably more complex than those needed for domestic deals. This white paper will help you understand the basics of these contracts and how they can affect your export operations.

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INTRODUCTION

The importance of getting your contract right can't be over-emphasized. A solid contract can help you avoid disputes and possible litigation, both of which are especially risky when selling outside of Canada, including to the United States.

To protect you effectively, any contract with a foreign customer must do the following:[1]

- It has to identify the parties to the contract. If affiliated companies, agents or representatives are involved, the contract should include them as well.
- It must specify the law that governs the contract. The business laws of Canada and your foreign market will always differ in at least a few ways, which can lead to disagreements over what a clause in a contract actually means. To make disputes less likely, the contract should specify which country's laws will govern the agreement.
- The contract must be comprehensive. It must include all the essential terms that the parties have agreed on, since leaving one out may lead to disputes.
- All the parts of the contract must be clearly written and readily understood by all parties. Ambiguous language in a contract invites disagreements and litigation.

INCOTERMS

Contract wording can be such a source of confusion that the international trade community has developed a set of formal terms, with commonly agreed meanings, to deal with the problem. These Incoterms, as they're called, deal with specific responsibilities in international trade transactions. They apply primarily to the following areas:

- **Costs:** Who is responsible for the expenses associated with a shipment at any given time during transit? Examples could be packing costs, international transport costs or customs duties.
- **Control:** Who owns the shipment at any given time during its transit?
- **Liability:** Who is responsible for the shipment at any given time during its transit?

When you word a contract, it's wise to use Incoterms wherever applicable. Because they have very precise meanings, they'll help you avoid ambiguous language in your sales agreements and reduce the risk of disagreement about who does what. You can find out more about these terms on the **Incoterms** website.

[1] Some of the information in this paper is based on the EDC publication *Commercial Contract Terms*, available from the **Publications/Guides** page of the EDC web site.

BEFORE YOU NEGOTIATE: DUE DILIGENCE

There's one crucial preliminary to negotiating a contract with a customer – due diligence. Without this, the foundation of a contract, assuming you eventually sign one, can be very shaky.

Basic due diligence includes checking into the company's creditworthiness, its financial situation, the quality of its management, its business history and its reputation in the local and international marketplace. Legal, consulting and credit-reporting firms can help you do this, but in many foreign markets it can be difficult to find out everything you'd like to know. The **Canadian Trade Commissioner Service** in the target market may be able to help you here, since its trade teams are familiar with local business conditions.

For its part, EDC can help you with its **EXPORT*Check*** service. For a modest fee, this service will allow you to review the credit profiles of more than 20 million U.S. and 80 million international customers.

READ THE CONTRACT VERY, VERY CAREFULLY!

You and your legal team should carefully scrutinize the contract's wording for potential risks, such as harsh penalties for late delivery, onerous indemnity clauses or clauses related to transfer of intellectual property to the customer. If possible, strike out such conditions or renegotiate them. Also, look for unexpected additional costs such as insurance requirements, performance guarantees, warranties and delivery conditions.

BASIC CONTRACT CLAUSES AND TERMS

The essentials of international trade contracts are outlined below.

Who and what is involved?

The contract must:

- Identify the parties to the contract and their full legal names.
- State that your customer has an obligation to purchase and pay for your goods or services, and that the vendor (you) must sell and deliver them to the customer.
- Describe in detail the goods or services you are selling to the customer.

How much is to be paid?

The contract must:

- Identify the currency to be used.
- State whether the price is fixed or adjustable and, if the latter, how adjustments will be made.
- State the total amount to be paid (fixed or adjusted).

When and how to pay?

This should state:

- The date by which full payment is due.
- Progress payments, if any, and the amount of each.
- Discounts to the customer for early payment.
- Bonuses to the vendor (you) for early completion of the contract.
- Interest charges for late payment.
- The documentation that will trigger payment, such as transportation documents or commercial invoices.
- The method of payment, such as open account or letter of credit.
- The payment terms, such as net 30 days.
- Whether there are holdback payments.

How does delivery work?

