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AMALINA BINTI AHMAD-TAJUDIN

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# **Legal Enforceability of Intentional Open Price in the US, England and the United Nations**

**AMALINA AHMAD TAJUDIN**

**A Thesis Submitted for the Degree of  
Doctor of Philosophy**

**Durham University**

**Durham Law School**

**June 2013**

## **Abstract**

Uncertainty regarding the price of goods has caused parties to divert from traditional fixed-price approaches to relational, open-price contract. This leads to different approaches under the various sales laws. The Uniform Commercial Code (UCC) in the US was drafted to cope with the changing market by allowing parties to opt for open price term at the time of entering into a contract, while the English Sale of Goods Act 1979 (SGA) and the United Nations Convention on Contracts for the International Sale of Goods (CISG) provide limited flexibility in setting the price, favouring traditional fixed-price contracts. As a result, the courts in the SGA and CISG jurisdictions are less likely to enforce contracts where parties intentionally leave the price open, even in cases where parties initially intend to be bound by the contract.

This thesis provides an assessment of the effectiveness of the UCC in coping with relational sales contracts regardless of their duration. It compares the UCC with the SGA and the CISG Nations sales using examples of relevant court decisions from both jurisdictions, and critically evaluates the difference between flexibility in setting the price at the time of entering into a contract under the UCC, and flexibility applied by the courts to remedy a contract upon affected by market changes.

This evaluation enables the thesis to propose ways in which SGA and the CISG might be made more adaptable with regard to relational sales, by following the example of the UCC in allowing open price as a choice for parties rather than as a remedy given by the courts to uphold a relational contract.

## **Copyright Declaration**

The copyright of this thesis rests with the author. No quotation from it should be published in any format without their prior written consent. Information derived from this thesis must be acknowledged appropriately.

## **Acknowledgements**

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‘The real voyage of discovery consists not in seeking new landscapes but in having new eyes.’

Marcel Proust, *Remembrance of Things Past 29* (CK Scott Mocrieff and Terence Kilmartin (trs), 1<sup>st</sup> edn, Vintage Books 1982) (1934)

This thesis is dedicated to Khaidzir, who has been with me in highs and lows.

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# Chapter One: Introduction to the Completeness versus the Incompleteness of a Contract

## 1.0 Introduction

In any sale between a buyer and seller, price is a crucial term to agree on. This chapter begins by explaining the price term in a contract before moving onto a gradual explanation of a contract's 'completeness'. Finally, the question of whether the price term should always be set or left open in a sales contract will be discussed. The thesis proposes a flexible approach to the contract, and suggests that determining the price when parties first enter the contract will minimise the need for courts to make further expensive adjustments during the contract's later stages. Contractual flexibility is a crucial element of merchants, who generally operate in an open-ended manner when approaching a contract.

While the US has been successful in implementing flexibility in commercial contracts, the United Nations CISG 1980 and the English Sale of Goods Act 1979 failed to adopt a similar idea into their respective sales laws. A concept of flexibility would be useful in both jurisdictions when dealing with relational contracts that are often exposed to the risks of changing circumstances. Changes in circumstance, such as market conditions, should not affect the validity of business contracts, irrespective of the duration of the contracts. Conversely, English and CISG courts favour rigid, fixed-term methods when deciding cases involving price by focusing entirely on written documents that parties have signed or accepted. Arguably, the rigidity of fixed-term methods causes courts to discount the often implicit, but nonetheless real, expectations on which the parties rely.<sup>1</sup>

To support the adoption of price flexibility into the SGA and the CISG, three main theories are used as the background of this thesis. The first theory is the 'relational contract' theory propounded by Macneil, the second is the 'self-enforcing contract' theory by Scott, and the third is the 'joint maximization rule' by Gergen. These theories are significant for improving the

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<sup>1</sup> Stewart Macaulay, 'The Real and the Paper Deal: Empirical Pictures of Relationships, Complexity and the Urge for Transparent Simple Rules,' 53, in David Campbell, Hugh Collins and John Wightman (eds), *Implicit Dimensions of Contract: Discrete, Relational & Network Contracts* (Oxford, Hart Publishing Co 2003).

current state of sales law in England and the United Nations when dealing with the validity of long-term sales affected by market volatility. Arguably, the three theories support the notion that flexibility is a useful extra-legal norm that maintains the validity of a contract without allowing parties to be opportunistic on the basis of absence of a fixed price.

Buyers and sellers (along with their lawyers) have responded to times of rapid market change by expanding the excuse clauses of their contracts. Of course, the parties could choose to be bound by a fixed price, but flexibility is useful in certain types of trade. The thesis recommends that a relational sale must be designed with a flexible price term in accordance with the custom of the particular trade. Moreover, the thesis suggests taking the nature and purpose of the business into account when drafting the contract. A strict compliance with classic contract law which demands rigidity in fixing the price term is ‘a convenient trap-door through which the imprudent or unscrupulous obligor can escape, leaving the innocent obligee to bear not only the loss of expected benefits but also the burden of liability to subpurchasers.’<sup>2</sup> Excusing performance on the basis of not having a fixed price is unacceptable as it imposes long-term rigidity on the parties during changing circumstances.

In the following section, the thesis begins by explaining the general idea of sales law and the fundamentals of the concept of incomplete contracts.

### **1.1 Price term: a crucial element of sales**

Price is at the heart of all sales contracts.<sup>3</sup> The current economy proves that businesses centre on profit, and profit undoubtedly centres on price.<sup>4</sup> Commerce is an economic activity where price clearly constitutes a crucial element of economic success or failure.<sup>5</sup> In a contract of sale, the price (paid or promised) constitutes a consideration to the delivery of the goods.<sup>6</sup> When a price is

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<sup>2</sup> Harold J Berman, ‘Excuse for Nonperformance in the Light of Contract Practices in International Trade’ (Dec, 1963) *Columbia Law Review*, vol 63, no 8, 1413-1439, 1437.

<sup>3</sup> Karl N Llewellyn, *Cases and Materials on Sales* (Chicago, Callaghan & Co 1930) 1.

<sup>4</sup> *ibid.*

<sup>5</sup> John O Honnold, ‘International Sales Law and the Open-Price Contract’ (1989), 915-933, 915 <<http://www.bibliojuridica.org/libros/2/645/8.pdf>> accessed 5 June 2007.

<sup>6</sup> L Vold, ‘Open Price Arrangements in the Sale of Goods’ (1930-1931) 5 *Temple Law Quarterly* 208.

fixed, there is barely any room for litigation over the matter.<sup>7</sup> Even if parties deal with each other at arm's length, both being equally competent to contract, they remain the best judges of what is likely to be to their advantage.<sup>8</sup> Indeed, the ultimate goal of any contract is for parties to maximise their joint expected return.<sup>9</sup>

However, a contract is not always completely agreed upon. Recent contractual trends have shown that business parties intentionally leave some contractual terms undecided.<sup>10</sup> The next section explains the preference for contractual incompleteness and is followed by an example of a court decision on the issue.

## 1.2 The completeness and incompleteness of a contract of sale

The parties' ultimate goal in making a contract is to maximise their profit. Often, parties can only fulfil their goal during the later stages of the contract, results in the deliberate act of leaving essential terms (such as price, quantity and time of delivery) open.<sup>11</sup> Vold notes that parties frequently decide on an open price because fixed prices are too inflexible for their business needs when entering into a contract.<sup>12</sup> Relational contracts commonly expect business parties to intentionally leave some contractual terms undecided.<sup>13</sup>

Moreover, the uncertainty of goods, or external matters affecting market conditions, should not prevent parties from entering into a contract.<sup>14</sup> Gilson, Sabel and Scott explained that parties respond to future uncertainty by braiding a contract that intertwines both formal and informal

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<sup>7</sup> *ibid.*

<sup>8</sup> *ibid.*

<sup>9</sup> Mark P Gergen, 'The Use of Open Terms in Contract' (1992) 92 *Columbia Law Review* 997, 1000.

<sup>10</sup> A good example within the CISG jurisdiction is the Germany 3 August 2005 District Court Neubrandenburg (*Pitted Sour Cherries case*) <<http://cisgw3.law.pace.edu/cases/050803g1.html>> accessed 20 March 2010. In this case the validity of the sales contract is not hindered by the fact that the parties have only agreed to fix the price 'during the season'. An example found in the English jurisdiction is the case of *Rafsanjan Pistachio Producers Cooperative v Kaufmanns Ltd* (Independent, January 12, 1998; (Queen's Bench Division (Commercial Cases), where the contract contemplates that delivery should be in instalments and the price clause says: 'to be agreed before each delivery.' This was because the price for the new 1996 Pistachio crop had not yet been formally appraised in Iran. Hence it was common for the plaintiff to agree forward contracts with his major customers for new crop quantities, which left the price to be agreed subsequently.

<sup>11</sup> Llewellyn, *Cases and Materials* (n 3) 1.

<sup>12</sup> Vold (n 6).

<sup>13</sup> *Pitted Sour Cherries* and *Rafsanjan Pistachio* (n 10).

<sup>14</sup> *ibid.*

mechanisms; this allows each party to assess the disposition and capacity of the other to respond cooperatively and effectively to unpredictable circumstances.<sup>15</sup> According to DiMatteo, the current trend for many modern alliance agreements is to blend fixed terms with more open, flexible terms.<sup>16</sup> Whilst hard and clear terms provide firm protection and boundaries for each party's investments and obligations, open and implicit terms and standards allow for greater operational flexibility; this flexibility fully exploits collaborative effort and generates the most innovation-related benefits.<sup>17</sup> This strikes a balance in a contract struck by '...interweaving explicit and implicit terms that respond to the uncertainty inherent in the innovation process.'<sup>18</sup>

Through braiding, a buyer and seller leave a range of future adjustments open (for example, price, time or quantity) in order to maintain the practicality of a business.<sup>19</sup> Hillman illustrates this form of dealing with the following example: a manufacturer or utility that contemplates long-term energy needs enters a twenty-year fuel supply agreement.<sup>20</sup> Both buyer and supplier agree on a base price subject to periodic adjustment determined by increased production costs. Initially, both parties are satisfied with the agreement, but later an unanticipated event such as an oil embargo or high inflation takes place and causes a dramatic rise in costs that outpace the price adjustment formula. The buyer refuses to adjust and the supplier, preferring the uncertain results of litigation to certain continuing losses, repudiates the agreement.

What possible solutions might the parties take to cope with an unanticipated event that affects the contract? Hillman explained five possible ways a court could respond: 1) grant specific performance or damages to the relying party; 2) conversely, excuse performance under the impracticability doctrine; 3) provide relief based on a party's restitution or reliance interest; 4)

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<sup>15</sup> Ronald J Gilson, Charles F Sabel and Robert E Scott, 'Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine' (October 2010) 110 *Columbia Law Review*, no 6, 1377.

<sup>16</sup> Larry A DiMatteo, 'Strategic Contracting: Contract Law as a Source of Competitive Advantage' (Winter 2010) 47, Issue 4, *American Business Law Journal* 1-80, 57.

<sup>17</sup> Ronald J Gilson, Charles F Sabel and Robert E Scott, 'Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration' (2009) 109 *Columbia Law Review* 431, 435.

<sup>18</sup> *ibid.*

<sup>19</sup> Vold (n 6).

<sup>20</sup> Robert A Hillman, 'Court Adjustment of Long-Term Contracts: An Analysis under Modern Contract Law' (1987) 1 *Duke Law Journal* 1.

defer any holding and order parties to bargain further; 5) adjust the contract by modifying the terms of the agreement and conditioning specific performance on accepting the changes.

*Westinghouse Electric Corp v Kerr-McGee Corp*<sup>21</sup> illustrates the inefficiency of a fixed-price method. The supplier was to supply uranium to the plants at up to twelve dollars a pound when the market price rose sharply to over forty dollars. However, instead of adjusting the contract, the court applied the second solution, the doctrine of impracticability, which does excuse performance in such a situation. If the court in *Westinghouse* adjusted the uranium price based on the current market price, the contract, despite the unpredictable market conditions, would have remained enforceable.<sup>22</sup> According to Hillman, a court has a duty to adjust modern long-term contracts that are susceptible to unanticipated disruption and might affect more than one party. However, an adjustment solution, although practical, may not appeal to a traditional contract law judge.

Under US sales law, namely Uniform Commercial Code (UCC), parties could voluntarily choose an open price when entering into a contract. If they cannot eventually agree on a price term, courts would be permitted to adjust the contract by applying 'reasonable price' under Section 2-305. This means that the parties may agree to fix all of a contract's term,<sup>23</sup> but remain free to braid the contract, if they wish, by leaving one or more of the contractual terms open until the later stages of the contract. Carlton supported the practice of braiding, stating that 'transactions often take place under 'contract' ... [but] many contracts specify neither a price nor quantity. They seem not to be binding legal documents, but rather more like agreements to agree'.<sup>24</sup>

In the next section, a brief history of flexible, open prices are explored; the issue of how its practice tackles a supervening disruption or circumstance affecting modern businesses will also be discussed.

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<sup>21</sup> 580 Federal Reporter, Second Series 1311 (7<sup>th</sup> Cir), 99 Supreme Court Reporter 353 (1978).

<sup>22</sup> Paul L Joskow, 'Price Adjustment in Long-term Contracts: The Case of Coal' (1988a) 31 Journal of Law and Economics, 47-83; see also O Hart, 'Incomplete Contracts and the Theory of the Firm' Journal of Law, Economics, and Organization, 4 (1988) 119-139; J Moore, 'Incomplete Contracts and Renegotiation', *Econometrica*, 56 (1988) 755-785.

<sup>23</sup> Section 2-305(4) clearly stipulates that if parties do not intend to be bound unless a price is fixed, then there can be no valid contract unless the price is fixed as agreed.

<sup>24</sup> Dennis W Carlton, 'The Rigidity of Prices' *American Economic Review* (1986) 76(4) 637-58, 640.

### **1.3 The law merchant: origin of preference for flexibility (or ‘adjustability’) rather than rigidity in a contract of sale**

This section will demonstrate that the method of leaving a contract incomplete by leaving its price open originates from the informal practice of the law merchant.<sup>25</sup> Section 1.1 above explained that a definite, fixed price might be too rigid to accord with the business needs of a party when entering into a contract.<sup>26</sup> To tackle rigidity, both braiding and adjusting the contract are equally possible. While a court executes a contract’s adjustment,<sup>27</sup> parties choose to braid a contract when entering it with a combination of open terms and fixed terms.<sup>28</sup>

The origin of the open price is traced to the eleventh and twelfth centuries when commercial renaissance took place in Europe.<sup>29</sup> This renaissance was partly related to the beginning of trade with the Eastern markets, and partly to general political and economic developments within Europe including the rise of autonomous political units such as towns and cities.<sup>30</sup> Gradually, the new European trading community grew and created a new system of law to govern its commercial activities.<sup>31</sup> Markets and fairs existed in the West, although without a highly developed legal order, for about two or three centuries.<sup>32</sup> The growth of commerce, the revival of the study of law in universities and the growth of legal systems, both ecclesiastical and secular, developed the law merchant that included the customs of the markets and fairs as well as maritime trade customs.<sup>33</sup>

The law merchant governed trade between merchants in fairs, markets and seaports<sup>34</sup> and was distinguishable from local, feudal, royal and ecclesiastical laws.<sup>35</sup> The law was unique for being

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<sup>25</sup> Mick Woodley, *Osborne’s Concise Law Dictionary*, Tenth Edition, (London, Sweet & Maxwell 2005).

<sup>26</sup> Vold (n 6).

<sup>27</sup> Hillman (n 20).

<sup>28</sup> Dimatteo (n 16).

<sup>29</sup> Harold J Berman and Colin Kaufman, ‘The Law of International Commercial Transactions (Lex Mercatoria)’ (1978) 19 *Harvard International Law Journal* 221, 224.

<sup>30</sup> *ibid.* Berman and Kaufman cited Robert Lopez, *The Commercial Revolution of the Middle Ages (1095-1350)*; Robert Lopez and Irving Raymond, *Medieval Trade in the Mediterranean World* (New York, Columbia University Press 1968).

<sup>31</sup> *ibid.*

<sup>32</sup> *ibid.* 225.

<sup>33</sup> *ibid.*

<sup>34</sup> *ibid.*

transnational, derived from mercantile customs, administered by merchants themselves, quick and informal in procedure and concentrated on equity and fairness.<sup>36</sup>

Although the law merchant was developed in England in a similar manner to other European countries,<sup>37</sup> the sixteenth and early seventeenth centuries saw its adoption in the courts of Admiralty and Chancery in England.<sup>38</sup> By late seventeenth century, the common-law courts at King's Bench and Common Pleas succeeded in covering jurisdictions over commercial cases.<sup>39</sup> During this time, questions relating to mercantile custom were submitted for decision to juries comprised of merchants.<sup>40</sup>

### 1.3.1 Formalisation of the law merchant

The law merchant, being a body of customary law practised by merchants and implicit in jury verdicts did not fit precisely into the common law of a leading commercial power such as eighteenth century England.<sup>41</sup> While individual merchants demanded a more clearly defined law,<sup>42</sup> the national policy propagated the need for the law's formal development instead of its continuous reliance on the merchant's informal commercial experience.<sup>43</sup> This policy was evident in Lord Mansfield's opinion, which claimed that the law merchant's rules should be regarded as questions of law that were only appropriate to be decided by courts.<sup>44</sup>

Nevertheless, the law merchant did not just apply to merchants alone, but to all people and, subsequently, became an integral part of substantive English common law.<sup>45</sup> Lord Mansfield and his successors' decisions resulted in the creation of a body of judicially declared English commercial law, which incorporated and refined rules developed earlier in Europe.<sup>46</sup> The

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<sup>35</sup> *ibid.*

<sup>36</sup> *ibid.*

<sup>37</sup> *ibid.* 226.

<sup>38</sup> *ibid.*

<sup>39</sup> *ibid.*

<sup>40</sup> *ibid.* See also Theodore Plucknett, *Concise History of the Common Law* (5<sup>th</sup> edn, Butterworths 1956), 660-64.

<sup>41</sup> *ibid.*

<sup>42</sup> *ibid.*

<sup>43</sup> *ibid.*

<sup>44</sup> *Pillans v van Mierop* 3 Burrow's King's Bench Reports 1663, 97 English Reports 1035.

<sup>45</sup> Berman and Kaufman, 'The Law of International Commercial Transactions (Lex Mercatoria)' (n 29).

<sup>46</sup> *ibid.*

incorporation of the law merchant added a cosmopolitan dimension to English common law, making the common law courts fulfil the needs of Britain's growing commerce.<sup>47</sup>

However, the law merchant gradually became less influential when sales law was codified.<sup>48</sup> Commercial law was nationalised and separated from the experience of merchants in England, the US, France, Germany and other European countries.<sup>49</sup> Clearly, codified sales law prevailed over the law merchant in most jurisdictions, but the US, upon the enactment of the UCC in 1952, is an exception to this.<sup>50</sup>

The international community of merchants engaged in trade across national boundaries and was absorbed by the UCC, which proves the relevance of mercantile elements such as retaining a flexible, open price in sales.<sup>51</sup> Arguably, the adoption of the UCC's approach to open prices improves the adaptability of the SGA and the CISG as sales laws, especially during changing circumstances. To fulfil this purpose, the adoption of the law merchant principles is crucial; this will be discussed in the next section.

### **1.3.2 General principles of the law merchant**

Despite the formalisation caused by the nationalisation and separation of commercial law from the experience of merchants, there are several general principles of the law merchant that have been absorbed into sales legislation and, have crucial roles in resolving disputes.<sup>52</sup> Lando explained that the law merchant principles are derived from public international law, uniform laws, the general principles of law, the rules of international organisations, customs and usages, standard form contracts and reports on arbitral awards.<sup>53</sup>

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<sup>47</sup> *ibid.*

<sup>48</sup> *ibid* 227.

<sup>49</sup> *ibid* 228.

<sup>50</sup> A more detailed account of the UCC and the history of sales law prior to the UCC itself will be made in Chapter Three of the present thesis.

<sup>51</sup> Berman and Kaufman (n 29).

<sup>52</sup> *ibid.*

<sup>53</sup> Ole Lando, 'The Lex Mercatoria in International Commercial Arbitration' (1985) 34 *International & Comparative Law Quarterly* 747, 748-52.

Mustill listed the rules that fostered the evolution of a transnational commercial legal system into one single, open-ended set of rules and principles.<sup>54</sup> While the list consists of a total of seventy eight rules, only eight are crucial for discussion in this thesis:

- 1) Parties are free to enter into contracts and to determine their contents (the principle of party autonomy).
- 2) Parties must act in accordance with the standard of good faith and fair dealing in international trade.
- 3) A valid contract is binding upon parties.
- 4) Parties must always act in accordance with a reasonable view of the specific nature of their contract and the circumstances involved. This is particularly important when considering the economic interests and expectations of parties.
- 5) Parties are bound by any usages that they have agreed on, and by any practice that they have established between themselves. Unless otherwise agreed, the parties are considered to have applied to their contract a usage that the parties knew or ought to have known within the particular trade.
- 6) Each party is under a good faith obligation to renegotiate the contract if there is a need to adapt it to changed circumstances. However, this should only be carried out if the parties can expect a reasonable and continuation of performance from one another.
- 7) Each party is under a good faith obligation to notify the other party of any problems that occur in the performance of a contract. Parties are also expected to cooperate with each other when such cooperation can reasonably be expected to fulfil the contract.
- 8) A contract should be performed in good faith.

These principles are further elaborated in Chapter Two with the discussion of how a sales law could be designed to accommodate an open price. The essence of commercial law rules, usages and documentary forms is moulded by the business world,<sup>55</sup> and it is obvious that commercial

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<sup>54</sup> Michael Mustill, 'The New Lex Mercatoria: The First Twenty-five Years' (1988) 4 *Arbitration International* 86, 109, 110-14.

<sup>55</sup> Roy M Goode, *Goode on Commercial Law* (Ewan McKendrick (ed), 4<sup>th</sup> edn, Lexis Nexis 2009) 1347.

law should facilitate legitimate commercial development instead of hindering it.<sup>56</sup> This is achieved through the development of principles within a sound conceptual framework, and not simply by supplying ad hoc responses to specific problems.<sup>57</sup> Primarily, the principles, rules and statutory provisions that uphold and protect acceptable mercantile customs and practices should also characterise commercial law.<sup>58</sup>

It is important to realise that any branch of law embodies contradictions, competing policies, uncertainties and, on occasion, injustices.<sup>59</sup> This includes commercial law's own tensions, which are not easily resolved.<sup>60</sup> Merchants prefer practical, flexible and familiar practice in modern business, for they are receptive towards the solemnity of the contract but do not care about its details.<sup>61</sup> This preference created a dilemma for contract law in handling long-term deals, which was especially apparent when a contract's flexibility depended, in some way, upon environmental elements.<sup>62</sup> The strain between the need to fix responsibilities at the outset, yet require them to be readjusted over time, permeates the existence of a long-term contractual relationship.<sup>63</sup>

As opposed to the law merchant, the cardinal common law principle established that an agreement was not enforceable if it was uncertain and indefinite in its material terms.<sup>64</sup> If the contract was sufficiently definite, then the courts were to enforce the agreement by filling contractual gaps where necessary.<sup>65</sup> If otherwise, the courts were bound by the common law to deny enforcement and leave the losses 'to lie where they fall'.<sup>66</sup> Clearly, formalisation may enhance legitimacy and facilitate clarity by ensuring better coordination between parties, but

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<sup>56</sup> *ibid.*

<sup>57</sup> *ibid.*

<sup>58</sup> *ibid* 1348.

<sup>59</sup> *ibid.*

<sup>60</sup> *ibid.*

<sup>61</sup> Lord Devlin, 'The Relationship between Commercial Law and Commercial Practice' (1951) 14 *Modern Law Review* 249-66, 266.

<sup>62</sup> Morten Hviid, 'Long-Term Contracts and Relational Contracts' in B Bouckaert and G De Geest (eds), *Encyclopedia of Law and Economics* (Cheltenham, Edward Elgar 2000) 46-72, 46.

<sup>63</sup> DG Baird, 'Self-Interest and Cooperation in Long-Term Contracts' (1990) 19 *Journal of Legal Studies* 583, 586.

<sup>64</sup> A classic example of a US decision is *Varney v Ditmars* 217 *New York Reports* 223, 111 *North Eastern Reporter* 822 (1916). A classic English case that is frequently cited in recent decisions is the House of Lords' decision in *May & Butcher Ltd v King* [1934] 2 *KB* 17.

<sup>65</sup> Restatement (Second) of Contracts S 33(2); Uniform Commercial Code S 2-204(3).

<sup>66</sup> *ibid.* This is a general proposition that is qualified to the extent that the agreement has been partially executed by the promisee.

arguably it also results in fewer long-term contracts along with reduced flexibility, motivation, innovation and creativity.<sup>67</sup> Furthermore, classic contract law demands that any modification in the contract should comply with rules governing the formation of contracts, which were often designed to fulfil short-term economic interest.<sup>68</sup>

On the other hand, modern legislation, such as the UCC, reflects law merchant principles and favours a contract's enforcement by upholding the parties' intentions.<sup>69</sup> If parties choose an open price, the price term is filled by an agreed standard between them; if the agreed method by the parties fails, a court can fill the price term by applying a reasonable price during the later stages of a contract.<sup>70</sup> This approach seems better equipped to cope with the relational nature of highly complex, long-term sales.

Before progressing into a deeper explanation of how open prices could become more sustainable within the SGA and the CISG, the following section will explore the ideas of the supporters of contractual flexibility, Llewellyn, Macaulay, Macneil and Scott. These scholars support, and argue for, the relevance of the merchant's approach to flexible pricing in contemporary sales.

## **1.4 The pro-flexibility scholars**

### **1.4.1 Llewellyn**

Llewellyn, one of the earliest scholars that propounded the idea of flexibility in contracting, was also the main force behind drafting the UCC in the US.<sup>71</sup> When observing changes in the development of commercial law, Llewellyn discovered flexible contracting among merchants in the late eighteenth and early nineteenth centuries,<sup>72</sup> which, he noted, was an 'abnormal'

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<sup>67</sup> PVL Vlaar, FAJ Van Den Bosch and HW Volderba, 'On the Evolution of Trust, Distrust, and Formal Coordination and Control in Interorganizational Relationships: Towards an Integrative Framework', ERIM Report Series Reference No ERS-2006-035-STR, 12 <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=920230](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=920230)> accessed 20 May 2011.

<sup>68</sup> Hugh Collins, *The Law of Contract* (4<sup>th</sup>edn, London, Butterworths 2003) 346.

<sup>69</sup> Arthur Corbin, *Corbin on Contracts*, S 95(1963) 400.

<sup>70</sup> *ibid.*

<sup>71</sup> ID Abyad, 'Commercial Reasonableness in Karl Llewellyn's Uniform Commercial Code Jurisprudence', (March 1997) *Virginia Law Review* 83 no 2, 429.

<sup>72</sup> Allen Blair, 'You Don't Have to Be Ludwig Wittgenstein, How Llewellyn's Concept of Agreement Should Change the Law of Open Quantity Contracts' (2006-2007) 37 *Seton Hall Law Review* 67, 77.

practice.<sup>73</sup> Evolution from the typical, classic contract to relational contracts found support from Justice Holmes:

In a modern market contracts are not defined to sales for immediate delivery. People will endeavour to forecast the future and to make agreements according to their prophecy. Speculation of this kind by competent men is the self-adjustment of society to the probable. Its value is well known as a means of avoiding or mitigating catastrophes, equalizing prices and providing for periods of want.<sup>74</sup>

The critical transformation took place in the US between 1870 and 1920, when the economy went from an agrarian exchange of localism in nature and face-to-face communications to modern, industrialised practices characterised by cosmopolitanism.<sup>75</sup> By the early 1940s, parties had been communicating at arm's length, (departing from traditional, 'face-to-face' communication between a seller and buyer), and Llewellyn thought it was time to replace the classic law paradigm with actual business practices.<sup>76</sup> The UCC was drafted to apply Llewellyn's idea of realism between law and commerce, and it allowed commercial practice to be a source of legal rules.<sup>77</sup>

Llewellyn believed that many transactions were too dependent on the traditional law.<sup>78</sup> Subsequently, the rigid, traditional law was gradually replaced by the compelling need for a less constrictive commercial law in long-range planning and commercial commitments within a modern mass-production economy.<sup>79</sup> The framework of the UCC pays less attention to the abstract rules.<sup>80</sup> Instead, it assists the courts to determine, whether the parties have acted

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<sup>73</sup> Llewellyn, *Cases and Materials* (n 3) 1.

<sup>74</sup> *Bd of Trade v Christie Grain & Stock Co* 198 United States Supreme Court Reports 236, 247 (1905).

<sup>75</sup> WF Pratt Jr, *American Contract Law at the Turn of the Century*, (1988) 39 *South Carolina Law Review* 415, 416; Richard D Brown, *Modernization: The Transformation of American Life 1600-1865* (Eric Posner, Hill and Wang, 1976) 9-13.

<sup>76</sup> Blair (n 72) 76.

<sup>77</sup> Abyad (n 71) 429.

<sup>78</sup> Karl N Llewellyn, 'What Price Contract? An Essay in Perspective' (1930-1931) 40 *Yale Law Journal* 704-751.

<sup>79</sup> Blair (n 72) 77.

<sup>80</sup> James Q Whitman, 'Note, Commercial Law and the American Volk: A Note on Llewellyn's German Sources for the Uniform Commercial Code' (1987) in *Faculty Scholarship Series, Paper 658*, 156 <

[http://digitalcommons.law.yale.edu/fss\\_papers/658](http://digitalcommons.law.yale.edu/fss_papers/658) > accessed 25 May 2012.

reasonably or in accordance with the customs and usage of trade.<sup>81</sup> For example, open price was constructed in the spirit of upholding the reality of modern commercial dealings.<sup>82</sup>

Clearly, the UCC is dedicated to clarity and good business sense in commercial law, and has brought the best laws and practices in the US together into one coherent statement.<sup>83</sup> Llewellyn claimed that ‘if a statute is to make sense, it must be read in the light of some assumed purpose. A statute merely declaring rule, with no purpose or objective, is nonsense.’<sup>84</sup> As the principal author of the UCC, Llewellyn directed the courts to address legal issues using practical, open-ended methods<sup>85</sup> of the UCC.

Llewellyn’s views regarding contract law’s evolution and the tacit presuppositions of promises are elaborated in his article *What Price Contract? An Essay in Perspective*, which forms a crux to the idea of contractual flexibility proposed by this thesis.

*‘What Price Contract? An Essay in Perspective’*<sup>86</sup>

Llewellyn began his explanation by strictly defining ‘contract’ as the specific legal machinery appropriate when a specialised economy (which relies on exchange, instead of tradition or authority) moves into the phase of credit and future dealings.<sup>87</sup> Contracts are formed in the market for land, goods, services, credit or any combination of these markets.<sup>88</sup> The mutual reliance of two dealers on their respective promise is of crucial importance,<sup>89</sup> but economy, deals and promises are such normal course of dealing within a credit economy that reliance on them is a matter of tacit presupposition.<sup>90</sup> Due to this, Llewellyn claimed that a deal or promise should be

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<sup>81</sup> *ibid.*

<sup>82</sup> Section 2-305 of the UCC.

<sup>83</sup> Walter D Malcolm, ‘The Uniform Commercial Code in the United States’, (Jan, 1963) *The International and Comparative Law Quarterly*, vol 12, no1, 226-246.

<sup>84</sup> Karl N Llewellyn, ‘Remarks on the Theory of Appellate Decision and the Rules or Canons about How Statutes are to be Constructed’ (1949-1950) 3 *Vanderbilt Law Review* 395,400.

<sup>85</sup> Since none of these terms are defined in the Code, the Code’s nature was considered to be open-ended and indefinite; this consideration attracted commentaries from different philosophers concerning its uniqueness.

<sup>86</sup> Llewellyn, ‘What Price Contract?’ (n 78) 751.

<sup>87</sup> *ibid* 717.

<sup>88</sup> *ibid.*

<sup>89</sup> *ibid.*

<sup>90</sup> *ibid* 709.

enforceable unless a reason appears to the contrary.<sup>91</sup> In this view, the duty of the law should be to enforce the agreements of laymen when, and if, they make them.<sup>92</sup>

The rapid change of the economy created complex contracts that older models are somewhat inadequate to cover the rights and obligations of the parties.<sup>93</sup> In addition to the legal obligation to perform the contract, Llewellyn also highlighted the social sense of duty to perform (or roughly labelled as the ‘non-legal obligation’).<sup>94</sup> Compared to traditional practice, legal obligation is a relatively new development.<sup>95</sup> Furthermore, the non-legal obligation (or the social or ‘moral’ obligation) is barely recognised in law, and the distinction between the two obligations has received little attention.<sup>96</sup>

To meet the needs of a rapidly changing economy, Llewellyn extended the nature of contractual flexibility to include several contractual types. These were: output and requirements contracts; maximum and minimum contracts; and contracts for products of varying quality, quantity and kind to be specified on a monthly basis.<sup>97</sup> Today, possessing an element of flexibility is a marked trend in marketing goods where long-term buyer-seller relations are more important than an exact definition of the risks affecting quantity, quality or price in a particular trade.<sup>98</sup>

In the following chapters, this thesis will seek to analyse the technique of adopting a less precise price term in order to maintain parties’ relations with each other. The extent of price flexibility within the SGA and the CISG will be compared with the view of Llewellyn adopted by the UCC. As the final joint product of the American Law Institute and the Conference of Commissioners on Uniform State Laws, drafted under the direction of Llewellyn as its chief reporter, the UCC is

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<sup>91</sup> *ibid* 710.

<sup>92</sup> *ibid*.

<sup>93</sup> *ibid* 712.

<sup>94</sup> *ibid*.

<sup>95</sup> *ibid*.

<sup>96</sup> *ibid* 713.

<sup>97</sup> *ibid* 727.

<sup>98</sup> *ibid*.

a model for other sales laws to emulate is further discussed in Chapter Three. The SGA and the CISG will be discussed in Chapters Four and Five respectively.<sup>99</sup>

### 1.4.2 Macaulay

As an internationally recognised leader of the law-in-action approach to the contract, Macaulay pioneered the study of business practices and the work of lawyers related to questions of contract law and was regarded by Yale's Grant Gilmore as 'the Lord High Executioner of the Contract is Dead Movement'.<sup>100</sup> Concurring with Llewellyn's view, Macaulay stated that it was too common to find discussions on complex contracts, such as franchises and dealerships, in the form of discrete transactions.<sup>101</sup> While Llewellyn regarded complex contracts as 'abnormal',<sup>102</sup> Macaulay employed the term 'relational' to describe contracts belonging to franchises and dealerships.

Parties who formed relational contracts thought excessive planning destabilised the trust between them, which lead to a decrease in flexibility and productivity in their business relationship.<sup>103</sup> When governing transactions, the choice between legal and non-legal measures greatly depends on the interplay of various factors. For example, the qualities of the contracting partner, the frequency of contracting, the internal management and the organisational objectives.<sup>104</sup>

Macaulay distinguished 'relational' contracts from 'discrete' contracts in the example: a true discrete contract is where a motorist who, after embarking on a long trip, drives into a service

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<sup>99</sup>Soia Mentschikoff, 'Highlights of the Uniform Commercial Code' (Mar, 1964), *The Modern Law Review*, vol 27, no 2, 167-189,167.

<sup>100</sup> Macaulay declined the honour and claimed to have said only that academic contract was dead while the real institution was alive and well. Also, he is one of the founders of the modern law and society movement. See < <http://www.law.wisc.edu/profiles/smacaula@wisc.edu> >

<sup>101</sup> Stewart Macaulay, 'Long-term Continuing Relations: the American Experience Regulating Dealerships and Franchises' in C Joerges (ed), *Franchising and the Law: Theoretical and Comparative Approaches in Europe and the United States*, (Nomos Verlagsgesellschaft 1991) 179-237, 180.

<sup>102</sup> Llewellyn, *Cases and Materials* (n 3).

<sup>103</sup> Stewart Macaulay, 'Non-Contractual Relations in Business: A Preliminary Study' (1963) 28 *American Sociological Review* 55-67, 64.

<sup>104</sup> This point is considered by Oliver E

Williamson, *The Economic Institutions of Capitalism* (New York, Free Press 1985) ch 3; D Charny, 'Non-legal Sanctions in Commercial Relationships' (1990) 104 *Harvard Law Review* 373-467; L Kaplow, 'Rules versus Standards: An Economic Analysis' (1992) 42 *Duke Law Journal* 557-629; AW Katz, 'The Economics of Form and Substance in Contract Interpretation' (2004) 104 *Columbia Law Review* 496-538.

station on a major highway far from the city.<sup>105</sup> The service station attendant advises him that his vehicle's tires are dangerously defective, and that the rest of his journey can only be completed safely by replacing them with new ones. The station attendant also knows that the motorist is far from home and unlikely to return to the station, and indeed the motorist affirms that he will not be visiting the station again. Due to this, the sale of the new tires could be referred to as a discrete transaction.<sup>106</sup> However, other elements may make the simple transaction take on a more relational function. For instance, the driver could hold a credit card, and the credit card company could influence the types of businesses that accept that particular card. Moreover, if the gas station was a franchise of a major oil company, the oil company could seek to influence the gas station.

A truly relational contract goes beyond the simple act of a motorist seeking tires at a local station, and incorporates a much more complex web of relationships. In this type of transaction, the tire sale is just one part of a stream of transactions involving factors contingent on the past, present and future. Although the motorist could look elsewhere, he would need to find another service station that met the same need his present one did, and a similar relationship would have to be established at her new station. If there was a violation of the present relationship's norm, the service station might stop giving special privileges to the regular motorist. While market forces might push the service station to continue favourable treatment despite the motorist's violation of the expected norm, the motorist might not feel entitled to ask for the favourable treatment.<sup>107</sup> This example concurs with the idea propagated by Macneil about relational contract theory.<sup>108</sup>

Due to the relational elements present in modern contracts, Macaulay doubted whether courts would (or could) give formal, objective meaning to highly contextual language and behaviour.<sup>109</sup> If judges limit themselves to solely dealing with parties' formal, textual expressions (the 'paper

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<sup>105</sup> Macaulay, 'Long-Term Continuing Relations' (n 101) 181.

<sup>106</sup> *ibid.*

<sup>107</sup> *ibid.*

<sup>108</sup> Ian R Macneil, 'The Many Futures of Contracts' (1974) 47 *Southern California Law Review* 691; 'Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neo-Classical, and Relational Contract Law' (1978) 72 *Northwestern University Law Review* 854; *The New Social Contract* (New Haven: 1980); 'Values in Contract: Internal and External', (1983) 78 *Northwestern University Law Review* 340; 'Relational Contract: What We Do and Do Not Know' (1985) *Wisconsin Law Review* 483.

<sup>109</sup> Macaulay, 'The Real Deal and the Paper Deal' (n 1) 62.

deal’)<sup>110</sup> they would only be able to perceive the ‘plain meaning’ of the words in the contract without appreciating the other factors they imply.<sup>111</sup> Observing this, Macaulay advocated that ‘paper deals’ do not reflect the ‘real’ expectations of the deal<sup>112</sup> and he recommended courts took a contextual approach to protect the parties’ unwritten expectations.<sup>113</sup> However, it is dependent upon the individual judges to choose whether to act in either a formal or more ‘realistic’ manner.<sup>114</sup>

Proving tacit expectations are likely to be difficult and costly.<sup>115</sup> The only way, according to Macaulay, for courts to fulfil parties’ expectations (both written and unwritten), is for a contract law to rest on standards instead of quantitative rules.<sup>116</sup> Examples of standards might include reliance on good faith,<sup>117</sup> a commitment to active cooperation or limitations depending on commercial reasonableness.<sup>118</sup>

Macaulay discussed the problems dealt with in business practices by contract law in 1963.<sup>119</sup> The businessmen then viewed the extra cost required to plan as unnecessary and so omitted complete planning for performance and non-performance.<sup>120</sup> The contractual documents were often neglected based on the assumption that, as the transaction progressed, it would create

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<sup>110</sup> *ibid.*

<sup>111</sup> *ibid.*

<sup>112</sup> *ibid.*

<sup>113</sup> *ibid.*

<sup>114</sup> This issue raised was ‘where should an interpreter of contract locate herself between pure textualism and pure contextualism?’ In Robert E Scott, ‘Death of Contract Law’ (Fall 2004) University of Toronto Law Journal, vol 54, no 4, 369,376.

<sup>115</sup> Macaulay, ‘The Real Deal and the Paper Deal’ (n 1) 52.

<sup>116</sup> *ibid.*

<sup>117</sup> For example, the Uniform Commercial Code under Section 2-305(2) states that all open price contracts under the legislation must be entered into in good faith.

<sup>118</sup> Macaulay (n 1) 52. Section 2-305(1) of the Code applies ‘reasonable price’ if parties leave the price undecided in a contract. A similar standard applies in Section 8(2) of the English Sale of Goods Act 1979 in the event where a buyer and seller are both silent on the price of the goods.

<sup>119</sup> Macaulay, ‘Long-Term Continuing Relations’ (n 101) 188. The specific section is ‘Wisconsin Research Program on Long-term continuing relations’.

<sup>120</sup> The observation in 1985 suggested that both journalism and appellate reports show that in the 1970s and 1980s there have been a huge number of major contracts cases than the 1963 article. The finding by Macaulay has been that the major economic changes have strained the culture of cooperation he found twenty years earlier. The relational sanctions indeed maintained playing a significant role but economic change had exposed their limits.

expectation,<sup>121</sup> it is ‘the powerful informal norms, rather than legal rules, that govern most contracting behaviour’.<sup>122</sup>

Macaulay’s view is useful when addressing complex and long-term contracts in this thesis, and when comparing the three legislations in proving the value of the mercantile, flexible open-price approach. As Macaulay pointed out, it is costly to prove a real deal based on the tacit expectations of parties, but flexible contracting is a cost-effective method when it comes to upholding the long-term intention of a buyer and a seller in a contract of sale. Features such as good faith,<sup>123</sup> a duty to cooperate, or commercial reasonableness<sup>124</sup> are much better at highlighting those tacit expectations than formally expressed, quantified terms.<sup>125</sup>

### **1.4.3 Macneil: the founder of relational contract theory**

Macneil worked on arbitration and legal and political philosophy, which contributed to the development of his relational contract theory.<sup>126</sup> Macneil admitted that the classic contract law’s value had been ‘enormous, and continues to be of substantial value’<sup>127</sup> but his work was driven by the belief that a more attractive, rival contract theory was both possible and necessary to displace the classic contract law.<sup>128</sup>

To understand contract law, one must first understand contracts, what they are, how they work, why people enter into them and why people use the law.<sup>129</sup> In a similar fashion to Llewellyn, Macneil emphasised the importance of understanding contracts as a social and economic institution in order to grasp the role of the law and lawyer within a huge network of

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<sup>121</sup> Macaulay, ‘Long-Term Continuing Relations’ (n 101) 189.

<sup>122</sup> Macaulay, ‘Non-Contractual Relations in Business’ (n 103) 64.

<sup>123</sup> text to n 117.

<sup>124</sup> text to n 118.

<sup>125</sup> *Scafom International* is a classic fixed-price case analysed in Chapter Six, where the renegotiation costs could have been avoided if the parties opted for open price in the first place.

<sup>126</sup> David Campbell, *The Relational Theory of Contract: Selected Works of Ian Macneil* (London, Sweet and Maxwell 2001) 4.

<sup>127</sup> Ian R Macneil, ‘Barriers to the Idea of Relational Contracts’ (1987a) in F Nicklisch (ed), *The Complex Long-term Contract* (Heidelberg, Miiller juristischer Verlag 1986).

<sup>128</sup> Ian R Macneil, ‘Reflections on Relational Contracts’, (1985a) 141 *Journal of Institutional and Theoretical Economics*, 541-46, 542.

<sup>129</sup> Ian R Macneil and Paul J Gudel, *Contracts: Exchange transactions and relations: cases and materials*, (3<sup>rd</sup> edn, New York, Foundation Press 2001) 2.

contracting.<sup>130</sup> The basic idea of a social institution is that every human is a discrete individual; physically, psychologically and socially. Therefore, it is necessary to sort the dual and conflicting existence as individuals and as members of a collective, without which individuality cannot exist.<sup>131</sup> Contracts resulting from the relation between people-‘... in which human *cooperate* to achieve their goals and to resolve (always only temporarily) the tensions created by our dualistic nature-simultaneously individual and social’.<sup>132</sup>

Macneil perceived that the failure of classic contract law was due to its unrealistic approach to the rules of acceptance, the agreement of remedies and the processes of hire and purchase. Macneil stated that a contract was ‘hardly a neat and logical structure of rules, but like all law a social instrument designed to accomplish the goals of a man’. To Macneil, the traditional contract law cannot efficiently govern extensive, meticulously planned, inter-firm contracts between large but economically interdependent firms. For example, a building contract is too complex to be specified during pre-contractual negotiations. In this case, parties would need to adjust price and time in an unspecified manner to suit their expectations and obligations both during construction and on the completion of the building contract.<sup>133</sup> To fix the future price at the time of entering into the contract, or to presentiate the price, would be inconvenient for the parties. Macneil defines the term presentiation as ‘a way of looking at things in which a person perceives the effect of the future on the present, it is a recognition that the course of the future is so unalterably bound by present conditions that the future has been brought effectively into the present so that it may be dealt with just as if it were in fact present’.<sup>134</sup> Presentiation works well with discrete transactions, but it is not necessarily easily applied to relational contracts. The longer a contract carries on, the more difficult it is to simply look at an original agreement and provide satisfactory answers. English law responded to the problem of presentiation by using the concept of ‘implied terms’. However, Macneil noted that this approach only accentuated the problems involved in presentiation.<sup>135</sup> He suggested that a better response would be ‘...to develop an overall structure

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<sup>130</sup> *ibid.*

<sup>131</sup> *ibid.*

<sup>132</sup> *ibid.*

<sup>133</sup> Campbell, *The Relational Theory of Contract* (n 126) 16.

<sup>134</sup> Macneil, ‘Adjustment of Relations’ (n 108) 862.

<sup>135</sup> Ian R Macneil, ‘Restatement (Second) of Contracts and Presentiation’, (1974) *Virginia Law Review*, vol 60, no 4, 589, 597.

of contract law of greater applicability than now exists and to merge both the details and the structure of transactional contract into that overall structure'.<sup>136</sup>

Instead of imposing rules intended for discrete transactions, the resolution of a problem arising from long-term or relational contracts becomes an underlying issue of a contract. Because of this, Macneil claimed that ten common contract norms should replace classic contract law theory's reliance on individual, rational self-interest as governing norm. The contractual norms are as follows: integrity, reciprocity, implementation of planning, effectuation of consent, flexibility, contractual solidarity, restitution, reliance on expectation, creation and restraint of power, propriety of means and harmonisation with the social matrix.<sup>137</sup>

Presentation may work well in simple, discrete transactions but this does not necessarily imply that it will work in relational sales; therefore, minimising the impact of presentation is crucial to every sales law. Relational theory will be used to test the capabilities of the present sales laws in England, the US and the CISG in enforcing open price and requirements on long-term contracts. The current thesis is motivated by the desire to test Macneil's suggested norm of flexibility on open price practice within the three jurisdictions. Although the question of flexible contracting is often raised in today's courts, planning flexibility into economic relations began in the US from the nineteenth century<sup>138</sup> and has yet to be adopted by the SGA and the CISG.

#### **1.4.3.1 Macneil's recommended techniques for greater contractual flexibility**

Although Macaulay has written on businesses problems faced in 1963 and generally explained that businesspeople have disliked formality, stating that 'the powerful norms, rather than legal rules, govern most contracting behaviour',<sup>139</sup> Macneil expanded on the elements of contractual norms. Macneil enumerated the various techniques applicable for adapting the flexible, relational nature of a contract that, as observed by Macaulay, do not always involve thorough planning for performance and non-performance.<sup>140</sup>

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<sup>136</sup> *ibid.*

<sup>137</sup> Macneil, 'Adjustment of Relations' (n 108) 862.

<sup>138</sup> *ibid.*

<sup>139</sup> Macaulay, 'Non-Contractual Relations in Business' (n 103) 55.

<sup>140</sup> *ibid.*

Depending on the nature and type of transaction, there are five applicable techniques suggested by Macneil that permit a certain amount of flexibility under any sales law: the use of standards, direct third party determination of performance relations, one party's control of terms, cost and gaps in planning, and agreements to agree.<sup>141</sup>

The first technique, the use of standards such as the Consumer Price Index is useful in periods of fluctuation, but it may cause problems if the standard is discontinued or altered. However, alternatively, a third party not related to the contractual relationship could establish a suitable standard.<sup>142</sup>

The second technique, a direct third party determination of performance, draws on the expertise of an outsider to the contract. An architect from the architects' institution could determine a number of aspects such as the performance of a relationship, general administration and the approval of a contractors' selection of superintendent.<sup>143</sup> Another way of using this technique is through arbitration, a method that is mostly known for solving existing rights arising from contracts.<sup>144</sup>

The third technique, one party's control of terms, is used instead of using external standards or independent third parties; one of the contract's parties will define, directly or indirectly, parts of the contractual relationship.<sup>145</sup> This technique entails that one party has the ability to terminate the relation, and is important in certain areas of enterprise including financial markets, commercial real estate transactions, commercial sales of goods and certain types of consumer transactions (such as insurance). To cope with the difficulties of the doctrine of consideration, the transactional legal structure produced a wide range of concepts, provisions, techniques and other devices limiting the doctrine's impact. According to Macneil, the drafter who desires to achieve workable flexibility must be aware of the limitations the law imposes on available techniques, but

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<sup>141</sup> Macneil, 'Adjustment of Relations' (n 108) 866-67.

<sup>142</sup> *ibid* 866.

<sup>143</sup> *ibid* 866-68.

<sup>144</sup> *ibid* 868.

<sup>145</sup> *ibid* 868-69.

also the opportunities the law offers. Under the UCC, the typical practice regarding the sale of gasoline requires the supplier to decide the price in good faith before each delivery takes place. This is further discussed under Chapter Three using relevant court decisions.

The fourth technique is a combined pricing method of all three of the above techniques namely, the use of standards, direct third-party determination and one-party control.<sup>146</sup> While this method is possible, all case laws cited in this thesis do not involve a mixed method but rather a single price determination method for the purposes of discussion on whether open price works best and not necessarily on the issue of which of the open-price method is the most ideal.

The fifth technique is the agreement to agree which allows parties to fill in gaps in their relation at a later date, but still defines what the contract's completion would require at the outset.<sup>147</sup> Macneil affirmed that these processes often lead to a future agreement.<sup>148</sup> In light of this, Macneil asserted that sales law should treat these gaps similarly to other gaps.<sup>149</sup> While applying an agreement to agree can be fatal to later securing judicial gap-filling,<sup>150</sup> this is avoidable by adding of an alternative gap-filling technique to come into operation if the parties are unable to agree.<sup>151</sup> While agreement to agree is commonly practised in relational contracts, classic contract law may not be able to validate this method of contracting, hindered by its presentation character that requires precise determination of terms in every relational contract.<sup>152</sup>

#### **1.4.3.2 The acceptance of Macneil's theory in the US**

Macneil's relational theory gained much attention in the US for many years, and Macneil was described as both 'a perceptive analyst of the American contract law scholarship and too modest'.<sup>153</sup> Relational contract theory left a significant impact on the understanding and teaching of contract law in the US, and at a basic level of understanding, contractual relations are

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<sup>146</sup> *ibid* 869.

<sup>147</sup> *ibid* 870-71.

<sup>148</sup> *ibid*.

<sup>149</sup> *ibid*.

<sup>150</sup> *ibid*.

<sup>151</sup> *ibid*.

<sup>152</sup> *ibid*.

<sup>153</sup> Jay Feinman, 'The Reception of Ian Macneil's Work on Contract in the USA', ch 2, 59 in David Campbell (ed), *The Relational Theory of Contract: Selected Works of Ian Macneil* (London, Sweet and Maxwell 2001).

categorised as ‘discrete’ and ‘relational’ within mainstream of scholarship and teaching concerning contracts in the US.<sup>154</sup> The US’s classic contract law, which will be further explained in Chapter Three, is closely associated with Williston and the original *Restatement of Contracts*; these sources were motivated by the ‘isolated bargain between independent, self-interested individuals’,<sup>155</sup> which stands in stark contrast to the ten norms of relational contracts suggested by Macneil.<sup>156</sup>

Subsequently, contextualisation occurred after the enshrinement of classical contract law in Williston’s (1920) treatise and the Restatement (American Law Institute 1932) in the 1920s.<sup>157</sup> The UCC however, continues to provide elements to adapt to the needs of the relational contracts; this includes performance, course of dealing, and usage of trade as sources of contract interpretation (Section 2-208) and good faith as a baseline obligation (Sections 1-201(19), 1-203, 2-103(1)(b)).

#### **1.4.4 Scott: the self-enforcing contract theory**

While flexibility has been extensively detailed by Macneil, Scott pioneered the theory of contractual ‘self-enforcement’.

Although a formalist, Scott concurred with Llewellyn, Macaulay and Macneil that although the world’s states are infinite, contracting parties have a limited capacity to specify their future performance, which leaves parties to favour incomplete contracts.<sup>158</sup> Leaving a contract incomplete is a deliberate act, and when examined, the contract often employs linguistic ambiguity or fails to specify provisions in numerical terms.<sup>159</sup> In addition, parties have a mutual

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<sup>154</sup> *ibid.*

<sup>155</sup> *ibid.*

<sup>156</sup> Macneil, ‘Adjustment of Relations’ (n 108).

<sup>157</sup> Classic law is seen as inaccurate, misleading or indeterminate in terms of its abstract rules. Focusing on the facts and circumstances of each individual case initiates the construction of principles and policies, but compliance with formal rules merely guides contract law decisions.

<sup>158</sup> Robert E Scott, ‘A Theory of Self-Enforcing Indefinite Agreements’ (November 2003) *Columbia Law Review*, vol 102, 1, 3.

<sup>159</sup> Oliver E Williamson, ‘Transaction Cost Economics: The Governance of Contractual Relations’, (1979) 22 *Journal of Law & Economics* 233, 235-238.

desire for binding but flexible, responses to uncertain future conditions, and so intentionally limit the scope and precision of verifiable terms.<sup>160</sup>

The assumption that contracts fit into a simple two-step formula of ‘offer’ and ‘acceptance’ encourages contractual rigidity.<sup>161</sup> In reality, parties are not strangers; they are normally familiar with each other and prefer to interact off contract and to be ‘mediated not by visible terms enforceable by a court, but by a particular balance of cooperation and coercion, communication and strategy’.<sup>162</sup> Scott discovered that cooperation might arise without any contracts at all, and that ‘contracting parties use a mix of legal and extra-legal mechanisms, as well as patterned and individualised responses, to ameliorate the information and enforcement deficits that threaten emergence patterns of cooperation’.<sup>163</sup>

Scott found that one of the reasons parties, such as the merchants, write deliberately incomplete agreements is because these agreements are potentially self-enforcing.<sup>164</sup> Scholars have appreciated that if the contracting parties have a good reputation, especially through repeated interactions, their contract is self-enforcing.<sup>165</sup> Scott argued that self-enforcement not only applies to long-term commercial contracts, but also to contracts between strangers.<sup>166</sup> A further explanation of self-enforcement theory will be made in the following chapters, which emphasise the fact that a contract between parties of good repute and repeat trade should enforce itself without any need for justification under the contract law. In the next chapter, gradual explanation will be made on the types of industries that specifically apply the theory of contractual ‘self-enforcement’, even though this thesis focuses on open terms applied in legally enforceable contracts, rather than those applied in alternative or extra-legal agreements.

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<sup>160</sup> Gillian K Hadfield, ‘Problematic Relations: Franchising and the Law of Incomplete Contracts’, (Apr, 1990) *Stanford Law Review*, vol, 42, no 4, 927-992, 928.

<sup>161</sup> Honnold, ‘International Sales Law’ (n 5) 916.

<sup>162</sup> *ibid.*

<sup>163</sup> Gilson, Sabel and Scott ‘Braiding: The Interaction of Formal and Informal Contracting’ (n 15) where the term used was ‘braiding’.

<sup>164</sup> Scott, ‘A Theory of Self-Enforcing’ (n 158) 1.

<sup>165</sup> *ibid.*

<sup>166</sup> *ibid* 21.

## **1.5 The impact of relational theory in England and international law (CISG)**

### **1.5.1 The acceptance of Macneil's relational contract theory in England**

While most contract law scholars in England did not support Macneil's relational contract theory, Collins seemed to concur with the view that there is a need for flexibility in UK contract law. He advocated that contract doctrine needs to overcome fundamental obstacles presented by classic law (for instance, by upholding consensual modifications made following changed circumstances) and that courts should consider long-term interests as a guide to cooperation requirements so that economic opportunities can be maximised.<sup>167</sup>

In addition to Collins, Halson admitted that contracting parties are not omniscient, and that contracting for all future possibilities in an uncertain and complex world would be very costly, if not impossible, for them to provide.<sup>168</sup> Although Halson did not suggest the use of open terms as an alternative to resolve the cost issue, he agreed that the costs of a contract's terms at the initial stage could be reduced if the law facilitates and encourages adaptive behaviour between contracting parties.<sup>169</sup> This is in concurrence with the earlier discussion in this thesis, which concluded that compliance with classic contract law demands for rigid price-fixing is 'a convenient trap-door through which the imprudent or unscrupulous obligor can escape, leaving the innocent obligee to bar not only the loss of expected benefits but also the burden of liability to subpurchasers'.<sup>170</sup>

Campbell and Harris stated that the explanation of long-term contracts using classic contract law is very problematic<sup>171</sup> because 'efficient long-term contractual behaviour must be understood as consciously cooperative' as a long-term contract is an analogy to a partnership.<sup>172</sup> Instead of aiming directly at utility maximisation through the performance of obligations that are specified in advanced, parties would indirectly aim for long-term cooperative behaviour based on trust.<sup>173</sup>

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<sup>167</sup> Hugh Collins, *The Law of Contract* (Cambridge University Press, 2003) 309.

<sup>168</sup> Roger Halson, 'Opportunism, Economic Duress and Contractual Modifications' (Oct 1991) *Law Quarterly Review* 107, 649-78, 649.

<sup>169</sup> *ibid.*

<sup>170</sup> Berman, 'Excuse for Nonperformance' (n 2).

<sup>171</sup> David Campbell and Donald Harris, 'Flexibility in Long-Term Contractual Relationships: The Role of Co-operation' (1993) 20 *Journal of Law & Society* 166.

<sup>172</sup> *ibid* 167.

<sup>173</sup> *ibid.*

This cooperative mechanism, through which utility is achieved in a long-term relationship, is fundamentally different from a short-term, specified contract,<sup>174</sup> where the precise conduct and the shares in the joint product required by future long-term cooperation are not specifiable in advance.<sup>175</sup> Consequently, parties accept a general and productively vague norm of fairness to apply to their long-term commercial relationship.<sup>176</sup>

Within the English judicial position, these scholars' findings were not applied by the courts even though flexibility, trust and cooperation are not new ideas to English law.<sup>177</sup> However, the recent decision of *Mamidoil*<sup>178</sup> proved that the English court has been more receptive to the idea of maintaining long-term cooperation between parties. This indicated that the English law has indirectly accepted a long-term contract as 'self-enforcing' when it is made between a buyer and seller of repeatedly good reputation.

### **1.5.2 The acceptance of Macneil's relational contract theory by the CISG**

The CISG has been influenced by a variety of jurisdictions (including civil law) and incorporates both civil and common law methods. Beginning in 1968, the task of unifying international sales law was taken over by the United Nations Conference on International Trade Law (UNCITRAL), whose broad membership includes countries of different legal traditions and socio-economic conditions.<sup>179</sup> The 62 nations comprised of 22 from the 'developed' world, 11 from socialist regimes and 29 from third world countries.<sup>180</sup>

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<sup>174</sup> *ibid* 173.

<sup>175</sup> *ibid* 167.

<sup>176</sup> *ibid*.

<sup>177</sup> Mance LJ recognised this in deciding *Baird Textiles Ltd v Marks & Spencer Plc* [2001] England and Wales Court of Appeal (Civil Division) 274; [2002] 1 All England Law Reports (Commercial Cases) 737; [2001] Commercial Law Cases 999; quoting Bowen LJ in *Sanders Bros v Maclean & Co* (1882-83) Law Reports 11 Queen's Bench Division 327, 343: 'Credit, not distrust, is the basis of commercial dealings; mercantile genius consists principally in knowing whom to trust and with whom to deal, and commercial intercourse and communications is no more based on the supposition of fraud than it is on the supposition of forgery.'

<sup>178</sup> *Mamidoil-Jetoil Greek Petroleum Co SA v Okta Crude Oil Refinery AD (No1)* [2001] England and Wales Court of Appeal (Civil Division) 406.

<sup>179</sup> Alejandro M Garro, 'Reconciliation of Legal Traditions in the UN Convention on Convention for the International Sale of Goods' (1989) 23 *International Lawyer* 443-48, 443.

<sup>180</sup> *ibid* 444.

Because states have different backgrounds and jurisdictions, during ratification a state may declare that it will only join the CISG in part.<sup>181</sup> A state may refuse to be bound either by Part II (on the formation of contracts), or by Part III (on the rights and obligations of the parties).<sup>182</sup> The only mandatory parts are Part I on the sphere of application and other general provisions, and Part IV on the final provisions on ratification and related matters.<sup>183</sup>

As sales are often relational, the CISG provides two approaches to making a contract. In the first approach, a state may choose to contract under Article 14(1), which requires a price to be implicitly fixed, and preference for a classical, fixed price approach is found under this provision. The socialist legal systems are more inclined towards this provision, because of their needs to comply with the requirements of a planned, state-operated economy.<sup>184</sup> This approach prioritises the contract's security and guaranteed foresight over other values.<sup>185</sup> The second approach, favoured by some Western legal systems, allows parties to adjust a contract without judicial interference.<sup>186</sup> This is found under Article 55, which recognises the relational element of a sale even if the price is not set at the time of entering into the contract.

The Honnold-Farnsworth debate provides us with two opposing views: while Honnold takes a similar view to Macneil, believing that a contract with an unstated price is potentially valid,<sup>187</sup> Farnsworth thinks that an open price is only valid when there is an implicit requirement to price. If there was an absence of an implicit standard, Farnsworth would claim there is no sufficient ground to make an offer or construct a valid contract.<sup>188</sup> The subtle difference between the two opinions is that that Honnold's view would validate open-price contracts regardless of their method of price determination, whereas Farnsworth's view requires a certain standard that takes away the possibility of having an 'agreement to agree' on a price. However, the remaining price-

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<sup>181</sup> *ibid.*

<sup>182</sup> *ibid.*

<sup>183</sup> *ibid.*

<sup>184</sup> *ibid.*

<sup>185</sup> Gyula Eorsi, 'A Propos the 1980 Vienna Convention on Contracts for the International Sale of Goods' (1983) 31 *American Journal of Comparative Law* 342.

<sup>186</sup> *ibid.* 343.

<sup>187</sup> John O Honnold, *Uniform Law for International Sales under the 1980 United Nations Convention* (9<sup>th</sup> edn, The Hague, Kluwer International 1999).

<sup>188</sup> E Allan Farnsworth, 'Formation of Contract,' ch 3, Section 3.04 in Matthew Bender, *International Sales: The United Nations Convention on Contracts for the International Sale of Goods* (Galston & Smit ed. 1984).

determination techniques suggested by Macneil (cost, market price, third party determination and one party determination) are compatible with Farnsworth's view.

Nevertheless, during periods of rapid price fluctuation, a controversy may arise if Farnsworth's view is applied to sales. When a CISG court is not receptive to open-price contracts, the wording of Article 14(1), together with a narrow construction of Article 55, could lead to the nullity of a contract.<sup>189</sup> To maintain the enforceability of relational sales during times of price fluctuation, open prices leave a contract's price flexible. Further discussions on CISG court decisions under both Articles 14 and 55 are made in Chapter Five of this thesis.

## 1.6 Conclusion

Open price is not a modern practice; it originates from the law merchant and was later integrated into codified sales law. Its integration into a sales law improves the facilitative effect of commercial law. The tendency to leave the contract incomplete by leaving the price open was common in the trade of the merchants, but more importantly the practice continues in today's modern alliances and long-term industries. Parties braid a contract by fixing some terms, but leaving others, such as the price open. While some parties may consider open price as a preferable option, it is a particularly necessary practice to counter the effects of price fluctuations in the sale of goods. The *Westinghouse* case showed that a fixed-price method could not guarantee a transaction's convenience during times of price fluctuation.<sup>190</sup> Leaving the price term to be determined at a later stage would ensure that the parties could maintain long-term cooperation and, more importantly rely on the completion of their contract when circumstances change. In other words, price fluctuations, whilst causing difficulties, should not frustrate a contract. Instead of being bound by a fixed price, which could become unfairly high or low during changing circumstances, parties could counter the hardship by setting an open price.

Ultimately, legislation should not be a trap door for a relying party when the contract's performance is excused on grounds of changing circumstances. Indeed, this is what happened when most sales laws were formalised and separated from the practices of merchants (see section

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<sup>189</sup> *ibid.*

<sup>190</sup> *Westinghouse* (n 21).

1.3.1 above). However, US sales law was critically transformed to adapt to changes improvised to adapt to the changes, after the economy shifted from agrarian to industrialised practices ‘characterised by cosmopolitanism’ between 1870 and 1920. Llewellyn replaced classic formalism with principles of actual business practices, which is why the UCC carries numerous mercantile principles. The UCC not only acknowledges the legal obligation to perform the contract, but it also recognises the non-legal obligation, ie the moral duty to perform the contract in a rapidly changing economy.

Further research from Macaulay and Macneil illustrates the theoretical aspect of the complexity of modern contracts. The relational contract is used to distinguish complex, ‘arm’s length’ deals, and is opposed to a ‘discrete contract,’ which signifies a traditional, direct, ‘face-to-face’ way of contracting where all the contract’s terms could be easily fixed from the outset. It was discovered that most businesses problems are not resolvable if classic contract law demands presentation from the parties in relational transactions. Parties may have tacit expectations that are costly and difficult to predict, and so sales law should be more adaptable to their needs. If parties are unable to set a price when they enter into a new contract, sales law should be able to validate the deal using standards of good faith and commercial reasonableness instead of imposing a fixed-price requirement for valid contracts. The departure from the classic approach is particularly necessary when parties are so familiar with each other that they interact off contract and create an ongoing, self-enforcing contractual relationship.

To further acknowledge the essential requirement for sales law to be adaptable and facilitative of open prices, Chapter Two discusses the more specific, practical examples of incomplete contracts employing open terms. Extensive explanation by Gergen about different types of contracts, including agency contracts, oil and gas leases, will be explored. Chapter Two also focuses on why parties opt for open price. A general discussion about relevant provisions for open-price contracts in the UCC, CISG and SGA will be made. These legislations will be looked at in further detail in subsequent chapters, which will relate relevant illustrations of case law to each of the scholarly ideas discussed in this chapter.

## Chapter Two: The Benefits of Contractual Flexibility through Open Terms (and Open Prices) in Various Industries

### 2.0 Introduction

Chapter One encapsulated the idea of an agreement's 'completeness or 'incompleteness' and noted how merchants customarily determined the terms of an agreement during its later stages-as opposed to determining the terms at the time of the conclusion of the contract. Indeed, the idea of contractual flexibility was a foreign concept in classic contract law<sup>1</sup> even though such flexibility was commonly practised from the early 1900s onwards.<sup>2</sup> Flexible contract practice was sparked by the parties' mutual desires for flexible, yet bound, responses to the uncertainty of future conditions that limit the scope and precision of verifiable terms.<sup>3</sup> As explained by Scott and Macneil, parties are precluded from fixing terms due to future possibilities that cannot be predicted or verified by courts beforehand.<sup>4</sup> In addition, the merchants' familiarity with each other<sup>5</sup> leads to their interaction off contract, with 'a particular balance of cooperation and coercion, communication and strategy'.<sup>6</sup> Halson thought that sales law should be more adaptive to the changing circumstances that affect a contract, and observed that costs could be saved by using a flexible approach to make a contract instead of demanding that parties provide contracts which cover all potential eventualities.<sup>7</sup>

While Chapter One explained the law merchant's history and the advent of flexible, open prices, this chapter elaborates on the technical reasons for commercial parties to choose incomplete contracts over, complete ones. The nature of commercial contract requires the contractual gap to be filled when future conditions become clearer,<sup>8</sup> and the law merchant's open-endedness provides a suitable way to facilitate this.

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<sup>1</sup> In the US, the term 'classic law' denotes contract law developed in the 19<sup>th</sup> century and brought to its pinnacle by Samuel Williston in *The Law of Contracts* (1920) and in the *Restatement of Contracts* (1932). The neoclassical contract law is a modified version, in some respects, of the details of the classic law. This is epitomised by Article 2 of the UCC as well as *Restatement (Second) of Contracts* (Tent. Drafts, 1973-78).

<sup>2</sup> *ibid* 2.

<sup>3</sup> Hadfield, Chapter One (n 160).

<sup>4</sup> Chapter One, Section 1.4 (iii) and (iv).

<sup>5</sup> Hadfield, Chapter One (n 160).

<sup>6</sup> *ibid*.

<sup>7</sup> Halson, Chapter One, 'Opportunism, Economic Duress and Contractual Modifications' (n 168) 649.

<sup>8</sup> RB Schlesinger, *Formation of Contracts, A Study of the Common Core of Legal Systems* vol 1 (Steven & Sons, London 1968) 440.

This chapter begins by defining an open term and distinguishing it from other terms, before explaining the reasons for having them in various contracts, including sales contracts. This chapter also elaborates on empirical studies of industries that apply open terms, and concludes that their feasibility in other contracts shows that they could be similarly applicable in sales contracts.

## 2.1 An 'open' term versus a 'missing' term

Chapter One revealed that flexibility was one of ten contractual norms recommended by Macneil to be implemented in relational contracts<sup>9</sup> and one way of implementing flexibility was for parties to use open terms in their contract. An 'open term' expresses mutual commitment to a contract on agreed major terms, while recognising the existence of open terms that remain to be negotiated.<sup>10</sup> The contract is intentionally entered by parties who acknowledge that some terms require further negotiation,<sup>11</sup> or reference to a certain market or a third party to set the price, as promulgated by Section 2-305(1) of the UCC. This practice emerged from the complexities associated with twentieth century commerce,<sup>12</sup> which involved large-scale production and expanding markets that carried great uncertainty and business hazards.<sup>13</sup> Open terms are commonly applied in long-term contracts where a workable balance exists between cooperation and coercion, and between communication and strategy.<sup>14</sup> Occasionally, open terms are used in one-off contracts where continuous cooperation is unnecessary<sup>15</sup> such as in professional services or commodity businesses that do not necessarily rely on a reciprocal, ongoing relationship.<sup>16</sup>

The UCC for example, secures the validity of a contract for sale even if the price of the goods is not settled. What if the parties could not agree on price even after a negotiation or a reference to a certain market or a third party to set the price? In any of this situation, Section 2-305(1) of the UCC secures the contract by permitting the application of a reasonable price at the time of delivery of the goods. The thesis perceives such extent of enforceability of open

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<sup>9</sup> Chapter One (n 108).

<sup>10</sup> Nellie E Choi, 'Contracts with Open or Missing terms under the Uniform Commercial Code and the Common Law: A Proposal for Unification' *Columbia Law Review* vol 103, no 1 (Jan 2003) 50-73, 50.

<sup>11</sup> *ibid.*

<sup>12</sup> Harold C Havighurst and Sidney M Berman, 'Requirement and Output Contracts' (1932) 27 *University of Illinois Law Review* 1.

<sup>13</sup> *ibid.*

<sup>14</sup> Hadfield, Chapter One (n 160).

<sup>15</sup> *ibid.*

<sup>16</sup> Stefanos Mouzas and Michael Furmston, 'From Contract to Umbrella Agreement' (2008) 67 *Cambridge Law Journal* 37-50, 42.

price as a practical way of contracting in long-term deals that requires flexibility to negotiate changing prices of the goods, yet maintaining the cooperative, ongoing relationships between the dealers.

An open term is commonly confused with a ‘missing term’, which denotes the unintentional omission of a term due to the occurrence of an urgent situation.<sup>17</sup> Aside from the missing term, there are three other terms that are commonly confused with open terms:<sup>18</sup>

1) The open term and the ‘pre-contractual’ term

Whereas an open term is arguably enforceable by law, a pre-contractual term demands future contracts, and has an uncertain legal status.<sup>19</sup> The English courts will probably not decide that pre-contractual terms bind parties. However, US courts are more willing to accept pre-contractual agreements than English courts. Furthermore, German jurisdiction perceives a pre-contract term (*Vorvertrag*) as binding because it is likely that parties will eventually complete the main contract (*Hauptvertrag*).

2) The ‘umbrella’ term

An umbrella term provides the framework for further contractual decisions, whereas open terms include most terms in a business deal.<sup>20</sup> In *Baird Textile Holdings Ltd v Marks & Spencer Plc*<sup>21</sup> the implied understanding was interpreted by the court as an informal umbrella agreement that governed a series of discrete contracts and created an obligation to give fair notice before terminating the relationship.<sup>22</sup>

3) General terms and conditions

Although general terms and conditions are applied in relatively discrete and anonymous transactions, an open term typically applies to contracts with a more complex and relational nature.

The above definitions prove that there is a slight but crucial distinction between an open term and other types of terms. ‘Inadvertent’ and ‘deliberate’ are useful terms to distinguish

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<sup>17</sup> Scott, Chapter One (n 158) 1.

<sup>18</sup> *ibid.*

<sup>19</sup> For example, its validity is explicitly stated under the UCC Section 2-305 and the CISG under Article 55 on open price. The UCC takes one step further as seen in Section 2-306 in that it enforces open quantity.

<sup>20</sup> Mouzas and Furmston, ‘From Contract to Umbrella Agreement’ (n 16) 41.

<sup>21</sup> [2001] England and Wales Court of Appeal (Civil Division) 274, [2002] All England Law Reports (Commercial Cases) 737.

<sup>22</sup> Mouzas and Furmston ‘From Contract to Umbrella Agreement’ (n 16) 41.

accidentally ‘missing’ a term from intentionally leaving it open and are useful for discussion in the individual chapters dealing with the UCC, SGA and CISG. Due to this, relevant cases involving relational sales will be divided into these respective categories. This distinction has been chosen because, while all three legislations unanimously enforce missing terms under the inadvertent category, they differ in degrees of flexibility when enforcing open terms that are deliberately entered into by parties.

## **2.2 Defining the problem: the practice of merchants versus the rigidity of the codified law’s rules**

Gilson, Sabel and Scott demonstrated that business parties tend to respond to future uncertainty by braiding their contracts,<sup>23</sup> indeed, modern alliances are formed by blending the hard, fixed terms with more open, flexible standards.<sup>24</sup> Whilst hard and explicit terms provide firm protections and boundaries for each firm’s investments and obligations, an open and implicit term allows for greater operational flexibility to fully exploit the collaborative effort and maximise benefits.<sup>25</sup> Therefore, braiding is a useful practice in maintaining a business’s practicality.<sup>26</sup>

Despite the many benefits of using open terms in mercantile business, it does not necessarily follow that traditional, simple, fixed terms have lost their relevance in commerce.<sup>27</sup> Gergen stressed that parties should not use open terms because of the difficulty of writing a contract. In fact, a fixed-term contract is the most convenient to enforce<sup>28</sup> and preferable when both parties know the probability of all possible outcomes.<sup>29</sup> For example, despite the complexity of the agreement, a financing contract between a bank and a major commercial borrower that has definite terms detailing repayment and security would benefit from a fixed-term approach.<sup>30</sup>

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<sup>23</sup> Gilson, Sabel and Scott, Chapter One, ‘Braiding: The Interaction of Formal and Informal Contracting’ (n 15) 1377.

<sup>24</sup> DiMatteo, Chapter One (n 16).

<sup>25</sup> Gilson, Sabel & Scott, Chapter One, ‘Contracting for Innovation’ (n 17) 435.

<sup>26</sup> Vold, Chapter One (n 6).

<sup>27</sup> Cf Section 2-305(1) and (4).

<sup>28</sup> Gergen, Chapter One (n 9) 1055.

<sup>29</sup> *ibid.*

<sup>30</sup> *ibid* 999.

Nevertheless, open terms prevail over fixed terms in trades where parties cannot predict future eventualities; they allow a contract to adapt to changing circumstances.<sup>31</sup> In Chapter One it was observed that the fixed-price method did not work in the relational sale of uranium in *Westinghouse Electric Corp v Kerr-McGee Corp*.<sup>32</sup> the utility requiring an energy supply, entered into a twenty-year fuel agreement with the supplier.<sup>33</sup> Although the typical practice was to agree on a base price, subject to periodic adjustment based on increased production costs, the parties fixed the price for the sale of the uranium in a traditional manner. Unanticipated high inflation caused a sudden increase in costs that made the fixed-price contract come to failure in the early 1970s. The impact affected Westinghouse, which, in order to honour its commitment, had to sell large quantities of uranium at the previously arranged fixed price even though it cost Westinghouse more to purchase it.

While contractual adjustments by courts may resolve the problems of fixed prices,<sup>34</sup> open prices would have been much more efficient (especially when considering that goods such as uranium are susceptible to price volatility.) Fixing a price when the contract was agreed was too early to predict the rapid increase in price caused by the cartel,<sup>35</sup> but if the parties agreed on an open price hike under Section 2-305 of the UCC, the contract's performance would not have been excused by Section 2-615 of the UCC on the basis of impracticability.

Because the need for open terms (specifically open prices) increases in the modern market, the next section will explain the position of the UCC, SGA and CISG in addressing the issue before discussing the extent to which these legislations permit flexibility without compromising a contract's certainty.

### **2.3 The current judicial position of the UCC, the SGA and the CISG**

Chapter One briefly discussed Llewellyn's discovery regarding the mercantile practice of flexibility, which began in the late eighteenth and early nineteenth centuries.<sup>36</sup> By the 1940s, Llewellyn realised that there had to be a replacement for classic law's approach to contracting

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<sup>31</sup> Keith J Crocker and Scott E Masten, 'Pretia ex Machina? Prices and Process in Long-Term Contracts' *Journal of Law and Economics*, vol 34, no 1(April 1991) 69-99, 73.

<sup>32</sup> 580 Federal Reporter, Second Series 1311 (7<sup>th</sup> Cir), 99 Supreme Court 353 (1978).

<sup>33</sup> Hillman, Chapter One (n 20) 1.

<sup>34</sup> *ibid*.

<sup>35</sup> Gergen, Chapter One (n 9) 1055. Gergen also stated that while the fixed-term contract regulates performance mainly by the threat of legal sanction, the open-term regulates performance by sharing the return.

<sup>36</sup> Blair, Chapter One (n 72) 77.

(using terms derived from commercial dealing), which could better accommodate actual business practice.<sup>37</sup> Flexibility is a noted trend in marketing goods between merchants, which assumes that long-term buyer-seller relations are more important than exact definitions of risks to goods' quantity, quality or price.<sup>38</sup>

The UCC was drafted through a joint effort with the American Law Institute and the Conference of Commissioners on Uniform State Law.<sup>39</sup> The UCC's approach is chosen by this thesis as a model for the adoption of similar practices of price flexibility under the SGA and the CISG. The UCC is designed to maintain a contract's certainty, yet it also functions as a 'gap-filling' law when parties leave terms open, either inadvertently or deliberately.<sup>40</sup> This is evident, especially in regard to price, under Section 2-305(1):

The parties if they so intend can conclude a contract for sale even though the price is not settled. In such a case the price is a reasonable price...if the price is to be fixed in terms of some agreed market or other standard as set or recorded by a third person or agency and it is not so set or recorded.

Although permitting open price, the UCC still approves conventional fixed prices under Section 2-305(4):

Where, however, the parties intend not to be bound unless the price to be fixed or agreed and it is not fixed...there is no contract. In such a case the buyer must return any goods already received or if unable so to do must pay their reasonable value at the time of delivery and the seller must return any portion of the price paid on account.

The UCC empowers a court to play its role in determining parties' primary intentions,<sup>41</sup> if parties intend to be bound by a fixed price alone, the absence of an agreement on price entitles the relying party to restitutionary remedies as seen in Section 2-305(4).<sup>42</sup> This means that parties may choose to fix the price<sup>43</sup> or, contrastingly, say nothing in regard to it.<sup>44</sup> Somewhere between fixed and total silence lies a range of flexible techniques validated by

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<sup>37</sup> *ibid* 76.

<sup>38</sup> Llewellyn, Chapter One, 'What Price Contract?' (n 78) 727.

<sup>39</sup> Mentschikoff, Chapter One (n 99) 167.

<sup>40</sup> *text to n 8*, 442.

<sup>41</sup> However, if the standard is vague, such as 'we will take care of you', there is indefiniteness and the agreement is unenforceable (*Shofler v Jordan* (284 S.W.2d 612 (Mo. App.1955)). In this case, the parties did not agree if 'care' indicated reimbursement for expenses and lost wages, or payment for physical pain and mental anguish resulting from an injury (615).

<sup>42</sup> Schlesinger (n 8) 448.

<sup>43</sup> Section 2-305(4).

<sup>44</sup> Section 2-305(1)(a).

Section 2-305(1). These include an agreement to agree<sup>45</sup> and determination of terms by a third person, agency<sup>46</sup> or, one of the parties.<sup>47</sup> Under the UCC, all sales contracts that apply any of these three price mechanisms are valid as long as parties intend to be bound to the contract<sup>48</sup> and that the price is set in good faith.<sup>49</sup> A further exploration on open price under the UCC is made in Chapter Three.

### 2.3.1 The position of the SGA with regard to open prices

While there is similarity between the SGA and the UCC in recognising the validity of inadvertently incomplete contracts,<sup>50</sup> the SGA does not validate deliberately incomplete contracts by parties with the ‘intention to be bound’ to the contract; the English court’s focus has always been on whether the price term was sufficiently definite. Section 8 of the SGA, the primary provision on price, does not uphold a fixed-price agreement during market exigencies.<sup>51</sup> If the parties did agree on a price mechanism, English courts would generally withhold enforcing the agreement if the method for price determination broke down.<sup>52</sup> While English courts look for ways to enforce open terms,<sup>53</sup> there is always the possibility of nullifying an open term, under the English law if the parties left the price undecided without agreeing on a specific fixing method.<sup>54</sup>

### 2.3.2 The position of the CISG with regard to open prices

The CISG has a dual, somewhat perplexing, approach to open prices. Its setup has had a mixed-influence on the various jurisdictions of its Contracting States, ranging from the most liberal approach to contracting (such as the US) to some of the most restrictive methods (as

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<sup>45</sup> Section 2-305(1)(b).

<sup>46</sup> Section 2-305(1)(c).

<sup>47</sup> Section 2-305(2).

<sup>48</sup> Section 2-204(3).

<sup>49</sup> Section 2-305(2).

<sup>50</sup> An example under the SGA is *Traditional Structures Ltd v HW Construction Ltd* [2010] EWHC 1530 (TCC); [2010] CILL 2899 where the contract was held as valid despite the mistakenly omitted price (of cladding, for the purpose of the structural steelwork and roof planning) on the part of the claimant.

<sup>51</sup> *Acertec Construction Products Ltd (formerly BRC Ltd) v Thamesteel Ltd* [2008] England and Wales High Court 2966 (Commercial Cases) (Queen’s Bench Division (Commercial Cases)).

<sup>52</sup> In *Rafsanjan Pistachio Producers Cooperative v Kaufmanns Ltd* (Independent, January 12, 1998; (Queen’s Bench Division (Commercial Cases) [para 7] : the agreed price clause was to be agreed before each delivery. This was because the price for a new 1996 Pistachio crop had not yet been formally appraised in Iran. The court did not uphold the contract, although it had been a common practice for the plaintiff to agree to forward contracts with his major customers to new crop quantities, which left the price to be agreed subsequently.

<sup>53</sup> *Acertec Construction Products Ltd, and Mamidoil-Jetoil Greek Petroleum Co SA v Oka Crude Oil Refinery AD (No1)* [2001] England and Wales Court of Appeal (Civil Division) 406.

<sup>54</sup> *Scott Coal Co Ltd v Danish Forestry Co Ltd* [2010] Scotland Court of Session, Inner House 56.

witnessed in socialist countries). To compromise with the needs of various Member States,<sup>55</sup> there are two approaches provided by Articles 14 and 55. As explained in Chapter One, Part II of Article 14, validates a contract if it ‘expressly or implicitly fixes or makes provision for determining the quantity and price of the goods.’ In contrast, the supplementary provision of Article 55, found under Part III of the CISG, states that open prices actually require a contract to have an ‘implicit’ price fixed by law. Concerning the applicability of both articles, Member States have the option to choose to be bound by either or both parts.<sup>56</sup>

Article 14 certainly suited countries with socialist legal systems as it complies with the requirements of a planned, state-operated economy.<sup>57</sup> It prioritises the security of a contract and its foreseeability over all other values.<sup>58</sup> Conversely, Article 55 is a more appealing alternative for Western legal systems, which favour flexible standards that allow parties to adjust a contract without judicial interference.<sup>59</sup> While a more detailed explanation about the correlation of Articles 14 and 55 is found in Chapter Five, it should be noted that open prices under Article 55 are often bound by the requirements of a fixed (or implicitly fixed price) under Article 14(1). Article 55 may be difficult to apply when the contract is agreed on, because other factors make it hard to decide on a fixed price.<sup>60</sup> For example, the goods involved could be seasonal,<sup>61</sup> or market volatility might occur and make the initially agreed upon price detrimental to one of the parties.<sup>62</sup> Article 55 is not in *pari materia* with Section 2-305(1), which implements the reasonable price at the time of delivery clause to ensure that the fairest price is applied in unforeseeable situation.

As commercial law has different broad principles to international sales,<sup>63</sup> which form the ‘bifocal world of international sales law’,<sup>64</sup> both the SGA and CISG need to keep up with the

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<sup>55</sup> Many articles under the CISG make a compromise to live up to the expectations of the member states. A further elaboration is made in Chapter Five on open price in the CISG 1980.

<sup>56</sup> *ibid.*

<sup>57</sup> *ibid.*

<sup>58</sup> Eorsi, Chapter One (n 185).

<sup>59</sup> *ibid.* 343.

<sup>60</sup> Hungary 25 September 1992 Supreme Court (*Pratt & Whitney v Malev*) < <http://cisgw3.law.pace.edu/cases/920925h1.html> >

<sup>61</sup> An example under the CISG is the Germany 3 August 2005 District Court Neubrandenburg (*Pitted Sour Cherries case*) < <http://cisgw3.law.pace.edu/cases/050803g1.html> >. In this case the validity of sales contract is not hindered by the fact that the parties have, with regard to the price, only agreed to fix it during the season.

<sup>62</sup> Belgium 19 June 2009 Court of Cassation [Supreme Court] (*Scafom International BV v Lorraine Tubes S.A.S.*) < <http://cisgw3.law.pace.edu/cases/090619b1.html> >

<sup>63</sup> MG Bridge, ‘The Bifocal World of International Sales: Vienna and Non-Vienna’ in Ross Cranston (ed), *Making Commercial Law* (Oxford, Clarendon Press 1997) 277-96, 277.

requirements of complex contracts. Recognising the reliability of the SGA and the CISG in both local and international sales, this thesis proposes that both sales laws adopt a more flexible approach to price fixing in order to maintain relational sales.

### 2.3.3 Thesis proposal

By using the UCC as a model, this thesis proposes a more adaptable approach to setting prices, and advises minimising the *presentational* approach the SGA and the CISG favour. Based on the self-enforcing nature of a relational, long-term contract, as well as the commercial context

of a trade, open prices are often a more convenient solution, provided parties are proven to have an intention to be contractually bound. Presentiating the future price makes a long-term, relational deal less viable during fluctuations, because parties are unaware of the exact risks they could face. A strict compliance with classic contract law, which demands in rigid price-fixing, is ‘a convenient trap-door through which the imprudent or unscrupulous obligor can escape, which may leave the innocent obligee to suffer loss of expected benefits and also potentially, loss to subpurchasers’.<sup>65</sup>

To strengthen this thesis’s proposition, the fixed-price decision in *Scafom International BV v Lorraine Tubes S.A.S.*<sup>66</sup> is analysed in Chapter Six. This case involved a trade of steel products that faced price fluctuation prior to their delivery to the buyer; both parties intended to be bound by the deal, but their contract provided for a fixed price. In order to modify the price, the seller brought the case before the courts to obtain an order for renegotiation to remedy the consequences of a rigid fixed-price term. Arguably, the parties should have drafted the contract with an open price, but whether the relevant law (the CISG) would have enabled an open price is questionable. This thesis claims that if parties intend to be bound by a deal,<sup>67</sup> using an open price is the ideal contracting method. This is particularly true in long-term contracts that cannot completely specify all the obligations of both parties in advance.<sup>68</sup> This claim was supported by Crocker and Masten’s finding in their study of the natural gas industry: ‘Our findings indicate that price adjustment processes tend to be more flexible the

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<sup>64</sup> *ibid.*

<sup>65</sup> Berman, Chapter One, ‘Excuse for Nonperformance’ (n 2).

<sup>66</sup> *Scafom International* (n 62).

<sup>67</sup> Section 2-204(3) of the UCC emphasises this.

<sup>68</sup> Victor P Goldberg, ‘Discretion in Long-Term Open Quantity Contracts: Reining in Good Faith’ August 2000, Working Paper no 176 <[http://papers.ssrn.com/paper.taf?abstract\\_id=234705](http://papers.ssrn.com/paper.taf?abstract_id=234705)> accessed 5 March 2011.

longer the duration of the contract, presumably reflecting the greater uncertainty associated with performance at more remote dates'.<sup>69</sup> Both relative and general prices can change remarkably over extended time periods, such as in a long-term contract, causing originally agreed upon prices to become inappropriate.<sup>70</sup>

Now that the judicial positions of the UCC, SGA and CISG have been briefly explained, the next section will strengthen this thesis proposition by exploring the technical benefits of having open terms in long-term industries.

## **2.4 The specific benefits of open terms**

This section continues to elaborate on examples of open terms in the natural gas, uranium, coal and petroleum coke industries and discovers how open terms benefit the contracting parties more than fixed terms. The following subsections (2.4.1-2.4.7) show why contractual adaptations are so crucial in these industries.

### **2.4.1 Prevention of contractual opportunism**

An intentional open term has to be expressly legalised in legislation that could, first and foremost, prevent contractual opportunism by a party during changing circumstances.

Halson defines opportunism as 'the attempt by one party to exploit a vulnerability of his contractual partner created by the contract itself'.<sup>71</sup> The modification of a contract is opportunistic when the opportunist is able to capture a greater share the contract's return than was originally on.<sup>72</sup> In economic terms, an opportunistic party is primarily concerned with their own interests, and the opportunistic party's action may reduce the joint expected return of a contract.<sup>73</sup> When the opportunistic party attempts to capture a greater share of a contract's return,<sup>74</sup> the other party suffers greater losses.<sup>75</sup>

In the UCC, Section 2-305 permits open-price contracts providing parties intend to be bound by the contract. While parties may be opportunistic in setting or accepting a price, potential

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<sup>69</sup> Crocker and Masten, 'Pretia Ex Machina' (n 31) 96.

<sup>70</sup> *ibid* 70.

<sup>71</sup> Roger Halson, *Contract Law* (Harlow, Longman 2001) 339.

<sup>72</sup> Gergen, Chapter One (n 9) 1002.

<sup>73</sup> *ibid*.

<sup>74</sup> *ibid*.

<sup>75</sup> *ibid*.

opportunism is offset by the requirement for good faith between parties under Section 2-305(2). Both the SGA and the CISG need to reconsider their current approach of favouring fixed-price contracts when parties could have left the price open,<sup>76</sup> and as long as good faith is present, there is no reason for a contract to be unenforceable.

Before moving on to discuss how open price prevents opportunism in sales, an example of how open terms prevent opportunism in agency contracts will be observed.

#### **2.4.1.2 Prevention of opportunistic behaviour in agency contracts**

An example where open terms prevent opportunism is found in an agency contract between a principal and his agent. Traditionally, the principal pays the agent a fixed fee when the agent performs the contractual obligation,<sup>77</sup> but an alternative method of paying the agent is by using an open payment procedure. This would mean that an agent would be induced to perform a contract through the promise of sharing the profit with the principal.<sup>78</sup>

By using an open payment method to remunerate the agent, the agent would have to fulfil the contract without committing opportunistic behaviour or avoiding his contractual obligations.<sup>79</sup> In contrast to the fixed-fee method, the agent would have more incentive to work because his pay would be based directly on his performance,<sup>80</sup> and the principal would not need to incur a cost to monitor the agent's performance. Clearly, using open terms to share a profit replaces the need for the principal to monitor the effort of the agent, and as a result of the agent's increased incentive to maintain optimum performance, both agent and principal are able reap more profit from the relationship.<sup>81</sup>

Using open terms (such as an open price) in sales minimises opportunism because the deal remains valid during instable market conditions, and adjustable price terms also strike a balance between a contract's buyer and seller.

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<sup>76</sup> Section 2.2 emphasised that the long-term interests of parties, such as incapability to predict the future, familiarity of business parties and long-term cooperation are among the most apparent reasons for using open terms.

<sup>77</sup> Gergen, Chapter One (n 9) 1009.

<sup>78</sup> *ibid* 1010.

<sup>79</sup> *ibid* 1009.

<sup>80</sup> *ibid*.

<sup>81</sup> Gergen, Chapter One (n 9) 1009.

## 2.4.2 Maximisation of each party's return

The essence of the joint maximisation rule is that parties should proceed on agreements with the highest net value available to each other after taking all potential risks into account.<sup>82</sup> Indeed, the ultimate aim of a contract is to maximise the parties' joint expected return but not necessarily their *ex post* return.<sup>83</sup>

To discover whether fixed or open terms are better at maximising the parties' profits, Fehr, Klein and Schmidt designed an experiment using a single transaction to test the choice between an incomplete bonus contract which relied on cooperation, and a more complete incentive contract that involved performance monitoring.<sup>84</sup> In this experiment, each principal was randomly and anonymously matched with a different agent. The principal had to choose between an incomplete contract, where the initial wage offer was enforceable but both effort and bonus were discretionary, and a more complete contract with explicit incentives for effort (and costly) sanctions for nonperformance. The result showed that ninety percent of the principals chose the bonus contract and responded generously to higher levels of effort from agents. The average bonus paid by the principals remarkably and proportionately increased with the level of effort provided by the agents. Irrespective of whether the agents were fair or selfish individuals, they would put in much greater effort than the self-interest theory predicted. The experiment revealed that the effort induced by open-term, bonus contracts were 2.5 times greater than the level of effort the fixed-term contracts generated.<sup>85</sup> Obviously, the incomplete, open-term bonus contract resulted in a much higher payoff to both parties than the complete, fixed-term contract.<sup>86</sup>

In sum, incomplete sales contracts promote enforceability and continual cooperation while leaving less room for opportunism when market changes occur. While open fees maximise the profits of principal and agent, open prices in sales ensures that the contract provides equal profits to both buyer and seller. Furthermore, when the price of goods suddenly drops or increases, it should not cause the excessive gain of one party over the loss of another. Rather,

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<sup>82</sup> *ibid* 1000.

<sup>83</sup> *ibid* 1001.

<sup>84</sup> Ernst Fehr, Alexander Klein and Klaus Schmidt, 'Fairness, Incentives and Contractual Incompleteness, Institute for Empirical Research in Economics' (2001) University of Zurich, Working Paper #72.

<sup>85</sup> *ibid*.

<sup>86</sup> The more complete, explicit contract, the lower the payoff as shirking or opportunism is costly to monitor, verify and sanction (as explained in the preceding paragraph). The bonus contract promotes greater efforts from agents as a principal's promise to pay a conditional bonus is credible and principals incur no enforcement costs.

open terms balance the contract allowing for a reasonable price at the time of delivery to be applied, a feature absent in a fixed-price contract.

### 2.4.3 A cost-effective method of contracting

Open terms promote cost-effective contracting because when a term is left open, parties need not incur extra expenses haggling or speculating over potential price fluctuations in stock.<sup>87</sup> Paying lawyers to review the fine print on sellers' forms, such as proposals, acknowledgements of orders, and invoices,<sup>88</sup> is costly and time-consuming. This is especially apparent, if a seller fills thousands of purchase orders every week and cannot afford to make the time to negotiate the details of each transaction.<sup>89</sup> The required review is a costly but necessary process to negotiate fixed-term contracts, but this process is unnecessary when using open terms, which do not require meticulous reviewing.<sup>90</sup> By avoiding haggling and testing planning for future price fluctuations, particularly when there are potential situations that affect a party's gain or loss, open terms present a more appealing alternative to fixed-terms.<sup>91</sup>

As we have seen above (in subsection (i)), open terms improve an agent's performance by sharing the return with the principal, which works best for contractual obligations that are difficult to enforce<sup>92</sup> such as those that require constant monitoring.<sup>93</sup> Moreover, the principal can make savings by allowing the agent to work independently, which further highlights the cost-effective nature of an open term contract. This stands in contrast to a fixed-term contract, which primarily regulates performance through the threat of legal sanctions<sup>94</sup> that are impractical and expensive.