You'll use Incoterms extensively in these clauses. They should state:

- Who is responsible for the costs of carriage, insurance, import and export clearance, packing, documentation and so forth.
- Who is responsible for the transfer of risk or for damages to goods during their transit from you to your customer.
- How the goods are to be delivered and who's responsible for the delivery costs.
- Which port of entry is to be used.
- How delivery is to be scheduled and what penalties apply to late delivery.
- How many shipments are involved in the total order.

What penalties and warranties are there?

This should state:

- The compensation provided to the other party if you or your customer fail to fulfil the contract terms.
- The interest applied to the invoice amount if the customer pays late.
- What warranties apply.

How are disputes to be settled?

This should state:

- The process for dispute settlement, such as negotiation, arbitration or litigation.
- If arbitration is to be used, the country and place where it will occur, the rules of arbitration that will apply and how the costs of arbitration will be divided.
- If litigation is to be used, the country and place where the litigation will occur, and the court in which it will be heard.
- A time frame for settling disputes.

When does the contract become effective?

This should state:

- The conditions and/or events under which the contract becomes effective, such as on contract signing or on the receipt of an advance payment.
- How the timing of the above conditions and/or events may affect the contract schedule.

Who has title to the goods?

This should state:

- When you transfer title to the goods to your customer, such as on full payment.
- Any legal requirements that apply in this area.

What law and language(s) are to be used?

This should state:

- The legal system that governs the contract.
- Whether a suitable translation will be provided if the contract is not in English (or French, if applicable).

What documentation is required?

This should specify the documents and procedures required over the course of the contract, such as technical documentation and delivery documents.

How and why can the contact be cancelled?

This should state:

- Who has the right to cancel the contract, and under what conditions they may do so.
- What payment and performance obligations apply to either party if the contact is cancelled.
- How any loss due to contract cancellation will be defined.

MORE ABOUT CONTRACT CANCELLATION

Your contract should establish penalties for the customer if the customer cancels the contract without just cause. However, it can sometimes be problematic (or very slow) to collect cancellation penalties when the customer is in a foreign country.

To cover yourself against this risk, you can use EDC's **Contract Frustration Insurance**, which will insure you for up to 90 per cent of your eligible losses resulting from a variety of political and commercial risks, including contract cancellation.

How should guarantees be managed?

In some sectors, it's common for foreign customers to require guarantees as a condition of doing business. These may be contractual guarantees such as bid, advance payment, performance and warranty guarantees; financial guarantees such as supplier guarantees; or regulatory guarantees such as license or permit guarantees.

Guarantees are essentially promises that you'll complete your contracts as agreed, and they provide for financial penalties if you don't. Your bank issues guarantees to your customers on your behalf, in the form of standby letters of credit (LCs) or letters of guarantee (LGs), which are for a sum equal to a specified percentage of the contract value. If you don't fulfil your contract, your customer can "call the guarantee" and your bank will be required to pay your customer the value of the guarantee, as specified by the LC or LG.

If your contract requires a guarantee, it should include clauses that:

- Establish the reason for issuing the guarantee.
- Establish the date of issue, the validity period, the expiry date and the triggers for expiry.
- Ensure that the guarantee corresponds to the requirements of the contract.

What happens in a "force majeure" situation?

Sometimes things happen that prevent either you or your customer from meeting the terms of the contract. If these events – such as natural disasters – are outside the control of both parties, they are called *force majeure*. Your contract should include clauses to deal with such situations, and should state:

- What constitutes force majeure.
- When the other party must be notified of a force majeure event.
- What steps the affected party has to take in the case of a force majeure situation.
- What options, such as contract cancellation, are available if there is a long delay in completing the contract owing to a force majeure event.

SUMMING UP

Because of the wide scope for misunderstanding, the terms and conditions of international trade contracts should be as unambiguous as possible. A poorly drafted contract increases the risk of disputes, which may lead to your customer's refusal to pay or other difficulties.

A well-written contract, in contrast, can contribute to the success of your first deal with a new customer, which can lay the foundation for a solid, long-term relationship. As your foreign business grows and your contracts work smoothly, you'll become known in your markets as a fair-minded, reliable vendor, whose deals cause no problems for your customers. With that reputation, you can look forward to more business, more sales and more international success.

FREE WEBINAR

Looking for additional insight on international trade contracts? Have questions? **Register for our free interactive webinar** on the ABC's of International Contracts.

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