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<sup>87</sup> Arthur Okun, *Prices and Quantities: A Macroeconomic Analysis* (Washington DC, Brookings Institution 1981) 89, 134-78.

<sup>88</sup> Macaulay, Chapter One, 'The Real Deal and the Paper Deal' (n 1) 54.

<sup>89</sup> *ibid.*

<sup>90</sup> Gergen, Chapter One (n 9) 997, 1009; Charles J Goetz & Robert E Scott, 'Principles of Relational Contracts' 67 *Virginia Law Review* 1089, 1092 (1981); Victor P Goldberg, 'Price Adjustment in Long-Term Contracts' 1985 *Wisconsin Law Review* 527, 531-33; Victor P Goldberg & John R Erickson, 'Quantity and Price Adjustments in Long-Term Contracts: A Case Study of Petroleum Coke', 30 *Journal of Law & Economics* 369, 370 (1987); Paul L Joskow, 'Asset Specificity and the Structure of Vertical Relationships: Empirical Evidence' 4 *Journal of Law, Economics and Organization* 95, 101 (1988).

<sup>91</sup> *ibid.*

<sup>92</sup> Gergen, Chapter One (n 9) 1055.

<sup>93</sup> *ibid.*

<sup>94</sup> *ibid.*

By choosing an open-price sale, which applies a price when the goods are delivered, parties avoid costly mistakes by attempting to predict or presentiate the price. Unless parties intend otherwise, the cost of renegotiation can be avoided and parties are able to contract in a convenient manner. This is particularly useful in steel businesses, where there is a large gap between the contract's formation and the goods' delivery. The uncertain price of steel cannot be presentiated during the early stages of the contract, and so, in many contracts, an open price is more practical to cope with market price volatility.<sup>95</sup>

#### **2.4.4 Maintaining long-term cooperation between parties**

Often the mutual aim of both parties is long-term cooperative behaviour founded on trust instead of obligations that are fixed in advance.<sup>96</sup> Open term contract's cooperation is fundamentally different from a classic and specified contract.<sup>97</sup>

Because precise conduct is not easily specified in advance,<sup>98</sup> a long-term contract tends to resort to an open-ended approach, which permits useful variation or renegotiation of a contract that no longer fits the discrete category that demands presentiation.<sup>99</sup> Because of this, the open-ended contract maintains party cooperation during changing circumstances.<sup>100</sup> Macneil's analysis of contractual behaviour showed that 'conduct which is predominantly so modelled with this element of cooperation in the minds of the parties that a contract no longer stands alone as in the discrete transaction, but is part of a relational web'.<sup>101</sup> As a contract's duration increases, it is sensible to use more flexible provisions for renegotiations,<sup>102</sup> and it is obvious that presentiation is impractical for the needs of the unpredictable, long-term contracts.

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<sup>95</sup> Berman, Chapter One (n 2) 1431, 1437.

<sup>96</sup> Campbell and Harris, Chapter One, 'Flexibility in Long-Term Contractual Relationships' (n 171) 167.

<sup>97</sup> *ibid.*

<sup>98</sup> *ibid.*

<sup>99</sup> *ibid.* 170.

<sup>100</sup> *ibid.* 170.

<sup>101</sup> Ian R Macneil, 'Restatement (Second) of Contracts and Presentiation' (1974) 60 *Virginia Law Review* 595.

<sup>102</sup> Crocker and Masten 'Pretia ex Machina' (n 31) 89.

#### 2.4.5 A planning mechanism<sup>103</sup>

Instead of a contract outlining specific, precise planning, Macneil claimed that a contract should function as a general planning mechanism.<sup>104</sup> Such general, gradual planning ensures the longevity of long-term relations during changing circumstances. For example, outbreaks of war at unexpected places and times, terrorist attacks, the unexpected influence of OPEC upon energy costs and the arrival of new technologies can all affect a contract<sup>105</sup> but, although they may impede the contract's execution, they do not necessarily frustrate sales completely.<sup>106</sup> This is because 'long-term contracts will be formed even when there is less than even readily available clarity about the terms of those contracts, clarity being rejected in favour of a productive ambiguity'.<sup>107</sup> This is common in the manufacturing industry where 'the planning was far from complete...'<sup>108</sup> Palay once noted that, 'looking beyond the [written] contract is important because parties who have, or anticipate, strong relational ties with their contracting opposites are not particularly worried about initial terms of agreement'.<sup>109</sup>

Since a contract plans, rather than dictates a commercial relationship, it should not be invalidated on the basis of having no fixed price or the failure of its price mechanism. For example: Corporation A completes a contract with Corporation B, which agrees that Corporation A will buy its requirement of widgets from Corporation B at the price at which Corporation C (a third party to the contract) publishes its widgets. However, Corporation C later discontinues publishing its widget prices. Under Section 2-305(1)(c) of the UCC, the parties, having previously designated Corporation C as a standard, can now select an alternative commercially reasonable standard, provided that the parties intended the implication of 'market standard'. Thus if Corporation D was another corporation that sold widgets and traded on the same market as the other corporations, the contract between

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<sup>103</sup> Macneil and Gudel, Chapter One, *Contracts: Exchange transactions and relations* (n 129) 2.

<sup>104</sup> *ibid.*

<sup>105</sup> Macaulay, Chapter One, 'The Real and the Paper Deal' (n 1) 54.

<sup>106</sup> *ibid.*

<sup>107</sup> Campbell and Harris, Chapter One, 'Flexibility in Long-Term Contractual Relationships' (n 171) 169.

<sup>108</sup> Hugh Beale, *Remedies for Breach of Contract* (London, Sweet and Maxwell 1980) 4-5.

<sup>109</sup> Thomas M Palay, 'A Contract Does Not a Contract Make' (1985) *Wisconsin Law Review* 561, 562. See also Hadfield, Chapter One (n 160).

Corporations A and B could use Corporation D's published prices as an equally reasonable standard to replace Corporation C's prices as the standard for the contract.<sup>110</sup>

Macneil expressed that 'trouble can also come if the standard is discontinued or altered in some way'.<sup>111</sup> However, this discontinuation should not impede the enforceability of a contract. The goal of planning is to strive to allow sufficient flexibility for a situation, but 'not so loose as to cause unnecessary problem to the contractual agreement'.<sup>112</sup> Parties need to be 'conscious of the possibility that a court will let the relations fall apart if the standard is too indefinite'.<sup>113</sup>

In sum, the long-term needs of a contract require the implementation of open terms as part of its planning mechanism. Open terms create a privileged trading relationship between the parties, which is crucial 'in times of difficult markets, of glut or scarcity, in the sense that it reinforces, by rendering unambiguous, each party's claim to remain in business relations with the other. It thus gives better, but not absolute, security to the trading position of each party.'<sup>114</sup> Section 2-305 of the UCC gives additional security to a contract because, as long as there is an alternative way of ascertaining the price (such as a referable standard), a contract could still be enforceable despite the failure of its price mechanism.

#### **2.4.6 Less risk during market price fluctuations**

If parties know all the risks, or are risk neutral when entering a contract, the traditional fixed-price method ensures the optimal performance of a contract.<sup>115</sup> On the other hand, if a contract involves risky market conditions, parties should use open terms to avoid these risks.<sup>116</sup>

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<sup>110</sup> Anon, 'UCC Section 2-305(1)(c): Open Price Terms and the Intention of the Parties in Sales Contracts', 1 Valparaiso University Law Review 381 (1967) vol 1, no 2, 381-409, 388. A further discussion on the limits and comparison between the common law and the UCC is found in Chapter Three.

<sup>111</sup> Ian R Macneil, 'A Primer of Contract Planning: The Lawyering Process: A Festschrift in Honor of Louis M. Brown' (1974-1975) Southern California Law Review 48, 627-704, 658.

<sup>112</sup> *ibid.*

<sup>113</sup> *ibid.*

<sup>114</sup> T Daintith, 'The Design and the Performance of Long-Term Contracts', in G Teubner and T Daintith (eds) Contract and Organisation (Berlin, W de Gruyter 1986)

<sup>115</sup> Gergen, Chapter One (n 9) 1007.

<sup>116</sup> AM Polinsky, 'Fixed Price versus Spot Contracts: A Study in Risk Allocation' (1987) 3 Journal of Law, Economics, and Organization 27, 28-29, 41-43.

Prosser exemplified a situation of unpredictable risk as follows: a prospective seller (S), who owns a thousand bushels of wheat, intends to sell her wheat to a prospective buyer (B).<sup>117</sup> S will have to consider the risks before selling the wheat to B because the market price of the wheat might decline. If this were to happen, S would receive less for her wheat than its current value. Similarly, B risks that if the market price rises before he buys the wheat, he would have to pay more than what he would expect to pay currently. Although S and B could fix the price upfront, the contract is still susceptible to market volatility, and in this case a fixed price is unlikely to work. An ideal business arrangement would be to subject the price of the wheat to a certain method of price determination; this method could be the market price at the time of delivery, or price renegotiation.<sup>118</sup> Leaving the wheat's price open is crucial if both parties intend to deal with each other for a significant period of time, and it would ensure that the agreement remained continuously valid without being affected by market conditions.

In the *Scafom International* situation, the market price of steel rose by more than 70% than the originally agreed price, which brought great loss to the seller and unexpected gain to the buyer. The presiding courts assisted the seller by ordering a price renegotiation that made a new, fair price enforceable. The continual enforceability is feasible because risks can be handled as they arise, and balance can be restored to the contract.<sup>119</sup>

#### **2.4.7 The self-enforcing nature of agreements<sup>120</sup>**

With specific regard to long-term deals, Scott advocated that an open-ended agreement could have a self-enforcing nature. To be classed as self-enforcing, a contract needs to fulfil two stringent requirements: reputation and repeated interaction.<sup>121</sup> Scott added that repeated, reputable business relationships tend to choose a deliberate open term.<sup>122</sup>

Two examples of industries that heavily rely on the element reputation as a way to ensure performance of a contract are the diamond and cotton trades. In diamond trades, diamond dealers prefer to resort to alternative governance, namely the private legal system, where

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<sup>117</sup> William L Prosser, 'Open Price in Contracts for the Sale of Goods' (1932) *Minnesota Law Review* vol XVI, 733.

<sup>118</sup> *ibid* 734.

<sup>119</sup> A greater analysis of *Scafom International* is made in Chapter Six, which further illustrates the inefficiency of fixed prices in comparison to open prices.

<sup>120</sup> Scott, Chapter One, 'A Theory of Self-Enforcing' (n 158) 3-4.

<sup>121</sup> *ibid* 3-4.

<sup>122</sup> *ibid* 46.

agreements are concluded using extra-legal contracts.<sup>123</sup> These agreements may be regularly subject to interpretation by the courts, particularly when involving the rights of third parties.<sup>124</sup> As a result, these agreements often take the form of legally enforceable contracts.<sup>125</sup> However, Bernstein has emphasised that even if a fully specified legally enforceable contract could be used and inexpensively drafted, the diamond dealers tend to incur the pre-contract transaction costs of entering into extra-legal agreements.<sup>126</sup> This is because a legally enforceable agreement, regardless of its cost and convenience of drafting, is not often favourable in the diamond industry, in comparison to signing the deal under a private legal system where secrecy is highly valued.<sup>127</sup> Individual traders are often appalled by litigation that might reveal trade practices and tarnish their reputation.<sup>128</sup> Hence, these traders resort to agreements that are self-enforcing, and enforceable only in the arbitration tribunals that handle disputes regarding diamond trades where reputation of parties is protected by making the existence and result of a dispute confidential.<sup>129</sup>

Similar to the diamond trade, reputation plays an essential role towards ensuring efficient performance of the contract in cotton business, as opposed to remedying a breach by way of awarding damages. The damage measures under UCC for instance, are designed to protect the expectancy interest by putting the “aggrieved party...in as good a position as if the other party had fully performed.”<sup>130</sup> In contrast, the private legal system in cotton trades tends to undercompensate as the aggrieved party is entitled only to market difference damages plus a one-half cent per pound penalty, a considerably trivial amount given the contemporary cotton prices.<sup>131</sup>

Moreover, the cotton industry does not often rely on the types of standard-like words, such as “reasonable,” “seasonable” and “without objection in the trade”.<sup>132</sup> As opposed to these

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<sup>123</sup> L Bernstein, ‘Opting out of the Legal System: Extralegal Contractual Relations in the Diamond Industry’ (1992) 21 *The Journal of Legal Studies*, 115-157, 154.

<sup>124</sup> *ibid.*

<sup>125</sup> *ibid* 134.

<sup>126</sup> *ibid* 134.

<sup>127</sup> *ibid* 120.

<sup>128</sup> *ibid.* In addition to this point, Bernstein described that a trader’s reputation is tarnished even in defending himself in a meritless lawsuit.

<sup>129</sup> *ibid* 135.

<sup>130</sup> Section 1-106 UCC.

<sup>131</sup> L Bernstein, ‘Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions’ (2001) 99 *Michigan Law Review* 1724, 1733.

<sup>132</sup> *ibid.*

objective standards found under the UCC, which shall be elaborated in the next chapter, contracts concluded in cotton business resort to the more clear and straightforward rules.<sup>133</sup> This includes the fact that the objective element of good faith is absent under the cotton trade, although unjust and undesirable business practices are noted by the arbitrators when giving opinions.<sup>134</sup> The formal adjudication used in cotton industry gives little weight to elements of the contracting context.<sup>135</sup> Rather, the parties demonstrate preference for renegotiation under ‘self-enforcing’ contracts, maintaining the element of cooperation amongst them.<sup>136</sup>

Uniquely, private legal systems under both trades work well. In cotton business for instance, the trade rules are revised periodically in accordance with the development of technology, market changes and ambiguities revealed during disputes.<sup>137</sup> Arguably however, the UCC secures fixed-term contracts without always giving room for efficient breach by way of damages. Section 2-305(4) for example honours the validity of fixed term contracts without allowing damages to replace the performance of such contract. It is this feature of the UCC that the thesis focuses on, and how this legal system also allows flexibility using open price in a legally-enforceable contract, rather than in an extra-legal agreement, can benefit both SGA and the CISG. Hence, the empirical studies section in Section 2.6 will further elaborate on long-term contracts that apply open terms, rather than limiting the explanation within the industries that value secrecy by way of entering into extra-legal contracts.

Arguably, both reputation and repeated interaction apply as stringent elements that could preserve the validity of a contract by overriding the current textual approaches of the SGA<sup>138</sup> and the CISG, which emphasise the specific wording of the SGA. In contrast with the SGA and CISG, Scott explained that the UCC goes beyond common law by explicitly authorising courts to fill open terms in otherwise incomplete agreements.<sup>139</sup> Although both common law and the UCC<sup>140</sup> honour the intent to be bound by parties,<sup>141</sup> the difference between them lies

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<sup>133</sup> *ibid.*

<sup>134</sup> *ibid* 1734.

<sup>135</sup> *ibid* 1735.

<sup>136</sup> *ibid* 1764.

<sup>137</sup> *Ibid* 1725.

<sup>138</sup> *Scammell (G) & Nephew, Ltd v Ouston* (1941) AC 251 [268] (Lord Wright): ‘... the test of intention is to be found in the words used.’

<sup>139</sup> Scott, Chapter One, ‘A Theory of Self-Enforcing’ (n 158) 10.

<sup>140</sup> Section 2-204(3) UCC.

in the presumptions that follow agreements with open or indefinite terms; the UCC demands that courts infer the existence of open terms from the intention of parties, but this demand is absent in common law.<sup>142</sup>

## **2.5 The UCC as the ideal model of a commercial law, and why its approach should be adopted by the SGA and the CISG**

This thesis proposes that more extensive flexibility is required in price determination for the sale of goods; this raises two essential questions. Firstly, to what extent has the UCC been successful in realising Llewellyn's goal? Second, if the UCC has been successful, what would the adoption of its improvement (specifically, its implementation of open price terms in long-term sales) bring to the current SGA and CISG?

Although an elaboration of the UCC role as a commercial code is detailed in Chapter Three, it is worth noting here that the UCC requires the price to be set in accordance with reasonable commercial standards<sup>143</sup> and in good faith between the parties.<sup>144</sup> If a claimant alleges unfair pricing has occurred, the claimant has to prove that the defendant failed to act in good faith,<sup>145</sup> and that the commercial injury is above and beyond a mere increase in price. Any allegation of dishonesty under Section 2-305 requires a basis in objective fact, which, at minimum, requires a basis in to the commercial realities of the case.<sup>146</sup> Good faith is a rebuttable presumption under the UCC, but the fact that it is implied under the UCC means that US courts, providing a price is commercially reasonable under Section 2-305(1), usually favour enforcing open price contract. Clearly open prices are limited by good faith, and parties cannot opportunistically leave a contract to the detriment of a relying party. The practice of open price, rather than the classic requirement of a fixed price, proves workable under the UCC in coping with relational sales.

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<sup>141</sup> On this notion, Scott quoted Arthur Corbin on *Corbin on Contracts* Section 95 at 400 (1963): '...[T]he court should not frustrate [the parties] intentions if it is possible to reach a fair and just result, even though this requires a choice among conflicting meanings and the filling of some gaps that the parties have left.'

<sup>142</sup> RE Scott and JS Kraus, *Contract Law and Theory* (3<sup>rd</sup> edn, 2002) 315-322.

<sup>143</sup> It would be interesting to compare the conundrum of 'dishonest' price fixing between the cases of *Autry Petroleum Company, McDonald Oil Company v BP Products North America Inc* (June 26, 2009), US District Court for the Middle District of Georgia and *Allapattah Services, Inc v Exxon Corporation* 61 Federal Supplement, Second Series 1308 (Southern District of Florida 1999). In the former, the court found that the dishonest act did not breach the duty of good faith, whereas the latter case involved a dishonest act amounting to bad faith. Further details are found in Chapter Three on Open Prices in the US.

<sup>144</sup> Section 2-305(2).

<sup>145</sup> See *Allapattah* case in Chapter Three of the UCC.

<sup>146</sup> *United Energy Distributors, Inc v ConocoPhillips*, not reported in Federal Supplement, Second Series 2008 WL 4458991 (DSC), 66 UCC Rep.Ser.2d 997 1-8,7.

The second question addresses the potential for improvement in the SGA and CISG upon adopting the UCC's approach. The UCC has five features that could potentially benefit both SGA and CISG: (1) the presence of a gap-filling rule in its law, (2) the limitation of freedom *from* a contract, (3) the protection of the relying party's interest, (4) an adaptable sales law based on the nature and type of transaction in question, and (5) reduced costs during contracting and transaction.<sup>147</sup>

If the SGA and CISG adopted open prices, this thesis predicts that contracting parties could benefit from the following points:

- 1) Incomplete contracts can be completed if sales law provides a gap-filling rule. As a commercial code, the active role of the UCC assumes the need to fill gaps in price terms under Section 2-305. Other ways of filling gaps in incomplete contracts involve action regarding quantity, duration and terms of payment.<sup>148</sup> Parties are less opportunistic as they are aware of the statutory gap filling that causes them to be liable for the contractual provisions they agree on, even in future negotiations; this practice certainly limits the freedom of parties to walk away from a contract.<sup>149</sup>
- 2) The parties' right to walk away from contract will be limited. Classic contract theory permits the parties' freedom to walk away from a contract, unburdened by contractual or residual liability. However, the requirement of explicit terms under the classic view is no longer needed due to the existence of statutory gap fillers.<sup>150</sup>
- 3) The interest of the party who relied on a promise must be protected because contracts should not be dissolved once reliance costs have been incurred. This is true even if the other party attempts to leave a contract without intending to exploit the other opportunistically. An example of this is observed in *Baird Textile Holdings Ltd v Marks & Spencer Plc*<sup>151</sup> In this case, Marks and Spencer chose to walk away from the contract without giving substantial notice (the plaintiff argued for three years) of their intentions. However, the court rejected the plaintiff's argument. Despite the good reputation and thirty years of repeated interactions between both parties, the court held

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<sup>147</sup> Omri Ben-Shahar, 'Freedom *from* Contract' 2004 Wisconsin Law Review 261- 270.

<sup>148</sup> *ibid* 265.

<sup>149</sup> *ibid* 264.

<sup>150</sup> Section 2-305 of UCC.

<sup>151</sup> *Baird Textiles Holdings Ltd* (n 21).

that there was no implicit contract between the parties that warranted an advanced notice of termination, causing the parties to lose a profit of £38.5m and a reimbursement for anticipated expenditure totalling £15.1m. This case clearly illustrates the absence of protection for a relying party from unreasonable withdrawal from the agreement.

- 4) Contractual flexibility is well suited to the nature of contemporary business because a contract's performance cannot be excused without considering the custom of a particular trade.<sup>152</sup> In the CISG case concerning *Pitted Sour Cherries case*,<sup>153</sup> the seasonal nature of the trade required that the contract had to be entered before the cherries' price could be determined. As a result of this, the buyer was liable for the payment of the entire quantity ordered from the seller.
- 5) Enabling parties to be contractually bound before their affirmation of intent is incomplete allows a reduction in transactional and contractual costs. Gergen's arguments regarding this have already been noted; haggling over prices during the contract's conclusion is unnecessary because the price is determinable when the goods are of delivered.<sup>154</sup>

This thesis establishes its proposition (that the UCC's approach to price flexibility should be adopted by the SGA and the CISG) on the above five rationales. The next section highlights some established, long-term industries that have successfully applied open terms to their contracts. However, the movie industry is a noted exception to this, which is better suited to fixed-term and less flexible form of contracts.

## **2.6 Empirical studies of long-term contracts that apply open terms**

Most of economic activity across all jurisdictions is in the form of complex, long-term contracts.<sup>155</sup> Although it is possible to find open terms in one-off transactions, open terms are more common in transactions of longer duration, which necessitates continuous cooperation;<sup>156</sup> the following empirical studies display this and are divided into two main categories: sales contracts and non-sales contracts.

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<sup>152</sup> Berman, Chapter One, 'Excuse for Nonperformance' (n 2) 1431, 1437.

<sup>153</sup> *Pitted Sour Cherries case* (n 61).

<sup>154</sup> Gergen, Chapter One (n 9) 1007.

<sup>155</sup> Goldberg and Erickson, 'Quantity and Price Adjustments in Long-Term Contracts' (n 90) 369.

<sup>156</sup> *ibid.*

## 2.6.1 Sales contracts

### 2.6.1.2 Natural gas

The typical duration of sales of natural gas between producers and pipelines lies between ten and fifteen years. The use of price-adjustment provisions in such contracts was common prior to the introduction of wellhead price regulation.<sup>157</sup> The three studies on long-term contracts for natural gas are by Crocker and Lyon<sup>158</sup> and Crocker and Masten.<sup>159</sup> Crocker and Masten observed that price-adjustment terms do not neatly divide into those that fix prices by external, objective criteria and those that give parties discretion in setting price.<sup>160</sup>

Two applicable price adjustment methods in the natural gas industry are redetermination and renegotiation.<sup>161</sup> In redetermination, parties could choose definite or indefinite escalators. A definite escalator is where prices are adjusted based on an explicit, predefined schedule, which increases prices at a stipulated rate, but has the apparent disadvantage of failing to use information arising from the parties' relationship, which means it shares the many disadvantages of fixed-price contracts.<sup>162</sup> In contrast, indefinite escalators relate contract prices to market conditions as they unfold, and price determination is taken from a general price index or the price of a substitute product. Using this escalator, price implementation remains straightforward and prices are more flexible. However, due to the relationship-specific nature of assets used in producing, transporting or consuming a product, the indexed prices fail to track prices when parties are isolated from market alternatives.<sup>163</sup>

The second price adjustment method is price renegotiation, which uses more flexible renegotiations provisions.<sup>164</sup>

### 2.6.1.3 Petroleum coke

Goldberg and Erickson stated that a written contract is 'at best an imperfect representation of the underlying economic relations'.<sup>165</sup> As a written document is an incomplete specification

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<sup>157</sup> Crocker and Masten, 'Pretia ex Machina' (n 31) 80.

<sup>158</sup> Keith J Crocker and Thomas P Lyon, 'What do Facilitating Practices Facilitate? An Empirical Investigation of Most Favored Nation Clauses in Natural Gas Contracts' 37 (1994) *Journal of Law and Economics*, 297-322.

<sup>159</sup> Keith J Crocker and Scott E Masten, 'Mitigating Contractual Hazards: Unilateral Options and Contract Length' (1988) 19 *Rand Journal of Economics* 327-343; 'Efficient Adaptation in Long-term Contracts: Take-or-Pay Provisions for Natural Gas' (1985) 75 *American Economic Review* 1083-1093.

<sup>160</sup> Crocker and Masten, 'Pretia ex Machina' (n 31) 83.

<sup>161</sup> *ibid* 75.

<sup>162</sup> *ibid* 75.

<sup>163</sup> *ibid*.

<sup>164</sup> *ibid* 89.

of the contract's terms and conditions, adjustments to changing conditions are frequently made without consulting written contracts.<sup>166</sup> Parties involved in a long-term contract have a mutual interest to enter into a contract that maximises its value to both of them.<sup>167</sup> Nevertheless, they also have the selfish interest of acquiring a large individual share,<sup>168</sup> and so, in the long run, both parties need the assurance of a continual relationship that maintains the flexibility to adapt to changing circumstances.<sup>169</sup>

While parties could simply establish a single price, or a schedule of future prices, that could remain in force for contract's duration, they have the option of providing a mechanism for adjusting prices in light of changing circumstances.<sup>170</sup> There was an increase in the use of renegotiation clauses in contracts between 1966 and 1973, but after 1973 price indexes were used more frequently.<sup>171</sup> This was due to two significant shocks to the industry (a rise in energy prices and an antitrust decision)<sup>172</sup> that caused price indexes to be refined, which provided greater short-term protection for price changes and regular price renegotiation on fixed dates (quarterly or annually), or at a party's request.<sup>173</sup>

Both renegotiation clauses and price indexes were useful methods to cope with changing circumstances,<sup>174</sup> and a hybrid method of indexing and renegotiation used an index with a maximum/minimum limitation.<sup>175</sup> The disadvantage of indexing is that indexed prices are less accurate when there is lower correlation between an index and the current correct price.<sup>176</sup> On the other hand, renegotiation carries the advantage of allowing parties to use accurate, current information when revising a contract.<sup>177</sup> However, if a party has a much greater vulnerability, the prospect of renegotiation is less attractive.<sup>178</sup>

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<sup>165</sup> Goldberg and Erickson, 'Quantity and Price Adjustments in Long-Term Contracts' (n 90) 370.

<sup>166</sup> *ibid* 371. This point correlates well with Macaulay, Chapter One (n 106) 55 where parties to relational contracts thought excessive planning destabilised the trust between them, leading to decrease in flexibility and productivity in business relationship.

<sup>167</sup> *ibid* 375.

<sup>168</sup> *ibid*.

<sup>169</sup> *ibid*.

<sup>170</sup> *ibid* 387.

<sup>171</sup> *ibid* 394.

<sup>172</sup> *ibid* 391.

<sup>173</sup> *ibid* 398.

<sup>174</sup> *ibid* 387.

<sup>175</sup> *ibid*.

<sup>176</sup> *ibid*.

<sup>177</sup> *ibid*.

<sup>178</sup> *ibid*.

#### 2.6.1.4 Coal

Joskow<sup>179</sup> studied the structure of long-term coal supply contracts and their relationship to price and quantity adjustment provisions, which both guard against opportunistic behaviour and provide flexibility to adapt to changing market conditions as the relationship plays itself out over time.<sup>180</sup> The long-term coal supply contracts negotiated in the late 1960s and 1970s typically handled the problem of price determination by specifying a base price and an adjustment formula to calculate future prices.<sup>181</sup>

Joskow argued that these price adjustment formulas were reasonably well adapted to adjusting prices to market values associated with supply changes, which increase or decrease the overall cost of producing coal.<sup>182</sup> Subsequently, the pricing provisions minimised the number of contractual breakdowns arising from a party's opportunity to breach their agreements.<sup>183</sup>

Empirical analyses indicate that the transaction prices associated with old contracts are quite poor at tracking changes in market conditions during the current coal market decline.<sup>184</sup> Prior to 1980, price adjustment relied on a base-price-plus-escalation formula (BPE), where the base price reflected prevailing market conditions when the contract was negotiated.<sup>185</sup> However, after the fall of the market price during the oil crises that occurred between 1984 and 1985,<sup>186</sup> the old contract price was high when, in reality, the average market value of coal was falling.<sup>187</sup> Therefore, a typical pre-1980 long-term contract (in force between 1984 and 1985) had its prices, which were set by the formula, far above current market prices. As a result, a buyer was bound by the rigid price of the old contract unless the long-term contract allowed for flexibility in price renegotiation.<sup>188</sup> Voluntary renegotiations were desirable

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<sup>179</sup> Joskow studied contracts between electricity generators and coal suppliers. Paul L Joskow, 'Vertical Integration and Long-term Contracts: The Case of Coal-Burning Electric Generating Plants' (1985a) 1 *Journal of Law, Economics, and Organization* 33-80; Paul L Joskow, 'Price Adjustment in Long-term Contracts: The Case of Coal' (1988a) 31 *Journal of Law and Economics*, 47-83; Paul L Joskow, 'The Performance of Long-term Contracts: Further Evidence from Coal Markets' (1990) 21 *Rand Journal of Economics* 251-274.

<sup>180</sup> *ibid* Joskow, 'The Performance of Long-Term Contracts', 251.

<sup>181</sup> *ibid* 252.

<sup>182</sup> *ibid*.

<sup>183</sup> *ibid*.

<sup>184</sup> *ibid* 253.

<sup>185</sup> *ibid* 256.

<sup>186</sup> *ibid* 261.

<sup>187</sup> *ibid* 257. In fact Joskow also explained that both geographical and physical attributes of coal could affect the difference between the transaction prices for old and the average prices for coal produced in the U.S.

<sup>188</sup> *ibid*.

because they made it possible for parties to overcome inefficient contractual rigidities.<sup>189</sup> This was possible via the inclusion of a scheduled reopener provision that allowed parties to renegotiate price and/or quantity provisions on dates specified in contracts.<sup>190</sup>

Aside from the base price and adjustment formula, as well as voluntary renegotiations, a third method was used to tackle the changing price in the coal market: using the quantity or taking provisions that typically specify minimum and maximum quantities.<sup>191</sup> This happens when the buyer is the highest-value user of a seller's coal, and contract prices are above the seller's cost. In this situation, a seller may negotiate a lower price in return for increased quantities, but only on the provision that a buyer intends to increase the annual quantities taken, or to extend the term of the contract.<sup>192</sup>

### **2.6.1.5 Uranium**

Until the early 1970s, the fixed-price contract was common in the uranium industry before, resorting to open prices based on market or spot prices.<sup>193</sup> The application of open prices began in 1974 and became the dominant contracting mode for purchases involving future deliveries, or term commitments, until the first half of 1978.<sup>194</sup> This was a positive change, because in the *Westinghouse* case we saw that the fixed-price method was harmed by a rapid rise in the price of uranium in the early 1970s. Polinsky explained that uranium sellers are typically private firms, and buyers are frequently public utilities that use uranium to produce electricity.<sup>195</sup> In this situation, it seems that sellers were more at risk than buyers during price fluctuations (since uranium only formed a small fraction of the utilities' production cost, which they passed through to consumers).<sup>196</sup>

### **2.6.1.6 Summary**

These empirical findings show that contracts for the supply of natural gas and coal tend to use flexible, open price terms to cope with the rapidity of the market and to maintain their enforceability when circumstances change (through referring to the current market price and renegotiation between parties) . The gradual contracting trend evolved from a traditional

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<sup>189</sup> *ibid* 263.

<sup>190</sup> *ibid* 264.

<sup>191</sup> *ibid*.

<sup>192</sup> *ibid*.

<sup>193</sup> Polinsky (n 116) 41.

<sup>194</sup> *ibid* 42.

<sup>195</sup> *ibid*.

<sup>196</sup> *ibid*.

fixed-price method to a more open price, which uses market prices or the price at delivery to determine the value of the goods.

In the example of the natural gas, aluminium and petroleum coke industries, the combination of price adjustment methods and a provision for renegotiation was strategised to cope with fluctuating prices in the industry. The downside to courts allowing renegotiation is the additional cost it generates, especially when renegotiations need to be arranged whenever there is a change in the market. Renegotiations undoubtedly filled a gap in a contract, but it as a costly step that could have been avoided by parties if they chose an open price or agreed on a renegotiation or adaptation clause in their contract.<sup>197</sup> Cases such as *Mamidoil-Jetoil*<sup>198</sup> (crude oil) and *Scafom International*<sup>199</sup> (steel) proved that the fixed-price method is less workable than open prices, particularly in long-term deals. Ideally, the law of contract would support the formation of contracts with open terms as an alternative to fixed terms.

The abovementioned techniques are used in different industries, and remain feasible as long as initial agreements are sufficiently definite<sup>200</sup> and the law imposes a duty of good faith on parties to resolve ambiguous terms.<sup>201</sup> This includes situations where a contract leaves the power to specify price or quantity to either or both parties. Clearly Section 2-305(1) of the UCC, regarding open price, is safeguarded by subsection (2) which states using good faith as a standard to prevent one party from setting unreasonably high (or low) prices.

## 2.6.2 Non-sales contracts

### 2.6.2.1 Building Construction

Zheng, Roehrich and Lewis examined two supply arrangements between a public buyer (National Health Service, UK) and a private supplier.<sup>202</sup> The first project involved the design, build, finance and operation of the new hospital, while the second was for the construction of

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<sup>197</sup> This fact is taken from *Scafom International* case, and a further analysis is made in Chapter Six.

<sup>198</sup> [2001] EWCA Civ 406.

<sup>199</sup> *Scafom International* (n 62).

<sup>200</sup> Although vague contracts may be voided for being indefinite, the UCC explicitly states under Section 2-311 (1) that 'an agreement for sale is otherwise sufficiently definite...to be a contract is not made invalid by the fact that it leaves particulars of performance to be specified by one of the parties. Any such specification must be made in good faith and within the limits set by commercial reasonableness.'

<sup>201</sup> Section 1-203 of the UCC '[e]very contract [covered by the Uniform Commercial Code] imposes an obligation of good faith in its performance and enforcement'.

<sup>202</sup> J Zheng, JK Roehrich and MA Lewis, 'The Dynamics of Contractual and Relational Governance: Evidence from Long-term Public-Private Procurement Arrangements' (2008) 14 J Purchasing Supply Manage 43-54.

an emergency services training facility. These projects were complex, had anticipated durations of thirty years and were incompletely drafted. The first project involved complex and comprehensive set of contractual documents. Despite the importance attached to formal contractual measures, due to the nature of public procurement projects, the parties themselves thought the documents were important for minimising risk and achieving the project's outcome. Additionally, although the second project was based on a more trusting and flexible relationship, a complex contract was still drawn up. The trusting relationship was engendered between the personnel from the two sides responsible for the initial bidding and procurement phase of the project. When this phase ended the personnel responsible (or the trust bidding) were moved to other tasks. The contract ensured the feasibility of performance, although the detailed contract does not govern on a day-to-day relationship.<sup>203</sup> Furthermore, costs of modern transportation, communications, interest rates, depreciation of equipment and taxes were not able to be calculated when the parties entered the contract.<sup>204</sup>

Clearly, the practicality of open terms very much depends on the nature and type of a transaction.<sup>205</sup> This indicates that not all industries could benefit from open terms. Unlike long-term sales of natural gas, aluminium, coke, uranium and building construction, the movie industry, for instance, does not benefit from a similar practice. Instead, a short-term contract without an open term best fits the needs of the movie industry.

### **2.6.2.2 Exception: the movie industry<sup>206</sup>**

The movie industry has previously had a governance structure favouring long-term contracts from the Age of the Studio (1929-1948) to the most recent era.<sup>207</sup> A contract between an actor and a studio used to be long-term (in some cases for seven years),<sup>208</sup> and Chisholm likened a studio and an actor, to a buyer and a seller of acting services.<sup>209</sup> The Age of the Studio invested resources to promote an actor as a particular type of character; the reasoning behind this was that audiences would recognise the star's character type and return for future

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<sup>203</sup> *ibid* 49-50.

<sup>204</sup> *ibid*.

<sup>205</sup> Ben-Shahar (n 147).

<sup>206</sup> DC Chisholm, 'Asset Specificity and Long-Term Contracts: The Case of the Motion-Pictures Industry' (1993) *Eastern Economic Journal*, vol 19 no 2, 143-55,143.

<sup>207</sup> *ibid*.

<sup>208</sup> *ibid*.

<sup>209</sup> *ibid* 146.

performances.<sup>210</sup> Therefore, both actor and studio had an incentive to adopt a long-term agreement, and after the studio invested in training and promoting an actor it wanted the star to remain with the studio in order to maintain its income.<sup>211</sup>

In the Tarzan series, the studio paid the salary of the actor playing Tarzan (Weismuller) for an unusually long period of ten years.<sup>212</sup> The contract's long duration burdened MGM studios to persistently pay a salary to Weismuller while the studio waited for the next Tarzan instalment.<sup>213</sup> In addition, MGM needed to incur a sunk cost (such as advertising expenditure) to promote Weismuller, and this cost would not necessarily apply to other actors.<sup>214</sup> In return, Weismuller had to abstain from other acting jobs that could cause the transfer of profit to other studios.<sup>215</sup>

Long-term deals decreased after the Age of the Studio due to a dramatic increase in the number of independent producers and the commercial introduction of television.<sup>216</sup> Moreover, by this time, actors had a variety of employment opportunities upon the successful completion of a film.<sup>217</sup> The decision of the Supreme Court in *The Paramount* case (1948) concluded that the major studios had violated the Sherman Antitrust Act of 1890 by restraining trade in the motion-pictures industry.<sup>218</sup> Because of this, a studio no longer had a guarantee that its films would be exhibited; rather, an independent film exhibitor would show the film.<sup>219</sup> Resultantly, the studio lost control of promoting stars and was no longer required to manufacture a certain number of films each month to keep their theatre chains satisfied.<sup>220</sup> Additionally, independent producers began to favour short-term contracts.<sup>221</sup>

The movie industry illustrates that the nature of an industry determines the duration of an agreement, and not vice-versa. The movie industry proves that if there are a sufficient number

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<sup>210</sup> *ibid* 147. For example, the studios had invested in promoting careers of the stars such as James Cagney was typecast as a 'Bum at Warner', and Clark Gable was consistently played the 'Dangerous Man'.

<sup>211</sup> *ibid* 148.

<sup>212</sup> Joel W Finler, *The Hollywood Story* (New York, Crown Publishers Inc 1988) 172.

<sup>213</sup> Chisholm (n 206) 150.

<sup>214</sup> *ibid*.

<sup>215</sup> *ibid*.

<sup>216</sup> *ibid* 151.

<sup>217</sup> *ibid* 151.

<sup>218</sup> *ibid* 150.

<sup>219</sup> *ibid* 150.

<sup>220</sup> See generally DF Prindle, *The Politics of Glamour: Ideology and Democracy in the Screen Actors Guild* (Madison, University of Wisconsin Press 1988).

<sup>221</sup> Chisholm (n 206) 151.

of suppliers or buyers, there is barely any need for long-term contracts or flexible terms to maintain cooperation between parties. To relate this point to sales, there is clearly no need for long-term deals if different suppliers and buyers are able to provide supplies easily. Nonetheless, in long-term contracts, it is often detrimental to one party if another withdraws or walks away from a long-term relationship without proper notice when their contract specifies their intent to be bound to the long-term relationship. To walk away from a contract by dealing with another supplier or buyer is to act opportunistically, particularly when the relying party had invested on the contract. This is why a legislation of sale must protect the interest of the relying party by permitting price flexibility; as long as price is ascertainable, a contract remains effective even in the event of a failure of the agreed price mechanism. Indeed, the significant change brought by the UCC in 1952 replaced the Willistonian formalism in the preceding Uniform Sales Act (1906-1947).

Now that we have witnessed the practicality of open terms in long-term industries, the next section deals with modern industries that apply open term contracts.

## **2.7 Modern day contracting: different ways of using open terms**

Gabuardi explained that globalisation and change are the two major forces that shape the world.<sup>222</sup> Transportation, communication and business record keeping became more varied, flexible, faster and reliable, which multiplied the number and size of commercial dealings.<sup>223</sup> Flexible methods of contracting under a single uniform law, instead of a disparate law, were necessary to keep up with current business patterns. Furthermore, most contracts are relational rather than discrete, and this was the reason for unifying commercial law in the US, which began with the Uniform Sales Act and was followed by the UCC itself in 1952.

In coping with complexity brought about by modernisation, examples of current business trends that apply open terms are provided below.

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<sup>222</sup> Charles A Gabuardi, 'Open Price Terms in the CISG, the UCC and Mexican Commercial Law' (June 2001) <<http://www.cisg.law.pace.edu/cisg/biblio/gabuardi.html>> accessed 5 July 2007.

<sup>223</sup> Charles Bunn, Harry Sneed and Richard Speidel, *An Introduction to the Uniform Commercial Code* (Charlottesville Va, Michie Co 1964) 1.

### 2.7.1 The requirements contract

A requirements contract adjusts the price to equal the seller's cost of production. This mechanism is similar to a negligence rule<sup>224</sup> because the contract induces the buyer to set quantity at a level that maximises the short-run joint return to both buyer and seller.<sup>225</sup> Section 2-306 of the UCC allows quantity to be set at a later stage in two types of contracts; requirements and output contracts.<sup>226</sup> In a requirements contract, the quantity is determined by a buyer's requirements for a commodity, whereas an output contract is determined by a seller's output or production of a commodity. For example, a requirements contract could be drawn up between a mine and a utility, and would include terms for adjusting the price to equal the mine's cost of production.<sup>227</sup> Similar to the function of a negligence term, the price term regulates the utility's exercise of discretion under the open quantity term.<sup>228</sup> The price term functions to divide the gain of a contract between parties, and is adjusted based on external criteria that define the mine's cost, and not on the basis of the mine's actual costs. Consequently, the price encourages the mine to minimise its production costs.<sup>229</sup>

A cost-pricing requirements contract does not need to rely on a court to regulate its performance, but instead allows a seller to regulate the buyer's performance through a contract's price term.<sup>230</sup> Unlike a fixed quantity contract, a cost-pricing requirements contract enables a buyer to adjust his demands in response to the price signal.<sup>231</sup> A buyer is bound to perform a contract since he must either buy the input from a seller or accept a non-existent, or much smaller, return on their investment.<sup>232</sup> Moreover, a seller is bound by a contract through his promise to supply whatever quantity a buyer requires.<sup>233</sup> Hence, both parties are discouraged from trying to hold up the other to capture a greater share of the gain.<sup>234</sup> The price must have a certain objective criteria to induce a seller to minimise costs, but this objectivity may divert from the seller's true cost and resulting in a performance error. If the price lies below a seller's cost, then a buyer could manipulate the price by increasing the

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<sup>224</sup> Gergen, Chapter One (n 9) 1000.

<sup>225</sup> *ibid.*

<sup>226</sup> James J White and Robert S Summers, *Uniform Commercial Code* (5<sup>th</sup> edn, 2002) 101-02.

<sup>227</sup> Gergen, Chapter One (n 9) 1046.

<sup>228</sup> *ibid.*

<sup>229</sup> *ibid.*

<sup>230</sup> *ibid.*

<sup>231</sup> *ibid* 1048.

<sup>232</sup> *ibid.*

<sup>233</sup> *ibid.*

<sup>234</sup> *ibid.*

quantity, which would result in a joint net loss on performance.<sup>235</sup> In addition, a deviation between price and cost could give a party further incentive to over or under invest.<sup>236</sup>

### 2.7.2 The agency contract

An agent is typically employed by a principal to develop an asset, and the principal pays the agent a fixed fee for their services while retaining the right to all returns.<sup>237</sup> Section 2.4.1 above explained that this arrangement encourages an agent to underperform,<sup>238</sup> which entails that the principal incurs extra costs to monitor the agent's conduct. An alternative method would be to use open terms through a sharing arrangement, to give the agent incentive to perform the contract.<sup>239</sup> Using this approach, both parties eventually share the return<sup>240</sup> when the agent pays a royalty to the principal.<sup>241</sup> The agent has to pay the royalty based on a negligence-like term included in the arrangement, which stipulates that the agent is liable for the principal's forgone gain if the agent failed to perform to a reasonable standard.<sup>242</sup> This stands in contrast with the traditional fixed fee agreement that requires the principal to pay the agent 'regardless of the agent's success'.<sup>243</sup>

### 2.7.3 Sale of seasonal goods or goods with volatile prices

As well as long-term contracts, open prices are also applicable to seasonal goods. For example, the prices of seasonal goods are commonly determined according to the market price of sour cherries, and are later fixed by the seller when the product is ready to be sold. In the CISG decision of *Pitted Sour Cherries case*,<sup>244</sup> the court ruled that the buyer, a German plaintiff, could not avoid the contract on the basis that he lacked the intention to be bound by it. The validity of the contract could not be disputed on the basis of parties only agreeing to fix the price 'during the season', because the price of the seasonal cherries was still

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<sup>235</sup> *ibid* 1049.

<sup>236</sup> *ibid*.

<sup>237</sup> *ibid* 1009.

<sup>238</sup> *ibid*.

<sup>239</sup> Optimum performance is assured in such arrangements because the opportunity for an agent to display opportunistic behaviour is significantly reduced compared to the fixed-fee method (where agent is paid regardless the quality of the agent's effort).

<sup>240</sup> Gergen, Chapter One (n 9) 1010.

<sup>241</sup> *ibid*.

<sup>242</sup> *ibid*.

<sup>243</sup> *ibid* 1027. However, a fixed-fee is the preferred option when an agent is known to perform well. In other words, if the agent is especially capable, then the favourable payment option for the principal would be a fixed fee based on the agent's effort.

<sup>244</sup> *Pitted Sour Cherries* (n 61).

determinable.<sup>245</sup> Ultimately, the CISG did not perceive the seasonal clause to have amounted to an agreement to agree.<sup>246</sup>

The focus of this thesis includes goods that are susceptible to market conditions in addition to seasonal goods; some of the industries constantly affected by market price fluctuations include, but are not limited to, steel products, gasoline, crude oil and natural gas. The subsequent chapters focus specifically on these goods, and will present the numerous benefits of open prices for industries in the US, UK and the United Nations' jurisdictions.

#### **2.7.4 IT outsourcing**

The IT sector is one example where an open, vague approach may provide undue discretion to the IT provider,<sup>247</sup> which could be utilised to charge additional fees for anything not specifically required under the contract, and could also prevent the upgrade of equipment an IT company was required to service.<sup>248</sup> At the same time, a contract that is overly detailed might breed relational rigidity and anti-collaborative behaviour.<sup>249</sup> Such contracts, especially those coupled with detailed default or penalty clauses for poor performance, are likely to deter innovative problem solving or cooperation.<sup>250</sup>

#### **2.7.5 Independent service station**

Besides seasonal goods and goods that are susceptible to market fluctuations, this thesis also discusses independent service station contracts, which are commonly practised under the UCC. The dealers of independent service stations are vulnerable to pricing abuse from their suppliers because they are bound by long-term, sole-source supply agreements with open price terms. By using open prices, suppliers could take advantage of dealers by unnecessarily charging extra for petroleum. In an attempt to counter this, Section 2-305 of the UCC provides a primary legal defence that requires that prices set by a supplier under an open price term must be set in good faith, which indicates that a supplier must act honestly and in accordance with reasonable commercial standards.

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<sup>245</sup> Article 14 CISG.

<sup>246</sup> An agreement to agree, based on the explanation by Macneil, could be binding if there is a measure that can be used by parties to fill the gaps in undecided contract terms.

<sup>247</sup> DiMatteo, Chapter One (n 16) 21. A further and detailed explanation is found in Arturs Kalnins & Kyle J Mayer, 'Relationships and Hybrid Contracts: An Analysis of Contract Choice in Information Technology' (2004) 20 *Journal of Law, Economics and Organization* 207.

<sup>248</sup> DiMatteo, Chapter One (n 16) 22.

<sup>249</sup> *ibid.*

<sup>250</sup> *ibid.*

An example involving an independent service station is found in *Autry Petroleum Company, McDonald Oil Company v BP Products North America Inc*<sup>251</sup> In this case, the court upheld open price provisions because good faith was presumed, and as long as the price remained commercially reasonable, the price-setter, which in this case was the supplier, had the right to take a profit from the business. While a commercially reasonable price should not be discriminatory, it does not equate to a low price.<sup>252</sup>

In sum, open price is not a unique method, as there are various types of open terms practised in different contracts, such as open quantity in requirements contracts, sharing arrangement in agency and open fee in IT outsourcing. These convenient methods of contracting should find support from a sound sales law through the focus on the intention of the parties and good faith, as seen in the UCC. This concept found in the UCC provides a common approach to all open terms.

## 2.8 Conclusion

As opposed to Chapter One which discussed the general aspects of incomplete contracts, this chapter has stressed that the long-term duration of a contract requires an open price. Goldberg and Erickson regard completely drafting a contract, as nothing more than ‘an imperfect representation of the underlying economic relations’.<sup>253</sup> Instead, frequent adjustments to changed conditions are made without consulting the written contracts.

Additionally, the needs for long-term contracts to be more adaptive to the market indicate that less *presentiation* and more flexibility, should take place. The open-ended contract maintains cooperation between parties in changing circumstances. As Macneil’s analysis of contractual behaviour showed ‘conduct which is predominantly so modelled with this element of cooperation in the minds of the parties that a contract no longer stands alone as in the discrete transaction, but is part of a relational web’.<sup>254</sup> As contract duration increases, it is sensible to use more flexible renegotiation provisions<sup>255</sup> and while rules that demand *presentiation* work

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<sup>251</sup> 334 Fed Appx 982 CA11 (Georgia), (June 26, 2009), US District Court for the Middle District of Georgia.

<sup>252</sup> *Shell Oil Co v HRN, Inc* 144 SW 3d 429(Texas 2004).

<sup>253</sup> Goldberg and Erickson, ‘Quantity and Price Adjustment on Long-Term Contracts’ (n 90) 370.

<sup>254</sup> Macneil, Chapter One, ‘Restatement (Second) of Contracts’ (n 105) 595.

<sup>255</sup> Crocker and Masten, ‘Pretia ex Machina (n 31) 89.

well for discrete, face-to-face contracts, they are not able to meet the needs of unpredictable, long-term contracts.

The specific benefits of open prices in long-term industries are crucial for proposing changes to the current *presentation* rules of the SGA and CISG. To maintain cooperation between parties during market changes, open terms minimise opportunism, or ‘the attempt by a party to a contract to exploit a vulnerability of his contractual partner which is created by the contract itself’.<sup>256</sup> A party who acts opportunistically and secures a greater share of a contract’s return brings about a reduction in the joint expected return of a contract. However, under the UCC, potential opportunism is offset by the requirement of good faith under Section 2-305(2). Both the SGA and the CISG could adopt a similar safeguard in validating open prices.

This chapter has also compared the benefit of open terms in agency contracts. In such a scenario, an agent’s capacity for opportunism of the agent is reduced if a principal pays the agent by using an open payment method, instead of a fixed fee. Open payments motivate an agent to perform well throughout the contract with the incentive of sharing the profit with the principal. Compared to the fixed fee method, the agent has more incentive to work efficiently because his pay is based directly on his performance.

Moreover, parties could maximise their wealth by making agreements with the intention to secure the highest net value for both parties, after taking risks into account. While open fees maximise the wealth or profit of both a principal and agent, having open prices in a sale ensures that the contract provides equal profit to a seller and buyer. In times of market volatility, open prices help balance the contract by filling the price gap with a fair and a commercially reasonable price for both parties. Due to this, neither party would suffer from a discriminatory price that causes the gain of one party and loss of another.

Ben-Shahar listed reasons for adopting the UCC’s approach as follows: firstly, the UCC makes a sales law more predisposed to fill gap; secondly, gap-filling rules may limit parties’ rights to walk away from a contract; thirdly, the UCC protects the interests of parties relying on an initial promise; fourthly, adopting flexibility allows sales law to adapt to the type of

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<sup>256</sup> Halson, *Contract Law* (n 71).

business the contract deals with, which means reducing costs; and finally, its adoption helps parties to save contracting costs.

Adopting the UCC's approach means that open prices always have a definite objective standard (such as a current market price) to be referred to, which makes long-term industries convenient to deal with. Moreover, as explained in Section 2.6 above, industries dealing with natural gas, petroleum coke, coal and uranium have already departed from traditional fixed fee methods. Studies have shown that price indexing and regulated, voluntary negotiations are more efficient in adapting to price changes, which can save a contract from being needlessly defeated.<sup>257</sup> Based on the exigencies of the market, or the unique circumstances of a sale, Section 2-305 of the UCC fills the gaps in a contract and enforces it in the event of a dispute.<sup>258</sup>

This thesis proposes that both CISG and SGA can learn important lessons by adopting the UCC's approach. However, if this were unacceptable, at least redefining their existing rulings to allow for greater flexibility when enforcing open prices would be an important progression. The next chapter explains the major positive changes made by the UCC, which employed the practice of merchants and their preference for attaching value to trade usage instead of relying on paper documents.

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<sup>257</sup> Cf *Spiritusfabriek Astra v Sugar Products Co* (1917) 176 Appellate Division 829, 163 New York Supreme Court 516.

<sup>258</sup> *ibid.*

## Chapter Three: Open Price in the US under the Uniform Commercial Code (UCC)

### 3.0 Introduction and background

This chapter illustrates how flexible pricing under the UCC copes with the needs of relational sales, and how flexible pricing is particularly beneficial to the gas supply industry. During the time of the law merchant, open-ended contracts were commonly practised and the UCC maintains the application of law merchant principles in most sales and fills unstated prices, whether they are inadvertently or deliberately left open, by using standards of reasonable price and good faith, instead of fixed terms.<sup>1</sup> This chapter begins by explaining the general development of commercial law in the US, and then details the development of open prices by Section 2-305 of the UCC. Finally, it discusses relevant decisions on open price and the use of good faith as a balancing element to regulate price setting.

Chapter Two showed that contracting parties accommodate uncertainty by stipulating contingent claims in a contract.<sup>2</sup> Instead of defining a full set of obligations at the outset, as implied by standard economic treatment, complex contracts leave terms and obligations open for future determination.<sup>3</sup> According to Macneil, a contract should not be a specific written document, but a planning mechanism that can be updated when required.<sup>4</sup> Indeed, this was how merchants viewed contracts, and certain trades today follow a similar practice; Chapter Two provided a brief account of each long-term industry that adjusts their contracts to market changes. Natural gas, aluminium, petroleum, coal and uranium are examples of contracts where a buyer and seller commit to base a sale's price on a price index, voluntary renegotiations or a combination of the two.

Clearly, leaving the price unstated is crucial to sustain the longevity of a contract in long-term industries. Crocker and Masten stated that the longer the duration of a contract, the more flexible

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<sup>1</sup> Macaulay, Chapter One, 'Long-Term Continuing Relations' (n 101) 188.

<sup>2</sup> Crocker and Masten, Chapter Two, 'Pretia ex Machina' (n 31) 71.

<sup>3</sup> *ibid* 72.

<sup>4</sup> See Chapter Two, Section 2.4(v).

the price term should be, which result in deliberate action by parties to leave crucial terms (such as price or quantity) of the contract open, until a later stage in the agreement.<sup>5</sup>

Although having an open price was common and acceptable before its official enactment by uniform laws, this situation changed when the American economy was transformed by major investments in new transportation and communication technologies in the middle of the nineteenth century.<sup>6</sup> This was witnessed in the development of a national transportation network of canals and railroads, which significantly reduced transportation costs of and increased the size of firms' potential markets.<sup>7</sup> Resultantly, in order to take advantage of new opportunities and to cope with new risks and uncertainties, mass-production industries grew in response to the restructuring of the business sector.<sup>8</sup> Scholars have referred to the changes as a second industrial revolution, which resulted in the US rising to be the greatest economic and military power of the twentieth century.<sup>9</sup>

Changes in the social, political and economic life of the US were contributory factors to the changes in its legal system.<sup>10</sup> Furthermore, the demand of the modern industrial economy also contributed to the rationalisation of the American legal system, which included the unifying different states' commercial law through the adoption of unified commercial codes.<sup>11</sup> Although the codification of common law traditions (which is where the American legal system emanated from) did not receive much attention at first, increasing pressure to codify English and American common law began in the sixteenth century.<sup>12</sup> The increase of commercial activity in the early 1900s, including large-scale sales across regions and borders, further highlighted the inadequacy

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<sup>5</sup> *ibid.*

<sup>6</sup> Alfred D Chandler, *The Visible Hand: The Managerial Revolution in American Business* (first published 1977, Belknap Press 2002) 125.

<sup>7</sup> Donald J Smythe, 'Why was the Uniform Sales Act adopted in some states but not others' (March 29, 2008) 3 < [extranet.isnie.org/uploads/isnie2008/smythe.pdf](http://extranet.isnie.org/uploads/isnie2008/smythe.pdf) > accessed 24 May 2011.

<sup>8</sup> *ibid.* 4.

<sup>9</sup> Richard R Nelson and Gavin G Wright, 'The Rise and Fall of American Technological Leadership: The Postwar Era in Historical Perspective' (1992) 30 *Journal of Economic Literature* 1931-64.

<sup>10</sup> Lawrence M Friedman, *A History of American Law* (first published 1973, Simon & Schuster, Inc 1985) 17.

<sup>11</sup> Smythe, 'Why was the Uniform Sales Act adopted' (n 7).

<sup>12</sup> Gunther A Weiss, 'The Enchantment of Codification in the Common-Law World' (2000) 25 *Yale Journal of International Law* 435.

of the existing US law's ability to cope with change.<sup>13</sup> By the nineteenth century, a large number of merchants viewed the legal profession with distrust and regarded the complexity of law as a way to hide the legal profession's monopoly on trade.<sup>14</sup> As Chapter One explained, this was due to the nationalisation of law and the separation of commercial law from mercantile practice.

As a result, the codification that began in the nineteenth century, which intended to promote accessibility to the law<sup>15</sup> ultimately failed because it only summarised common law instead of reforming it completely.<sup>16</sup> Furthermore, none of the codes were made uniform in order to bring coherence and rationality to the states' laws in response to the demands of modernisation.<sup>17</sup>

The American Bar Association (ABA) was founded in 1878 to support the effort of uniformity of legislation throughout the union before establishing the National Conference of Commissioners on Uniform State Laws (NCCUSL) in 1892.<sup>18</sup> Without delay, the NCCUSL drafted a host of model uniform codes, which included the Uniform Sales Act (1906-1947).<sup>19</sup> In comparison to the codification movement of the nineteenth and the twentieth centuries, which was drafted by legal practitioners, legal academics brought a remarkable difference to the new legal codes.<sup>20</sup> The drafting and partial success of the Uniform Sales Act provided 'a natural experiment on the causes and consequences of legal codification...and general insights into the role of legal institutions in American economic growth and development'.<sup>21</sup> The Uniform Sales Act will be further discussed in the next section, but will be preceded by an examination of the current commercial code in the US (the UCC), which replaced its predecessor in 1952.

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<sup>13</sup> Charles Bunn, Harry Snead, Richard Speidel, *An Introduction to the Uniform Commercial Code* (KR Redden (ed), Charlottesville, Va, Michie Co 1964) 1.

<sup>14</sup> Peter J King, *Utilitarian Jurisprudence in America: The Influence of Bentham and Austin on American Legal Thought in the Nineteenth Century* (London, Garland 1986).

<sup>15</sup> Weiss (n 12).

<sup>16</sup> *ibid.*

<sup>17</sup> Smythe, 'Why was the Uniform Sales Act adopted' (n 7).

<sup>18</sup> Robert A Stein, 'On Uniformity Efforts to Ensure Uniform State Laws Have Helped Uphold the Rule of Law', (July 2002) ABA Journal, 69.

<sup>19</sup> Smythe, 'Why was the Uniform Sales Act adopted' (n 7) 8.

<sup>20</sup> NEH Hull, 'Restatement and Reform: A New Perspective on the Origins of the American Law Institute' (1990) 8 Law & History Review 55.

<sup>21</sup> Smythe, 'Why was the Uniform Sales Act adopted' (n 7) 9.

### **3.0.1 The insertion of law merchant principles into the UCC as a codified sales law**

Llewellyn was an experienced commercial lawyer and a close observer of the behaviour of commercial actors in particular trades and markets, but according to Scott, he did not possess the conceptual tools required to address the theoretical problems of relational contract.<sup>22</sup> Prior to drafting the UCC, Llewellyn discovered that parties often voluntarily adjusted to changing circumstances over the life of a contract.<sup>23</sup> In addition, there were strong social norms preventing opportunistic behaviour from buyers and sellers, which were crucial to the continuous enforceability of a contract.<sup>24</sup> Furthermore, it should be noted that Llewellyn's observation of these factors proved to be similar to Macaulay's later findings.<sup>25</sup>

Believing that relational contract problems were solvable if the law identified and incorporated the working rules of parties,<sup>26</sup> Llewellyn incorporated objectivity under Article 2 of the UCC, which defined the content of an agreement as including trade usage, prior dealings and parties' experience.<sup>27</sup> An agreement is defined by Section 1-201(3) as 'the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance as provided in this Act'. This concept is amplified in Section 1-205, which specifies that the course of dealing and trade usage gives particular meaning to, and qualifies the terms of, an agreement. To further incorporate mercantile custom in the UCC, Comment 1 to Section 1-205 states that 'the meaning of the agreement is to be determined by the language used by them and by their action, read and interpreted in the light of commercial practices and other surrounding circumstances'.

Llewellyn believed that the merchant tribunal mechanism was crucial in incorporating flexible, tailored defaults so that courts could identify mercantile norms.<sup>28</sup> The concept of flexibility does

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<sup>22</sup> Robert E Scott, 'The Rise and Fall of Article 2' (May 2002) 29 < [http://ssrn.com/abstract\\_id=302822](http://ssrn.com/abstract_id=302822) > accessed 13 April 2012.

<sup>23</sup> *ibid.*

<sup>24</sup> *ibid.*

<sup>25</sup> Macaulay, Chapter One (n 101) 188. The 'Wisconsin Research Program on Long-Term Continuing Relations' conducted by Macaulay, found that parties omit complete planning terms since new expectations are created as a transaction progresses, which makes planning in advance costly and unnecessary.

<sup>26</sup> *ibid.*

<sup>27</sup> Scott, 'The Rise and Fall of Article 2' (n 22).

<sup>28</sup> *ibid.* 30.

not indicate a subjective determination of what parties really mean in their agreements,<sup>29</sup> but it provides rules that encourage efficient *ex ante* contracting.<sup>30</sup> Furthermore, the incorporation of efficient *ex ante* rules correlates well with Gergen's concept of joint-maximisation, which claims that maximising the profits of both parties should be calculated on an *ex ante* return instead of parties' return *ex post*.<sup>31</sup>

The open-ended practice discovered by Llewellyn proves useful in contracts that are susceptible to the fluctuation of oil prices.<sup>32</sup> For example, crude oil price tripled when demands exceed supply and, along with the intervention of political events, oil exporters changed their method of setting prices.<sup>33</sup> Similarly, downstream prices for refined gasoline have experienced similar drastic fluctuations, which have led to the average US retail price of one gallon of gas to increase by nearly 250 percent from the end of 1995 to the middle of 2005.<sup>34</sup> Such price increases would be disastrous to a long-term supply contract between a gasoline refiner and a dealer who fixed their prices in the mid-1990s.<sup>35</sup>

Typically, these types of contracts would run for years and would have bankrupted the refiner if the refiner did not anticipate the future change in the cost of crude oil. On the other hand, the dealer would have reaped an enormous profit by selling gasoline at more than twice its cost to a market willing to pay higher prices for gasoline. Gasoline refining markets are discussed in greater detail below and this chapter concludes that the UCC has been successful at preserving the validity of open prices in gasoline markets.

Before studying the UCC in greater depths, the following section explains the sales law prior to the advent of the UCC. The Uniform Sales Act in the US was based on common law, was in

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<sup>29</sup> *ibid.*

<sup>30</sup> *ibid.*

<sup>31</sup> Gergen, Chapter One (n 9) 1000-1001, 1009.

<sup>32</sup> Douglas C Berry, David M Byers and Daniel J Oates, 'Open Price Agreements: Good Faith Pricing in the Franchise Relationship', (2007-2008) 27 Franchise Law Journal, 45-56, 46.

<sup>33</sup> Energy Info Admin, US Dept of Energy, Monthly Energy Review 123 (Sept 2006), 126 < [www.cia.doe.gov/emeu/mer/pdf/mer.pdf](http://www.cia.doe.gov/emeu/mer/pdf/mer.pdf) > accessed 3 February 2011.

<sup>34</sup> *ibid.*

<sup>35</sup> text to n 32.

force between 1906 and 1947, but received little attention for its formalistic approach, despite its goal of codifying and unifying the commercial law in the US.

### **3.1 The emergence of uniform law: the Uniform Sales Act (1906-1947) in the US**

During the late 1800s, US commercial law remained state-based, and was governed by common law rather than statutory law.<sup>36</sup> Despite the rigidity of fixed price terms, there were judicial decisions made under common law that proved that deliberately leaving price term undecided did not necessarily vitiate a contract. In *Acebal v Levy*<sup>37</sup> the goods were delivered, but the memorandum was not required to name a price if no price were agreed, since the law impliedly requires payment of a reasonable price. Similarly, in *McIllmoil v Frawley Motor Co*,<sup>38</sup> the court held that the price and model of a new car was determinable as the plaintiff could simply select one car out of three alternative models, which were all sold at set prices. Therefore, the plaintiff had to purchase a new car as was initially agreed with the defendant. In this case, traditional common law ruled the contract invalid due to its lack of specific terms; for as long as there was external evidence to ascertain the price, the contract remained valid.<sup>39</sup>

The pressure to codify English common law in the US began in the sixteenth century, and prior to the English Civil War, codification became appealing to a growing merchant class who were dissatisfied with the inconsistencies in common law and old statutes.<sup>40</sup> Although English law was not formally codified in any significant respect until much later, and even then only to a restricted extent, commentaries by Blackstone suggest that it facilitated greater uniformity and relieved some of the pressure for codification.<sup>41</sup> The Enlightenment later rejuvenated the interest in codification<sup>42</sup> when Bentham called for the rationalisation of all laws in a single utilitarian legal

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<sup>36</sup> Macaulay, Chapter One, 'Long-Term Continuing Relations' (n 101) 188.

<sup>37</sup> (1834) 10 Bingham's Common Pleas Reports 376, 3 Law Journal Reports, Common Pleas 98.

<sup>38</sup> 213 Pacific Reporter 971, 972 (California 1923).

<sup>39</sup> Although both common law and the UCC honour parties' intent to be bound, the difference between them does not lie in the purpose of the rule itself, but in the presumption that follows from agreements with open or indefinite terms. The UCC prioritises the intention of parties over the open or indefinite terms, and this feature is absent from common law.

<sup>40</sup> Smythe, 'Why was the Uniform Sales Act adopted' (n 7) 5.

<sup>41</sup> Weiss (n 12).

<sup>42</sup> Smythe, 'Why was the Uniform Sales Act adopted' (n 7).

code.<sup>43</sup> Although Bentham's arguments failed to stand, he did succeed in influencing a movement of American thinking.<sup>44</sup>

Between 1890 and 1910, there were two known methods of unifying the law; the first was by federalising the law through a federal statute that could be applied to interstate transactions, and the second required setting a series of uniform state laws.<sup>45</sup> The latter method was chosen, and the NCCUSL, a special, independent body initiated by the ABA, was created.<sup>46</sup> The NCCUSL composed of commissioners from every state whose duty was (and still is) to prepare and recommend uniform laws for commercial matters that could be enacted by state legislatures.<sup>47</sup> Additionally, the NCCUSL promulgated the Uniform Negotiable Instruments Law in 1896 and the Uniform Sales Act in 1906.<sup>48</sup>

### **3.1.1 The rise of the Uniform Sales Act (1906-1947)**

The Uniform Sales Act (1906-1947) was a precursor to Article 2 of the UCC, and was adopted by thirty-four states between 1906 and 1947.<sup>49</sup> Mirroring the English SGA (1893),<sup>50</sup> it represented the first serious attempt to codify and unify American sales law.<sup>51</sup> Despite being drafted by Samuel Williston, one of the most well-known contracts scholars of his time, the Act was only adopted in thirty-four 34 of the forty-eight states that were members of the union by the middle of the twentieth century.<sup>52</sup> Mooney stated that 'Williston has seized the strategic ground of American contract law when he drafted the Uniform Sales Act and went on to publish his monumental Restatement of Contracts.'<sup>53</sup>

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<sup>43</sup> *ibid* 4.

<sup>44</sup> *ibid*.

<sup>45</sup> Bunn, Snead and Speidel (n 13) 2.

<sup>46</sup> *ibid*.

<sup>47</sup> *ibid* 4.

<sup>48</sup> Bradford Stone, *Uniform Commercial Code in a Nutshell* (Minnesota, West Pub Co1994) ix.

<sup>49</sup> Smythe, 'Why was the Uniform Sales Act adopted' (n 7) 2.

<sup>50</sup> Mentschikoff, Chapter One (n 99) 172.

<sup>51</sup> Smythe, 'Why was the Uniform Sales Act adopted' (n 7) 2.

<sup>52</sup> *ibid*.

<sup>53</sup> Eugene F Mooney, 'Old Kontract Principles and Karl's New Kode: An Essay on the Jurisprudence of Our New Commercial Law' (1966) 11 Villanova Law Review 213-258, 224.

There are two basic ideas central to Willistonian formalism: first, that a contract's terms should be interpreted according to their plain meaning, and second, that written terms have priority over unwritten expressions of agreement.<sup>54</sup> These ideas were implemented in Sections 9 and 10 of the Uniform Sales Act with specific regard to a sale's price term:

#### Section 9 Definition and ascertainment of price

9(1) The price may be fixed by the contract, or may be left to be fixed in such manner as may be agreed, or it may be determined by the course of dealing between the parties

9(2)...

9(3)...

9(4) Where the price is not determined in accordance with the foregoing provisions the buyer must pay a reasonable price. What is a reasonable price is a question of fact dependent on the circumstances of each particular case.

#### Section 10 Sale at valuation

10 (1) Where there is a contract to sell or a sale of goods at a price or on terms to be fixed by a third person, and such third person without default of the seller or the buyer, cannot or does not fix the price or terms, the contract or the sale is thereby avoided; but if the goods or any part thereof have been delivered to and appropriated by the buyer he must pay a reasonable price therefore.

Sections 9 and 10 above are identical to the current Sections 8 and 9 of the SGA in England.<sup>55</sup> Therefore, it is crucial to distinguish the benefits of the liberal changes introduced by the UCC (in comparison with Sections 9 and 10 above) before applying open prices to the current forms of the SGA and CISG.

The UCC makes a significant leap from formalism to flexibility; Speidel explains as follows:

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<sup>54</sup> Scott, 'The Rise and Fall of Article 2' (n 22) 13.

<sup>55</sup> A further exploration of cases held under Sections 8 and 9 the SGA is made in Chapter Four.

[T]he intention to contract is...substituted for the bargain paradigm [every term must be fully agreed before any relief can be granted]<sup>56</sup> as the test for liability.... [I]f the seller and buyer agree to the future sale of described goods in a stated quantity and clearly state that they ‘intend to contract,’ the bargain is enforceable even though no other terms have been agreed.<sup>57</sup>

Clearly, the intentions of parties significantly affect classic contract law, which demands the presentation of future circumstances from relational sales.<sup>58</sup> When forced to choose between allowing one party to escape a contract when facing a price determination method failure, or allowing a court to make a contract for the parties, the UCC favours the latter.<sup>59</sup> Hawkland supports this approach:

Section 2-305 is based on the sensible assumption that the expectations of the parties are best satisfied by enforcing their open price agreement, even if it becomes necessary for the court ‘to make a contract for the parties’ by supplying a reasonable price as the price term. Surely, it would seem that a fairer and juster result is reached by this action on the part of the court than would be reached by a ruling that the contract was completely unenforceable.<sup>60</sup>

### **3.1.2 The *Louisville* case: where the approaches of the Uniform Sales Act and UCC are distinguished**

The opinions of Speidel and Hawkland lead to the conclusion that the intentions and expectations of parties are paramount when deciding the validity of a contract<sup>61</sup> and the duty of a court is to fill any gaps in the contract in order to uphold these intentions, which is exactly what the UCC has brought to the US. Since this thesis proposes that the UCC, parties’ intention to be bound to a contract is the ideal test for liability, this section distinguishes the UCC from the previous

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<sup>56</sup> Anon, Chapter Two (n 110) 398, citing Professor Richard Speidel, Annual Convention of the Association of American Law Schools, December 28, 1966.

<sup>57</sup> *ibid.*

<sup>58</sup> Even in recent cases, courts repeatedly emphasise that as long as parties have signed the contract in good faith, and that bad faith is not apparent, the open price contract remains valid. Per *Yonaty v Amerada Hess Corp* 2005 WL 146041 (NDNY 2005): ‘If there is no proof on defendant’s profit margins....it is difficult for the court to assess the defendant’s pricing policy’. In *Shell Oil Co v HRN, Inc* 141 South Western 3d 429 (Texas 2004) ‘the whole notion of subjective bad faith is irrelevant as the supplier’s only obligation is to charge a posted price that fall somewhere within a range of prices charged by all suppliers in the marketplace’.

<sup>59</sup> Section 2-305(1)(c): ‘...the price is a reasonable price at the time for delivery if the price is to be fixed in terms of some agreed market or other standard as set or recorded by a third person or agency and it is not so set or recorded’. A further explanation is made in the following sections with regards to Section 2-305 as the governing provision on open price under the UCC.

<sup>60</sup> William D Hawkland, *Sales and Bulk Sales* 18 (3<sup>rd</sup> edn, Pennsylvania, The American Law Institute-American Bar Association 1976) 74.

<sup>61</sup> text to n 56 and n 60.

Uniform Sales Act by testing whether the failure of price mechanism to set price vitiates a sale. Moreover, the price mechanism's failure to set the price is an unreliable defence for opportunistic parties who intend to escape a contract. Hence the UCC brought a positive change in the US legal system by changing the liability test from inquiring whether a price is fixed to ascertaining the parties' intent to be contractually bound, and this positive effect will hopefully benefit other legal systems too.

While Section 3.5.1 of this chapter further elaborates on open prices under Section 2-305(1) of the UCC, the current section of the chapter briefly explains the essence of the Section and notes that it is the very provision that replaces both Sections 9 and 10 of the Uniform Sales Act and validates open prices, which is possible in three different situations: firstly, when parties are silent as to the price,<sup>62</sup> secondly, if the parties intend to agree but fail to agree on price,<sup>63</sup> and thirdly, when the price is to be fixed in terms of some agreed market or other standard as set or recorded by a third person or agency and it is not so set or recorded.<sup>64</sup> Since the first situation, silence about the price finds resemblance under the old Uniform Sales Act (Section 9(4)), the difference lies in the remaining two situations under Section 2-305(1), which are agreements to agree and failure of agreed market, standard or a third person to set the price. Under the Uniform Sales Act, a contract is invalidated if falls under either category.

In reality, modern sales tend to fall into these two additional categories for being incompletely drafted. To illustrate the contrast between the two laws, the case of *Louisville Soap Co v Taylor*<sup>65</sup> is elaborated below.

### **3.1.2.1 *Louisville: facts***

In the *Louisville* case, the contract required the appellant to purchase rosin (at least 20,000 barrels, and up to 40,000 round barrels) and to pay the price determined by the official daily closing price of the Savannah Board of Trade.<sup>66</sup> The price term '[t]o be 50c. per 280lbs. over the official closing Savannah, Georgia, market on date order is received at Mobile, Alabama. In the

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<sup>62</sup> Section 2-305(1) (a).

<sup>63</sup> Section 2-305(1) (b).

<sup>64</sup> Section 2-305(1) (c).

<sup>65</sup> 279 Fed 470 (6<sup>th</sup> Cir), 259 US Supreme Court 583 (1922).

<sup>66</sup> *ibid*

event of two closing prices, the average is to apply'.<sup>67</sup> Under the contract, the appellant ordered and received 12,989 round barrels of rosin, which it paid in full, to fulfil its requirements. Since the minimum amount to be purchased was 20,000 and no less, the seller claimed the loss of 7,011 round barrels to make up the difference.

The next section discusses the decision of the court based on the application of Section 10 of the Uniform Sales Act.

### **3.1.2.2 Which price method did the parties intend to be bound by: the price set by the board, or the price posted by the board based on the market price?**

Because the parties chose a fixed-price term, the appellant had to pay the respondent (the seller) the market price based on the official closing price of the Savannah market. As long as at least 20,000 barrels of rosin were purchased,<sup>68</sup> the price did not really matter because the market price was used as a referable standard.<sup>69</sup> The Board of Trade was under the obligation to post the market price, which was the official price from actual transactions and reflected the true market condition.<sup>70</sup> However, the Board was not authorised to post an official closing price when there was no sale in the Savannah market for two months, and when this occurred, the board posted a price that did not represent the current condition of the market (the actual price the board posted price belonged to the last sale). Due to this, the appellant claimed that they should be released from the obligation to pay the respondent for 7,011 barrels of rosin because there was no agreed on method for fixing the price.<sup>71</sup>

### **3.1.2.3 Application of the Uniform Sales Act in *Louisville***

Applying Section 10 of the Uniform Sales Act (despite its inapplicability in the state of Kentucky),<sup>72</sup> the Court of Appeals for the Sixth Circuit held that when a third party is supposed to fix the price but fails to do so (without any fault caused by the seller or the buyer), the seller is

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<sup>67</sup> *ibid* 472.

<sup>68</sup> *ibid*. If the appellant wanted to purchase in excess of the maximum, and the respondent could not supply, the buyer would be allowed to buy the excess elsewhere.

<sup>69</sup> *ibid* 470.

<sup>70</sup> *ibid*.

<sup>71</sup> *ibid* 475.

<sup>72</sup> The state of Kentucky did not adopt the Uniform Sales Act until the year 1928.

released from his obligation to sell and deliver, and the buyer is released from his promise to accept and pay.<sup>73</sup> The Board of Trade was perceived by the court as the price setting method for the sale of rosin, and decided that the failure of the goods' valuation caused the ultimate failure of the contract. The court held that 'this doctrine has been universally applied to contracts of sale and other forms of contracts, and has been written into the Uniform Sales Act...'<sup>74</sup>

An important question remains to be asked: what was the exact intent of the parties when entering the contract? In reality, the parties did not intend the Board of Trade to be their price valuer/price determination method. Instead, they intended that a market price indicator should determine the value of the goods, and that the Board of Trade's role was only to post the available market price. In light of this, Prosser argued that the court misinterpreted the contract.<sup>75</sup> As the Board of Trade was not intended to be a valuer, but rather a market reporter, the only reasonable conclusion the court should have come to was that 'the obvious intent was to close a deal at the market, and if there should be no market, then at a reasonable price.'<sup>76</sup> Since the parties intended the market price to be the standard to set prices by, and not the price evaluated by the Board of Trade, the correct and applicable section of the Uniform Sales Act was Section 9, and not Section 10.

Nevertheless, the author predicts that the court would have arrived at the same conclusion, even if Section 9 had been correctly applied in this case. This conclusion is reached because the court would have applied the same reasoning (of there being 'no market price in Savannah' available to price the rosin), and so there was no existing standard the board could refer to in order to price the rosin.

#### **3.1.2.4 How *Louisville* would be decided under the UCC**

Conversely, a UCC court would have upheld the deal. Instead of taking the approach of the Uniform Sales Act, which released the appellant from paying the agreed quantity of rosin,

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<sup>73</sup> *ibid* 479.

<sup>74</sup> *ibid*.

<sup>75</sup> Prosser, Chapter Two, (n 117) 733, 781. Prosser believed that if there was no market price, then a reasonable price applies. As the case occurred prior to the UCC, there was no distinction between a 'valuation price' and a 'price to be set by a specified *market* indicator'.

<sup>76</sup> *ibid*.

Section 2-305(1) of the UCC would have protected the right of the respondent. First and foremost, Section 2-305(1) prioritises the original intent of the parties when the contract was signed, and the parties in *Louisville* did intend to be bound by the contract because they appointed the Board of Trade to provide the price of the Savannah market. The intention to be bound, under Section 2-305(1), ought to be understood in light of the Official Code Comment 4 to Section 2-305:

...there may be cases in which a particular person's judgment is not chosen merely as a barometer or index of a fair price but is an essential condition to the parties' intent to make any contract at all. For example, the case where a known and trusted expert is to "value" a particular painting for which there is no market standard differs sharply from the situation where a named expert is to determine the grade of cotton, and the difference would support a finding that in the one the parties did not intend to make a binding agreement if that expert were unavailable whereas in the other they did so intend...

In the *Louisville* case, the parties' intentions did not rely on the board as a trusted method to set the price of the rosin; the board was just a third party that recorded the price, which means the contract falls under Section 2-305(1)(c) of the UCC. This subsection validates the contract even if a third party fails to set a price, which the board failed to do.

In addition to the criticism posed by Prosser, Hawkland also criticised the decision of the Court of Appeal. The court could have constructed a market price that would be fairer to the parties, so that long-term contracts could utilise open-price contracts without the risk of being held unenforceable, and that the business could be done 'in conformity with the economics of the situation'.<sup>77</sup> In *Louisville* the contract was simply invalidated *in toto* because the designated market failed to provide the anticipated data. The parties certainly did not desire the contract to end due to the absence of the Savannah market price, and the contract would have proved so if that was what the parties intended.

Unlike the Court of Appeal in *Louisville*, a UCC court would have approached the case by first determining whether the parties intended the contract to be bound by the Savannah price. Since the appellant had agreed to buy at least 20,000 barrels of rosin, then the absence of a market price

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<sup>77</sup> Hawkland (n 60) 75.

in Savannah could have been solved by referring to the market price of rosin in a different county or state. Again, if the parties intended the contract to be bound by reference to the Savannah price and no other equally reasonable standard,<sup>78</sup> a UCC court would have opined that the parties should have stated this in the contract.

In sum, it appears to be more probable for a contract of this type to be valid under Section 2-305(1) of the UCC than under Sections 9 and 10 of the Uniform Sales Act. While Section 2-305 of the UCC is not a reversal of Sections 9 and 10 of the Uniform Sales Act, it does reverse the decision on the question of the failure of external price standards.<sup>79</sup> This is supported by the Comment on Section 2-305, which rejects the idea of invalidating an agreement because of indefiniteness. As long as parties intend to make a binding agreement by using an open price,<sup>80</sup> the intentions of parties may be upheld by applying a commercially reasonable price to the products.

*Louisville* shows that Section 10 (and perhaps even Section 9) tends to overlook the parties' intentions and the relational context of a sale. Ultimately, the inflexibility of the Uniform Sales Act leads to its downfall.

### **3.1.3 The downfall of the Uniform Sales Act (1906-1947)**

The Uniform Sales Act received a mixed reception in the US, and was initially adopted in just over half of its states.<sup>81</sup> The Act ultimately failed to achieve complete legal uniformity in the southern states of the US, but was influential upon other states due to several factors. First, its influence was catalysed by the 'neighbourhood effect',<sup>82</sup> whereby states were encouraged to adopt the Act when their neighbouring states did so.<sup>83</sup> The neighbourhood effect had less impact upon the southern states,<sup>84</sup> but was more influential in the western region, which made the latter

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<sup>78</sup> See Anon, Chapter Two (n 110), whereby a sale remain valid as long as there exists an equally reasonable standard to price the goods in lieu of the market price.

<sup>79</sup> Scott, 'The Rise and Fall of Article 2' (n 22) 17.

<sup>80</sup> Official Code Comment 1 to UCC Section 2-305. More elaboration also found in Mooney (n 53).

<sup>81</sup> *ibid* 224.

<sup>82</sup> Smythe, 'Why was the Uniform Sales Law adopted' 3.

<sup>83</sup> *ibid* 17.

<sup>84</sup> *ibid*. Only Tennessee, Alabama and Arkansas adopted the Act within the southern region. Smythe further elaborated that other contributing factors include late development of manufacturing sectors, regional preferences in

six times more likely to adopt the Act than their southern counterparts.<sup>85</sup> Gradually, the adoption of the Act took place in the most of the west, which included all the states on the Pacific Coast and their immediate neighbours.<sup>86</sup>

Clearly, manufacturing factors accelerated the adoption of the Act into core manufacturing states such as Connecticut, Massachusetts, New Jersey, Ohio, and Rhode Island in the early 1900s.<sup>87</sup> Additionally, the acceptance of the Act was probably due to the change in the general attitude of the legal profession between the nineteenth and early twentieth centuries.<sup>88</sup> The ABA and other state bar associations, as well as progressive law professors brought about the codification movement, and formed significant allies within the legal academy.<sup>89</sup>

As previously explained, the Act was recommended by the NCCUSL for enactment in several states. In 1917 the NCCUSL advocated a Federal Sales Act and received support from the ABA and The Merchants' Association of New York,<sup>90</sup> but by the early 1940s, they recognised that the Act needed substantial revision to keep up with modern commercial practice.<sup>91</sup> Subsequently, the UCC's preparation was initiated when the American Law Institute (ALI) and the NCCUSL joined forces in 1942,<sup>92</sup> despite the strong opposition in three-fourths of the states that had been implementing the Act.<sup>93</sup>

The UCC was the product of the combination of the ALI and the NCCUSL, and was constructed with rules to fit specific situations based on trade usage and mercantile customs. However, these rules were only applicable to those who regularly dealt in a sphere where such customs were well known.<sup>94</sup> The traditional approach of the Uniform Sales Act, which made rules depending on

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maintaining their political and cultural autonomy and perhaps the fact that the Act was drafted outside the region, which made the States less receptive to the law (at 537).

<sup>85</sup> *ibid*, where the findings were made under the logistic regression data.

<sup>86</sup> *ibid* 12.

<sup>87</sup> *ibid*.

<sup>88</sup> *ibid* 4.

<sup>89</sup> Stein (n 18).

<sup>90</sup> Frank Winston, 'Article Two-Sales' (1951-1952) 22 *Tennessee Law Review* 784, 785.

<sup>91</sup> *ibid*.

<sup>92</sup> *ibid*.

<sup>93</sup> *ibid*.

<sup>94</sup> *ibid*.

each case on the terms of the contract and circumstances, or on the contract, expressed or implied, was abandoned by the UCC.<sup>95</sup> This constituted a basic but significant change in US law as it moved away from a law that was only applicable depending upon the existence of documented facts, towards a law that prioritises the mercantile identity of parties.<sup>96</sup>

### **3.2 The UCC: the application of Llewellyn's trade usage rule**

Llewellyn identified two major flaws in the Uniform Sales Act, which were attributed to Willistonian formalism: first, the rules were inefficient because they were grounded in legal doctrine rather than actual practice; second, the rules were too general and insensitive to particular circumstances, which lead parties in some industries to allocate risks differently than parties in other commercial contexts.<sup>97</sup> To counter these flaws, Llewellyn introduced two approaches into the UCC. The first is the 'contextual approach' (as opposed to Willistonian's textual approach), and the second is employing trade usage as a tailored rule (as opposed to Willistonian's general rules, which applied a one size fits all approach).

Regarding the first approach, Llewellyn chose context as the sole factor for instructing courts to focus on what the particular trade understood the contract to mean. He departed from the view of Corbin who regarded context as an opportunity to uncover the subjective intent of contracting parties.<sup>98</sup> In Corbin's view, the courts were left to fill gaps in the contract by focusing on what the parties subjectively intended.<sup>99</sup>

The second change Llewellyn brought about was determining the efficiency of the contract within a particular trade or industry. This change, ensuring that the terms in question were equally decided upon and could not be dictated by a stronger party to a weaker one.<sup>100</sup> This approach is indicative of contractual freedom for each party, as discovered by Llewellyn through

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<sup>95</sup> *ibid.*

<sup>96</sup> *ibid.*

<sup>97</sup> Scott, 'The Rise and Fall of Article 2' (n 22) 16.

<sup>98</sup> *ibid.* 14.

<sup>99</sup> Dennis M Patterson, 'Of Llewellyn, Wittgenstein and the Uniform Commercial Code' (1989) 68 *Texas Law Review* 169, 187-88.

<sup>100</sup> *ibid.*

his observation of contractual arrangement in litigated cases.<sup>101</sup> Subsequently, Llewellyn formed a strategy of filling contractual by using objective methods that maximised the *ex ante* value of a contract, which is viewed by both parties when contracting.<sup>102</sup> This approach assumes that the law should simply identify and incorporate working rules which are already being successfully used by the parties, instead of imposing abstract and general rules, particularly in complex contracts.<sup>103</sup>

Scott observes that Llewellyn was in turn influenced by Commons, who rejected the economic models that perceive individuals as selfish and individualistic.<sup>104</sup> In fact, Llewellyn perceived a group of merchants in a particular trade or practice is a group of people that cooperate with each other, yet capable of and would engage in self-policing their own contractual terms.<sup>105</sup> Therefore, the UCC is obliged to provide room for mercantile flexibility according to trade usage when setting out contractual terms.<sup>106</sup>

In its finished form, Llewellyn regarded the UCC as ‘worth adopting being the better body of law on the subject matter involved than the existing law of any one of the states. It would be worth adopting without reference to uniformity’.<sup>107</sup> The next section explains the setup of the UCC before proceeding to discuss the open prices specifically.

### **3.3 The collaboration leading to the creation of the UCC**

As mentioned above, the NCCUSL and the ALI joined forces to set up the UCC.<sup>108</sup> The NCCUSL was composed of commissioners from each of the fifty states of the US, the District of Columbia and Puerto Rico,<sup>109</sup> who were experienced lawyers, judges and teachers of law from

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<sup>101</sup> *ibid.*

<sup>102</sup> Karl N Llewellyn, ‘On Warranty of Quality and Society’ (1936) 36 *Columbia Law Review* 699.

<sup>103</sup> Scott ‘The Rise and Fall of Article 2’ (n 22) 15.

<sup>104</sup> *ibid* 19.

<sup>105</sup> Allan R Kamp, ‘Between-The-Wars Social Thought: Karl Llewellyn, Legal Realism, and the Uniform Commercial Code in Context’, (1995) 59 *Albany L Rev* 325, 354-65.

<sup>106</sup> Clearly, the UCC’s policy is in line with the spirit of cooperation in complex contracts as propounded by Macneil. A further analysis of the coherence of these ideas is made under Chapter Six of this thesis.

<sup>107</sup> Karl N Llewellyn, ‘Why A Commercial Code’, 22 *Tennessee Law Review* (1951-1953) 779,785.

<sup>108</sup> Malcolm, Chapter One (n 83) 228.

<sup>109</sup> *ibid* 227.

leading law schools.<sup>110</sup> The ALI was a voluntary organisation established in 1923, which comprised of approximately 1,500 judges, law professors and leading members of the Bar.<sup>111</sup> ALI was organised for improving the law, and is primarily noted for its series of restatements on various subjects including, but not limited to, contracts, torts, agencies and trusts.<sup>112</sup>

By 1944, the NCCUSL had been collaborating with ALI to expand the revised sales act project to include the drafting of the comprehensive UCC,<sup>113</sup> which was successfully drafted under the direction of Llewellyn as its Chief Reporter.<sup>114</sup> Mentschikoff regarded the UCC as ‘the most ambitious codification ever undertaken in the Anglo-American legal world and is the product of twenty years of effort by literally hundreds of American lawyers and businessmen’.<sup>115</sup>

### **3.3.1 The background to the setup of the UCC (1938-1952)**

In 1938, there was a proposal sponsored by the Merchants’ Association of New York City for a federal sales Act to govern all interstate transactions.<sup>116</sup> As a response to the inadequacies in the Uniform Sales Act, the NCCUSL attempted to revise the former, which it had initially prepared in 1906.<sup>117</sup>

In 1940, the NCCUSL adopted a proposal to prepare a uniform commercial code that embraced the modernisation and co-ordination of the Uniform Sales Act, the Uniform Negotiable Instruments Law, the Uniform Bills of Lading Act, the Uniform Warehouse Receipts Act, and all other Uniform Acts in the field of commercial law, but added new provisions where no uniform Acts addressed important and closely related commercial problems.<sup>118</sup> ALI joined in the undertaking the following year, and participated in the 1942 discussion about the draft Revised

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<sup>110</sup> *ibid.*

<sup>111</sup> *ibid* 229.

<sup>112</sup> *ibid.*

<sup>113</sup> Mentschikoff, Chapter One (n 99) 167.

<sup>114</sup> *ibid.*

<sup>115</sup> *ibid.* For greater detail on the UCC history, see also Soia Mentschikoff, ‘The Uniform Commercial Code: An Experiment in Democracy in Drafting’ (1950) 36 American Bar Association Journal 419; Malcolm, Chapter One (n 83) 228.

<sup>116</sup> Malcolm, Chapter One (n 83) 228.

<sup>117</sup> *ibid.*

<sup>118</sup> *ibid.*

Sales Act, which was a proposed chapter related to sales, for the prospective code.<sup>119</sup> In 1945, the project was financed by a grant of approximately \$100,000 from the Maurice and Laura Falk Foundation, Pittsburgh, Pennsylvania and other contributions by the Beaumont Foundation of Cleveland, Ohio and ninety-eight other business and law firms.<sup>120</sup>

Between 1945 and 1952, there were a huge number of drafts and re-drafts of parts of the proposed code, which prepared by reportorial staff supervised by an editorial board.<sup>121</sup> These redrafts were carefully considered by advisory groups of judges, lawyers and law teachers before being shown to the Council of ALI, special Sections of the NCCUSL, and general members of the two organisations.<sup>122</sup> The reporting and advisory groups also consulted with individuals and organisations in business and banking circles which later came forward with criticisms.<sup>123</sup>

Subsequently, the first complete draft of the UCC was released in May 1949.<sup>124</sup> During the preparatory stage of the UCC, the successive drafts were made available to the public and were extensively commented on in legal periodicals. As a result of this, subsequent drafts took much of this criticism into account.<sup>125</sup> Many of the drafts and problems that arose during the drafting process were studied by bar associations and other groups in different parts of the country.<sup>126</sup> By 1946, a committee on the UCC of the Section of Corporation, Banking and Business Law of the American Bar Association was organised and followed the development of the UCC from that time onwards.<sup>127</sup>

The final text of the proposed UCC was completed in September 1951 and was approved by both the NCCUSL and ALI, and also by the House of Delegates of the American Bar Association.<sup>128</sup>

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<sup>119</sup> *ibid.*

<sup>120</sup> *ibid.*

<sup>121</sup> *ibid.*

<sup>122</sup> *ibid.*

<sup>123</sup> *ibid.*

<sup>124</sup> *ibid.*

<sup>125</sup> *ibid* 230.

<sup>126</sup> *ibid.*

<sup>127</sup> *ibid.*

<sup>128</sup> *ibid.*

Ultimately, the publication of an official edition of the UCC, with explanatory comments, took place in October 1952 and was released as the 1952 Official Text and Comments Edition.<sup>129</sup>

### **3.3.2 The gradual acceptance of the UCC by different states (1952-1962)**

The period between 1952 and 1958 was a testing period for the UCC.<sup>130</sup> Pennsylvania, being one of the largest commercial and industrial states in the US, with a huge volume of commercial activity in all of its phases, was the first state to officially adopt the UCC.<sup>131</sup> To ensure the uniformity of the law with the most current (1958) version of the UCC, Pennsylvania re-enacted the 1958 version and implemented all of the amendments included in that version that were suggested during the testing period (of 1952 to 1958).<sup>132</sup> The complete acceptance and approval of the UCC was given by the Assembly of Pennsylvania with a vote of 195 to one, and this led to the UCC's final, unanimous approval by the Senate (both votes finally occurred on September 23, 1959).<sup>133</sup>

The second state to enact the UCC was Massachusetts, and from October 1 1958, the enactment included all of the amendments included in the 1958 version of the UCC within its provisions.<sup>134</sup> In conjunction with the completion of the extensive testing period from 1952 to 1958, and the adoption by an important commercial state (Massachusetts), rapid enactments in the sixteen other states took place after 1958, which resulted in the UCC's enactment in a total of eighteen different states.<sup>135</sup> The states that adopted the UCC were Kentucky (July 1, 1960), New Hampshire (July 1, 1961), Connecticut (October 1, 1961), Rhode Island, Arkansas, Wyoming and New Mexico, (January 1 and 2, 1962), Ohio and Illinois (July 1, 1962), Oklahoma, Alaska and New Jersey (January 1, 1963), Georgia (April 1, 1963), Oregon (September 1, 1963), Michigan (January 1, 1964) and New York (September 27, 1964).<sup>136</sup>

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<sup>129</sup> *ibid.*

<sup>130</sup> *ibid* 232.

<sup>131</sup> *ibid.*

<sup>132</sup> *ibid.*

<sup>133</sup> *ibid.*

<sup>134</sup> *ibid* 233.

<sup>135</sup> *ibid.*

<sup>136</sup> *ibid.*

There was a fairly extensive educational program provided within these states to familiarise the members of the bar and business community with the provisions of the UCC.<sup>137</sup> In summary, the transition period from law before the UCC, to the full incorporation of the UCC, went smoothly, and the UCC has worked very satisfactorily since then.<sup>138</sup>

### **3.3.3 The effect of adopting the UCC**

As explained above, the UCC abandoned traditional approaches of enforcing contracts based on the terms of the contract and circumstances of the case or on the contract, express or implied.<sup>139</sup> This was a significant shift in US sales law, which now enforces a sale based on the nature of the facts apparent to the trading identity of the parties.<sup>140</sup> The UCC further modified the idea that parties can choose to conclude contracts without setting a price.<sup>141</sup> Nonetheless, these agreements still need to fulfil the test of good faith to be enforceable under the UCC.<sup>142</sup>

Regarded as the Bible for the sale of goods in the US, the UCC was ‘conceived, drafted, and enacted into statutory law as a code and not a mere collection of statutory rules.’<sup>143</sup> It applies to the transactions of goods as defined under Section 2-103. Indeed the UCC comprises of nine articles, including the law of sales, negotiable instruments, bank deposits and collections, letters of credit, bulk sales, documents of title, transfer and registration of investment securities, and secured transactions involving all kinds of movables.<sup>144</sup> The UCC replaced seven uniform acts, a model collection of the American Bankers’ Association and a host of individual state statutes that deal with various security devices.<sup>145</sup>

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<sup>137</sup> *ibid.*

<sup>138</sup> *ibid.*

<sup>139</sup> Winston (n 90) 787. The traditional approach remains applicable in the current Sale of Goods Act 1979 and the CISG 1980 upon relational sales.

<sup>140</sup> *ibid.*

<sup>141</sup> Section 2-305(1) of the UCC.

<sup>142</sup> Winston (n 90) 792.

<sup>143</sup> Mooney (n 53) 221.

<sup>144</sup> Mentschikoff, Chapter One (n 99) 167.

<sup>145</sup> *ibid.*

Despite its many features, the UCC is referred to as a commercial transactions document.<sup>146</sup> Ultimately, the unification of modern commercial law, through the UCC, has been made by breaking away from the English model, which the Uniform Sales Act was based on.<sup>147</sup>

### 3.4 The policy and purpose of the UCC

The UCC is dedicated to clarity and good business sense in commercial law, and also the unification of the best laws and practices in the US.<sup>148</sup> Llewellyn stated that ‘if a statute is to make sense, it must be read in the light of some assumed purpose. A statute merely declaring rule, with no purpose or objective, is nonsense.’<sup>149</sup> Llewellyn formed most of his ideas about contract law before beginning to draft the UCC,<sup>150</sup> and working towards the comprehensive codification of commercial law.<sup>151</sup>

The UCC is to be liberally construed and applied,<sup>152</sup> and among its underlying purposes and policies are the following important points:

- 1) To simplify, clarify and modernise the law governing commercial transactions
- 2) To permit the *continued expansion of commercial practices*<sup>153</sup> through custom, usage and agreement of the parties
- 3) To make uniform the law among various jurisdictions<sup>154</sup>

Interestingly, the second purpose (b) proves that the UCC not only unified the law and provides rules of commercial practices, but that it also promotes the continuous expansion of commercial practices using custom, usage and the agreement of parties. This purpose provides the rationale as to why an agreement may be flexibly drafted in an open-ended manner, and why it leaves

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<sup>146</sup> Smythe (n 49) xi.

<sup>147</sup> *ibid* 19.

<sup>148</sup> Malcolm, Chapter One (n 83) 226.

<sup>149</sup> Llewellyn, Chapter One, ‘Remarks on the Theory’ (n 84).

<sup>150</sup> Mooney (n 53) 223.

<sup>151</sup> *ibid*.

<sup>152</sup> Section 1-202(1) of the UCC.

<sup>153</sup> Emphasis added.

<sup>154</sup> Stone (n 48) 19.

adequate room for courts to move in and readjust contracts over time. Stone relates this purpose with Comment 1 of Section 1-102, which states:

This Act is drawn to provide flexibility so that, since it is intended to be a semi-permanent piece of legislation, it will provide its own machinery for expansion of commercial practices. The Code intends to make the law embodied in it to be developed by the courts in the light of unforeseen and new circumstances and practices, provided that the proper construction of the Act requires that its interpretation and application be limited to its reason.<sup>155</sup>

The next section covers the salient features of the UCC, namely its open-endedness and freedom of contracting which support its function as a flexible code that ensures that all of its purposes and policies are fulfilled.

### **3.4.1 The salient features of the UCC: open-endedness and freedom of contracting**

When drafting a contract, the relative certainty and uniformity of its construction depends on the court's perception of the situation represented by the contract,<sup>156</sup> and proper construction follows the reason and is limited or extended by it.<sup>157</sup> For instance, all definition sections under the UCC state that 'in this Act (Article) unless the context otherwise requires' allows a court to limit or extend definitions in accordance with the reason of the rule in which they appear. Clearly, open-endedness and the reliance on reason as the foundation for the contract's construction are made explicit, but the idea remains general to the code. In fact, the first canon of construction states that '[t]his is why Section 1-202(1) states that Act shall be liberally construed and applied to promote its underlying purposes and policies'.

### **3.4.2 The open-ended nature of a contract**

The UCC was not drafted in the same manner that conveyancers would have drafted it, who Llewellyn regards 'the metes and bounds boys.'<sup>158</sup> Rather, Llewellyn directed the courts to address legal issues in a practical way by using the UCC's open-ended methods,<sup>159</sup> which include whether the parties have acted reasonably and in accordance with the standard customs and

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<sup>155</sup> *ibid* xiv on Comment 1 to Section 1-102 of UCC.

<sup>156</sup> Mentschikoff, Chapter One (n 99) 170.

<sup>157</sup> *ibid*.

<sup>158</sup> Llewellyn, Chapter One, 'Remarks on the Theory' (n 84).

<sup>159</sup> Since none of these terms are defined in the code, the code is considered open-ended or indefinite in nature, which attracted commentaries from different philosophers about its uniqueness.

usages of trade. He gained inspiration from the open-ended nature of the German ‘immanent law’ tradition, which is found in *Handelsgesetzbuch*.<sup>160</sup> This German code is open-ended because if there is an absence of commercial custom, the general civil law will be applied.<sup>161</sup> Moreover, the German legal tradition stipulates that any given case should be decided according to *Natur der Sache* (the nature of the matter) rather than complex set of rules or *gesetzliche Beweisregeln*.<sup>162</sup> Commercial law was created by the merchant community, and had its own conscience and customary law based on good faith and honest dealing.<sup>163</sup> This feature of *Handelsgesetzbuch* was adopted by Llewellyn, resulting in the UCC’s emergence as an open-ended and non-exhaustive commercial code.

Whitman compares the UCC and *Handelsgesetzbuch*<sup>164</sup> by referring to Article 1 of the German code, which states that ‘Insofar as this Code does not determine an issue, commercial custom is to be applied. In the absence of commercial custom, the general civil law is to be applied.’<sup>165</sup> However, Llewellyn was aware of the potential unsuitability of applying old customs to modern commercial transactions, and so he drafted Section 1-103 of UCC taking this issue into account: ‘unless displaced by the particular provisions of this Act, the principles of law and equity, including the law merchant...shall supplement its provisions.’<sup>166</sup>

### 3.4.3 Freedom to contract

Aside from employing open-ended features, the UCC also adopts the principle of freedom to contract which allows parties to vary UCC provisions through their mutual agreement. This principle is the reason for which the UCC has so many gap-filling rules that apply unless parties agree otherwise.

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<sup>160</sup> Whitman, Chapter One (n 80) 159.

<sup>161</sup> *ibid.*

<sup>162</sup> *ibid* 160.

<sup>163</sup> *ibid* 163. On n 45 of Whitman’s article, he states that ‘merchants must abide by standards of honest dealing and good faith rather than by statute.’ Whitman cited from a German text of 2 JG Busch, *Theoretisch-Praktische Darstellung Der Handlung* 364 (1792) 357-358).

<sup>164</sup> *ibid* 172 where Whitman cited from Article 1 (1861) of *Handelsgesetzbuch*.

<sup>165</sup> *ibid.* At n 67 Whitman translated from the original version of Article 1 *Handelsgesetzbuch* (HGB): ‘In Handelssachen kommen, insoweit dieses Gesetzbuch keine Bestimmungen enthält, die Handelsgebräuche und in deren Ermangelung das allgemeine bürgerliche Recht zur Anwendung.’

<sup>166</sup> *ibid* 172.

However, there are four exceptions to this freedom to contract:<sup>167</sup>

- 1) The obligations of good faith, diligence, reasonableness and care prescribed by the code may not be disclaimed by agreement.<sup>168</sup>
- 2) All sections that explicitly preclude variance cannot be varied.<sup>169</sup>
- 3) Some terms are implicit rather than explicit, and they cannot be varied.<sup>170</sup>
- 4) Certain contracts and clauses may not be enforceable due to unconscionability.<sup>171</sup>

These exceptions act as safeguards to having a freedom to contract, and if a contract falls under any one of the above exceptions, it is deemed unenforceable. This correlates with the emphasis made by Ben-Shahar in Chapter Two: if parties sign an agreement on the basis of contractual freedom, they are in agreement not to walk away from the contractual obligations by which they intend themselves to be bound.<sup>172</sup>

An example of a practice that utilises the freedom to contract and use open-ended contractual terms is found in having an open price (under Article 2, regarding sales); the next section further explores Article 2.

### **3.5 Article 2 of the UCC: sales**

Prevented by the courts' inflexible attitude towards the classic law doctrine, business interests and legal scholars were unsuccessful in their attempt to accommodate open price contracts under the Uniform Sales Act (1906-1947).<sup>173</sup> Accordingly, advocates for a more liberal approach to contract law found their solution in Article 2 of the UCC.<sup>174</sup>

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<sup>167</sup> Bunn, Snead and Speidel (n 13) xv.

<sup>168</sup> Examples are Sections 1-102(3) and Comment 2, Sections 1-203, 1-205 and Comment 4 of Section 4-103.

<sup>169</sup> Sections 2-318 and 9-501(3).

<sup>170</sup> Sections 1-102, Comment 2, Sections 2-201, 9-301, 9-201.

<sup>171</sup> Sections 2-302, 2-309(3), 2-719(3), 2-718 and Comment 1.

<sup>172</sup> Ben-Shahar, Chapter Two (n 132) 261- 270.

<sup>173</sup> See Section 3.1.1. Section 9(4) of the Uniform Sales Act (1906-1947) states that '[w]here the price is not determined...the buyer must pay a reasonable price'.

<sup>174</sup> American Law Institute & NCCUSL, Uniform Commercial Code (1951).

Every state, with the exception of Louisiana, has adopted Article 2, including Section 2-305 of the UCC as the main body of law regulating transactions for goods. The state of Louisiana has not enacted Article 2 (sales) because it has chosen to maintain ‘its own civil code, unique to its own heritage’.<sup>175</sup> Under the civil code, every sale needs to have a fixed price in order to be valid,<sup>176</sup> and if a contract fails for lack of a determinate price, but the seller still performs their contractual obligations, the solution is to apply the theory of *quantum meruit*, which entitles the seller to receive a fair and equitable price.<sup>177</sup>

The next section of the chapter focuses on Section 2-305 where, except in Louisiana, open prices are widely applicable in all US states.

### 3.5.1 Open prices under the UCC

Although recognising the importance of open prices, Llewellyn nevertheless acknowledged that price was at the heart of all sales contracts.<sup>178</sup> After all, the economy proves that businesses centre on profit, and profit certainly centres on price.<sup>179</sup> Therefore, the price, paid or promised, constitutes a consideration for the goods to transfer in a contract of sale.<sup>180</sup>

However, the goods themselves, or external matters that affect marketing conditions, may be uncertain, which causes difficulty in fixing a price term in advance.<sup>181</sup> Chapter One explained that in response to uncertainty, Gilson, Sabel and Scott described the method of braiding a contract, which entails parties write an agreement by intertwining formal and informal mechanisms that allow each other to assess the disposition and capacity of the other to respond

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<sup>175</sup> AN Yiannopoulos, ‘Requiem for a Civil Code: A Commemorative Essay First Worldwide Congress on Mixed Jurisdictions: Salience and Unity in the Mixed Jurisdiction Experience: Traits, Pattern, Culture, Commonalities’ 78 *Tulane Law Review* 379 (2003-2004) 393.

<sup>176</sup> This is based on Louisiana Civil Code Annotation, where Revised Article 2464 contained the certainty requirement; the Revised Article 2466 recognises an implied, reasonable price between merchants who fail to provide the price. *DB Orban Co v Lakco Pipe & Supply, Inc* 496 South Reporter, Second Series 1382 (Louisiana Court Appeal 3d Cir 1986).

<sup>177</sup> *Tahoe Corp v P&G Gathering Systems, Inc*, 506 So 2d 1336 (Louisiana Court Appeal 2d Cir 1987).

<sup>178</sup> Llewellyn, Chapter One, *Cases and Materials* (n 3) 1.

<sup>179</sup> *ibid.*

<sup>180</sup> Vold, Chapter One (n 6).

<sup>181</sup> *ibid.*

cooperatively and effectively to unpredictable circumstances.<sup>182</sup> DiMatteo supports the idea, stating that many modern alliance agreements blend both hard, fixed terms with more open, flexible terms or standards.<sup>183</sup> Whilst the fixed terms provide protections and boundaries for each firm's investments and obligations, the open and implicit terms allow for greater operational flexibility, which is required to fully exploit the collaborative effort and to generate the most innovation-related benefits.<sup>184</sup>

By intertwining informal and formal elements into the contract, a buyer and seller can fix some of the contract's terms while leaving others future adjustment, which might include leaving the price, time or quantity arrangements open to ensure that the business is more practical in case circumstances change.<sup>185</sup> Section 2-305 validates the braiding of a contract through its validation of open price,<sup>186</sup> and this remains valid as long as both parties intend to be bound to the contract by having an open price that is determined in good faith.<sup>187</sup>

Article 2 governs contracts involving the sale of goods worth more than \$500;<sup>188</sup> with the exception of Louisiana, all US states have adopted some version of UCC Article 2 with minor variations.<sup>189</sup> Section 2-305 provides several ways to determine the price term in the event of a missing or deliberately undecided price:<sup>190</sup>

### Section 2-305

- (1) The parties if they so intend may conclude a contract for sale even if the price is not settled. In such a situation the price is a reasonable price at the time for delivery if
  - (a) nothing is said as to price;

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<sup>182</sup> Gilson, Sabel and Scott, Chapter One (n 15) 1377.

<sup>183</sup> DiMatteo, Chapter One (n 16).

<sup>184</sup> Gilson, Sabel and Scott, Chapter One (n 17) 435.

<sup>185</sup> Vold, Chapter One (n 6).

<sup>186</sup> Section 2-305 does not apply if a course of prior dealings settles a price as seen in *Roy Buckner Chevrolet, Inc v Cagle*, 418 South Reporter, Second Series 878, 34 UCC Reporting Service 413 (9 Alabama Supreme Court Reports 1982); *Palmer v Idaho Peterbilt, Inc*, 102 Idaho 800, 641 Pacific Reporter, Second Series 346, 33 UCC Reporting Service 827 (Court of Appeal 1982).

<sup>187</sup> Sections 2-305(1) and (2) of the UCC.

<sup>188</sup> Section 2-201 (1) (1977) of the UCC.

<sup>189</sup> *Pennzoil Co v Fed Energy Regulatory Commission*. 789 Federal Reporter, Second Series 1128, 1142 (5<sup>th</sup> Cir 1986) 'All states except Louisiana have adopted the UCC...'

<sup>190</sup> The Uniform Commercial Code, as amended in 2003.

- (b) the price is left to be agreed by the parties and they fail to agree; or
  - (c) the price is to be fixed in terms of some agreed market or other standard as set or recorded by a third person or agency and it is not so set or recorded.
- (2) A price to be fixed by the seller or by the buyer means a price to be fixed in good faith.
- (3) If a price left to be fixed otherwise than by agreement of the parties fails to be fixed through fault of one party the other may at the party's option treat the contract as cancelled or the party may fix a reasonable price.
- (4) If, however, the parties intend not to be bound unless the price is fixed or agreed and it is not fixed or agreed there is no contract. In such a case the buyer must return any goods already received or if unable to do so must pay their reasonable value at the time of delivery and the seller must return any portion of the price paid on account.

The UCC drafters reframed the problem of open prices by linking it to the intentions of parties.<sup>191</sup> A well-drafted open price term will indicate whether or not the parties intend to be bound and an expression of intent to be bound, in the absence of a fixed-price term, usually does not appear in the contract. Therefore, to determine parties' intentions, all available, relevant evidence should be considered. When parties decide to set the price in the future, the presumption under Section 2-305(1) assumes that both parties (seller and buyer) intend to be bound to the contract even if they are unable to come to a subsequent agreement on the price.

Section 2-305 (above) provided courts with a method (taking the parties' original intentions into account), to rely on an agreement that lacks a price term.<sup>192</sup> Additionally, this provision embraced the practical reality, generally ignored by courts, that agreeing to an open-price contract strongly implies that parties intended to fulfil their obligations.<sup>193</sup> If the parties do not want the court to set the price, but would rather the contract failed if they were unable to agree on a price, it is the

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<sup>191</sup> Berry, Byers and Oates (n 32) 46.

<sup>192</sup> Prosser, Chapter Two (n 117) 736 whereby Prosser states that '[t]he court insists that it cannot make a contract for the parties, but it sometimes is willing to read into the agreement they have made a provision which is not visibly there.'

<sup>193</sup> *ibid* 736-37. Intention is not to be supposed and/or presumed to be unreasonable. The fact that pains have been taken to enter into a contract, indicates that although the price cannot be fixed, considerable importance is attached to the terms upon which there has been agreement. Courts should, if they can, give effect to these terms.

parties' obligation to explicitly state this in the contract itself, or else to show by other convincing evidence that such a result was intended.

Apart requiring an intention to be contractually bound, a valid open price requires both parties to operate in good faith.<sup>194</sup> However, if the price is agreed to derive from reference to a third party or agency (for example, a posted price from another seller) and the price is not set due to the fault of one party, then the other party has the option to set a reasonable price or cancel the contract.<sup>195</sup> Nevertheless, intention remains the key element: if the parties agree that they will only be bound by a fixed price, and the price was not set when making the contract, then the contract is not valid.<sup>196</sup>

### **3.5.2 Decisions under Section 2-305 regarding open or missing price terms in a contract**

A supporting provision to Section 2-305 is found in Section 2-204(3), which claims that 'even though one or more terms are left open a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy.' In *Paluokos v Intermountain Chevrolet Co.*,<sup>197</sup> the court ruled that the UCC 'does not require a document itemising all the specific terms of the agreement... that some terms are undetermined does not defeat the existence of a contract provided the parties 'intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy.'<sup>198</sup>

Although the UCC refers to open and not missing terms, Comment to Section 2-204(3) explains that the provision applies to both deliberate open terms and missing terms:

If the parties intend to enter into a binding agreement, this subsection [(3)] recognizes that agreement as valid in law, despite missing terms, if there is any reasonably certain basis for granting a remedy.... Nor is the fact that one or more terms are left to be agreed upon enough of itself to defeat an otherwise adequate agreement.<sup>199</sup>

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<sup>194</sup> Section 2-305(2).

<sup>195</sup> Section 2-305(3).

<sup>196</sup> In this situation, the buyer, under Section 2-305(4) must return goods received or, if that is impossible, pay the 'reasonable value at the time of delivery.' In turn, the seller must account for any payments received.

<sup>197</sup> 588 Pacific Reporter, Second Series, 939, 942 (Idaho 1978).

<sup>198</sup> *ibid.*

<sup>199</sup> Comment to Section 2-204(3) UCC.

Acknowledging Section 2-305 to cover both open and missing terms, the following section distinguishes the two by explaining decisions made under missing or inadvertently incomplete price terms, and decisions made under open or deliberately incomplete price terms.

### 3.5.3 Missing price terms

In a similar manner to open price, parties must have intended to form a contract in a missing price situation,<sup>200</sup> and the intention to be contractually bound is typically derived from the parties' conduct.<sup>201</sup> A shipment of goods, where the seller believes a contract exists, provides an example of conduct.<sup>202</sup> In addition, the buyer's acceptance and use of the shipped goods is indicative of the buyer's belief that a contract has been formed.<sup>203</sup>

However, the mere exchange of goods is not categorised as a missing-price contract because the exchange may be too indefinite to prove the contract's terms under the UCC.<sup>204</sup> *Quaker State Mushroom Company, Inc v Dominick's Finer Foods, Inc of Illinois*<sup>205</sup> illustrates this point: the parties exchanged proposed prices, but the one-year contract had already expired, without renewal eight months before the ordering dates. The buyer (Dominick's) had ordered four shipments of mushrooms and presumed that the old (and already expired) price still applied. However, the seller (Quaker) sent a notice of price increase to Dominick's before shipping the mushrooms. Dominick's did not expressly agree to the price increase and the court ruled that, although both parties proved by their conduct that they intended to make new, individual deals<sup>206</sup> from the four orders and deliveries, Section 2-305(1) was not applicable because the parties did not mention anything about the price, leave it open, or leave it to be determined by an outside agent. The court found that there was no contract, and the previously expired contract had no relevance to the four individual orders. Through the application of Section 2-305(4), Dominick's

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<sup>200</sup> MJ Boettcher and JC Gerish, *Enforceable Contracts without Agreement on Price*, (June 2005), Michigan Bar Journal 34-37, 35 < [www.michbar.org/journal/pdf/pdf4article875.pdf](http://www.michbar.org/journal/pdf/pdf4article875.pdf) > accessed 9 August 2009.

<sup>201</sup> *ibid.*

<sup>202</sup> *ibid.*

<sup>203</sup> *ibid.*

<sup>204</sup> *ibid.*

<sup>205</sup> 635 Federal Supplement 1281 (North Dakota Ill 1986).

<sup>206</sup> *ibid* 1284, whereby the court held that these four orders had to be analysed as individual contracts that had no relations to the old price set by the parties.

was bound to return the mushrooms and receive a refund, or, if it could not do so, ‘pay the reasonable value of the mushrooms at the time of delivery.’<sup>207</sup>

Although the UCC does not enforce price exchange, a contract with a missing price term is enforceable because the abovementioned Comment to Section 2-204(3) states the ‘agreement as valid in law, despite missing terms’.<sup>208</sup> A missing price differs from a price exchange because the parties have unintentionally missed stating the price term due to an unpredicted event.<sup>209</sup>

An emergency situation is an example of an unpredicted event, and is observed in *Alter & Sons, Inc v United Engineers & Constructors, Inc*<sup>210</sup> In this case, the defendant previously made repeat purchases of substantial quantities of equipment from a plaintiff for the construction of a nuclear plant. On July 6, 1972, with the exception of the price term, both parties agreed on a contract, which included the specifications and identity of equipment to be supplied by plaintiff to defendant, the conditions relating to a sale, the date and manner of delivery, and the scope and extent of the plaintiff’s flexibility in regard to the defendant’s specifications. The defendant gave the plaintiff a purchase order number and directed him to order the equipment for delivery on July 10 but the plaintiff was not informed about the specific purpose of the equipment or the reasons behind the July 10 delivery. However, the court discovered that the plant operation required substantial quantities of water to cool its nuclear reactors.

In June 1972, a part of machinery linked to nuclear plant’s permanent water supply system broke, and because the cooling process was critical to the plant’s operation, the Atomic Energy Commission closed the plant until a support pumping system was available for future emergency use. The reason the contract’s delivery date was set as a condition for purchase was because the defendant scheduled a shakedown of the plant immediately after July 10.

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<sup>207</sup> *ibid* 1286.

<sup>208</sup> *text to n 199.*

<sup>209</sup> Choi, Chapter Two (n 10) 50.

<sup>210</sup> 366 Federal Supplement 959, 965-66 (South Dakota Ill 1973).

The court resolved that the intention of parties must be made in the light of facts and conduct of the parties;<sup>211</sup> previously, setting a purchase order verbally, with a specific delivery date, before producing a written purchase order was customary in transactions between the plaintiff and defendant. A sales agreement was concluded between the parties on July 6, 1972 when the defendant handed to the plaintiff a purchase order and directed him to deliver the equipment by July 10. The defendants wanted the equipment to be obtained and delivered no later than July 10, 1972, and the defendant presented their request to plaintiff as an emergency atmosphere that the plaintiff was obliged to address in an almost impossible time frame.

If we compare the *Quaker State* case which involved a mere exchange of prices, it is apparent that there was no exchange of price or cross-offers involved in *Alter & Sons*. The *Alter & Sons* case had a missing price because the plant urgently required the construction equipment to cool down the nuclear reactors before a price was decided on. The other terms the parties in the *Alter & Sons* had decided on included the specification of goods, the delivery date, the manner of delivery and the seller's flexibility in catering to the buyer's specification.

The UCC, SGA and CISG<sup>212</sup> are in unanimous agreement about the enforceability of contracts that omit the price term, but they differ in their enforcement of deliberate open-price practice. The UCC takes the more liberal approach validating deliberate open prices in order to adjust to unpredictability of the market and other changing circumstances, which demand deliberate incompleteness in sales. Using some contemporary examples of court decisions under Section 2-305, the following section shows that the UCC preserves the enforceability of a sale, as long as there is evidence of each party's intention to be bound to the contract, and that the price is set in good faith.

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<sup>211</sup> *Paluokos* (n 197).

<sup>212</sup> In Chapter Four a couple of English cases will be used to illustrate the 'inadvertent category': *Traditional Structures Ltd v HW Construction Ltd* [2010] EWHC 1530 (TCC); [2010] CILL 2899 and *McCandless Aircraft LC v Andrew Mark Payne, Eminence Aviation Limited* [2010] EWHC 1835 (QB). In Chapter Five an example of an emergency situation is portrayed in the *Oven Case* Switzerland 27 April 2007 Canton Appellate Court Valais (*Oven case*) < <http://cisgw3.law.pace.edu/cases/070427s1.html> > and *Pratt and Whitney v Malev Hungarian Airlines*, Hungary 25 September 1992 Supreme Court < <http://cisgw3.law.pace.edu/cases/920925h1.html> >

### 3.5.4 Open or deliberate price terms

Chapter Two discussed the wide range between open term contracts and contracts that apply open prices, which include contracts related to the sale of seasonal goods of raw products, IT outsourcing and independent service stations.<sup>213</sup> While open prices for typical seasonal goods are further elaborated on in Chapters Four and Five, this section focuses on open-price contracts between suppliers and dealers of independent service stations. As one of the most common industries that applies open price in the US, the supplier-dealer cases will illustrate how the UCC enforces open prices, but at the same time prevent opportunistic behaviour from parties.

Considering that the UCC does not specify that open price apply to long-term commercial relationships, there are a number of short-term contracts that apply open prices, such as *Autry Petroleum Company, McDonald Oil Company v BP Products North America Inc.*<sup>214</sup> The jobbers (Autry) were required to purchase a minimum amount of fuel from BP over a three-year contract. The price term provided that<sup>215</sup>:

[t]he price which Jobber will pay for each product sold under this contract will be Company's jobber buying price, as recorded at the applicable Company business unit, regional office or such other office as Company may designate from time to time, in effect on the date and the time of sale from the respective terminals designated by Company.

The phrase 'from time to time' shows that the deal is categorised as an agreement to agree, and if parties fail to agree, the UCC would apply a reasonable price at the time of delivery as the effective price. In this case, BP had the exclusive right to determine the price of the contract, and there was no clause that controlled how BP should set it. Moreover, BP was under no obligation under the contract to discuss how it sets the jobber buying price, and therefore did not need to be transparent in its pricing. BP then offered the jobbers a prompt-pay discount of one percent off the jobber buying price for purchases paid by electronic fund transfer (EFT) within ten days of lift. The promise was duly executed by BP when invoicing the jobbers the one percent ten-day prompt-day discount.

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<sup>213</sup> See Chapter Two, Section 2.7.

<sup>214</sup> *Autry Petroleum Company, McDonald Oil Company v BP Products North America Inc* 334 Fed Appx 982 CA 11 (Ga), (June 26, 2009), US District Court for the Middle District of Georgia.

<sup>215</sup> *ibid* (n 1) of the case report.

However, the jobbers later claimed that BP inflated its calculation by including the costs associated with offering the prompt-pay discount, and the jobbers alleged that this constituted an indirect denial of the promised prompt-pay discount, which amounted to a hidden recapture that frustrated their expectations. This led to a breach of BP's obligation to the open price in good faith. The jobbers cited Sections 1-203<sup>216</sup> and 2-305(2), which states that the supplier should perform their obligation in good faith, because good faith is implied in every contract.

In the next section, we will see how good faith safeguards the rights of both parties when a court decides to enforce an open price.

### **3.6 Good faith as a safeguard under the UCC**

Typically, open prices cases under the UCC revolve around the post-formation issue of whether the price was set in good faith. Contrastingly, the SGA and CISG focus on whether an open-price contract was formed in the first place. The availability of a body of case law on good faith and open prices provides some evidence on the capacity of courts to resolve disputes over prices that arise under this type of contracts.

Good faith and fair dealing play crucial roles in the UCC; as an implicit component in an open-price contract,<sup>217</sup> the parties are responsible to observe reasonable commercial standards of fair dealing.<sup>218</sup> Even a contractual provision that merely establishes minimum and maximum prices for goods requires price negotiations based on good faith negotiations between parties.<sup>219</sup>

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<sup>216</sup> Section 1-203 states that 'every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement.'

<sup>217</sup> *Mathis v Exxon Corp*, 302 F3d 448, 59 Fed R Evid Serv 1178, 48 UCC Reporting Service, Second Series 1 (5<sup>th</sup> Cir 2002), 48 Fed Appx 919 (5<sup>th</sup> Cir 2002); *Schwartz v Sun Co, Inc (R & M)*, 2763d 900, 46 UCC Reporting Service 2d 615 (6<sup>th</sup> Cir 2002); *Richard Short Oil Co, Inc v Texaco, Inc*, 799 Federal Reporter, Second Series 415, 2 UCC Reporting Service, Second Series 98 (8<sup>th</sup> Cir. 1986).

<sup>218</sup> *Columbus Milk Producers' Co-op v Department of Agriculture*, 48 Wisconsin, Second Series 451, 180 NW 2d 617, 8 UCC Reporting Service 481 (1970).

<sup>219</sup> *Oregon-Washington Vegetable & Fruit Growers Ass'n v Sunset Packing Co of Or.*, 254 Oregon 33, 456 P 2d 1002, 6 UCC Reporting Service 917 (1969).

In *Autry Petroleum Company*, as a supplier, BP was sued for unfairly pricing its fuel, but in their defence they have acted honestly and in accordance with reasonable commercial standards. Rejecting the jobbers' arguments, the federal district court agreed with BP and granted its motion for summary judgment. Section 2-305 implies the good-faith performance of explicit contractual provisions, and does not impose any additional obligations on the contracting parties that are not explicitly stated in their contract. Indeed, the court found that the one percent prompt-pay discount term offered by BP, and reflected on BP invoices had been integrated into the contract over the course of trade.

The court found nothing within the standard BP supply contract that prohibited BP from recouping the promised discount by increasing its sales price, and subsequently rejected the jobbers' contention that the defendant breached their contractual duty by recouping the cost of the discount as part of the jobber buying price. To impose an obligation on the defendant to ignore any prompt-payment discount costs when it determines the price of its product would mean re-writing the parties' contract. Clearly, this policy is not in line with the generalised good-faith requirement of the UCC.

*Autry Petroleum Company* acts as an illustration of enforceable open prices under the UCC that do not rewrite the parties' original contract. BP granted the discounted price, which fulfilled the good-faith requirement upon their contractual obligations. To discharge a contract, a claimant needs to prove bad faith, which the jobbers were unable to do in this case.

### **3.6.1 Proving objective bad faith in open-price contracts: evidence of commercial injury must be present in order to discharge an open price**

The liberal approach of the UCC to open prices leads to the following questions: to what extent is an open price enforceable? What evidence is required from the claimant in order to discharge the contract?

Based on *Autry Petroleum Company*, good faith is only challengeable if the claimant produces evidence of bad faith. Furthermore, the pricing of goods may only be regarded as unfair when bad faith is proven, which means that a court would not allow a contract to continue and commercially injure the relying party.

In contrast to *Autry Petroleum Company*, in the case of *Allapattah Services, Inc v Exxon Corporation*<sup>220</sup> an open price was nullified by evidence of bad faith; this is detailed in the following section.

### **3.6.2 Evidence of bad faith: double-charging dealers with the intent of driving them out of business**

Considering that the contract contained no explicit limitation on the dealer to fix the price, the *Allapattah* case contained similar facts to the *Autry Petroleum Company* case. As the dealer, Exxon had the unilateral right to set pricing, similar to the discounted offer in *Autry Petroleum Company* whereby the dealer offered a discount for cash payments. Exxon then imposed a three percent processing fee on all credit card transactions, and also expressed that it would reduce the price of the open-term contract by an amount that on average, would offset the three percent credit card processing fee. This arrangement continued for 6 months until Exxon stopped providing the promised offset, and instead began to double-charge the dealers for costs associated with credit card processing.

The main problem did not concern the actual amount Exxon charged for its wholesale gasoline to its dealers, but the manner in which the wholesale price was calculated. There was sufficient evidence to prove that Exxon's discount for cash program double-charged the dealers for credit card processing, and that Exxon concealed this systematic and intentional practice from the dealers. Furthermore, Exxon implemented these overcharges with hope of driving some of its dealers out of business.

To case of *Allapattah* is distinguished from *Autry Petroleum Company* because Exxon, as a supplier, specifically promised to adjust its prices, but broke the promise. However, in *Autry Petroleum Company*, the standard BP supply contract did not prohibit BP from recouping the promised discount by increasing its sales price, and the jobbers failed to prove a breach of contract on BP's behalf when the latter recouped the cost of the discount as part of the jobber buying price.

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<sup>220</sup> 61 Federal Supplement, Second Series 1308 (Southern District of Florida 1999).

Without evidence, a dealer cannot subjectively invoke bad faith; the Texas Supreme Court emphasised this point in *Shell Oil Co v HRN, Inc*<sup>221</sup> The Dealer Agreement stipulated that each dealer agreed to buy Shell-branded gasoline from Shell at the dealer tank wagon (DTW) price, which included delivery to the dealer's (HRN) station by a Shell tanker truck (a common practice to counter price volatility in the gasoline refining and marketing industry). Furthermore, Section 2-305(b) of the Texas Business and Commerce Code governed the contract (in *pari materia* with Section 2-305(2) of the UCC).

Apart from HRN, Shell also sells branded and unbranded gasoline to other jobbers, who operate fleets of trucks collecting gasoline from refiners' terminals and distributing it to their own or independent stations. Indeed, the price charged to the jobbers was the rack price, which was available for gasoline bought from and picked up at Shell's terminals. The rack price was lower because it did not include a delivery service, but the DTW price included a delivery charge and so carried a higher price. The dealer, alleging that the DTW price was an opportunistic attempt by Shell to replace the dealers with more profitable company-operated outlets, failed to state whether the DTW price could be considered as commercially reasonable. Instead, the dealers alleged that Shell acted in bad faith by setting its DTW price with the intention of running the dealers out of business.

In the *Shell* case, the court ruled that as long as the DTW price fell within the range of DTW prices charged by other refiners within relevant geographic markets, the price should be considered commercially reasonable. Since the DTW price Shell charged was uniform among similarly situated dealers, it clearly did not have a discriminatory motivation; a relatively high, yet commercially reasonable price is not evidence of bad faith. Since price set in good faith price is not synonymous with lowest price available, to claim that the price was set in bad faith would require the dealer to suffer damages above and beyond a mere increase in price.

In conclusion, good faith under the UCC is a safeguard put in place by Llewellyn to regulate discretion when setting prices. If a claimant failed to prove bad faith objectively, then, as seen in

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<sup>221</sup> 144 South Western Reporter, Third Series 429(Texas 2004).

*Autry Petroleum Company*, the defendant is presumed to have priced the goods in good faith. Good faith is a workable standard to maximise the enforceability of open price, unless bad faith is proven by the claimant.

In contrast with the *Autry Petroleum Company* and *Shell Oil* cases, bad faith was successfully proven in *Allapattah* when Exxon's discount-for-cash program double-charged its dealers for credit card processing and drove them out of business. In this case, the open price was unenforceable. Other potential evidence of bad faith includes evading the spirit of the bargain, a lack of diligence and the abuse of power when specifying terms.<sup>222</sup>

### **3.7 Conclusion**

The UCC has a greater function than a standard uniform law; it unifies the law between the states, as the CISG does with its Member States, and it codifies the law, as the SGA does with English sales law preceding 1893; but, most importantly, it caters to the needs of relational contracts.

Influenced by open-ended contracts under the German Civil Code of *Handelsgesetzbuch*, and Commons' conclusion that a group of people often act for the collective good rather than individual gain, Llewellyn combined open-ended contracts and mercantile custom so that contemporary businesses that involve relational sales can benefit from price flexibility and the law merchant. As merchants are viewed as a collective entity that works cooperatively, contracts are used as planning mechanism rather than as specified documents since business corporations are collections of people, and in such collective entities it is rare that their activities are tightly co-ordinated.<sup>223</sup> Palay supported this point, stating that 'looking beyond the [written] contract is important because parties who have, or anticipate, strong relational ties with their contracting opposites are not particularly worried about initial terms of agreement'.<sup>224</sup> Business people

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<sup>222</sup> Restatement (Second) of Contracts, Comment to Section 205.

<sup>223</sup> Macaulay, Chapter One, 'Non-Contractual Relations in Business' (n 103) 55.

<sup>224</sup> Palay, Chapter Two (n 110) 561, 562. See also Hadfield, Chapter One (n 160).

perceive excessive contract planning as a way of undermining the trust between parties, inflexible and counterproductive for developing good business relationships.<sup>225</sup>

Llewellyn concluded that, in comparison with the 1906 Uniform Sales Act, the three vital changes brought about by the UCC lie in its value to the public, its value to lawyers and the bar, and its practicality:

Obscurity we have in the Uniform Commercial Code too, but the obscurity there, compared to the obscurity of the present law, is clarity itself... if there were no question of uniformity in the picture, the Code still represents from the standpoint of the business and of the commercial lawyer, and from the standpoint of the general community much of the better body of law on the subject matter involved than the existing law of any one of the states. It would be worth adopting without reference to uniformity.<sup>226</sup>

Indeed, the success of the UCC as a commercial law was validated when it succeeded at unifying commercial law across all states, which was something the Uniform Sales Act (1906-1947) failed to achieve. The flexibility and open-ended nature of an agreement, however liberal it may sound, actually limits a party's potential for opportunistic behaviour because it gives them less freedom from to walk away from a contract they originally intended to be bound by. If a contract stipulates that the price is to be agreed later or to be set by a mutually agreed upon pricing mechanism, the failure of the price agreement or pricing mechanism does not automatically invalidate the contract.<sup>227</sup> As shown above, the courts are able to take a principled approach to resolving post-formation disputes over open price clauses.

The Uniform Sales Act would not have produced similar results; in the *Louisville* case, the contract was invalidated because the court assumed that the agreement required valuation under Section 10, when the parties intended for an existing market standard to determine the price under Section 9. Even if the court had correctly applied Section 9, the fact that there was no current price available in the Savannah market (due to the absence of a sale of rosin for two months) did not make any difference in the court's final judgment. Nevertheless, the court

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<sup>225</sup> Macaulay, Chapter One, 'Non-Contractual Relations in Business' (n 103) 55.

<sup>226</sup> Karl N Llewellyn, 'Why A Commercial Code' 22 *Tennessee Law Review* (1951-1953) 779,785.

<sup>227</sup> Macaulay, Chapter One, 'The Real Deal and the Paper Deal' (n 1) 52.

insisted on the contract's failure because its price mechanism broke down, and the relying party did not receive any compensation for damages because the court concluded that the price was not determinable using another equally reasonable standard. Moreover, there was no effort by the court to construct a market price based on other available prices. Conversely, a UCC court would have determined whether the parties intended that the Savannah market should act as the sole factor for the contract's validity. Obviously, the parties never specified that only the Savannah market should govern the sale, and so the court could have filled the price gap by referring to the price of rosin sold in other locations.

Extensive gap filling in open-price contracts is recommended by this thesis as a practice that should apply under the current SGA and CISG. By providing extensive flexibility in sales, many relational contracts, particularly long-term sales, would greatly benefit from this feature. Furthermore, the rights of a weaker party are protected from the opportunistic behaviour of a more dominant party. If the relevant provisions of the SGA and the CISG have negatively impacted contracting parties, as seen in *Louisville*, the parties' intent to be bound by the contract should be used as the test for liability instead. This thesis author believes that a breakdown in the price mechanism should not be an excuse for a party to refuse to perform, nor a hindrance to both parties in the completion of their contract.

The price mechanism's failure is fixable if there is an alternative way of ascertaining objective price. For example, using the current market price and direct reference to trade usage could be ways of ascertaining an objective price.<sup>228</sup> As in the *Shell Oil* case, if there is a price in relevant geographic markets, then it can be used as an objective alternative price.

This thesis proposes that the SGA and the CISG should adopt the objective approach of Llewellyn. Prosser affirmed that open prices should be a more acceptable practice because of the presence of a current market price, which acts as an objective standard to which the contract may refer. In this manner, a price term can be determined objectively, unlike other terms of the contract such as quantity and time of delivery, where standard market quantity and standard time

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<sup>228</sup> Scott, 'The Rise and Fall of Article 2' (n 22) 29.

of delivery do not exist. As long as parties intend to make a deal, the price term is a subsidiary matter, and the original purpose of the transaction should not be defeated.<sup>229</sup>

The next chapter illustrates how English courts are currently experiencing weaknesses similar to the Uniform Sales Act, which was originally based on the SGA itself. Usually, courts would refuse to enforce deliberate open prices because ‘to do that would be to contradict the express terms of the document which they (ie the parties) have signed’,<sup>230</sup> and also because supplying a price term results amounts to making a contract for the parties.<sup>231</sup> Conversely, in *Autry Petroleum Company* case, the UCC enforced an open price without rewriting or remaking the contract for the parties.<sup>232</sup> The difference lies in the UCC’s use of the parties’ intention to enforce the contract, which is absent in Sections 8 and 9 of the SGA. As a result, current English decisions, such as *Rafsanjan Pistachio Producers Cooperative v Kaufmanns Ltd*,<sup>233</sup> suffer from the ‘Louisville effect’, which occurs when a court denies the existence of market price standards.<sup>234</sup> Therefore, the current form of the SGA not only contains completely similar wordings to the 1906 Uniform Sales Act, but it also shares its negative impact.

The situation is more perplexing for the CISG because there is an effort to strike a balance between formalism and flexibility under Articles 14 and 55. In Chapter Five the thesis will present the contrasting view seen in the Honnold-Farnsworth debate. In the debate, one opinion shows preference for formality and the plain meaning of contractual wordings,<sup>235</sup> and the other

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<sup>229</sup> Cf *Spiritusfabriek Astra v Sugar Products Co* (1917) 176 App Div 829, 163 NY S 516.

<sup>230</sup> *May & Butcher, Ltd v The King* [1934] 2 KB 17, 22 (Lord Warrington of Clyffe).

<sup>231</sup> *ibid.* See also *Scammell (G) & Nephew, Ltd v Ouston* (1941) AC 251 and *Foley v Classique Coaches* (1934) 2 KB 1.

<sup>232</sup> *Autry Petroleum Company, McDonald Oil Company v BP Products North America Inc* 334 Fed Appx 982 CA 11 (Georgia), (June 26, 2009) US District Court for the Middle District of Georgia.

<sup>233</sup> 19 December 1997.

<sup>234</sup> Although ruling the contract as invalid, Rix LJ did state that there was an available market to buy in raw Iranian nuts from other sources of supply. This means that the contract price was ascertainable, and the contract could have been upheld, maintaining the eight-year business cooperation between the parties. In addition, despite the frost and the tightening of market prices, the price of \$4300/4400, quoted to defendants by the plaintiffs on 27 May, indicates that the frost did not the cause the prices to soar or constitute a changing circumstance that barred the enforcement of the contract.

<sup>235</sup> Farnsworth, Chapter One (n 188) ‘Formation of Contract’ 3-1 to 3-18.

proposes a contextual view that claims that as long as a contract is validly agreed on, deliberate open prices should be allowed.<sup>236</sup>

This thesis will continue to test Llewellyn's criticisms of the Uniform Sales Act against both the SGA and CISG. It will also claim that, while presentation may be beneficial to straightforward, simple contracts, both legislations should learn to accommodate price flexibility. Therefore, both legislations should statutorily uphold the importance of enforcing open prices as long as the parties intend to be bound to the contract and the price is fairly set.

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<sup>236</sup> John O Honnold, 'Criteria for an Offer' 147-57 in John O Honnold, *Uniform Law for International Sales under the 1980 United Nations Convention* (3rd edn, The Hague, Kluwer Law International 1999).

## **Chapter Four: Open Price in England under the English Sale of Goods Act 1979 (SGA)**

### **4.0 Introduction**

This chapter elucidates the extent of an open price's flexibility when coping with relational sales under this thesis's second comparative legislation: the English Sale of Goods Act 1979 (SGA). This chapter begins by recounting the history of the laws governing the sale of goods in England and the development of the SGA, thereby highlighting the relevant provisions regarding price. The later sections of the chapter elaborate on the current flexibility granted by the SGA to open prices under Sections 8 and 9 of the SGA from validating inadvertently incomplete contracts (using a reasonable price in order to determine the price) to approving parties' mutually agreed price determination mechanisms and overseeing their course of dealing between parties. This chapter will show that departing from presentation and moving towards flexibility is a crucial step in adapting the SGA to relational contracts that involve potential changing circumstances.

The SGA was the product of Chalmers' careful reading of nineteenth century cases regarding small-scale commodity sales. This chapter addresses the issue of whether the price term presentation required by Chalmers is still relevant in modern business, which generally favours complex, long-term contracts. Both small and large-scale contracts equally require a high degree of certainty concerning a final price, and flexibility could certainly benefit trades that frequently use open prices under the SGA (such as the supply of seasonal goods or good with volatile prices). In specific trades, the parties' intention to be bound must prevail over any breakdown of price mechanism.

The previous chapter revealed that modernisation was the force behind the shift from presentation, or the straightforward, discrete rule of complete contracts, to a more flexible, relational practice for dealing with incomplete contracts. This shift was apparent in the US when the Uniform Sales Act (1906-1947) was replaced by the UCC. In the *Louisville* case, the court could have constructed a market price that gives more justice to the parties than what was actually achieved. This would have been possible under the UCC, but the Uniform Sales Act lacked the ability to construct a fair market price. Effectively, the Uniform Sales Act was criticised for limiting its application of a reasonable price. The court arrived at its

decision due to the influence of Willistonian formalism, which emphasised formality in determining the validity of a contract. Although contractual formalism may have suited a discrete, simple deal, it is not necessarily best suited to dealing with relational, long-term contracts, which are often highly complex in nature.

The two main weaknesses of the Uniform Sales Act lay in the inefficiency of using a textual approach to interpret contracts, and the generalisation of sales, which failed to consider the specific nature of certain commercial transactions. In response to this, the UCC was drafted to significantly change the state of sales law by using objective criteria to derive the parties' intention. Rather than relying on the facts and circumstances of the contract, criteria such as trade usage or established practice are referred to when deriving the parties' intention to be bound in a contract. Beginning with Pennsylvania, the adoption of the UCC by other states eventually replaced the then Uniform Sales Act. At present, all US states except Louisiana, implement open prices under Section 2-305 of Article 2.

This chapter also tests whether the two weaknesses of the Uniform Sales Act are present in Sections 8 and 9 of the English SGA. A more flexible interpretation of both provisions allows contractual freedom whilst minimising opportunistic behaviour from parties.

The following section explains the history of the English legislation relating to the sale of goods and its development prior to 1893. After this, the next section proceeds to discuss relevant court decisions concerning missing and deliberately open prices.

#### **4.1 The historical background of the English Sale of Goods Act 1979**

For various reasons, some of them historical, English law is the governing law for international commodity sales.<sup>1</sup> The major commodities traders were long ago absorbed by multinational traders, but judging by the parties' names in cases reported, it was rare that the parties were English.<sup>2</sup> Historically, English law played a leading role in cotton sales and homogenous commodities, and foreign parties frequently made contracts that took place outside of the United Kingdom but were still governed by the English law.<sup>3</sup>

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<sup>1</sup> Michael G Bridge, 'Uniformity and Diversity in the Law of International Sale' (2003) 15 Pace International Law Review 55.

<sup>2</sup> *ibid* n 8.

<sup>3</sup> *ibid* 58.

Prior to the English Sale of Goods Act 1979, the sales law in England was governed by the English Sale of Goods Act 1893. Other sources that contributed to regulating the sale of goods in England include the statutory provisions of the Factors Act 1889, the Unfair Contract Terms Act 1977 and the Unfair Contract Terms Regulations 1999. The case law of the 1979 Act, and those that pre-date the 1893 Act also form part of the sources.<sup>4</sup> The case law which pre-dates the 1893 Act is specifically referred to in three different situations: where there is ambiguity in the SGA, where there is a technical meaning to a term that the old cases may assist to explain, and where a point is not covered by the Act which then defers to the old decisions.<sup>5</sup> Nevertheless, reference to pre-1893 cases is not always necessary, although in reality it often provides the accepted meaning of sections in the 1893 Act.<sup>6</sup>

The consolidation provided a simpler version of the law, as explained by Lord Herschell in *Bank of England v Vagliano Brothers*:<sup>7</sup>

...the purpose of such a statute surely was that on any point specifically dealt with by it, the law should be ascertained by interpreting the language used instead of, as before, by roaming over a vast number of authorities in order to discover what the law was, extracting it by a minute critical examination of prior decisions.

Chalmers' intention was for the SGA to encompass all special rules about the sale of goods, but *not* to codify the general principles of contract law.<sup>8</sup> This is clear under Section 62(2):

The rules of the common law, including the *law merchant*<sup>9</sup> except in so far as they are inconsistent with the provisions of this Act, and in particular the rules relating to the law of principal and agent and the effect of fraud, misrepresentation, duress or coercion, mistake, or other invalidating course, apply to contracts for the sale of goods.

The 1979 Act is a consolidation of amendments that took place between 1893 and 1979, but apart from a couple of sections, the section numbers of the 1893 and 1979 laws are identical.<sup>10</sup>

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<sup>4</sup> *ibid.*

<sup>5</sup> *ibid.*

<sup>6</sup> *ibid.*

<sup>7</sup> [1891] AC 107, 144-145.

<sup>8</sup> Patrick S Atiyah, John N Adams and Hector MacQueen, *Atiyah's Sale of Goods* (12<sup>th</sup> edn, Harlow, Pearson/Longman 2010) 5.

<sup>9</sup> Emphasis added.

<sup>10</sup> Bridge (n 1).

It is clear that the SGA includes the principles of the law merchant in addition to common law principles of the law merchant. The SGA often governs international sales either because it is closely connected with the transaction, or simply because its reputation leads most contracting parties to accept it as their governing law.<sup>11</sup> It is common to find parties who want English law to govern their contracts or to resolve their disputes.<sup>12</sup> Trade between parties can be subjected to the SGA, even if the seller, the buyer and the goods are not involved with England at all.<sup>13</sup>

The next section explores decisions made on cases with deliberately incomplete contracts decided prior to 1893. This gives some background to the drafting of Sections 8 and 9, and helps to explain the evolution of open price under English courts, from the traditional approach of Sections 8 and 9 of SGA 1979 (with no amendment from the 1893 version) to its recent adaptability to relational flexibility when circumstances changed.

#### **4.1.1 Price terms in English contracts concluded prior to 1893**

Traditionally, English courts would not enforce a sale if the agreed price mechanism failed. In *Darbey v Whitaker & Another*,<sup>14</sup> the court declared that it had no power to decree specific performance of a contract (sale or purchase) that required its price to be fixed by arbitration. The only exception to this rule was if the arbitrators had previously fixed the price.<sup>15</sup> The ruling was subsequently followed by Sir William Grant in *Milnes v Gery*,<sup>16</sup> who held that there could be no specific performance of an agreement for sale.<sup>17</sup> Because the arbitrators failed to agree on the estimated price and no third person was appointed to make the final determination on the price of the estate, the court refused to enforce specific performance of the contract.<sup>18</sup> Furthermore, the court did not award any damages to the plaintiff, because a valid contract must have existed in order to award damages for its breach.<sup>19</sup> Considering that there was no previously fixed price for the contract, the court refused to create an alternative arrangement for the parties.<sup>20</sup> However, a more liberal view was taken in *Wilks v Davis*:<sup>21</sup> the

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<sup>11</sup> M Furmston, *Sale and Supply of Goods* (3<sup>rd</sup> edn, London, Cavendish 2000) 5.

<sup>12</sup> text to n 1.

<sup>13</sup> *ibid.*

<sup>14</sup> (1857) 4 Drewry 134.

<sup>15</sup> *ibid* 140.

<sup>16</sup> (1807) 14 Vesey Junior 400 or 33 ER 574.

<sup>17</sup> 33 ER 574, 578.

<sup>18</sup> *ibid* 575.

<sup>19</sup> *ibid* 578.

<sup>20</sup> *ibid* 577 (Sir William Grant).

court was willing to intervene and ascertain the price in order to uphold the contract, but only on the condition that the parties agreed to a valuation and did not name which third party was able to make the valuation.<sup>22</sup> Additionally, if one of the parties prevented a valuation to be made by the third party, then the contract would be invalidated.<sup>23</sup> In *Vickers v Vickers*<sup>24</sup> the plaintiff did not allow the valuer to proceed with the valuation of stock, and thus the contract was invalidated because of its lack of set price.

Now that we have briefly covered the pre-1893 decisions, the following section explains and gives examples of the current sections of the SGA 1979 and the methods of fixing prices under the SGA.

## 4.2 The SGA 1979

As a body of commercial law, the SGA consists of seven parts and four schedules.<sup>25</sup> Below are the relevant sections under the SGA relating to price:

### Section 2

(1) A contract by which the seller transfers or agrees to transfer the property in goods to the buyer for a money consideration, called the price.

Price, either paid or promised, constitutes a promise for the transaction to take place.<sup>26</sup> This is visible under Section 2(1), which implies that a transaction entails that one party promises to transfer the ownership of goods and the other pays its value in money. Therefore, contracts that have no monetary price, or where the object of sale is not goods but land or intangible property (ie interests which cannot be physically possessed such as shares, patents and

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<sup>21</sup> (1817) 3 Mer 507.

<sup>22</sup> The court substantiated this point by distinguishing the present case from the situation in *Agar v Macklew* (1825) 57 ER 405 where the proviso found was personal and is confined to the five persons named as valuers in the agreement. In the latter case there is no room for a more liberal interpretation of the agreement.

<sup>23</sup> *Thurnell v Balbirnie* (1837) 2 M & W 786; *Vickers v Vickers* (1807) LR 4 Eq 529; *Milnes v Gery* (1807) 14 Ves Jr 400.

<sup>24</sup> (1867) LR 4 Eq 529. Nevertheless, *Sudbrook Trading Estate Ltd v Eggleton* [1983] AC 444 overruled *Vickers*, by concluding that if a party (in this case the lessor) refused to appoint a valuer, the court would intervene by ascertaining a fair and reasonable price.

<sup>25</sup> Westlaw database

<<http://login.westlaw.co.uk.ezphost.dur.ac.uk/maf/wluk/app/document?&src=ri&docguid=I603B7AB0E42311DAA7CF8F68F6EE57AB&hitguid=ICC7F47D0E44911DA8D70A0E70A78ED65&suppsrguid=ia744d0b000000126d0faf7e8850ead78&spos=104&epos=104&td=338>> accessed 15 February 2010.

<sup>26</sup> See Vold, Chapter One (n 6).

copyrights), are not governed by the SGA.<sup>27</sup> Moreover, barter, or exchange and contract of service do not fall under the SGA either.<sup>28</sup>

Sections 8 and 9 of the SGA are the more specific sections regarding methods of fixing (or non-fixing) prices:

### Section 8

- (1) The price in a contract of sale may be fixed by the contract, or may be left to be fixed in a manner agreed by the contract, or may be determined by the course of dealings between the parties.
- (2) Where the price is not determined as mentioned in sub-section (1) above, the buyer must pay a reasonable price.
- (3) What is a reasonable price is a question of fact dependent on the circumstances of each particular case.

### Section 9

- (1) Where there is an agreement to sell goods on the terms that the price is to be fixed by valuation of a third party, and he cannot or does not make the valuation, the agreement is avoided; but if the goods or any part of them have been delivered to and appropriated by the buyer, he must pay a reasonable price for them.
- (2) Where the third party is prevented from making the valuation by the fault of the seller or buyer, the party not at fault may maintain an action for damages against the party at fault.

Based on the above provisions, there are several ways of determining the price of the goods other than the classic fixed price method that are allowed under the SGA:

#### 1) Silence

In Chapter Two, two types of open price were distinguished: ‘inadvertent’ and deliberate.<sup>29</sup> Choi defined inadvertent open prices as ‘missing’ prices because of their unintentional omission of a contractual term. On the other hand, deliberate open prices

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<sup>27</sup> *ibid.*

<sup>28</sup> *ibid.*

<sup>29</sup> See Chapter Two, Section 2.1.

acknowledge the terms that still require negotiation (for example, rental prices) and intentionally leave them to be determined at a later time.<sup>30</sup> An example of unintentional silence concerning a price term is as follows: a customer, who had no previous course of dealing with a supplier, telephones the supplier for the first time to order certain goods to be delivered. However, the customer fails to ask the supplier for the price of the goods.<sup>31</sup>

Having similarity with Section 2-305(1)(a) of the UCC, Section 8(2) applies a reasonable price to validate sales where parties are silent regarding the price. Based on Section 8(3), the reasonable price depends on the circumstances of each case. If the seller is in business, evidence of the seller's usual prices will be a good indicator as to what amounts to a reasonable price, and a court will take into account the size, location and expense of the seller's premises, reputation (for instance, Harrods Food Hall will be more reputable than ordinary supermarkets), and quality of service offered to determine a reasonable price.

In the absence of a standard price (for example, when the seller has ceased trading), the court needs to rely on other evidence to decide on a reasonable price. As long as there are clear indications of the going rate, and of acceptable policy within particular industries, both Section 8(2) and 8(3) validate contracts without a price term that would otherwise be perceived as 'vague' or 'incomplete'.<sup>32</sup>

## 2) Fixing the price in the manner agreed by the parties

When parties are not silent about the price but neither have fixed it in the clearest terms, they may deliberately choose a particular standard or mechanism in order to ascertain the price later in the contract. The following clause, taken from the leading case of *May and Butcher Limited v The King*,<sup>33</sup> is an example of this: 'the price to be paid for ...shall be the fair amount of the value thereof, such amount to be settled, in case the parties shall differ as to the same, by arbitration...' Alternatively, as in *Re Brand Estates, Ltd.*,<sup>34</sup> the price may also be agreed to be fixed by at the discretion of

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<sup>30</sup> Choi, Chapter Two (n 10).

<sup>31</sup> Furmston (n 11).

<sup>32</sup> Linda Mulcahy, *Contract Law in Perspective* (5<sup>th</sup> edn, Oxon, Routledge-Cavendish 2008) 74.

<sup>33</sup> [1934] 2 KB 17.

<sup>34</sup> (1936) 3 All ER 374.

one of the parties. Their discretion is neither absolute nor arbitrary, and the price must be set in reasonable and honest opinion.<sup>35</sup>

3) Fixing the price based on the course of dealing

Open prices work best in relational sales when parties have dealt with each other previously; when this is the case, the applicable price can be determined on their course of dealing. However, most relational sales involve pricing volatile goods that require constant updating, and due to this, old set prices often do not apply to repeated future transactions between parties. This is seen in *Mamidoil*,<sup>36</sup> where the reasonable fee for handling crude oil changes from time to time over the course of a ten-year deal. In fact, even a short-term deal over a period of one year could require a renegotiation; the *Quaker Mushroom* case provides an example of this,<sup>37</sup> and shows that a previous course of dealing is not always a reliable price determination mechanism in volatile price industries. The natural gas, coal, petroleum coke and uranium industries typically opt choose either, or a combination of both a price index and regular voluntary renegotiations to maintain their long-term cooperative relationship.

4) Using a third party to fix the price

Another possible way to set the price term is by appointing a third party to evaluate the price. Section 9 validates a contract that requires its price to be fixed by a third party. However, the contract may be avoided if valuers fail to fix the price (or if a party disagrees with the valuer's conclusion).<sup>38</sup> Unlike UCC courts,<sup>39</sup> English courts refuse to act as valuers for a contract.<sup>40</sup> Rather, if the goods or any part of them have been delivered to and appropriated by the buyer, the buyer must pay a reasonable price. If one party prevents the valuation, that party will be held liable and the other

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<sup>35</sup> *ibid* 378.

<sup>36</sup> Further explanation on *Mamidoil-Jetoil Greek Petroleum Co SA v Okta Crude Oil Refinery AD (No 1)* [2001] EWCA Civ 406 is seen in the subsequent section on deliberate open prices.

<sup>37</sup> See Chapter Three (n 208). In this case the new orders could not depend on the old price set agreed more than a year when parties first entered into the contract.

<sup>38</sup> If the seller regards the valuation as being too low, or the buyer as too high, it must be proven that the valuation is negligent. In *Arenson v Casson* [1977] AC 747, proving a valuation as negligent is not the same as proving that other valuers would have reached a different figure, but to show that the figure produced was one that no reasonably competent valuer could have arrived at.

<sup>39</sup> Section 2-305(1)(c) states that if a third party or a standard chosen by the parties fails to set the price, the court is willing to rewrite the contract to enforce their intended contract.

<sup>40</sup> Section 9(1) of the SGA, and *Tillet v Charing Cross Bridge*, 28 LJ Ch 863; *May & Butcher, Ltd v The King* 21.

party, who is not at fault, may maintain an action for damages against the party at fault.<sup>41</sup>

#### **4.2.1 The limited application of reasonable price under the SGA to deliberate open-price contracts**

The SGA applies reasonable price only to contracts where the parties are silent regarding price. It does not apply when parties deliberately leave the price term open, even if there is a reasonable market price available that could be applied to the goods. Conversely, under the UCC a court applies a reasonable price to a contract in three different situations: when parties are silent about the price,<sup>42</sup> if parties fail to agree on a price,<sup>43</sup> and if a third party or an applicable standard fails to determine a price.<sup>44</sup>

Instead of extending the application of reasonable price, the majority of judges prefer to rely on a traditional approach, which invalidates a deal when a price mechanism fails to set the price. English courts maintain the traditional approach based on the similarity between Sections 8 and 9:<sup>45</sup> under Section 9, a contract is avoided if a third party fails to state the price, and similarly a contract is canceled, under Section 8, if the parties to the contract fail to set the price.

This similarity originates from the ruling of *May & Butcher*, and further detail of its textual approach is explained in the next section.

#### **4.3 Reinforcing the limits of reasonable price: application of a purely textual approach in relational sales**

A general presumption of English law is that parties are to provide every essential term of a deal,<sup>46</sup> and if there are gaps in a contract, courts will fill the gaps in two possible ways. A court may use the incidences or particular circumstances to give efficacy to contract.<sup>47</sup> Alternatively, a court may imply a term based on the entirety of the document or its unexpressed terms.<sup>48</sup> Nevertheless, case law proves that English courts tend to enforce terms

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<sup>41</sup> The departure from this concept was made in *Sudbrook Trading Estate Ltd v Eggleton* [1983] AC 444.

<sup>42</sup> Section 2-305(1) (a) of the UCC.

<sup>43</sup> Section 2-305(1) (b) of the UCC.

<sup>44</sup> Section 2-305(1) (c) of the UCC.

<sup>45</sup> *May and Butcher* (n 33) 20 (Lord Buckmaster).

<sup>46</sup> *Luxor (Eastbourne), Ltd v Cooper* (1941) AC 108, 137.

<sup>47</sup> *Lister v Romford Ice Co* (1957) 1 All ER 125, 137, (1957) AC 555, 121 JP 98 (HL).

<sup>48</sup> 36 Halsbury 289.

that fall into the ‘it goes without saying’ category.<sup>49</sup> On this point, Macaulay doubted whether courts should disregard the contextual meaning of a contract by focusing solely on the words of a document<sup>50</sup> (the textual matter).<sup>51</sup> Clearly, English judges prioritise the plain meaning of the contract’s wording,<sup>52</sup> but the paper document does not always reflect the implied deal or the parties’ actual expectations.<sup>53</sup>

The application of a reasonable price under Section 8(2) could have been extended to fill price terms deliberately left open by the parties, but it seems that current English courts prioritise the requirement of a fixed price over the overall aim, or business efficacy of a trade that requires an open price in order to allow a higher degree of flexibility. A certain degree of presentation in a sale under the SGA may have worked well in the simple, discrete sales of the past, but it does not necessarily apply to contemporary relational sales. The analogy made by the House of Lords in *May & Butcher*, and applied by the current courts, is likely to invalidate deliberate open-price contracts in volatile trades.

#### **4.3.1 The *May and Butcher* case: where presentation prevails over flexibility**

The *May & Butcher* deal involved the payment of a deposit, although parties had yet to agree on price, delivery date and the quantity of the old tentage. The deal stipulated that the suppliers had to purchase all of the tentage. The parties had two separate correspondences by post, which were dated June 29, 1921 and January 7, 1922 respectively. The first letter stated that the deposit of £1000 paid by the suppliers, secured the purchase of all old tentage, which would become by December 31, 1921. The parties also agreed that all disputes with reference to, or arising out of, the agreement would be referred to arbitration in accordance with the Arbitration Act 1889.

The second letter retained similar terms, except that it included a variation stating that ‘the prices to be agreed upon between the Commission and the purchasers in accordance with the terms of clause 3 of the said earlier contract shall include delivery free on rail...nearest to the depots at which the said tentage may be lying...’.<sup>54</sup> In addition, the letter stated that the

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<sup>49</sup> *Luxor (Eastbourne), Ltd* (n 46) 137.

<sup>50</sup> Macaulay, Chapter One, ‘The Real Deal and the Paper Deal’ (n 1) 62.

<sup>51</sup> *ibid* 51.

<sup>52</sup> *ibid*.

<sup>53</sup> *ibid*.

<sup>54</sup> *May & Butcher* (n 33) 19.

Commission may also at any time in their uncontrolled discretion and before it has been dispatched to or collected by or resold by the purchasers, certify that any portion of the said tentage is required by the British Government and the Commission shall be at liberty to withhold delivery of such portion.<sup>55</sup>

While the Commission claimed that there was no valid contract, the suppliants counterclaimed that the non-agreement of the tentage's price should be settled by a reasonable price under Section 8(2). The suppliants added that, even if the court rejected both the reasonable price and the validity of the arbitration process, the bargain ended in 1922 and was unfair, as they were entitled to the opportunity of entering further agreements for future goods, which was referred to in the contract's terms.

#### **4.3.2 The decision of the House of Lords**

Rejecting the suppliants' contention, the court insisted that the entire matter depended on the construction of the actual words of the contract.<sup>56</sup> Additionally, Lord Buckmaster held that there was no valid contract because there was no textual agreement to the prices. An arbitration clause would only be effective if parties have a binding contract, which meant that contractual terms such as quantity, price and delivery date had to be agreed upon in the clearest manner.<sup>57</sup>

According to Lord Buckmaster, failure to agree on price means that the contract should fail for indefiniteness. Lord Buckmaster made an analogy by extending the effect of Section 9 upon Section 8: under Section 9, if a valuer fails to evaluate a price, the contract is avoided.<sup>58</sup> Based on the analogy, Lord Buckmaster held that a similar effect is apparent under Section 8 when parties agree to set a price but eventually fail to do so.

While fixing the price term may 'enhance legitimacy and facilitate sense making',<sup>59</sup> its application in *May & Butcher* does not always accommodate relational sales sufficiently.<sup>60</sup>

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<sup>55</sup> *ibid.*

<sup>56</sup> *ibid.*

<sup>57</sup> *ibid.* 21.

<sup>58</sup> See Section 4.2.

<sup>59</sup> PWL Vlaar, FAJ Van Den Bosch and HW Volderba, On the Evolution of Trust, Distrust, and Formal Coordination and Control in Interorganizational Relationships: Towards an Integrative Framework', ERIM Report Series Reference No. ERS-2006-035-STR at 12, <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=920230](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=920230)>

*May & Butcher* was not a case of impossibility of performance, and there was no reason for the Commission to withhold delivery of the tentage.<sup>61</sup> Although the price was subject to an agreement to agree, tentage is a non-specialised commodity that has a referable market price,<sup>62</sup> and arguably a reasonable price was determinable by the court.

Had Section 8(2) been interpreted as flexibly as Section 2-305(1)(b)<sup>63</sup> of the UCC, the contract in *May & Butcher* could have been enforceable. It was a case of both parties needing to find an agreement to agree, and a reasonable price might have filled the gap in the event of the parties' failure to agree on price.

#### **4.3.3 Flexibility: a useful extra-legal norm to substitute presentation under the SGA**

In his 1974 article of 'Restatement (Second) of Contracts and Presentation,' Macneil argued that on the one hand, a sales law that based on presentation may mold a relational sale into the presentation character;<sup>64</sup> on the other hand, a sales law may also be changed in its overall structure by merging both presentation and relational elements, such as the manner in which Llewellyn drafted the UCC. Chapter Three observed that the UCC falls under the second category. The major shift brought by the UCC was introducing price flexibility in lieu of price rigidity caused by the Willistonian formalism since 1906. This change was precipitated by modernisation and the complexity of contemporary contracts that requires sales law to adapt to secure the validity of relational sales.

English law could potentially adopt a similar approach to price flexibility to cater to the needs of commercial contracts. While the SGA maintains classic principles, English courts admit that, depending on the nature of a trade, departing from the rigidity of classic fixed prices is possible; as seen in the case of *Scammell (G) & Nephew, Ltd v Ouston*,<sup>65</sup> Viscount Maugham held that in certain types of contract, the court was willing to imply terms from commercial documents of dealings where the parties were familiar with each other and were under the

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<sup>60</sup> Blair, Chapter One (n 72) 76.

<sup>61</sup> *May and Butcher* (n 33)19.

<sup>62</sup> Chapter Five discusses the CISG, Section 5.41 explains that an agreement involving the missing price of two jet engines in *Pratt and Whitney v Malev Hungarian Airlines* Hungary 25 September 1992 Supreme Court <<http://cisgw3.law.pace.edu/cases/920925h1.html>> case has a more subjective reference to price, as they are highly specialised goods and have no comparable market price, as opposed to goods such as tentage in the present case.

<sup>63</sup> Even if the parties fail to agree on a price, a court under the UCC has the power to fill the contractual gap using a reasonable price at the time of delivery.

<sup>64</sup> Macneil, Chapter One, 'Restatement (Second) of Contracts' (n 135) 597.

<sup>65</sup> (1941) AC 251, 255.

impression that they had made a binding contract.<sup>66</sup> Laymen who are familiar with each other typically enter into a contract ‘unassisted by persons with a legal training...to use words or phrases with a precise or definite meaning’.<sup>67</sup> Indeed, not every trade demands a fixed price in order to validate a contract.<sup>68</sup>

While *Scammell (G)* is an English decision that approves price flexibility based on the nature of a trade, relational contracts are often invalidated by *May & Butcher*, which is cited favourably by English courts, as the next section shows. Current decisions, particularly with regard to deliberate open prices illustrate the complex position of relational sales in England.

#### 4.4 Decisions under Sections 8 and 9 of the SGA 1979

Research discloses that there are nineteen court decisions that relate to Section 8, and only one case that cites Section 9 as an exception, rather than an applicable rule.<sup>69</sup> Four of these decisions are discussed in this thesis to test the practicality of open prices under each provision. Although Sections 8 and 9 do not specifically govern unintentional or intentional open prices,<sup>70</sup> listed decisions prove that the provisions govern both situations of unintentional and intentional open price. To test how effectively Section 8 copes with relational sales, the discussion is separated into two categories; the ‘missing price’ category (when parties unintentionally leave the price open) and the ‘open price’ category (when parties leave the price open intentionally).

Nevertheless, since the earlier decisions in the *Hillas* and *Foley* cases did not involve direct reference to Section 8, a summary of both cases is made before moving to the discussion of the more recent decisions in the next section of this chapter, which looks at deliberate open price.

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<sup>66</sup> *ibid.*

<sup>67</sup> *ibid.* 254.

<sup>68</sup> In the next section (which deals with deliberate open price), the *Hillas v Arcos Ltd* case demonstrates, that a buyer’s requirement of ‘fair specification’ is sufficient enough to form a valid contract and make the seller liable to perform it.

<sup>69</sup> As Section 9 was cited to illustrate a hypothetical situation, a deeper analysis of open price is not necessary in relation to the case of *Leigh & Silavan Ltd v Aliakmon Shipping Co Ltd (The Aliakmon)* [1986] AC 785. It stated that ‘unless the sellers reserve the rights of transfer of the property under Section 9 of the Sale of Goods Act 1979, the buyer could only claim for negligence for loss of or damage to property if he had either the legal ownership of or a possessory title to the property at the time when the damage occurred’ (*The Aliakmon*, 803).

<sup>70</sup> The Legislation Analysis section in the Westlaw database regarded Section 8 to ‘deal with price’ without specifying ‘missing’ or ‘deliberate’ open price.

#### **4.4.1 Inadvertently open price: two examples from the English jurisdiction on ‘missing price’**

This section provides two recent decisions where the English courts applied ‘reasonable price’ as gap filler when parties were silent on the price term.

##### **4.4.1.1 *Traditional Structures Ltd v HW Construction Ltd*<sup>71</sup>**

In this case, a claimant mistakenly omitted the price of cladding in a tender. The claimant quoted £42,000 for the steelwork and £38,000 for the cladding in the original document, but the quotation copy sent to the defendant omitted the pricing for the cladding situated on the last line of the document. The claimant then sent a revised copy but the defendant rejected the revision.

As a result of the two versions of tender, the defendant alleged that the claimant had quoted £38,000 to cover both the steelwork and cladding. The claimant then sought a reasonable price for the cladding element of the works and/or rectification of the sub-contract on the grounds of unilateral mistake.<sup>72</sup> Judge David Grant accepted the view that ‘even failure to agree the price is not necessarily fatal in such a case’.<sup>73</sup> Section 8(2) provides that if no price is determined by the contract, a reasonable price must be paid. This judgment was given to the claimant, and a reasonable price for the cladding work as completed was at £34, 754.17.<sup>74</sup>

##### **4.4.1.2 *McCandless Aircraft LC v Andrew Mark Payne, Eminence Aviation Limited*<sup>75</sup>**

The plaintiff had been an aircraft broker for 30 years in the state of Iowa, US, specialising in fixed wing aircraft and without experience dealing in helicopters. The sale involved a Robinson R44 Clipper helicopter, reached orally in 2006 in Iowa, USA for \$265,000. The plaintiff claimed that the sale was conditional; the plaintiff was to retain title until the buyer resells it to a third party within six months of delivery, failing which the defendant was to pay \$265,000 for the helicopter to the plaintiff. Later, there was confusion regarding whether this price was a wholesale or a retail price.<sup>76</sup> The defendant suspected that the seller overcharged

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<sup>71</sup> [2010] EWHC 1530 (TCC); [2010] Construction Industry Law Letter (CILL) 2899.

<sup>72</sup> *ibid* [19].

<sup>73</sup> The claimant cited paragraph 2-113 of Joseph Chitty, *Chitty on Contracts* (Hugh G Beale (ed), 30<sup>th</sup> edn, Sweet and Maxwell 2008).

<sup>74</sup> Aside from Section 8(2), Section 15(1) of the Supply of Goods and Services Act 1982 Contracts was applicable, which states that the claimant is entitled to a reasonable pay for the completed work.

<sup>75</sup> [2010] EWHC 1835 (QB).

<sup>76</sup> *ibid* [71].

on the price after being advised by the Robinson manufacturer that the market price of the Clipper model was \$240,000.

The helicopter arrived in England on 15 February 2007. The parties did not agree on the final price, but the defendant accepted the delivery and used the helicopter. The helicopter was not resold in the UK. Later the defendants delivered the helicopter to the plaintiff. The plaintiff had managed to sell the helicopter in the US on 10 May 2012 with the resale price of \$180,000, yet had incurred substantial interest charges through the bank loan by which it funded the purchase of the helicopter. The courts held that a binding contract existed once the buyer accepted the delivery, which implies validation of the contract.<sup>77</sup> Despite the absence of a market price in a second hand helicopter,<sup>78</sup> the absence of agreement as to price after the delivery took place in England was resolved by Section 8(2) using expert advice and other contemporaneous evidence to evaluate a reasonable price for the helicopter. The price evaluation found that although the helicopter had been flown (for a relatively low number of hours), the evidence showed that the marketability nevertheless increased by an amount that depended on the current market conditions, and its value was certainly not diminished.<sup>79</sup> Therefore, since the parties had orally agreed \$265,000 as the price in Iowa, the court held that the plaintiff was entitled to damages of \$85,000, a result of the difference between the original sale price of \$265,000 and the resale price of \$180,000.

Clearly acceptance of the delivery constitutes a sufficient proof that the contract exists. Indisputably, reasonable price applies in such ‘inadvertently missing price’ contracts.

#### **4.4.2 Deliberate open price**

In the second category, the chapter tests whether open price under English law is enforceable in relational sales in a similar manner to the UCC. On the one hand, the UCC enforces a deal where the price is silent, where parties fail to agree on price, or where a third party or a standard agree fails to set the price. Yet on the other hand, the SGA requires presentation the future price rather than price flexibility. As a result, the application of a reasonable price under Section 8(2) is limited only to cases of silence, rather than cases where parties intentionally omit the price.

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<sup>77</sup> *ibid* [203].

<sup>78</sup> *ibid.* [204]

<sup>79</sup> *ibid* [182, 13.2].

The first two decisions in the *Hillas v Arcos Ltd* and *Foley v Classique Coaches* cases had no clear relation to Section 8, although both involved a determinable price term. Both courts referred to and distinguished the *May & Butcher* principle of ‘an agreement to agree is not a contract’, from the circumstances found in *Hillas* and *Foley*.

#### 4.4.2.1 *Hillas & Co v Arcos Ltd*<sup>80</sup>

The over-dependence on classic contract formalities was first criticised in the *Hillas* case.<sup>81</sup> Presentiating price was regarded unnecessary by the House of Lords, thus departing from the traditional fixed-price method. Based on the nature of the trade, the phrase of fair specification was sufficient to constitute an objective standard for assessing the quality and price of timber contracted, thereby approving flexibility without compromising certainty of price.

Previously the seller, Arcos and the buyer, Hillas, had performed a contract for the supply of Russian timber for the year 1930. A year later, Hillas took up an option for Arcos to supply 100,000 further timber ‘of fair specification’ for delivery. There were no particulars as to the type of timber, the terms of shipment or any of the other matters stated in the contract. Since the seller had sold the timber to a third party, the seller argued that the option was avoided due to uncertainty. The buyer disagreed, arguing that the words ‘*fair specification*’ within the timber industry could be construed with sufficient precision to establish a binding agreement between the parties.

The House of Lords accepted the argument of the buyer, holding that each case must be decided on the construction of the particular contract and on whether the parties believed that they had a contract. Enforcing the contract, the court prevented the seller from opportunistically selling the additional timber to a different buyer when in fact the seller had agreed to provide further timber of fair specification for the buyer. Based on the nature of the timber trade, ‘of fair specification’ was sufficient to mean ‘goods distributed over kinds, qualities, and sizes in the fair proportions having regard to the output of the season... That is

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<sup>80</sup> (1932) 147 LT 503.

<sup>81</sup> *ibid.*

something which if the parties fail to agree can be ascertained just as much as the fair value of a property.’<sup>82</sup>

Therefore, the 100,000 standards were to be of Russian softwood goods of fair specification. The parties needed to work out the necessary adjustments by a process of give-and-take in order to arrive at an equitable or reasonable apportionment on the basis of the capacity of the respondent to produce and deliver. If they failed to do so, the law could be invoked to determine what was reasonable in the way of specification.

#### **4.4.2.2 *Foley v Classique Coaches*<sup>83</sup> – sale of petrol on a long-term basis**

*Foley v Classique Coaches* is a remarkable case where the English Court of Appeal successfully upheld the intentions of the parties. The price term was deliberately left open and subject to an ‘agreement to agree’. The agreement stipulated that the respondent agreed to sell to the appellant a piece of land next to the former’s land, but the sale of land was subject to a supplementary agreement. In the supplementary agreement, the appellant was to purchase from the respondent all the petrol required for the appellant’s business as motor coach proprietors. The petrol was to be sold ‘at a price to be agreed by the parties in writing and from time to time’.<sup>84</sup> In addition, Clause 8 of the supplemental agreement provided that ‘any dispute or difference arising regarding the subject matter or construction of the agreement would be submitted to arbitration in the usual way, in accordance with provisions of the Arbitration Act, 1889’.

The land was duly conveyed to the appellants, and for three years the appellants had obtained their petrol from the respondent. However, a dispute occurred with regard to price (and quality) of the petrol, and the appellants attempted to repudiate the sale of petrol on the basis of ‘no agreement in writing as to price’.<sup>85</sup>

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<sup>82</sup> *ibid* 512.

<sup>83</sup> [1934] 2 KB 1.

<sup>84</sup> Clause 1 of the April 11, 1930 agreement.

<sup>85</sup> Under the UCC, selling to an exclusive buyer (‘output’ contracts), or buying from an exclusive seller (‘requirements’ contracts) is possible by virtue of Section 2-306, although this provision is not covered in this thesis.

Acknowledging the fact that the contract was meant to be a long-term deal,<sup>86</sup> the Court of Appeal held that the agreement was terminable only in the event of winding-up of the appellants' company. Although the price was subject to agreement to agree 'from time to time', the price was determinable in the three years prior to the dispute. Scrutton LJ pointed out that without intention to be bound, the transactions would not have taken place in the previous three years.<sup>87</sup>

Moreover, Maugham LJ recognised that the agreement was binding, considering its form to be 'duly stamped and bears the signs of a legal contract', as opposed to *May & Butcher*, whereby the terms of the contract were written in an informal letter.<sup>88</sup> The highlight of the decision was that Maugham LJ distinguished *Foley* from *May & Butcher* in that the petrol could not be supplied by suppliers elsewhere,<sup>89</sup> since it was the main factor that induced the respondent to sell part of his land. Based on the principle of *The Moorcock*,<sup>90</sup> the law must promote 'business efficacy...intended at all event by both parties who are business men'.<sup>91</sup> Maugham LJ held that the deal was valid as long as the price was not set above the commercial price which the appellants could pay.<sup>92</sup> In the event of failure to determine the price, the arbitration clause could be used to determine a reasonable price. The arbitration clause is useful to save the contract from becoming invalid, because *verba intentioni, non e contra, debent inservire*: 'words ought to be made subservient to the intent, and not the other way about.'<sup>93</sup>

Taking advantage of the open price of the petrol by repudiating the contract was considered opportunistic because the appellant exploited the vulnerability of his contractual partner (the respondent).<sup>94</sup> Chapter Two explained that such modification of the contract is considered opportunistic when the opportunist is able to capture a greater share of the returns of the

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<sup>86</sup> Clause 3 of April 11, 1930 contract: 'This agreement shall remain in force during the life of the vendor and his present wife if she survives him.'

<sup>87</sup> *Foley* (n 83) 8 (Scrutton LJ).

<sup>88</sup> *ibid* 13 (Maugham LJ).

<sup>89</sup> *ibid* 15. As long as the respondent could supply the petrol, the obligation to purchase is to last on the part of the appellant.

<sup>90</sup> (1889) LR 14 PD 64.

<sup>91</sup> *ibid* 68.

<sup>92</sup> *Foley* (n 83) 15 (Maugham LJ).

<sup>93</sup> *ibid* 16.

<sup>94</sup> Halson, Chapter One, 'Opportunism, Economic Duress and Contractual Modifications' (n 168) 650.

contract,<sup>95</sup> potentially reducing the joint expected return on a contract.<sup>96</sup> In this case, there was not any opportunistic behaviour on the part of the respondent, for example in the seen in the price of the petrol, as the price set by the respondent was reasonable and in fact lower than the price payable by the public.<sup>97</sup> There was no overcharging that amounted to ‘bad faith’ or that caused commercial injury to the appellants.

Had the case been decided under the UCC, the contract would have been similarly valid, unless the appellants proved that the respondent did not meet the requirement of good faith under Section 2-305(2) in setting the petrol price. The difference lies in the reliance upon a clear provision that open price is valid, as opposed to Section 8 of the SGA that relies on the *verba intentioni* legal maxim and a principle of a non-sale decision as seen in *The Moorcock* to cater to be flexible with price setting in relational contracts. In other words, unlike the UCC, price flexibility under the SGA is not as readily available in the hands of the parties as the UCC. Under the UCC, parties could opt for price flexibility when concluding the contract; but under the SGA, the parties obtain the benefit of flexible pricing only by discretion of the English courts.

#### **4.4.2.3 Summary of the decisions in the *Hillas* and *Foley* cases**

Both *Hillas* and *Foley* proved that there can be exceptions to the general rule of presentation. Indeed, the English courts acknowledged the relational nature of contracts in both cases. However, the SGA has not been granting flexible pricing as an alternative method when concluding the contract. Rather, the parties benefit from flexible pricing only through the discretion of the English courts. This means that it is upon the courts to decide whether to flexibly interpret Section 8 using external sources to validate the relational elements in a deal. To flexibly interpret Section 8, the courts considered two crucial factors, namely the nature of the trade itself and the state of mind of the parties in determining the validity of the sale. With regard to the nature of the trade, the court held in the *Hillas* case that the quality and price of the Russian timber were determinable even though the parties merely stated that the Russian timber was to be purchased based on ‘fair specification’. In the *Foley* case, the agreement to

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<sup>95</sup> Gergen, Chapter One (n 9) 1002.

<sup>96</sup> *Ibid.*

<sup>97</sup> *Foley* (n 83) 8 (Scrutton LJ).

sell the land was subject to the sale of the petrol, and therefore there was no reason not to effectuate the business intended by parties.<sup>98</sup>

The courts also evaluated the state of mind of the parties. The court inferred the intention of the parties based on the early years of the contract. In the *Foley* case, the court stated that as long as the prices were fair and reasonable, the appellants should continue to purchase petrol from the respondent.<sup>99</sup> Clearly presentation was not required in either case; instead open price proved workable, depending on the nature of the trade and the prevailing intent of both parties.

The presentation factor in *May & Butcher* was not followed by the courts in both cases. The analogy drawn by Lord Buckmaster in *May & Butcher* was between the workability of Section 8 and that of Section 9. The analogy is that if a contract is avoided based on failure of a third party to set the price as required under Section 9, then a contract is similarly avoided if the parties did not agree on a price term under Section 8.

In *Hillas*, the court found that the seller was unable to supply the additional timbers as they had sold them to a third party. The court agreed with the buyer, stating that the words ‘of fair specification’ were sufficient to constitute a contract. Clearly the court disapproved of the opportunistic act of the seller in selling the additional timber to a different buyer in full awareness of the option taken up by the buyer in the year 1931. Therefore, a reasonable price was applicable because the parties had not agreed on a specific price. Even with an agreement to agree on the petrol price, the price was determinable and therefore the contract remained valid.

Although of contrasting decisions, *Foley* and *May & Butcher* were similar in that both cases involved agreements that contained an arbitration clause in case of a dispute between the parties. The writer of the thesis considers that the price of the tentage in *May & Butcher* was determinable from the market price, just as it was for the petrol price in *Foley*. The only

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<sup>98</sup> While *The Moorcock* did not involve the issue of open price sale of goods (rather, the dispute was over a damaged vessel due to uneven condition of the bed of the river adjoining the jetty, where the vessel was discharged) the business efficacy principle in *The Moorcock* was applicable in *Foley*.

<sup>99</sup> *Foley* (n 83) 15 (Maugham LJ).

difference was that *Foley* involved a long-term deal and the court validated the contract even though the petrol price was to be renegotiated from time to time.

While the English courts were able to distinguish straightforward cases such as *Foley* and *Hillas* from *May & Butcher*, recent cases showed that the courts struggle in distinguishing whether a case falls in the *May & Butcher* category, or whether a case involves a relational sale that brings it under the *Foley* and *Hillas* exception to the classic general rule of presentation. As a result, a relational case is often confused with the application of *May & Butcher*, and there has not been any consistency with regard to flexible interpretation of Sections 8 and 9 of the SGA, even when parties proved to be bound by the contract.

#### **4.4.3 How the current English courts determine the validity of an open price in relational sales**

This subsection illustrates the rigid interpretation of Sections 8 and 9 in preserving the validity of open price in relational sales. In addition, it also covers the issue of whether the presentation concept found in *May & Butcher*, influenced the perspective of the courts in validating an open price in long-term contracts. As opposed to the previous decisions that did not involve direct reference to Section 8, more recent current have resorted to Section 8. Similarly, the current English courts have had to resort to external authorities or principles in order to enforce an open price. Examples are discussed below.

##### **4.4.3.1 *Mamidoil-Jetoil Greek Petroleum Co SA v Okta Crude Oil Refinery AD (No 1)*<sup>100</sup> – trade of crude oil**

In 1993, the appellant, *Mamidoil*, entered into a contract with the respondent, Okta regarding the purchases of crude oil, with the handling fee for 500,000 tonnes of crude oil purchases per year. While the respondent claimed that the maximum period of the contract was ten years, the appellant appealed that the contract was to continue beyond ten years as the contract had never exactly specified a ten-year term as the maximum period of the contract.<sup>101</sup>

Affirming the claim of the appellant, Rix LJ held that the case was not open-term based on an agreement to agree and that the handling fee could easily be determined by implication of a

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<sup>100</sup> [2001] 2 Lloyd's Rep 76.

<sup>101</sup> *ibid* [70] whereby the annex to the 1993 contract contemplated a relationship of more than ten years.

reasonable fee ‘without a difficulty’;<sup>102</sup> although there was no available market or list price for the handling service, it was possible to derive the price based on price increases over the years that constituted the objective criteria for working out a reasonable fee.<sup>103</sup> Hence the court decided that \$4 per tonne was a reasonable price, for the 500,000 tonnes of crude oil purchased per year.<sup>104</sup> As the trade of crude oil usually specified a minimum, rather than a maximum, term, it would be unreasonable for the court to limit the parties’ commercial relationship to ten years.<sup>105</sup> Given the commercial history of the parties,<sup>106</sup> the presence of an arbitration clause and the fact that the contract had continued with successive agreements over a considerable period of time, it was appropriate to perceive the contract as extending longer than ten years. The court decided that if no agreement was reached as to reasonable fees, the fees should be determined from the specified dates.

Rix LJ held the following:<sup>107</sup>

...in a commercial contract that deals with the future and sometimes the long-term future of necessity leaves certain matters such a price to be worked over time, an arbitration clause assists the court to find sufficient certainty by means of the implication of what is reasonable. Which is not to say, that the court will not itself provide the dispute resolution machinery, even in the absence of an arbitration clause.

The above paragraph indicates that, depending on the commercial nature of the contract, the English courts are prepared to flexibly interpret open price, even in the absence of an arbitration clause. This approach has resemblance with the open-ended feature of the UCC in preserving intended long-term contracts without depending on the presence of an arbitration clause. The UCC departed from the traditional approach of the contract rule that often depends ‘on the terms of the contract and circumstances of the case’ or ‘on the contract, express or implied’,<sup>108</sup> rather than the relational nature of the trade.<sup>109</sup> As a result, the priority of commercial rules that had often depended on the facts of the case shifts to the identity of

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<sup>102</sup> *ibid* [73] (Rix LJ).

<sup>103</sup> *ibid*.

<sup>104</sup> *ibid* [75] (Rix LJ).

<sup>105</sup> *ibid* [71] (Rix LJ).

<sup>106</sup> While the 1993 contract concerned only crude oil which the respondent was to purchase for its own account, the respondent and appellant had previous dealings with each other in a 1979 contract, which was in fact renewed as the ‘1993 contract’ for a further period to the end of 1994, with a minimum of 500,000 tonnes crude oil assured to be handled by the appellant.

<sup>107</sup> *Mamidoil* (n 100) [67] (Rix LJ).

<sup>108</sup> Winston, Chapter Three (n 90) 787. Such traditional approach however, is still applicable in the current Sale of Goods Act 1979 and the CISG 1980.

<sup>109</sup> Chapter 3, Section 3.3.3.

the parties.<sup>110</sup> Thus parties' course of dealing, usage of trade, or the circumstances of their contract are several useful factors<sup>111</sup> for the courts to consider when validating relational sales.

Based on *Mamidoil*, there is a likelihood of validating open price in relational sale within the English jurisdiction, even when parties deliberately leave the term open, or fail to provide the exact duration of the continuity of the contract. Gradually, English sales law has recognised the relational characteristics of long-term sales, as opposed to the presentation of every term of the contract propounded by classic theory. However, the courts may not be unanimous in allowing such flexibility. The subsequent case illustrates that the court followed *May & Butcher*, even if the open price term was used in long-term business relationship which was intended by the parties to be binding.

#### **4.4.3.2 *Rafsanjan Pistachio Producers Cooperative v Kaufmanns Ltd*<sup>112</sup> – trade of seasonal goods**

In this case, the parties had a commercial relationship of eight years. The plaintiffs were an agricultural cooperative company formed in Iran and whose agent had been based in London since 1987. The company agreed to sell raw pistachio nuts to the defendants, who were manufacturers of dried fruit and nut products, including roasted pistachio nuts. The parties entered into the deal on 14 November 1996. Terms other than price, such as quantity (fixed as 200 metric tonnes), type of pistachio nuts, time of delivery, payment method and date were fixed in the contract. The delivery of the pistachio nuts was to be made in instalments from 'January to end June 1997'.<sup>113</sup>

A change in circumstance occurred on 12 April 1997, however, when a severe spring frost occurred in the growing area in Iran, causing difficulty in estimating a price for the 1997 Iranian crop.<sup>114</sup> While the defendants demanded a fixed price for the ordered pistachios, the plaintiffs were unable to do so. Therefore, the plaintiffs adopted the common practice of

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<sup>110</sup> *ibid.*

<sup>111</sup> *ibid* 789. See also *Washington Mills Co v Frohlich* (1927) 5 Tennessee Appeals Report 217, 227.

<sup>112</sup> 19 December 1997.

<sup>113</sup> As per stated in the parties' contract for the sale of pistachio nuts, ie Contract No C-0999/96.

<sup>114</sup> As late as September 1997, the "Cracker" magazine, the voice of the International Nut Council, was unable to put any figure on the estimated crop for 1997.

agreeing forward contracts with their major customers, regarding new crop quantities and leaving the price open and to be agreed subsequently.

The main issue was whether the 14 November 1996 agreement constituted a binding contract or an agreement to agree under the SGA. There were three evidences of a valid contract in this case. Firstly, the parties had a clear intention of entering into legal relations, as indicated by the fact that document of 14 November 1996 was labelled as a contract, with a stated contract number of C-0999/96. The document required a counter-signature from the defendants, which was provided, and the plaintiffs immediately notified its head office, which is the usual way in which contracts between parties are carried out. Secondly, the plaintiffs knew that the defendants were manufacturers and not mere traders, and would therefore have appreciated the security of continued supply after having been doing business with one another for eight years.<sup>115</sup> Thirdly, all terms other than price were determined by the agreement. Determining the price was unlikely to present any difficulty, as both sides agreed that the price would be the market price.

Conversely, the plaintiffs claimed the agreement as non-binding. Relying on *May & Butcher*, they argued that an agreement to agree, particularly when wholly executory, is of no contractual force. According to the plaintiffs, there are three exceptions under English sales law where an agreement to agree is valid: firstly, if the contract has been wholly or partly performed; secondly, if the contract indicates that it is to be binding despite the absence of an agreement and provided machinery for the resolution of disputes, such as an arbitration clause; thirdly, if the matter left to be agreed is subsidiary to the main purpose of the contract and the criteria to be applied in reaching an agreement, or if the gaps are filled by reference to the course of dealing between the parties. The plaintiffs argued that none of these exceptions was applicable. As price is a crucial term in a contract of sale of goods, the plaintiffs claimed that the price should be fixed, as stipulated by Section 2(1) of the SGA. Without a price term, they stated that the agreement was indefinite on this basis.

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<sup>115</sup> Based on the explanation in Chapter Two, the contract fulfilled both stringent elements of ‘reputation’ and ‘repeated interactions’, the crucial elements of ‘self-enforcing’ contracts according to Scott. A further analysis will be made in Chapter Six.

#### **4.4.3.2.1 Relational elements of the contract in *Rafsanjan* highlighted by the High Court of Justice, Queen's Bench Division Commercial Court: determinable price, long-term cooperation and good business reputation between the parties**

Although the presentation concept in *May & Butcher* was applied in the *Rafsanjan* case, Rix LJ admitted the presence of the relational nature of the contract in question. Firstly, the uncertain price of the pistachios was in fact determinable based on market price available from other sources of supply. Therefore, instead of ordering the defendants to purchase from other suppliers, the court could have recognised the validity of the deal.<sup>116</sup> The court clearly had the opportunity to decide the price based on what the trade took the contract to mean.<sup>117</sup>

Secondly, not only did the open price maintain good cooperative relations<sup>118</sup> between both parties, but the plaintiffs also knew that, since the defendants were manufacturers and not mere traders, the deal was not entered into on a one-off basis. Rather, it was a long-term deal which ensured the continued security of supply after years of business with one another.<sup>119</sup> To switch supplier meant that the defendants would have had to pay somewhat over the odds for supply. Applying Scott's self-enforcing contract theory, the repeated commercial transactions between the parties in the previous eight years<sup>120</sup> proved that they did intend to be bound by the contract, even though they failed to fix the price. If the parties had set the price and the spring frost had greatly affected it to the detriment of either party, the court could certainly have ordered price renegotiation to ensure that the deal remained enforceable under the circumstances.<sup>121</sup>

In this case, considering the relational nature of the trade that demands more flexibility and less presentation in order to work, the court could have interpreted Section 8 in a more flexible manner. Indeed, Macneil stated that while presentation may be integrated in a sales

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<sup>116</sup> See Chapter Three (n 98), (n 99) on Llewellyn's objectivity versus Corbin's concept of subjective intention.

<sup>117</sup> *ibid.*

<sup>118</sup> Chapter Two, Section 2.4, paras (iv) and (v) on Macneil's concept of open-term contracts as a tool to maintain long-term cooperation and as a planning mechanism respectively.

<sup>119</sup> From the explanation in Chapter Two, this indicated that the contract has fulfilled both stringent elements of 'reputation' and 'repeated interactions', the crucial elements of 'self-enforcing' contracts according to Professor Scott. A further analysis will be made in Chapter Six.

<sup>120</sup> Chapter Two, Section 2.4, para (ix) explained that both 'reputation' and 'repeated interaction' are the elements of a 'self-enforcing' contract.

<sup>121</sup> Chapter Two, Section 2.6, explained that long-term industries such as natural gas, petroleum coke, coal and uranium typically use either a price index or price renegotiation, or combination of both, to counter the fluctuation in the price of the goods.

law, the law may be interpreted to cater to the needs of the relational contract.<sup>122</sup> Hence, the least that the court could do was to flexibly interpret the law in order to cater for the needs of relational sales so that total presentation is not the ultimate goal, but only a theoretical goal.<sup>123</sup> Flexible interpretation of ‘reasonable price’ certainly reduces, although does not diminish the unnecessary abrasion between the classic SGA and the nature of relational sales.<sup>124</sup>

#### 4.5 Conclusion

This chapter has discussed the scope of open price allowed under the current SGA and the shortcoming of the presentation character in coping with relational sales. Clearly, the current SGA suffers from similar drawbacks experienced by the US Uniform Sales Act, a sales law preceding the UCC. Both of these laws made presentation central to rules on the formation of contract, and failed to give due attention to the relational aspect of many agreements. In Chapter Three, a decision under the Uniform Sales Act, in the *Louisville Soap Co. v Taylor* case,<sup>125</sup> showed that when the price mechanism broke down, Section 10 of the Uniform Sales Act did not permit the application of a market price even though the Savannah market price did exist. While *Louisville* did intend to be bound by the contract by appointing a board of trade which was to provide the posted price based on the Savannah market, the contract was held as unenforceable. Yet, a contrasting result would have occurred under the UCC, as Section 2-305(1)(c) applies reasonable price when a third party such as the board of trade, fails to set the price. However, the current SGA could not produce a similar result, since Section 9 states that the contract is avoided if a third party failed to set price. This was the analogy made by Lord Buckmaster in order to invalidate an agreement to agree in *May & Butcher*. In contrast, the UCC states that an ‘equally reasonable price’<sup>126</sup> and ‘uniform price among the suppliers within relevant geographic market’ are reliable price indicators for the validation of an open price.<sup>127</sup>

If parties do intend to have an open price, then clearly the sales law should validate the contract. Fortunately for the US, the UCC has been the governing commercial law in the last

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<sup>122</sup> Macneil, Chapter One (n 108) ‘Adjustment of Relations’ 888.

<sup>123</sup> Macneil, Chapter One (n 135) ‘Restatement (Second) of Contracts’ 597.

<sup>124</sup> Macneil, Chapter One (n 108) ‘Adjustment of Relations’ 888.

<sup>125</sup> See Chapter Three (n 65); 279 Federal Reports 470 (6<sup>th</sup> Cir), 259 US Supreme Court 583 (1922).

<sup>126</sup> See Chapter Two (n 110).

<sup>127</sup> Chapter Three (n 220) *Shell Oil Co v HRN, Inc* 144 South Western, Third Series 429(Texas 2004).

sixty years, ensuring that relational contracts involving gasoline and other volatile goods are well-catered for by its open-ended character.

This thesis considers that, to be as effective a commercial code as the UCC, the missing element of ‘intention to be bound’ ought to be included in Sections 8 and 9, and indeed it ought to govern formation, so that a contract would be valid even if the price is intentionally left open by the parties. Alternatively, Sections 8 and 9 could be flexibly interpreted when preserving the validity of relational sales.

There are two additional circumstances, absent under the SGA, in which the UCC validates an open price by applying a reasonable price. They are firstly where parties fail to agree on price and secondly where a third party or a particular price standard fails to set the price’. To address these situations, the English courts have often had to apply the analogy drawn by Lord Buckmaster: under Section 9, a contract is avoided if the valuer fails to evaluate the price.<sup>128</sup> A contract is regarded by Lord Buckmaster as invalid under Section 8 if parties agree to set the price or set a mere agreement to agree.

The *May & Butcher* principle has been a useful defence for a party wishing to opportunistically step out of a contract. While the English courts departed from *May & Butcher* in *Foley and Hillas*, recent decisions demonstrate that presentation may affect the validity of a relational sale. In *Mamidoil* the court was successful in distinguishing its situation from that of *May & Butcher* but, conversely, the court failed to maintain the enforceability of a long-term contract in *Rafsanjan*, even though a market price was available.

In a nutshell, there is scope for flexibility as set out in Sections 8 and 9, but this could work better if the SGA were amended to counter the problem of breakdown of price mechanisms. A viable way of resolving this conflict is by adopting two valuable points derived from Section 2-305 of the UCC. The first and primary factor of a valid contract is intention to be bound, and the second is the application of reasonable price in cases of failed price mechanism. These are the two valuable points of the UCC as a commercial code that the SGA could learn from and adopt in the English legal system, in order to improve the workability of open price in modern contracts.

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<sup>128</sup> As explained in Section 4.2.

In the next chapter, we will see that, unlike the decisions in *Rafsanjan*, the CISG has been successful in dealing with relational sale on seasonal goods when dealing with open price. We will discuss one problem with the application of Article 55, caused by the limiting and conflicting approach of Article 14(1), which requires express or implicit provision on price. Although contracting states of the CISG may choose to ratify either one or both of the article(s), the conflicting approach between the two provisions were well debated in the Honnold-Farnsworth debate and applied by the courts in the relevant decisions. Chapter Five explains the conflicting provisions and discusses whether Article 55 could be flexibly interpreted as with Section 2-305(1) of the UCC.

## Chapter Five: Open Price in the United Nations Convention on Contracts for the International Sale of Goods 1980 (CISG)

### 5.0 Introduction: the idea of uniformity and harmonisation of the law

Chapter Three showed that the UCC shifted from formalism to flexibility by validating relational sales based on the intention of parties to be bound rather than on a fixed-price term. Since Section 2-305(1) validates intentional open price, presentation is minimised, and consequently, relational contracts that apply open price are more secure in their validity. While presentation element exists under Section 2-305(4) that validates fixed-price contracts, Section 2-305(1) minimises presentation by empowering the court to apply a reasonable price based on the ‘market price at the time of delivery’.<sup>1</sup> Thus, a contract of sale of goods is effectively capable of fair performance without being restricted by a fixed-price term.<sup>2</sup>

Conversely, the SGA in England maintains the formalistic approach of 1893, leading the courts to look at the other surrounding circumstances of the case in order to validate a sale. Section 4.4.1 of Chapter Four showed that despite the seasonal nature of the pistachio nut trade, which requires flexible pricing at a later stage of the contract, the decision in *Rafsanjan* demonstrated the tendency of the English court to invalidate relational sales on the basis of absence of a determinable price, leaving the buyer uncompensated. Presentation was demanded despite the seasonal nature of the business of pistachio nuts that required flexible pricing at a later stage of the contract. This was evident when the court refused to apply reasonable price, even though there was an availability of market price for the pistachios. Instead, the court concurred with the limited scope of reasonable price under Section 8(2) of the SGA to cover only the situation of silence as to price, and not in a situation of relational sale such as in the case of *Rafsanjan*, even if the parties were proven to have intended to be bound by their contract.

This chapter continues the comparative analysis between open price under the CISG 1980, and that of the UCC in the US. While open price is expressly legalised by the UCC, and has gradually become acceptable (although less favoured by English judges) under the SGA, the

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<sup>1</sup> Section 2-305(1) of the UCC.

<sup>2</sup> Chapter Two, Section 2.6.4: a fixed-price term was unworkable in *Westinghouse* in times of price hike caused by a uranium cartel in the early 1970s.

CISG has a compromising feature between the two spectrums; it allows its contracting parties to choose to fix the price, or to leave the price open under two distinguished provisions. The CISG provides both presentation and relational approaches as options under Articles 14(1) and 55. Under the CISG, contracting parties may choose to be bound either by a fixed (express or implicit) price term or by an open-price term under Articles 14(1) and 55 respectively. This chapter proposes for a flexible approach to price terms, and Section 5.2 will further elaborate on open price under the CISG. The main argument in this chapter lies in the fact that open price under Article 55 of the CISG suffers from the effect of presentation through the requirement of at least an implicitly fixed price, under Article 14(1).

Many years before the advent of the CISG, efforts to harmonise and unify commercial law began in the US, Scandinavia and Europe, which then called for a more global and comprehensive response.<sup>3</sup> Unifying international sales law, however, was not a simple task, due to the perceived risk of incompatibility with national laws, which are naturally territorial.<sup>4</sup> Despite the difficulty, the inter-reliant structure of the world economy led to the idea that a harmonious, if not unified, set of legal rules should govern transactions all over the world<sup>5</sup> in order to reduce barriers to international trade.<sup>6</sup> Initial efforts were made by the United Nations Commission on International Trade Law (UNCITRAL), with the mission statement ‘the development on international trade on the basis of equality and mutual benefit is important in promoting friendly relations among States’.<sup>7</sup> Consequently, the CISG was established, setting out rules to govern certain aspects of the formation and performance of everyday commercial contracts between sellers and buyers whose places of business are in different countries.<sup>8</sup>

Before discussing in greater depth on open price practice under Section 5.2, the Section below elucidates the history and some of the key features of the CISG as an international sales law that successfully unifies the national laws of various countries.

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<sup>3</sup> Arthur Rosett, ‘Critical Reflections on the United Nations Convention on Contracts for the International Sale of Goods’, 45 Ohio State Law Journal (1984) 265-305.

<sup>4</sup> Sieg Eiselen, ‘Adoption of the Vienna Convention for the International Sale of Goods (the CISG) in South Africa’, 116 South African Law Journal, Part II (1996) 323-370, 325.

<sup>5</sup> text to n 3.

<sup>6</sup> Bridge, Chapter One (n 1).

<sup>7</sup> ibid 56. Bridge has regarded the CISG as an ‘astonishingly effective instrument’.

<sup>8</sup> John P McMahon, ‘Guide for Managers and Counsel’, (revised May 2010), <<http://www.cisg.law.pace.edu/cisg/guides.html>> accessed 2 February 2011.

## 5.1 The birth of the CISG 1980

The distinction between both Articles 14 and 55 could be traced back to the compromise nature of the CISG that resulted from the participation of various member states. Hence, understanding the history of the drafting of the CISG is crucial when tracing the origin of the compromise nature of the CISG. The CISG is a product of compromise, and that the provisions on certainty of price are themselves a product of compromise. Interpreting provisions of open price is not a simple task considering that some contracting states have and prefer fixed-price policies, as opposed to others that prefer open price. The CISG harmonises the national laws of the contracting states by providing both fixed and open prices provisions to meet both preferences.

The unification of the national laws of the contracting states by the CISG was precipitated by the demands of economic and political realities.<sup>9</sup> In the earlier continental European tradition, legal unification was perceived as beneficial and desirable that it should be actively promoted.<sup>10</sup> Modernisation in transportation, communications, and technology are contributory factors to the increase in the legal order supporting worldwide commerce.<sup>11</sup>

Prior to the Second World War, the International Institute for the Unification of Private Law (UNIDROIT) under the auspices of the League of Nations attempted to prepare a uniform law on the international sale of goods.<sup>12</sup> Subsequently, the considerable effort of unifying international sales law came under the 1964 Hague Conventions, where two uniform laws were adopted.<sup>13</sup> They were the Uniform Law of International Sale of Goods (ULIS) and the Uniform Law on the Formation of Contract for the International Sale of Goods (ULF).<sup>14</sup>

Nevertheless, the lack of worldwide participation in the drafting of the Hague Conventions made most of the concepts embodied in these drafts ‘could not be translated into words and

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<sup>9</sup> text to n 3.

<sup>10</sup> Eiselen (n 4) 325.

<sup>11</sup> text to n 3.

<sup>12</sup> Kazuaki Sono, ‘The Vienna Sales Conventions: History and Perspective’, in *International Sale of Goods: Dubrovnik Lectures 1, 2* (Petar Sarcevic and Paul Volken (eds) 1986).

<sup>13</sup> Paul Amato, ‘U.N. Convention on Contracts for the International Sale of Goods-The Open Price Term and Uniform Application: An Early Interpretation by the Hungarian Courts’, 13 *Journal of Law and Commerce* (1993) 1-29, 2.

<sup>14</sup> *ibid.*

ideas that were intelligible in other parts of the world.’<sup>15</sup> The root of the problem was that most of the world was not ‘present at the creation’.<sup>16</sup> Many countries in Africa and Asia did not exist as independent states when the uniform laws were made.<sup>17</sup> Indeed there was a psychological barrier to world-wide adoption in Africa and Asia while the draft was made.<sup>18</sup> For other parts of the world-nearly all of the common law world, Eastern Europe and Latin America-for a ‘variety of reasons’, also did not participate.<sup>19</sup>

Despite the failure of wholesale acceptance of the 1962 Hague Conventions, there was a rapid growth in international trade in the years. This led to the adoption of ULIS and ULF, and the United Nations Commission on International Trade Law (UNCITRAL) proceeded with an effort to promote adoption of uniform international rules in various areas such as sales, arbitration, negotiable instruments and transport.<sup>20</sup> By 1968, the UNICTRAL took over the task of unifying the law of international sales consisting of different legal traditions and socio-economic conditions.<sup>21</sup> After ten years of work by UNCITRAL, there was a unanimous agreement by participating states on a convention, which was submitted for signature in Vienna.<sup>22</sup> Effectively, the CISG was created to facilitate the world trade and to remove uncertainty created by conflicting states’ national laws.<sup>23</sup>

The CISG is a product of more than two generations of international negotiation, and was unanimously approved by delegations representing 62 national legal systems at a diplomatic conference convened by the United Nations General Assembly in Vienna in 1980.<sup>24</sup> Its final text was approved at a diplomatic conference convened by the United Nations General

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<sup>15</sup> John O Honnold, ‘The Sales Convention: Background, Status, Application’ 8 *Journal of Law and Commerce* 1-10 (1988) 1-10, 3.

<sup>16</sup> *ibid.*

<sup>17</sup> *ibid.* 4.

<sup>18</sup> *ibid.*

<sup>19</sup> *ibid.* 3.

<sup>20</sup> *ibid.* 4.

<sup>21</sup> Alejandro M Garro, ‘Reconciliation of Legal Traditions in the U.N. Convention on Convention for the International Sale of Goods’ 23 *International Lawyer* (1989) 443-48, 443.

<sup>22</sup> Amato(n 13) 3.

<sup>23</sup> *ibid.* Amato cites Dennis J Rhoades, ‘The United Nations Convention on Contracts for the International Sale of Goods: Encouraging the Use of Uniform International Law’ 5 *Transnational Law*, 387, 390 (1992) (original article not found).

<sup>24</sup> *ibid.*

Assembly in Vienna in 1980.<sup>25</sup> The 62 nations comprised of 22 from the ‘Western developed’ countries, 11 ‘socialist regimes’ and 29 third world countries.<sup>26</sup> The US delegates participated actively in the discussions of the CISG, voting in favour of the final text of the CISG.<sup>27</sup> The US signed the CISG on August 31, 1981, and subsequently on September 21, 1983, the US President requested for the advice and consent of the Senate to the ratification of the CISG.<sup>28</sup> Consequently, the unanimous ratification of the Senate took place in October 1986.<sup>29</sup> By December 11, 1986, officials from the mission to the United Nations of the United States deposited the instrument of ratification at United Nations Headquarters in New York.<sup>30</sup>

There was never a consensus reached among the 62 participating nations on the CISG final text, considering their huge differences of views.<sup>31</sup> After thirty years of hard technical negotiations, the fact that the delegates were able to agree on a uniform law that displaced familiar national concepts and policies could only be explained as a compromise.<sup>32</sup> The completion of the text and its opening for signature were the primary steps, followed by the stage of integrating the CISG as part of international trade practice.<sup>33</sup> Consequently, many CISG articles are compromise in nature that they do not represent the individual preferences of the delegates; rather they were drafted to live up to the expectations of all participating countries.<sup>34</sup> In a particular example of open price provisions, the need to reach a consensus has created difficult questions of interpretations.

### **5.1.1 The sphere of application of the CISG**

The CISG was not meant to be an all-encompassing law of sales, but was designed to promote simplicity, practicality and clarity and to be ‘free from the legal ‘short-hand’ and complicated

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<sup>25</sup> Garro (n 21) 444. The point is supported by *Final Act of the United Nations Conference on Contracts for the International Sale of Goods*, Apr 10, 1980. UN Doc A/Conf. 97/18, with Annex, United Nations Convention on Contracts for the International Sale of Goods, reprinted in 19 ILM 668 (1980).

<sup>26</sup> *ibid.*

<sup>27</sup> *ibid* 445.

<sup>28</sup> *ibid.*

<sup>29</sup> *ibid.*

<sup>30</sup> *ibid* 446.

<sup>31</sup> *ibid* 449.

<sup>32</sup> *ibid.*

<sup>33</sup> Sono (n 12) v.

<sup>34</sup> Garro cites JD Feltham, ‘The United Nations Convention on Contracts for the International Sales of Goods’ 1981 *Journal of Business Law* 346, 361. Feltham, an English delegate to the Vienna conference, suggested that the CISG may not be an improvement for the individual interests of merchants from developed countries, who may be in a bargaining position strong enough to be able to impose over the other party the application of a sophisticated law of commercial transactions.

legal theory familiar to many legal practitioners'.<sup>35</sup> It was drafted in businessmen's language, with practical details.<sup>36</sup> Unlike the ULIS and the ULF, which were drafted in an abstract way so as to cover all possible situations, the CISG is modest in its approach. It admits those matters that are not covered and are left to be resolved by the applicable law, under the traditional rules of private international law.<sup>37</sup>

The CISG applies to contracts of sales of goods between parties whose places of business are in different states.<sup>38</sup> Either both states are parties to the CISG, or the rules of private international law of one contracting state lead to the application of the law of another contracting state.<sup>39</sup> Each contracting state has two sets of rules for sales: a domestic law of sales for general application, and a set of rules applicable to a particular subgroup of sales, namely the international sales law.<sup>40</sup>

If parties have no choice-of-law provision in an international sales contract, they cannot be certain which law a national tribunal will apply to resolve any dispute arising from the contract.<sup>41</sup> Under the CISG, a contracting state's court need not apply foreign sales law indicated by choice-of-law rules. Instead, a court in a contracting state will apply the CISG by virtue of Article 1,<sup>42</sup> unless the parties to the contract have agreed to exclude some or all of the rules in the CISG.<sup>43</sup>

The provisions of the CISG govern the formation of international sales contracts, and the rights and obligations of the buyers and sellers arising from such contracts.<sup>44</sup> At the time of ratification, a state may declare that it will join the CISG only in part: Article 92(1) of the CISG provides an option for a state to refuse to be bound either by Part II, on the formation of

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<sup>35</sup> Sono (n 12) 7. For example, the term *force majeure* has a variety of interpretations depending upon the legal system. In cases where a short-hand expression had to be used such as the word 'delivery', the drafters of the CISG provided a clear definition. In his work, Sono regarded the CISG as free from dogma as it is, after all, businessmen who must understand the meaning of the provisions.

<sup>36</sup> *ibid.*

<sup>37</sup> *ibid.*

<sup>38</sup> text to n 21, 447.

<sup>39</sup> *ibid* 448.

<sup>40</sup> *ibid.*

<sup>41</sup> *ibid.*

<sup>42</sup> Article 1(1): This Convention applies to contracts of sale of goods between parties whose places of business are in different States: (a) when the States are Contracting States; or (b) when the rules of private international law lead to the application of the law of a Contracting State.

<sup>43</sup> *ibid.*

<sup>44</sup> *ibid* 447.

contracts, or by Part III, on the rights and obligations of the parties of the CISG. The only mandatory parts are Part I on the sphere of application and other general provisions, and Part IV on the final provisions on ratification and related matters.<sup>45</sup>

To apply the CISG, there are three distinct criteria to be satisfied:<sup>46</sup> firstly, the contract must be a contract for the sale of goods;<sup>47</sup> secondly, the parties to the contract must have their places of business in different states; and finally, the CISG applies only when (a) both parties are contracting states, or (b) the rules of private international law lead to the application of the law of one of the contracting states.<sup>48</sup> Hence, if a seller whose place of business is in England, contracts to sell goods to the buyer B, whose place of business is in Ruritania, CISG will apply if both England and Ruritania are contracting states, or if the law applicable to the contract is that of one of the contracting states.<sup>49</sup>

### **5.1.2 Transactions excluded by the CISG**

The CISG does not apply to consumer sales,<sup>50</sup> to sales by auction or under execution, or sales of securities, negotiable instruments, money, ships, vessels, hovercraft, aircraft<sup>51</sup> or electricity.<sup>52</sup> It also does not apply to the liability of the seller for death or personal injury caused by the goods to any person.<sup>53</sup> There is a comprehensive set of rules governing the formation, performance, remedies for failure of contracts for the sale of goods within its jurisdictional scope.<sup>54</sup> When CISG applies, it displaces national and local rules.<sup>55</sup> These exclusions however, do not apply to cases of relational sales discussed under Section 5.4 of the current thesis.

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<sup>45</sup> *ibid.*

<sup>46</sup> Article 1(1) of the CISG.

<sup>47</sup> Article 3 of the CISG states that contracts for the supply of goods to be manufactured or produced are considered sales unless the party ordering the goods undertakes to supply a substantial part of the materials, or a preponderant part of the obligations of the party furnishing the goods is the supply of labour and other services.

<sup>48</sup> Goode, Chapter One (n 55) 1018.

<sup>49</sup> *ibid* 1019.

<sup>50</sup> Article 2 specifies that consumer sales are sale of goods ‘bought for personal, family or household use, unless the seller, at any time before or at the conclusion of the contract, neither knew nor ought to have known that the goods were bought for any such use’.

<sup>51</sup> The Hungarian Supreme Court has held that despite the non-application to aircraft sales, the CISG applies to the sale of individual components of an aircraft in *Malev*.

<sup>52</sup> Article 2 CISG.

<sup>53</sup> Article 5 CISG.

<sup>54</sup> Rosett (n 3) 265.

<sup>55</sup> *ibid.*

In addition to the abovementioned exclusions, the CISG maintains a simple character by reserving an uncertain number of issues for national law, which preserves the private autonomy of contracting parties and permits them to exclude by agreement the application of the CISG or any of its provisions. The derogation is by Article 6, whereby ‘the parties may exclude the application of this Convention or, subject to Article 12, derogate from or vary the effect of any of its provisions.’

### **5.1.3 Interpreting the CISG as a uniform law**

To maintain its uniform characteristics, there are several interpretive approaches that could be used to avoid the tendency to construe the CISG under the light of a national law. Honnold prescribed four ways of interpretive approaches: the first is to see how other legal systems have read and characterised the text through scholarly writings of these systems;<sup>56</sup> the second is to rely on the legislative history of the CISG, which may reveal the specific provision’s objective;<sup>57</sup> the third is to rely on the general principles of the CISG as a form of gap filling by analogical application of the statute to effectuate its purpose;<sup>58</sup> and the fourth is to seek recourse to either domestic or foreign case law to aid the interpretation of the CISG.<sup>59</sup>

Open price is one of the relevant issues within the CISG that requires an interpretive approach.<sup>60</sup> This is particularly due to the two existing ways in which a price term may be dealt with under the CISG. The first of these is Article 14(1), which requires at least an implicit method to fix the price of the goods, and the second is Article 55, which does not require a price term at all in a contract, so long as the price is determinable using ‘the price generally charged at the time of the conclusion of the contract, under the general comparable circumstances’.<sup>61</sup>

The next section gives further explanation of both provisions, before comparing the legal stance of the CISG on open price with that of the UCC in the US, and the SGA in England.

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<sup>56</sup> Honnold (n 15) 208.

<sup>57</sup> *ibid* 209.

<sup>58</sup> *ibid* 211.

<sup>59</sup> *ibid* 211.

<sup>60</sup> Chapter Six shows that in the case of *Scaфом International*, the Supreme Court resorted to the UNIDROIT principles not only for interpretive purposes but also in order to allow the renegotiation of the contract price when market fluctuations affected the price fixed by the parties.

<sup>61</sup> Article 55.

## 5.2 Open price practice

We have seen the workability of open price in the decisions of the UCC and the SGA. The CISG jurisdiction is of no exception, but its compromising nature means its rules have more potential for diversity in order to suit the needs of various states.

The states that approved the CISG hold varying views on the definiteness of a price term. Rosett, for example, explained that socialist countries object to the idea of an open price because they need to ensure that their contracts adhere to the predetermined macroeconomic governmental plan.<sup>62</sup> In such a planned economy, open-price contracts are invalid.<sup>63</sup> Other states also perceive open-price contracts with hostility, particularly when the unilateral fixing of the price causes disadvantage to the weaker party.<sup>64</sup> Within developing countries, the argument has been that an open price does not serve their interests due to the unfavourable terms of trade for raw materials, in contrast with the ever increasing price of manufactured goods.<sup>65</sup> Conversely, the US takes a far more liberal approach; it validates open price and quantity under Sections 2-305 and 2-306 respectively, to allow price and quantity to be adjusted in the light of sellers' output and buyers' requirements.

As a result of the diverging view of the member states, the CISG has a two-part rule on open price for them to choose from, as explained in the following section.

### 5.2.1 Article 14(1) of Part II versus Article 55 of Part III of the CISG

The contracting states may opt for the traditional fixed-price method under Article 14(1), or for an open price under Article 55. Article 14 serves well for the policy of member states that do not favour open price, while Article 55 is purposeful for parties that are receptive to open

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<sup>62</sup> Rosett (n 3) 289.

<sup>63</sup> Garro (n 21) 463.

<sup>64</sup> Rosett (n 3) 289.

<sup>65</sup> Garro (n 21) fn 88 cites SK Date-Bah, 'The Convention on the International Sale of Goods from the Perspective of the Developing Countries', *La Vendita Internazionale*, Milan: Giuffrè (1981) 23-28. Date-Bah states that:

[i]f a contract can be formed without an agreement on price, this would create the danger of buyers being landed, after vague negotiations, with sales contracts whose contract prices would be imposed by the court: many such courts would be in the developed countries and could impose unreasonably high prices for manufactured goods. Such contract price would tend to be the sellers' prices and, as is well-known, while the prices of the raw materials exported by the developing countries are generally fixed in the commodity markets of the developed world, the prices of manufactured goods are usually determined by the manufacturers themselves (Date-Bah, 28).

price. These two articles fall into two different parts of the CISG: Article 14(1) is under Part II, on the formation of contracts, while Article 55 falls under Part III, on the sale of goods.

Both of these parts have their own, particular history. The work on the formation of contracts for the international sale of goods began in 1934 when the International Institute for the Unification of Private Law in Rome (UNIDROIT) separated out formation of contracts,<sup>66</sup> from the Institute's general work on the international sale of goods.<sup>67</sup> By year 1936, a draft Uniform Law on International Contracts by Correspondence was prepared;<sup>68</sup> although progress on international sales was affected by World War II, and the work was not resumed until 1956,<sup>69</sup> at which point the Governing Council of UNIDROIT completed a new draft for the formation section, and the general work on sales was completed in a Draft Uniform Law on the International Sale of Goods, revised by a special committee named at a conference at The Hague.<sup>70</sup>

When UNIDROIT transmitted its draft on the formation of contracts to the Dutch government, it was submitted to the diplomatic conference at The Hague, where the international sales draft was also submitted.<sup>71</sup> Hence there were two separate conventions, one dealing with the formation of sales contracts and the other on the substantive law of sales.<sup>72</sup> Before both sections became effective, the UNCITRAL was also revising the law of international sales and had considered incorporating the provisions on formation in a 'Part II' of the CISG, similarly to the way in which provisions on formation form part of Article 2 of the UCC.<sup>73</sup>

As some of the provisions of Part II were controversial, it was decided that a contracting state would be granted the option to ratify the entire CISG but leave out Part II.<sup>74</sup> Having

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<sup>66</sup> text to n 2.

<sup>67</sup> E Allan Farnsworth, 'Formation of Contract', published in Matthew Bender, *International Sales: The United Nations Convention on Contracts for the International Sale of Goods*, (Galston & Smit ed, 1984), ch 3, [3-1] – [3-18], 3-3.

<sup>68</sup> *ibid.*

<sup>69</sup> *ibid.*

<sup>70</sup> *ibid.*

<sup>71</sup> *ibid.*

<sup>72</sup> *ibid.*

<sup>73</sup> *ibid* [3-4].

<sup>74</sup> Article 92(1) CISG.

undergone minor changes at the Diplomatic Conference in Vienna in 1980,<sup>75</sup> Part II of the CISG on the formation of contracts contains 11 articles based on the traditional premise that a contract is formed by means of an offer and an acceptance.<sup>76</sup> The first four articles (Articles 14-17) deal with offer, the following five (Articles 18-22) deal with acceptance and the last two (Articles 23-24) deal with the time at which a contract is concluded.

Part III of the CISG on the sale of goods, contains 64 articles across five separate chapters (Articles 25-88).

### **5.2.2 Article 14(1): meaning and purpose**

Article 14(1) of Part II of the CISG requires a valid contract to have a fixed price, or at least an implicit provision that fixes the price. Subsection (1) is outlined below:

#### Article 14(1)

A proposal for concluding a contract addressed to one or more specific persons constitutes an offer if it is *sufficiently definite* and indicates the *intention of the offeror to be bound*<sup>77</sup> in case of acceptance. A proposal is sufficiently definite if it indicates the goods and expressly or implicitly fixes or makes provision for determining the quantity and the price.

In the above provision, the three criteria of a valid offer are: a) that the offer is addressed to a specific person, b) that the offer is sufficiently definite, and c) that it indicates the offeror's intention to be bound. Two crucial points for the purpose of the thesis discussion in this thesis are the requirement of a sufficiently definite price and the phrase intention of the offeror to be bound.

The unfortunate implication of Article 14(1) is that not only must the goods be indicated, but there should also be an express or at least implicit provision to determine the quantity and price of the goods. In other words, a proposal *is not* sufficiently definite *unless* it does this.<sup>78</sup> The US consistently opposed this language during the drafting process, but was unsuccessful

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<sup>75</sup> Farnsworth (n 67) [3-4].

<sup>76</sup> *ibid* [3-5].

<sup>77</sup> Emphasis added.

<sup>78</sup> Farnsworth (n 67).

in its attempt to have it deleted in Vienna.<sup>79</sup> Recalling the points from Chapter Three, the UCC in the US relies on flexibility as an extra-legal norm of a relational contract that originates from the practice of the merchants that has relevance in today's relational sales. The 'working rules' of the merchants neither depends on express nor implicit price provisions in order to have a valid contract. This minimises the presentation element that easily invalidates a sale on the basis of absence of a determinable price, a clear opposite from what propagated from Article 14(1).

While Article 14(1) may not be able to cope with relational sales, it works efficiently for less relational transactions. For example, parties may expressly agree on a price of video recorders through an exchange of calculation charts, and the buyer may agree to the invoicing of the seller.<sup>80</sup> In an implicit price<sup>81</sup> situation, a buyer sends an order for goods listed in the seller's catalogue or where he orders spare parts, he may decide to make no specification regarding price at the time of placing the order. He may not have the seller's price list, or he may not know whether the price list he has is current. Nevertheless, the buyer is implicitly offering to pay the price currently being charged by the seller for such goods. Article 14(1) provides that if this is the case, the buyer has implicitly made provision for the determination of price and his order for the goods would constitute an offer.<sup>82</sup>

Despite allowing an implicit price, it appears that Article 14 renders unenforceable those contracts that deliberately leave price and quantity open,<sup>83</sup> although it does include intention to be bound as a prerequisite of a valid offer. This resembles Section 2-305(1) of the UCC, although the latter extends the intention to be bound to cover cases of absence of a price term due to silence, agreement to agree and failure of a third party or an agreed standard to fix the price. An American attorney would therefore be familiar with the phrase intention of the offeror to be bound in the case of acceptance under Article 14(1).<sup>84</sup> The only, but crucial,

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<sup>79</sup> Honnold, Chapter One, *Uniform Law for International Sales* (n 187).

<sup>80</sup> German case of 9 May 2000 CLOUT Case No 343 [Landgericht Darmstadt, Germany, 9 May 2000].

<sup>81</sup> Guide to CISG Article 14, [15] of the Secretariat Commentary <

<http://cisgw3.law.pace.edu/cisg/text/secomm/secomm-14.htm> > accessed 12 April 2009.

<sup>82</sup> *ibid* [16] then went on stating that a similar case could occur where the buyer orders goods from a catalogue for future delivery, it may be implicit in his order and from relevant circumstance that the buyer is offering to pay the price currently being charged by the seller at the time of the delivery.

<sup>83</sup> text to n 79.

<sup>84</sup> John E Murray, Jr, 'An Essay on the Formation of Contracts and Related Matters under the United Nations Convention on Contracts for the International Sale of Goods'<sup>8</sup> *Journal of Law and Commerce* (1988) 11-51.

difference from the CISG is that Article 14(1) still requires the price to be determinable, at least implicitly, regardless of whether the contract is discrete or relational.

The implicit price requirement is favoured by countries that hold a more restrictive view of contracting, such as the former USSR and France.<sup>85</sup> Conversely, it is less appealing to the sales practice of states with a more flexible view of formation, such as the United States and Scandinavian states such as Denmark, Finland, Norway and Sweden, and therefore these states have opted for reservation from the rules of Part II on contract formation,<sup>86</sup> as permitted by Article 92 of the CISG.<sup>87</sup> Effectively, the Scandinavian states are in favour of open price, leading to the adoption of Article 55 in Part III of the CISG. This provision is explained in the following section:

### **5.2.3 Article 55: meaning and purpose**

#### Article 55

Where a contract has been validly concluded but does not expressly or implicitly fix or make provision for determining the price, the parties are considered, in the absence of any indication to the contrary, 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.

Article 55 is drafted in contrast with Article 14(1), whereby a contract may be valid even without an implicit price. At first glance, it seems that Article 55 approves the realities of relational contracts that demand flexibility in the price term. The history of Article 55 dates back to Article 67 of the 1956 Draft of the ULIS wherein the buyer is required to pay the usual price charged by the seller at the time that the contract is concluded, or instead a reasonable price based on the current market price.<sup>88</sup>

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<sup>85</sup> The USSR and France are amongst the States. See also Farnsworth (n 67).

<sup>86</sup> Joseph Lookofsky, 'The 1980 United Nations Convention on Contracts for the International Sale of Goods' < <http://www.cisg.law.pace.edu/cisg/biblio/lookofsky.html> > accessed 14 July 2012, [328].

<sup>87</sup> Article 92(1): A Contracting State may declare at the time of signature, ratification, acceptance, approval or accession that it will not be bound by Part II of this Convention or that it will not be bound by Part III of this Convention.

<sup>88</sup> Gyula Eörsi, 'Article 55', in Bianca-Bonell Commentary on the International Sales Law (Giuffrè: Milan 1987) 401-09, 409 < <http://www.cisg.law.pace.edu/cisg/biblio/eorsi-bb55.html> > accessed 13 May 2010.

In the absence of an express or implicit price, the effective price will be the price generally charged at the time of the conclusion of the contract for such goods, sold under comparable circumstances in the trade concerned. This is the price which would presumably have been agreed upon by the parties at the time of contracting had they agreed upon one at that time. The Commentary states that the seller should not later be able to claim for the price that prevailed at the time of the delivery of the goods, if that price was higher than the one the seller was charging at the time of the conclusion of the contract.<sup>89</sup>

### **5.3 The Honnold-Farnsworth debate on Article 14 and Article 55**

Generally, both articles deal with two different matters, yet the interpretation of the two is inter-related. Article 14 is concerned with offers and the formation of a contract, and Article 55 with the obligations and performance of the contract. The debate is explained in the two sections that follow:

#### **5.3.1 The view of Farnsworth**

The American legal scholars who participated in the diplomatic negotiations disagree about the interpretation of Article 55.<sup>90</sup> According to Farnsworth, Article 55 only operates if a contract has been validly concluded under Article 14(1).<sup>91</sup> Thus if the US were to ratify the CISG but not take Part II,<sup>92</sup> a contract with an unstated price would be able to be validly concluded because UCC 2-305 would then apply. The problem arises if a state is to ratify the entire CISG, including Part II, making it arguable that Article 14 prevents a contract with an unstated price from being validly concluded.<sup>93</sup> This suggests the impossibility of Article 55 to take effect.<sup>94</sup>

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<sup>89</sup> *ibid.* The writer deduces that the CISG may permit open price, but does not permit price at the time of delivery as the effective price. In the coming analysis chapter, we will see in *Scafom International* case that Article 55 could not resolve the problem even if the parties had opted for open price under this provision. This is because market price that increased by 70% was detrimental to the seller who now had to sell to the buyer the steel-tubes with the agreed price in the contract (which was, 70% lower than the market price). By enforcing the contract at the original agreed price would therefore be excessively profitable to the buyer. The court ordered for renegotiation for a new price rather than validating the old price set at the time of the conclusion of the contract.

<sup>90</sup> *ibid.*

<sup>91</sup> Farnsworth (n 67) [3-9].

<sup>92</sup> This option is available under Article 92(1) where a Contracting state may declare...that it will not be bound by Part II of this Convention.

<sup>93</sup> Farnsworth (n 67) [3-9].

<sup>94</sup> *ibid.*

In addition, Farnsworth pointed out that if a contract with an unstated price *is* validly concluded, the CISG differs from the UCC as to how that price is to be determined. Clearly, Article 55 refers to ‘the price generally charged in the trade at the *time of the conclusion of the contract*’, while Section 2-305 refers to a reasonable price at the *time for delivery*.<sup>95</sup> Before concluding the current chapter, the writer will discuss whether or not the UCC’s approach of applying the price at the *time of delivery* is a more workable alternative in open-price contract than the price generally charged at the *time of the conclusion of the contract* under the present Article 55.

### **5.3.2 The view of Honnold**

In contrast with the view of Farnsworth, Honnold viewed both elements of Article 14(1), namely ‘definiteness’ and the ‘offeror’s intention to be bound’, as key elements, but the latter as the chief element of a valid contract. Honnold nonetheless admitted that as a price term was crucial to economic success, parties would rarely enter into a binding contract without at least an implicit understanding of the price, or a means of determining the price.<sup>96</sup> A lack of clarity regarding price may occur in emergency situations, such as urgent orders for the manufacture of minor replacement parts, or requests to rush a shipment of goods where the buyer may not have access to the seller’s price list. Such situations may be common also due to the ever-increasing spread of standardised goods that have standardised prices, along with modern means of communication that facilitates ordering without bargaining.<sup>97</sup>

In 1977, a review on the element of validity in the opening phrase of Article 55 was made to restrict the scope of the article ‘to agreements that were valid by the applicable law’, namely the domestic law applicable under rules of private international law.<sup>98</sup> If the law of the state provides that open price agreements are not binding contracts, Article 55 is inapplicable. If, however, the law of the state recognises open price contracts, then it must be ascertained that no other grounds for invalidity exists under the applicable law. From this fact, it is deducible that there is no reason for a deal to be invalidated under Article 55 merely because it does not comply with the implicit requirement of Article 14(1).

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<sup>95</sup> *ibid* [3-10].

<sup>96</sup> John O Honnold, ‘Criteria for an Offer’, in *Uniform Law for International Sales under the 1980 United Nations Convention* (3<sup>rd</sup> edn, The Hague, Kluwer Law International 1999) 147-157, 152.

<sup>97</sup> *ibid*.

<sup>98</sup> John O Honnold, ‘Article 55’ in *Uniform Law for International Sales under the 1980 United Nations Convention* (3<sup>rd</sup> edn, The Hague, Kluwer Law International 1999) 353-57, 356.

To strengthen his proposition, Honnold provided an example in which open price under Article 55 should be independent from Article 14(1). In this case, following negotiations, the seller and the buyer signed a contract of sale that called for the seller to manufacture and ship goods according to the specifications and quantity stated in the agreement. The agreement did not fix a price, and instead stated that it derogates from any implication of Article 14(1). The seller manufactured and delivered the goods, which the buyer accepted and used, but no price could be agreed between the parties.

In the above situation, there was not an exchange of offer and acceptance. However, the parties intended to be bound by the contract even though the price had not been fixed.<sup>99</sup> Potentially, an opportunistic buyer could defend himself using Article 14(1) as an excuse to have a non-binding agreement, as there was not express or implicit way to fix the contract.

Honnold concluded that it was unreasonable for Article 14 to be a prerequisite of Article 55. Article 14(1) clarifies that a communication that does not state or make provision for the price is not an offer, that a reply stating ‘I accept’ does not necessarily create a valid contract. However, if there is no clear offer and acceptance, Article 55 resolves the issue, stating that a contract may be validly concluded even if it does not expressly or implicitly fix or make provision for determining the price. Honnold thinks that the phrase ‘where a contract has been validly concluded’ is indicative of a valid contract to be independent from the need for express or implied provision for determining the price, yet enforceable under the CISG.<sup>100</sup>

The trend of the CISG courts, however, is to automatically categorise a case under Article 14(1) when a contract includes an ‘implicit’ method of determining the price. Yet there is no resolution for the conflict between Articles 14(1) and 55. Whether open price under Article 55 is subject to implicit requirement or is independent from Article 14(1) as intended by parties is an issue rarely discussed in most court decisions.<sup>101</sup>

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<sup>99</sup> Article 6 of the CISG states that the parties may exclude the application of this Convention or, subject to Article 12, derogate from or vary the effect of any of its provision.

<sup>100</sup> John O Honnold, ‘Criteria for an Offer’, in *Uniform Law for International Sales under the 1980 United Nations Convention* (3rd edn, The Hague, Kluwer Law International 1999) 147-157.

<sup>101</sup> Austria 10 November 1994 Supreme Court (*Chinchilla furs case*)

<<http://cisgw3.law.pace.edu/cases/941110a3.html>>. Case law on UNCITRAL texts (CLOUT) abstract no 106. The contract was for the sale of chinchilla furs, concluded between a German seller and an Austrian buyer. The parties occasionally traded with furs without an agreement on the precise quantity and price. Typically, the

### 5.3.3 Honnold's opinion as the prevailing view

In resolving the tension between Articles 14 and 55, the writer of the current thesis believes that the reasoning given by Honnold in the debate is the more cogent opinion, forming a sensible interpretation of the seemingly incompatible provisions of the CISG in order to maintain their sensibility.<sup>102</sup>

Garro likewise supported the reconcilability of both provisions, since Article 14(1) requires that the price be at least implicitly fixed, while Article 55 validates open price using an implicit price fixed by operation of law, namely, the price generally charged at the time of conclusion of the contract.<sup>103</sup> Both provisions require an objective standard to determine price, and hence should not conflict with each other when dealing with certainty of price. Moreover, their reconcilability is also supported by both Articles 7(1) and 8 of the CISG (in Part I, which is a mandatory section for all contracting states). Article 7(1) states that the international character and uniformity of the CISG, and good faith are to be upheld when interpreting the provisions of the CISG; Article 8 emphasises the intent of a party as a tool of interpreting the party's statements and conduct,<sup>104</sup> wherein such interpretation is 'according to the understanding that a reasonable person of the same kind as the other party would have had in the circumstances.'<sup>105</sup> In determining the intent of a party or the understanding a reasonable person would have had, due consideration is given to all relevant circumstances of the case, including negotiations, any practices which the parties have established between themselves, usages and any subsequent conduct of the parties.<sup>106</sup> These provisions indicate that there should not be any conflict between Articles 14(1) and 55 in order to maintain the international character of the CISG as a whole.

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parties agreed on furs of average or good quality, and that on a price range of 35 to 65 German Marks per item. The buyer argued that a quantity of the pelts delivered were of low quality and paid no more than 10 Marks per fur to the seller. The Supreme Court made a direct reference to Article 14(1), finding that the criteria of definiteness of an offer are met if the parties have implicitly fixed both the quantity and the price in a way that makes it possible to identify the parties' intention. There was no resolution for the inconsistency of Articles 14 and 55 CISG and what open price really meant within the context of Article 55. Rather, the court directly addressed the range between 35 and 65 German marks for each piece as a 'sufficiently definite' indicator under Article 14(1) to determine the price in respect of the quantity and quality of the furs that the German breeder had delivered.

<sup>102</sup> Garro (n 21) 464.

<sup>103</sup> *ibid.* In addition, such concept is present under the English law whereby implicit terms could mean implicitly derived from parties' conduct or implicitly derived from the operation of law.

<sup>104</sup> Article 8(1) of the CISG.

<sup>105</sup> The application of Article 8(2) was stressed in Murray (n 84).

<sup>106</sup> Article 8(3) of the CISG.

In addition to the sensibility and reconcilability of the CISG, the writer also supports the view of Lookofsky that the absence of a price term should not render the agreement unenforceable, particularly when the intention of the parties was to enter into a binding agreement.<sup>107</sup> If a reasonable person regards the deal as binding, the agreement must be recognised as binding. The emphasis of the CISG on the reasonable understanding of the parties and their predominant intention could overcome any notion that the language of Article 14(1) concerning an explicit or implicit fixing of the price should be construed to permit technical gaps regarding that understanding and intention.

The interpretation made by Honnold best serves the best interests of both buyer and seller in relational sales during rapid price fluctuations. Reliance upon the restrictive wording of Article 14(1) and a narrow construction of Article 55 lead to the nullity of the contract, particularly if parties are of contracting states that are less receptive to open price contracts. Honnold's approach would help to ensure the validity of the relational contracts, concurring with Macneil in terms of lessening presentation and focusing more on the relational spectrum of a contract.

The next section, Section 5.3.4 compares the impact of Article 55 on open price under the CISG, with that of Section 2-305 of the UCC.

#### **5.3.4 Impact of open price under Article 55 of the CISG in comparison with Section 2-305 of the UCC**

According to the Commentary, Article 55 has effect only if one of the parties has his place of business in a state which has ratified or accepted Part III but not Part II of the CISG, and if the law of the state provides that a contract can be validly concluded even though it does not expressly or impliedly fix or make provisions for determining the price.<sup>108</sup> Lookofsky explained that Article 55 had relevance for the Scandinavian States who all declared themselves 'not bound' by Article 14.<sup>109</sup> The perception of open price under Article 55 as dependent on 'implicit price' under Article 14 reflects that Article 55 is *only* significant in cases where one of the parties reside in a Scandinavian state.

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<sup>107</sup> Lookofsky (n 86).

<sup>108</sup> Guide to CISG Article 55, [2] of the Secretariat Commentary, <  
<http://cisgw3.law.pace.edu/cisg/text/secomm/secomm-55.html> >

<sup>109</sup> text to n 86.

The UCC complies with the concept suggested by Lookofsky, in that Section 2-305 provides the courts with an excuse to impose, to the extent of the parties' original intentions, a price term not found in the agreement.<sup>110</sup> Section 2-305 embraces the fact that agreeing to an open price means that the parties intend to accomplish profit out of a contract, a practical reality ignored by most courts.<sup>111</sup> If parties do not wish the court to set the price but would rather the contract failed in the absence of their ability to agree on a price, it is obligatory upon them to make an express statement to that effect in the contract itself, or to show by other convincing evidence that such result was intended.<sup>112</sup>

Despite the independence of Article 55 in validating intentional open price, relevant decisions demonstrate that open price is valid only if it fulfils Article 14(1). As explained earlier, the court may be able to discern parties' true intention based on Article 8, whereby if parties appear to be intended to be bound without a price clause, then the parties' intention to leave the price open is to prevail.<sup>113</sup> This is particularly essential if the parties have dealt with each other and having prior course of dealing and course of performance or in cases where trade usage allows a price to be implied. Similar to the law merchant under the UCC, the parties' experiences as well as their trade usage are useful in supplying open terms.<sup>114</sup> The CISG provides that open terms may be supplied by recourse to usage (Article 9(2)), by practices established between the parties (Article 9(1)) or by general interpretation of the parties' conduct (Article 8).

The next section discusses the interdependency of both Articles using examples from the relevant court decisions.

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<sup>110</sup> See Prosser, Chapter Two (n 117) 736-37 whereby Prosser stated that '[t]he court insists that it cannot make a contract for the parties, but it is sometimes willing to read into the agreement they have made a provision which is not visibly there.'

<sup>111</sup> *ibid* whereby Prosser stated that intention is not to be supposed and/or presumed to be unreasonable. The fact that some pains have been taken to enter into such a contract, where the price cannot be fixed, indicates that considerable importance is attached to the terms upon which there has in fact been agreement. Courts should if they can give effect to these terms.

<sup>112</sup> For example, Section 2-305(4) recognises that if parties intend not to be bound unless the price is fixed or agreed and it is not fixed or agreed, there is therefore no contract. In such a case, the buyer must return the delivered goods, or if unable to do so, must pay a reasonable price at the time of delivery, while the seller has to return any portion of the price paid on account.

<sup>113</sup> *ibid*.

<sup>114</sup> *ibid*.

## 5.4 Decisions relating to Articles 14 and 55

### 5.4.1 Cases where parties inadvertently leave the price open

As in previous chapters, the cases discussed in this section are divided into two categories, the ‘inadvertent’ category and the ‘deliberate’ category.

Below are two examples of decisions of the inadvertent category, namely the *Oven case* and the *Malev case*.

#### 5.4.1.1 *Oven case*<sup>115</sup> – silence as to price

In this case, the seller was managing a business covering the manufacturing, repairing, acquiring and selling of kitchen equipment, while the buyer was managing a hotel in Switzerland. The contract was for the purchase of an oven to replace an existing oven that broke down before a particular weekend- a situation of urgency for most hotel businesses.

On Friday, 8 March 2002, the oven in the kitchen of Public Utility E broke down and in the same afternoon, its executive chef asked the seller to repair or replace the defective equipment or to replace it. Nevertheless, under undocumented circumstances, the executive chef rejected the repair of the oven. K, the representative of the seller, contacted its oven supplier, Company L, indicating the reasons for urgent delivery of the replacement oven to Switzerland the next day. Company L had only one oven available, and K accepted this oven, of the brand and type Lainox ME 110 P, but did not mention the oven’s price to the executive chef. The seller alleged to have sold the oven to the buyer, for which the issued bill remained unpaid. The seller thus based its action on the conclusion of a contract with the buyer for the international sale of goods.

The court enforced the inadvertently missing price by deriving the intention of the parties through the behaviour of the buyer after the delivery. When the buyer asked for a copy of the bill, she never contested the price. In addition, the buyer requested the seller to send her a letter of guarantee for the oven. This behaviour, which took place over several months, implied that the sale was concluded even though the seller had not initially indicated the price.

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<sup>115</sup> Switzerland 27 April 2007 Canton Appellate Court Valais (*Oven case*)  
<<http://cisgw3.law.pace.edu/cases/070427s1.html>>

The conduct of the buyer was only a part of the reason used by the court to derive intention. Article 55 resolved the issue, for a contract may be validly concluded without any (express or implicit) reference to price, since the price may be objectively determined according to the price generally charged at the time of conclusion of the contract. In this case, the contract gave no indication as to the price of the oven, it was deemed to be the price currently practised for such goods, and the buyer thus bore the risk of paying more than foreseen if he accepted the delivered goods. Applying Article 55, the court applied the price currently practised, which amounted to 6,972.17 €.

Article 55 fills the gap of a price when parties have indeed validly concluded the contract, even in emergency situations where there was no proper offer and acceptance. Naturally in this case, the delivery took place almost instantly after the time of formation of the contract. The ‘price generally charged at the time of the conclusion of the contract’ under Article 55 was accurately applied for the sale of the oven in this case, which did not involve volatile market as far as the oven is concerned.

This leads to the question of whether the application of Article 55 would be similarly effective for products such as steel and oil, where the relational nature of those contracts creates a large gap between the time the contract is formed and the time of delivery. At any point of time within this gap the product’s price may fluctuate, meaning that the price at the time of delivery far deviates from the price generally charged at the time of conclusion of the contract.

#### **5.4.1.2 *Pratt and Whitney v Malev Hungarian Airlines*<sup>116</sup>**

The case involved a proposal for the sale of two jet engines, with an additional engine option. The selection of the engine would depend on whether Malev purchased aircraft of Airbus, or of Boeing. The writer proposal included prices for both engines, but later, when the proposal was amended to include the additional engine, there was no price stated for this additional engine option. Malev telexed a letter that it had chosen Pratt & Whitney engines for Boeing aircraft. This option took place after various exchanges with Pratt & Whitney on engine

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<sup>116</sup> Hungary 25 September 1992 Supreme Court (*Pratt & Whitney v. Malev*)  
<<http://cisgw3.law.pace.edu/cases/920925h1.html>>

maintenance and building a spare parts pool in Hungary. However, three month after signing the acceptance letter, Malev informed that it would not purchase the engines.

The primary concern was whether the missing price term of the additional engine caused uncertainty in contract. While Malev claimed that there was uncertainty in price as Pratt & Whitney did not indicate its own price index in order to calculate the base price of the additional engine, Pratt & Whitney claimed that the price was determinable in a precise manner. The proposal stated the product, quantity and data on how the price calculation could be made. The Budapest Metropolitan Court held that there was a valid contract between the parties for ‘an offer may be valid even without a fixed price or number of goods, if it contains provisions for the definition of the price and quantity’.

The Supreme Court reversed the decision and reached the opposite conclusion; it found that no valid contract had been formed. The court relied primarily on Article 14(1), stating that in order to constitute an offer, a proposal is sufficiently definite if it indicates the product, the quantity and the price or contains directions as to how these terms can be defined. Since a price was not stated for the additional Boeing engine option that Pratt & Whitney had added to the contract, the proposal lacked a sufficient price term that cannot constitute an offer under the CISG. Recognising the approach of Farnsworth, the Supreme Court held that the divergence of Article 14 and 55 implies that both of them cannot be construed together, and that Article 55 applies only if there is a valid contract under Article 14.<sup>117</sup>

As a result, not only did the Supreme Court denied Pratt & Whitney any recovery, but it ordered them to reimburse Malev HUF 15,150,000 for the costs of the litigation, and that Pratt & Whitney was to bear its costs itself. Article 55 did not have any impact on the Supreme Court’s analysis.<sup>118</sup> In fact, Article 14(1) ‘implicit price’ requirement has somewhat constituted a prerequisite to a valid contract under Article 55. The perturbing factor was that the Supreme Court avoided addressing the issue of whether there was an element of intention to be bound between the parties when applying Article 14(1),<sup>119</sup> and that the price of the additional engine was determinable based on the data provided by Pratt & Whitney. Although

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<sup>117</sup> As seen in *Chinchilla Furs* (n 101).

<sup>118</sup> Harry M Flechtner, ‘The Several Texts of the CISG in a Decentralized System: Observations on Translations, Reservations and other Challenges to the Uniformity Principle in Article 7(1)’ 17 *Journal of Law and Commerce* (1988) 187-217.

<sup>119</sup> *Pratt and Whitney v Malev* (n 116).

an aircraft engine is specialised goods, there could have been an acceptable method to determine its price. Koneru suggested that ‘an independent appraiser familiar with the aircraft engine industry’ is one possible method of price determination in this case.<sup>120</sup> Hence, there was a possibility of a valid contract not only under Article 55 but also under Article 14(1) as the price of the additional engine were determinable. Koneru also commented that the court could have derived the parties’ intent based on their conduct, under Article 8, and failure of the Supreme Court to address Article 8 reflected the fact that ‘not only Malev, but also the Court failed to observe good faith under the Convention’.<sup>121</sup>

The decision would have resulted otherwise under Section 2-305 of the UCC. The contract would have been valid based on the evidence of intention of the parties and thus the UCC courts would not approve of Malev’s bad faith in repudiating in agreement that Malev itself almost certainly assumed was binding. This is detrimental to Pratt & Whitney, who have incurred on reliance costs based on the agreement made. Flechtner added that ‘[i]magine if the tables were turned, and it was Pratt & Whitney who refused to sell the engines after Malev had committed to purchase Boeing aircraft’.<sup>122</sup> Arguably, the Supreme Court’s decision ignored the international character of the CISG by straining for an interpretation favourable to the party of the same nationality as the court.<sup>123</sup>

The next section discusses deliberate open-price contracts and demonstrates how Article 55 itself deals with open price in relational sales.

#### **5.4.2 A case where parties deliberately left the price open**

Based on the Pace Law website,<sup>124</sup> there are 42 reported cases under Article 55 on deliberate open price, but only one involved goods of changing price based on the market, where the price was determinable only when the product was in its season. In this category, the parties deliberately opt for an open price, with a price mechanism to allow calculation of the price.

The case is explained below.

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<sup>120</sup> Phanesh Koneru, ‘The International Interpretation of the UN Convention on Contracts for the International Sale of Goods: An Approach Based on General Principles’ 6 *Minnesota Journal of Global Trade* (1997) 105-152.

<sup>121</sup> *ibid.*

<sup>122</sup> *ibid.*

<sup>123</sup> text to n 118, 212-13.

<sup>124</sup> CISG DATABASE, < <http://www.cisg.law.pace.edu/> >

#### 5.4.2.1 *Pitted Sour Cherries case*<sup>125</sup>

The German plaintiff (the buyer), a trader of fruits and vegetables, maintained supply contracts with a trade chain which operates a branch, while the Belgian defendant (the seller) was a company processing foods and vegetables. Upon completion of an oral discussion regarding the delivery of pitted sour cherries, the seller sent the buyer a letter on 13 June 2003, stating that the quantity of pitted sour cherries would be 400,000 jars, with their price to be fixed during the season. The deliveries were to take place between July 2003 and May 2004, and payments were to be made within 30 days of each invoice. The buyer then ordered 50,000 jars of sour cherries from the seller at a price of EUR 0.95 per jar, which the seller delivered directly.

On 15 October 2003, the seller sent the buyer a second letter to confirm the purchase of 400,000 jars, this time at a price of 0.90 Euro per jar. This letter stated that the first truck would be delivered in November 2003 and that the rest of the deliveries were to continue until the end of May 2004. The seller stated that the 50,000 jars of sour cherries previously purchased, although these were obtained by the buyer from the seller after 13 June 2003, were not to be regarded as performance on the basis of this contract. The buyer purchased a total of 130,464 jars between January and July 2004, paying between EUR 0.87 and 0.90 per jar for the six deliveries in this period.

The buyer insisted that based on Article 14(1), there was no valid contract of sale of sour cherries at the price of EUR 0.90, alleging that the letters dated 13 June and 15 October 2003 were neither offers within the meaning of Article 14(1) nor as commercial letters of confirmation. The buyer claimed that the letter dated 13 June 2003 lacked a price proposal and gave no implicit price. In the absence of implicit price, the buyer claimed that there was no binding contract and no obligation to accept a further 269, 536 jars of the cherries.

The court nonetheless held that the second letter of the seller dated 15 October 2003 constituted circumstantial evidence of conclusion of the contract and stated that the arrangement to fix the price ‘during the season’ indicated that the price was implicitly determinable within Article 14(1). Furthermore, the buyer had taken delivery of the goods and

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<sup>125</sup> Germany 3 August 2005 District Court Neubrandenburg (*Pitted Sour Cherries case*)  
<<http://cisgw3.law.pace.edu/cases/050803g1.html>>

paid the price charged by the seller with respect to every delivery received. The court also applied Article 8 and interpreted the clause ‘to be fixed during the season’ as an implicit agreement of the seasonal prices of the seller for the year 2003.

Again, Article 14(1) was referred to in order to decide whether the price was determinable, but following Honnold, the courts did focus on intent to be bound by looking at the conduct of the parties and the fact that partial delivery had taken place. Article 55 was applicable without depending on Article 14(1) requirement of an implicit price, thus validating the contract without being affected by the vagueness of the phrase ‘to be fixed during the season.’

In sum, this case shows that the CISG can be applied so as to allow for a contract where presentation of the price of the goods, due to seasonal variations, as long as the price is sufficiently determined or at least determinable based on the market.

### **5.5 Conclusion: amending or flexibly interpreting Article 55 makes it a more effective gap filler for intentional open-price contracts**

This chapter has shown that there is some room to allow for relational contracts under the CISG, subject to the presentation requirement. While open price under Article 55 is an alternative to parties that deal with specialised or seasonal goods, such as in *Malev* and *Pitted Sour Cherries* respectively, Article 14(1) is often cited by an opportunistic party that intended to leave the relational contract. Clearly Article 14(1) governs the contract if both parties intend to be bound only if there is a fixed or implicitly fixed price in their contract. However, the situations in *Malev* and *Pitted Sour Cherries* were the opposite; both cases involve relational elements that require flexibility, and that parties intend to be bound even though the prices were not specified.

In *Malev*, Pratt & Whitney was left uncompensated despite incurring reliance costs on the basis of the agreement. As the court’s decision was based on Article 14(1), it refused to go further into examining the determinability of the price of the jet engine. Instead, it concurred with the claim by the buyer (Malev) that there was no valid contract. In fact, evidence of intent and determinability of price existed in this case, as discussed above.<sup>126</sup> In *Pitted Sour*

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<sup>126</sup> See Section 5.4.1, text to n 120-n 122.

*Cherries* the buyer similarly relied on Article 14(1) in order to be released from the contract when in fact the buyer had accepted the partial delivery of the sour cherries.

Adopting the approach of Section 2-305 of the UCC would improve the overall utility of the CISG as a sales law, for it merges both presentation and relational elements in the overall structure of the law,<sup>127</sup> and which of the two applies depends on what the parties have intended. If the parties intended for a fixed price, then clearly the presentation method under Section 2-305(4) would be applicable; if the parties opted for open price, then the relational approach under Section 2-305(1) applies. This means that a UCC court validates or invalidates a contract based on what the parties have intended from the beginning of the contract. To opt for price flexibility is a matter of choice for the parties and the courts would decide accordingly. While both approaches are similarly found in the CISG, the courts are influenced by the presentation character under Article 14(1) of fixed or implicitly fixed price seems to over Article 55 validation of open price.

The distinction between Articles 14 and 55 originated from the compromise nature of the CISG, which resulted from the participation of its various member states. The common law, the socialist countries and the French legal system require a statement to be definite in order to qualify as an offer, and developing countries show less inclination for open price terms based on their uncertainty in the case of raw materials.<sup>128</sup> For socialists and civil states, Article 14(1) under Part II is the ideal method of contracting, while Article 55 suits the needs of countries that are more receptive to open price.

The CISG courts have not been able to decide whether or not intention to be bound is the main requirement of a valid relational sale that applies open price. Whether applying Articles 14(1) or 55, the court has tended to consider whether a price term is sufficiently definite but without due consideration of the nature of the business in which the contract was formed. In *Malev*, the Supreme Court stated that Article 14(1) was not fulfilled effectively in deriving the intention of the parties, but neither stated nor explained whether *Malev* fell into the Article 55 category.

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<sup>127</sup> Macneil, Chapter One 'Restatement (Second) of Contracts' (n 135) 597.

<sup>128</sup> *ibid.*

Recognising the fact that an open price contract may be validly concluded (even without a clear offer and acceptance under Article 55, the writer agrees with the argument offered by Lookofsky, who stated that the courts and arbitrators ought to discern the intention of the parties in the concrete case, and determine whether or not the parties themselves actually *wanted* their open-price agreement to be binding.<sup>129</sup> Amending or interpreting Article 55 in a similar way to Section 2-305 would benefit many relational sales in the future, as the courts would be able to evaluate the validity of a sale, as long as parties intend to be bound by a contract under Article 55. Recourse need not be had to Article 14(1) as Article 55 directly validates the contract. This enhances the relational character of Article 55 without being impeded by presentational character of Article 14(1), a shift strongly recommended by Macneil and Llewellyn as explained in Chapter One.

Another benefit of flexible interpretation of Article 55 would be that all member states (except Scandinavian states that have clearly excluded Article 14(1) and Part II of the CISG)<sup>130</sup> that have ratified both Articles 14(1) and Article 55 would benefit from intentional open prices under Article 55. This improves the current situation where an incompletely drafted contract is subject to the interpretation of Article 14(1) which may or may not nullify an open price term even in cases where parties intended to be bound by the deal.

Finally, and most importantly, opportunistic parties may not be able to use the requirement of a ‘sufficiently definite’ price under Article 14(1) to nullify the contract.

Clearly Article 55 has not been as relational as the US had hoped for after opposing the language of Article 14(1) in Vienna. This is because Article 55 applies reasonable price at the time of entering into the contract rather than at the time of delivery. It does not exactly cater to the need of changing markets when applying ‘price generally charged at the time of the conclusion of the contract’, leading to the impracticality of the CISG in dealing with contracts of volatile prices. It seems that Article 55 is limited to resolving accidental omission of price such as seen in the *Oven case*, considering that an item such as an oven is not in the category of goods of volatile price.

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<sup>129</sup> Lookofsky (n 86) [102].

<sup>130</sup> text to n 87. By virtue of Article 92, any Member State has the option to make reservation on the application of Part II or Part III of the CISG. The Scandinavian countries have declared not to be bound by Part II.

We will see in Chapter Six that the price at the time of delivery matters in contracts that involve goods of volatile price, and is preferable to the price generally charged at the time of the conclusion of the contract provided by current Article 55. Indeed, based on the *Pitted Sour Cherries* case, it would appear the price at the time of delivery is more practical for considering the seasonal products, for which price determination is not possible until the season has started. For sales involving products such as steel and fuel, the sustainability of the sale if concluded under Article 55 is questionable, but certainly improvable by adopting a similar approach to that of Section 2-305 of the UCC.

In sum, the interpretation of a contract should aim to fulfill the parties' intention, but more importantly to uphold the international character of the CISG as pronounced by Article 7(1).<sup>131</sup> Moreover, the Preamble of the CISG states that '[c]onsidering that the development of international trade on the basis of equality and mutual benefit is an important element in promoting friendly relations among States' shows that the CISG should minimise opportunism by parties who use Article 14(1) to release themselves from contractual obligations. Minimising presentation under Article 14(1) improves the overall purpose of CISG as a sales law, in harmony with the spirit of integrating presentation under the contract, as opposed to complete presentation upon relational contracts.<sup>132</sup>

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<sup>131</sup> Article 7(1): '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.'

<sup>132</sup> Macneil, Chapter One (n 108) 'Adjustment of Relations' 888.

## Chapter Six: Analysis

### 6.0 Introduction

This thesis proposes for the validation of open price based on the needs of a relational contract. Relational contract theory views contracts as relationships, rather than as discrete transactions.<sup>1</sup> In a relational contract, the relationship between parties is based on trust, and it involves a high degree of cooperation on a long-term basis. The ongoing interaction between the parties grows and varies as events occur over time.<sup>2</sup> To cope with the trend of the market, any sales law that based its principles on classic approach faces challenges in minimising presentation and maximising flexibility when addressing open price in relational sales.<sup>3</sup>

As discussed earlier, Macneil explained the four potential responses of a contract law when applied to relational sales;<sup>4</sup> firstly, the contract law may not apply to the particular contract in question;<sup>5</sup> secondly, the relational contract may be decided in accordance with concepts of presentation present in the contract law;<sup>6</sup> thirdly, the law may be modified in such a way that total presentation is a theoretical and not an ultimate goal;<sup>7</sup> or, finally, the overall structure of the contract law may be developed for a greater general application by merging both relational and presentation elements.<sup>8</sup>

This thesis classified the UCC, the SGA and the CISG based on the above four responses. On the one hand, the design of the UCC was based on the fourth response; it recognises presentation, by enforcing a fixed-price contract, if that was intended by the parties from the beginning of the deal.<sup>9</sup> At the same time, it promotes relational elements by validating contracts with inadvertent or deliberate open price terms. This is evident in Section 2-305(1) of the UCC, where a contract is valid on the basis of reasonable price in three situations: when parties are silent regarding price, when parties fail to agree on a price and when an appointed third party or a standard fails to set the price. The law merchant practices of open price and

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<sup>1</sup> Macneil, Chapter One 'The Many Futures of Contract' (n 108) 691.

<sup>2</sup> Macneil, Chapter One 'Restatement (Second) of Contracts' (n 135) 595.

<sup>3</sup> *ibid* 596.

<sup>4</sup> *ibid* 597.

<sup>5</sup> *ibid*.

<sup>6</sup> *ibid*.

<sup>7</sup> *ibid*.

<sup>8</sup> *ibid*.

<sup>9</sup> Section 2-305(4) of UCC.

duty to set the price in good faith enrich the overall structure of the UCC by merging presentation and relational characteristics in a sale.

On the other hand, the SGA and the CISG portray the characteristics of the second response. Many decisions on relational sales are made in accordance with the concept of presentation.<sup>10</sup> While the SGA and CISG courts are inclined to take the approach in line with the third response, namely to limit presentation as a theoretical rather than ultimate goal of the law, they are still limited by the principles of presentation. For example, when deciding the validity of a relational sale, English courts frequently cite the *May & Butcher* principle of agreement to agree being a non-binding agreement on the basis of there being no price presented for the sale of tantage. The post-*May & Butcher* decisions such as *Hillas*<sup>11</sup> and *Foley*<sup>12</sup> proved to be exceptions to the rule, but the current decision of *Rafsanjan*<sup>13</sup> proves that presentation under Section 8 and in *May & Butcher* remains the guiding principle of the SGA. The relational contract in *Rafsanjan* was invalidated even though the parties had been dealing with each other for eight years and there was an available market price for the pistachios that the court could refer to in order to apply reasonable price.

Similarly, the CISG courts are bound by the presentation character of Article 14(1) that requires ‘implicit price’ as a requirement to a valid contract. In *Pitted Sour Cherries case*,<sup>14</sup> clearly the court had successfully departed from the presentation element of Article 14(1), thus validating the contract on the basis of Article 55. However, Article 14(1) did invalidate the agreement in *Malev*<sup>15</sup> on the basis of there being no fixed price for the additional jet engine even though parties were proven to be bound, and that the engine price was calculable from the data for base price calculation provided by the seller.

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<sup>10</sup> *May and Butcher Limited v The King* [1934] 2 KB 17 (as discussed in Chapter Four, Section 4.3.1); Hungary 25 September 1992 Supreme Court (*Pratt & Whitney v Malev*) <<http://cisgw3.law.pace.edu/cases/920925h1.html>> (as discussed in Chapter Five, Section 5.4.1). Both cases highlighted of application of presentation approach in the English and CISG jurisdictions respectively.

<sup>11</sup> *Hillas & Co v Arcos Ltd* (1932) 147 LT 503.

<sup>12</sup> *Foley v Classique Coaches* [1934] 2 KB 1.

<sup>13</sup> 19 December 1997.

<sup>14</sup> Germany 3 August 2005 District Court Neubrandenburg (*Pitted Sour Cherries case*) <<http://cisgw3.law.pace.edu/cases/050803g1.html>>

<sup>15</sup> *Pratt & Whitney* (n 10).

The abovementioned decisions prove that while the courts have been able to modify relational contracts to sustain enforceability, the way flexibility is applied to the contract is also crucial. The UCC proves to be advantageous as it allows parties, from the beginning of the contract, to choose to have a fixed price or an open price. The SGA, to a lesser extent allows flexibility, subject to the decision of the court, to enforce open price. Similar to the SGA, price flexibility under the CISG is granted by the courts when required, as opposed to being an option for the parties from the time when they first entered into the contract. As a result, potentially valuable relationships are unnecessarily difficult to enter into under both SGA and CISG. Parties may have no choice but to enter into a contract of sale with a fixed price, even at the risk of market fluctuation or other uncertainties.

To test which of the three sales laws is the best at catering to uncertainty in the price of the goods, this chapter analyses the case of *Scafom International BV v Lorraine Tubes S.A.S.*<sup>16</sup> and demonstrates the consequence of limiting flexibility in price at the time of formation of the contract. The analysis of this chapter proves that a relational sale such as in *Scafom International* could have used an open price with a price index and/or a price renegotiation clause from the beginning of the contract to cater to the price fluctuations that had occurred before the delivery of the goods. The failure to do so indirectly invited judicial intervention that did not necessarily suit the relational nature of the contract.

The three main points discussed in this chapter are: 1) the price flexibility offered by the CISG as a post-hardship remedy, rather than an available choice for the parties; 2) how the merged presentation and flexibility feature under the UCC would have resolved the issue in *Scafom International*; and 3) how *Scafom International* would have found no solution under the SGA, considering that the limited flexibility provided under Section 8 of the SGA neither enforces, nor frustrates the contract.

The section below begins by providing the facts and decisions of the presiding courts on *Scafom International*, before moving to the three main issues.

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<sup>16</sup> Belgium 19 June 2009 Court of Cassation [Supreme Court] < <http://cisgw3.law.pace.edu/cases/090619b1.html> >

## **6.1 *Scafom International BV v Lorraine Tubes S.A.S.***

*Scafom International BV* was a CISG case. The agreement was for the sale of warm-rolled steel tubes, between the seller Exma, a French-based company and the buyer, *Scafom International BV*, a Dutch company, in order for the latter to use them to produce scaffolding. The fixed terms in the contract were for the price, date and place of delivery of the steel (in Belgium), but there was no price adjustment clause in the event of supervening circumstances.

After the conclusion of the contract but prior to delivery, the price of steel unexpectedly rose by about 70%. The seller then gave notice to the buyer to recalculate the agreed price due to the unforeseeable increase. The buyer did not accept the suggestion and sued the seller instead.

Below are the specifics of the decisions from each deciding court on the case.

### **6.1.1 The court decisions**

#### **6.1.1.1 Tongeren Commercial Court**

The report of the decision was brief; it appears that the court ordered the seller to deliver the products to the buyer, and the buyer to pay half of the requested price increase. The court regarded the price fluctuations as foreseeable and believed that a price adjustment clause should have been included in the contract. As part of the business risk assumed by the seller, the court held that the circumstances did not make the contract impossible under Article 79, although they made the performance of it more onerous.

#### **6.1.1.2 Appeal Court**

Briefly reported, the Antwerp Court of Appeal similarly held that the contract was enforceable, but on a different basis. It held that the issue was not covered by the CISG, and that the question should therefore be governed by the national law applicable to the contract. The court referred to Article 4 of the Rome Convention on the Law Applicable to Contractual Obligations, and then applied French law in the judgment. Article 1135 of the French Civil Code gave the parties in such circumstances the right to renegotiate the contract. The fact that the buyer refused to renegotiate the price constituted a breach of contract and therefore the appeal court entitled compensation to the seller. This caused the buyer to proceed for appeal in the Supreme Court.

### 6.1.1.3 The Supreme Court

The Supreme Court held that the hardship caused by the price increase amounted to an impediment to the performance of the contract under Article 79 of the CISG. Article 79(1) states that a party is not liable for a failure to perform any of his obligations if the impediment was beyond his control, and if he could not reasonably be expected to have taken into account, avoided or overcome the impediment or its consequences at the time of the conclusion of the contract. A pure reliance on Article 79 meant that the contract was avoided. Hence Article 79(1) had a similar effect to a *force majeure*, and lead to the avoidance of the contract.

While Article 79(1) resolves *force majeure* conditions by validating non-performance of a contract, there has not been any provision under the CISG that resolves situations of supervening change, such as market fluctuation, which render the performance more onerous or cause hardship to one of the parties. Realising that the price increase did not amount to a *force majeure*, the Supreme Court enforced the agreement by referring to Article 7(1) and (2) of the CISG. According to Article 7(1) and (2), reference to the general principles governing the law of international trade, such as the UNIDROIT Principles for International Commercial Contracts. Under the UNIDROIT Principles, the party invoking changed circumstances that have caused imbalance in the contract is entitled to seek the renegotiation of the contract.<sup>17</sup>

Clearly the Supreme Court upheld the decision of the Court of Appeal, holding that renegotiation was the solution to the case, although both courts cited different legal principles to arrive at a similar conclusion. Both courts were unanimous in that the seller was accurate in claiming for renegotiation due to the hardship caused by the unforeseeable increase in the price of steel. Having no price adjustment clause in the contract to adapt to the fluctuation, the buyer was bound to agree to a new price. Renegotiation prevents an exceptionally detrimental situation for the seller, provided that such renegotiation is executed in good faith.<sup>18</sup>

Hansebout commented that *Scafom International* was a landmark decision for two reasons;<sup>19</sup> primarily, the Supreme Court categorised market fluctuation as impediment under Article 79,

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<sup>17</sup> Article 6.2.2(1) of the UNIDROIT Principles.

<sup>18</sup> Article 7.1 of the UNIDROIT Principles.

<sup>19</sup> Alexander Hansebout, 'Landmark Supreme Court decision on hardship under CISG' (29 March 2010), <<http://www.internationallawoffice.com/Newsletters/Detail.aspx?g=6a74fcf3-9728-4469-b63a-5e51ded3f666>> accessed 20 June 2012.

and secondly, for the first time in history, the Supreme Court referred to the UNIDROIT Principles in order to resolve a dispute. A question arises as to whether market fluctuations do impede the contract (and lead to its avoidance), or, are common affairs of business<sup>20</sup> that is foreseeable (thus impeding the contract and leading to its avoidance), or whether fluctuations are common in business and are therefore foreseeable (not affecting the enforceability of the contract).

## **6.2 Renegotiation as a post-fluctuation remedy under the CISG**

Chapter One demonstrated that traditional fixed-price method does ensure the optimal performance of a contract.<sup>21</sup> This is particularly true when parties know all the risks or are risk neutral when entering a contract.<sup>22</sup> Hence, under the circumstances of known or neutral risks, a rational person would not enter into a transaction, in conscious ignorance of the magnitude of risks that might affect his return, when there are ways to precisely determine the risks.<sup>23</sup> Nevertheless, a fixed-term contract is less ideal when the risks are not easily determined.<sup>24</sup> Previous chapters demonstrate that economic exchanges are relational and involved risks of market fluctuations,<sup>25</sup> making fixed-price deals difficult to be executed during price fluctuations.<sup>26</sup> As a result, presentiating price is less crucial or desirable when there is a risk in the uncertainty in price, unless and until future circumstances take place.<sup>27</sup>

As elaborated in Chapter Two, long-term industries such as natural gas, uranium, coal and petroleum coke, have in general departed from the use of fixed price to price index, or a voluntary renegotiation clause, or a combination of both. This shift of price flexibility took place in the early 1970s due to the market fluctuations that affected the industries.<sup>28</sup> In fact, this shift does fulfil the aim of the Preamble of the CISG, which states that ‘[c]onsidering that the development of international trade on the basis of equality and mutual benefit is an important element in promoting friendly relations among States.’ In relation to this chapter’s analysis, as opposed to fixed price, open price based on price index or voluntary renegotiation, or both combined, allow equality and mutual benefit between foreign traders, in

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<sup>20</sup> *Intertraded SA v Lesieur Tourteaux SARL* [1978] 2 Lloyds Rep 509 (Lord Denning).

<sup>21</sup> Gergen, Chapter One (n 9) 1007.

<sup>22</sup> *ibid.*

<sup>23</sup> *ibid.*

<sup>24</sup> *ibid.*

<sup>25</sup> Macneil, Chapter One (n 135) ‘Restatement (Second) of Contracts’ 596.

<sup>26</sup> *ibid.*

<sup>27</sup> *ibid.*

<sup>28</sup> See Chapter Two, Section 2.6.

accordance with the Preamble of the CISG. Open price lessens the risk of non-enforceability of a contract when prices of the goods are uncertain, plans the business relationships of parties that lead to expansion of business using flexible terms and most importantly and minimises the room for opportunistic behaviour of leaving the contract in fluctuating markets.<sup>29</sup>

In the case of *Scafom International*, the courts unanimously remedied the situation using a similar shift; the fixed-price term was remedied by a price renegotiation method to enforce the contract. If the parties truly intended to be bound only by a fixed price, the contract should have remained valid despite market fluctuations; no price renegotiation would have been necessary to remedy rigidity caused by the fixed price. However, this was not the case for the parties in *Scafom International*. Although it was not clear why the parties did not include a price adjustment clause, they did intend to be bound by the contract. Both parties' conducts proved that they intended to proceed with the contract despite market fluctuation; the seller requested for price renegotiation, while the buyer insisted on the original price to apply, despite the fluctuation. Applying both French Civil Code and the UNIDROIT Principles in Court of Appeal and Supreme Court respectively, the courts ordered for price renegotiation to enforce the contract; however, it is questionable whether this reflected the parties' intentions.

Clearly, the courts permitted price flexibility only when the issue of hardship was brought before the courts. An alternative view to this method is if the CISG in itself allowed parties to incorporate a mechanism for price flexibility in the contract, so that recourse need not be had to these external principles each time the court decides to enforce a price term of the contract affected by fluctuation. This is feasible by flexibly interpreting Article 14(1) and thereby removes the dependency of the CISG upon supplemental law such as the UNIDROIT Principles and a State's civil code to provide flexibility to the contract due to changes in market prices.<sup>30</sup>

Undeniably, the UNIDROIT Principles as a model law carries a great merit when correcting such major deficiency of impeding a contract by Article 79 of the CISG.<sup>31</sup> However,

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<sup>29</sup> *ibid* Section 2.4.

<sup>30</sup> Harry M Flechtner, 'The Exemption Provisions of the Sales Convention, Including Comments on "Hardship" Doctrine and the 19 June 2009 Decision of the Belgian Cassation Court', Legal Studies Research Paper Series, Working Paper No 2011-09, March 2011, University of Pittsburgh School of Law, Pennsylvania, <<http://ssrn.com/abstract=1785545>> accessed 29 June 2012.

<sup>31</sup> Article 7(1) CISG: 'In the interpretation of this Convention, regard shall be had to its international character and to the need to promote uniformity in its application....'. Article 7(2): Questions concerning matters governed

Flechtner stressed that the CISG ought to be independent from a supplemental law such as the UNIDROIT Principles.<sup>32</sup> This is based on Article 7(2), which states that a gap under the CISG is to be filled by looking within *its* provisions to determine its general principles, and not by looking *outside* the CISG to determine general international law principles. Reference to the UNIDROIT Principles to renegotiate the contract price indicated that Article 7(2) has been compromised. If tribunals or courts continue to find a gap in a contract that the CISG could not fill, the CISG would be less than an ideal sales law to achieve its goal of creating a uniform international sales law. No doubt that the CISG was drafted to be simple and clear in character but there will always be an endless competition between the civil law and common law systems in proving which of the two incorporates a more familiar traditional approach into the decisions construing the CISG.

### **6.3 Flexibility within Section 2-305(1) of the UCC: an option for the parties at the time of entering into the contract**

Within the four-part responses of Macneil, the UCC utilises the fourth response as it merges both presentation and relational elements under Section 2-305. There would be two possible resolutions to situation in *Scafom International* under the UCC. Since the UCC recognises presentation under Section 2-305(4), the first possibility is that the court would determine if the fixed-price term is the reason for parties to agree to the contract. If a UCC court finds that the parties did wish to set a fixed price, then the change in circumstances would not normally affect the enforceability of the contract. In other words, the price remains fixed, and the risk of fluctuation is borne the relevant party.

The second possibility under the UCC is more interesting. Considering the volatile price of the steel, the parties themselves could have entered into a complete contract from the very beginning, yet left the price term open under Section 2-305(1). Deliberately setting an open price in *Scafom International* would have saved time and cost, as parties could have avoided price haggling process. A fair price could have been negotiated at a later stage, and the price decided would have to have been fair for both buyer and seller. Both buyer and seller in *Scafom International* could validly enter into the contract, yet need not incur court expenses<sup>33</sup>

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by this Convention which are not expressly settled in it are to be settled in conformity with the general principles, in conformity with the law applicable by virtue of the rules of private international law.

<sup>32</sup>Flechtner (n 30).

<sup>33</sup>Gergen, Chapter One (n 9).

to enforce the open price. Open price allows the dealing of goods that are susceptible to market fluctuation to be flexible, regardless of the contract duration.<sup>34</sup>

Even if the parties or parties' agreed pricing method failed to set the price, Section 2-305(1) would allow the court to apply a reasonable price. Section 2-305(1) states that reasonable price at the time of delivery applies in three possible situations: silence of parties as to price,<sup>35</sup> agreement to agree<sup>36</sup> and cases where price was not set by an appointed third party.<sup>37</sup> Clearly, setting a reasonable price secures the validity of a contract that falls in any of these three situations. Applying reasonable price is in line with the aim of the UCC principal drafter, Llewellyn, who stressed that, unless the price at the time of delivery is discriminatory or commercially unreasonable, an objective reference as to price (such as that indicated by the current market) is all that is required for a valid open price under the UCC.<sup>38</sup>

Does this indicate that the UCC enforces every open price agreements regardless of circumstances? With reference to Section 2-615 of the UCC, a contract is unenforceable in impracticable situation. Nevertheless, impracticability does not include cost increase or a change in market condition.<sup>39</sup> Rather, frustrating circumstances such as war, embargo, crop failures, or the failure of a major source of supply that contributes to the market change or prevents a seller from obtaining supplies necessary to the performance of the contract are justifications for impracticability.<sup>40</sup> Clearly, a non-performing party has fewer tendencies to be opportunistic within the limited circumstances of 'impracticability,' which excludes market price changes.

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<sup>34</sup> *ibid.*

<sup>35</sup> Section 2-305(1)(a) of UCC.

<sup>36</sup> Section 2-305(1)(b) of UCC.

<sup>37</sup> Section 2-305(1)(c) of UCC.

<sup>38</sup> Llewellyn, Chapter One (n 102) 699.

<sup>39</sup> JM Perillo, 'Hardship and its Impact on Contractual Obligations: A Comparative Analysis' (April 1996), 1-14, 9 < <http://www.cisg.law.pace.edu/cisg/biblio/perillo4.html> > accessed 8 October 2011.

<sup>40</sup> Section 2-615 of UCC: Note 4 of the Section.

#### 6.4 Flexibility versus frustration within the SGA: which of the two prevails under Section 8?

This section tests the hypothetical impact of Section 8 of the SGA on *Scafom International*. As seen in Chapter Four, the wording of Section 8(1) is: '[t]he price in a contract of sale may be fixed by the contract, or may be left to be fixed in a manner agreed by the contract, or may be determined by the course of dealings between the parties'. Since the parties in *Scafom International* had primarily fixed the terms of the contract including the price of the steel tubes, the contract was valid in accordance with Section 8(1).

However, Section 8 does not state whether a fixed-price contract remains enforceable in spite of changing circumstances. While there is no direct answer to the issue, Section 8(2) limits the application of 'reasonable price' to situations where parties are silent as to price,<sup>41</sup> or where parties have missed or forgotten to set it. Reasonable price does not apply when a fixed-price contract is affected by the market, as in the present case.

Does the limited scope of application of reasonable price under Section 8(2) indicate that the English law perceives a contract such as one in *Scafom International* as frustrated or impracticable? Under the English law, there can be a relief from the total impossibility of performance or the total frustration of the purpose of the contract. However, similar to Section 2-615 of the UCC, the English law does not categorise market fluctuation as a situation of impossibility of performance. While performance was impossible in *Taylor v Caldwell*<sup>42</sup> due to a burnt down of a hired music hall prior to the hiring dates, a 1646 case of *Paradine v Jane*<sup>43</sup> demonstrated that an obligation to pay money differs from impossibility of performance. The fact that the defendant was expelled from his possession by the German prince and army did not release him from the obligation to pay his rent, for the rent was a duty created by the parties, and that 'the law would not protect him beyond his own agreement...'.<sup>44</sup>

The English law would not view the 70% price increase in the steel market as frustration to the contract in *Scafom International*, for a frustration requires 'a change in the significance of the obligation that the thing undertaken would, if performed, be a different thing from that

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<sup>41</sup> *Traditional Structures Ltd v HW Construction Ltd* [2010] EWHC 1530 (TCC); [2010] Construction Industry Law Letter (CILL) 2899.

<sup>42</sup> (1863) 122 ER 309.

<sup>43</sup> (1646) Alyn 26, 82 ER 897 (KB).

<sup>44</sup> *ibid* 898.

contracted for.<sup>45</sup> An increase in the price of labour and materials would not normally impede the performance of the contract.<sup>46</sup> For example, the failure of a supplier to supply the contractual material would not normally frustrate a contract,<sup>47</sup> even if it was caused by electrical fault and interruptions in the supply by rail of raw materials to the sellers, as these occurrences were considered common in the world of business.<sup>48</sup> If a seller makes an unqualified promise to sell, he bears the risk of his contemplated source of supply where that source is not a specific source, or the goods are not specific goods.<sup>49</sup> He is not excused by frustration, unless it is physically impossible for him to deliver the goods.<sup>50</sup>

Avoidance in performing the contract could, arguably, amount to opportunistic behaviour. Applying this principle to the present case, the seller accepted the risk of 70% increment in price. If the seller did not wish to take on that risk, it should have negotiated for the insertion of a price adjustment clause in the contract to cater to the market price. This, of course, is only possible if the legal system allows the parties to insert such clauses in the contract.

#### **6.4.1 Limited efforts of expanding reasonable price under Section 8(2) of the SGA in securing relational sales**

As have been discussed in the earlier section, the SGA would not invalidate the fixed-price term in *Scafom International*. In fact, current trend within the English courts' decisions show that Section 8(2) has been expanded to cover cases of price fluctuations. The approach is similar to CISG, where an English court would modify the contract, but only if the term is left open. A fixed price term that burdens a party in the performance of the contract is unlikely to be enforceable under the CISG and the SGA. This differs from Section 2-305 of the UCC, where deliberate open price is an alternative method of contracting available for the parties beginning from the time when parties enter into the contract.

In modifying contracts affected by the rigidity of presentation, the English courts have resorted to the traditional maxim of *certum est quod certum reddi potest* to flexibly interpret reasonable price under Section 8(2) and have thereby departed from the classic approach of *May & Butcher*. The maxim assisted the court to validate a contract using reasonable price for

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<sup>45</sup> *Davis Contractors v Fareham Urban District Council* [1956] App LR 04/19 (Lord Radcliffe).

<sup>46</sup> *ibid.*

<sup>47</sup> *CTI Group Inc v Transclear SA* [2007] 2 CLC 530 (Comm) (531) (Field J).

<sup>48</sup> *Intertradex SA v Lesieur Tourteaux SARL* [1978] 2 Lloyds Rep 509 (Lord Denning).

<sup>49</sup> *ibid.*

<sup>50</sup> *ibid.*

the handling fee, in the purchases of crude oil in *Mamidoil-Jetoil Greek Petroleum Co SA v Otkra Crude Oil Refinery AD (No 1)*.<sup>51</sup> In addition to the maxim, Rix LJ reasoned that the departure from presentation is possible in three circumstances.<sup>52</sup> There are firstly, commercial dealings where parties are familiar with the trade in question, secondly ‘agreement to agree’ that has come into existence, and thirdly, a contract of future performance over a period, where the parties may desire or need to leave matters to be adjusted in the working out of their contract. In these situations, the English courts would assist the parties to preserve rather than destroy the contract on the basis that what can be made certain is itself certain (*certum est quod certum reddi potest*).

The first situation mentioned by Rix LJ on commercial dealings where parties are familiar with the trade, relates to Llewellyn’s concept of objectivity, where an open price is determinable based on the market price/any objective standard<sup>53</sup> referable at the time of delivery. In the second situation of an ‘agreement to agree’, there is an example from a court decision of *Acertec Construction Products Ltd (formerly BRC Limited) v Thamesteel Limited*<sup>54</sup> where the English court did validate an ‘agreement to agree’ by applying reasonable price when the agreement provided no mechanism to ascertain price in default of agreement. Richard Sibbery QC held that the post-termination mechanisms were utilisable to enforce the clearly-expressed intention of the parties so that the obligations were binding upon the parties. The third situation refers to long-term contract, where matters are adjusted at a later stage of the contract on the basis of *certum est quod certum reddi potest*. Again, the courts should be willing to make certain what is already certain. This correlates well with Berman’s idea that matters are best adjustable based on the gap between the time of contract formation and the time of delivery of the goods, as price fluctuation may take place at any point of time in the gap.<sup>55</sup> This demonstrates the openness of the English court in accepting contract as a planning mechanism rather than a document of specified terms, although the SGA as a sales law has not been as expressive on the issue. In addition, the courts have been more receptive towards the element of trust between the parties in setting the price based on the parties’ familiarity with each other through good repute and repeated interaction in the duration of the contract.<sup>56</sup>

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<sup>51</sup> [2001] 2 Lloyd’s Rep 76.

<sup>52</sup> *Mamidoil* [69].

<sup>53</sup> Llewellyn, Chapter One (n 102) 699.

<sup>54</sup> [2008] EWHC 2966.

<sup>55</sup> Berman, Chapter One, ‘Excuse for Nonperformance’ (n 2).

<sup>56</sup> Good repute and repeated interactions are elements of a contract that self-enforces, (See Scott, Chapter One, ‘A Theory of Self-Enforcing’ (n 158) 1).

Bearing in mind however, that *Scafom International* is distinguishable from *Mamidoil* and *Acertec* as it was a contract where the parties fixed the price upfront, without any reference to a price adjustment clause. An English court does not enforce a contract where parties have fixed the price, but affected by changing circumstance. Flexible interpretation of Section 8(2), (as seen in *Mamidoil*) is feasible only if the parties leave the price open whereby the court is willing to maintain the equilibrium of the contract by applying a fair and reasonable price for both buyer and seller.<sup>57</sup>

Within the English law, elements of co-operation, flexibility and trust are not new ideas,<sup>58</sup> although the current English law is regarded to have fallen out of step with commercial practice<sup>59</sup> and no longer reflects the reality of the market.<sup>60</sup> Although Macneil's relational contract theory is not well-received in many decisions, recent trends exemplified in *Mamidoil* and *Acertec Construction* prove that English judges have been prepared to depart from the rigidity of requiring a definite or fixed price on the ground of the relational nature of a trade. In trades that typically involve a considerable gap between the time when the contract is formed and the time when actual delivery of the goods takes place, market fluctuations are common affairs, and the courts now recognise that parties should have the option of providing for their own price renegotiations. This applies not only to *Scafom International*, but also to *Rafsanjan* discussed in Chapter Four,<sup>61</sup> where the parties could have opted for open price in order to allow for unforeseen circumstances and to save litigation costs. Open price allows long-term contracts to function as planning documents, instead of documents that specify terms,<sup>62</sup> which often leads to hardship in performance during price fluctuations.

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<sup>57</sup>This remedy is not available under the UNIDROIT Principles, for a failed renegotiation means the court is to terminate the agreement or even imposed a term into the contract which the parties had never agreed to in the first place (Article 6.2.3).

<sup>58</sup> This is supported by the analysis of the case of *Baird Textile v Marks and Spencer Plc* (2003) (HL) [51] (Baroness Mulandrew) in *Feminist Judgments From Theory to Practice* (Rosemary Hunter, Clare McGlynn, Erika Rackley (eds), Hart Publishing 2010).

<sup>59</sup> *ibid* [37].

<sup>60</sup> *ibid* [50].

<sup>61</sup> Chapter Four, Section 4.4.1.

<sup>62</sup> Macneil and Gudel, Chapter One, *Contracts: Exchange transactions and relations* (n 129) 2.

## 6.5 Conclusion

While open price is an ideal alternative method in countering uncertainty in price, a fixed-term contract is generally preferable when both parties know the probability of all possible outcomes. In fact, if a buyer wants to be assured of a supply and that the seller is risk neutral, a fixed price works in such a relationship. Otherwise, as illustrated by the *Westinghouse* case, (as discussed in Chapters One and Two) the fixing of terms, particularly the price term, can make the overall sale unworkable. In *Westinghouse*, the fixed-price term caused the risk of the changing price to be unevenly distributed between a buyer and a seller. This is particularly true when the seller is at higher risk to honour the contract.<sup>63</sup>

Clearly a similar effect of *Westinghouse* is seen in *Scaфом International*, which illustrates the unworkability of a relational sale when a price is fixed and the parties cannot be confident that the courts will uphold an agreement with an open price. In fact, parties greatly depend on the courts to provide flexibility to counter the hardship caused by the fixed-price contract during market fluctuations. In *Scaфом International*, the parties might have wished to have left the price open, as steel products have reference as to market price at the time of delivery. Alternatively, the parties might have included flexibility by agreeing on a voluntary renegotiation clause in case the market price fluctuates. While renegotiation seems ideal in keeping the contract in line with the current market conditions, the highlight of the UCC is that it validates deliberate open price as a choice for the parties at the time of entering a contract, as opposed to remedying the situation using price renegotiation after hardship / fluctuations occur. However, under the CISG, it was not clear that either route was possible.

Cases involving situations such as that of *Scaфом International* are common, and raise a crucial question of how a sales law resolves the unenforceability of a fixed-price in market fluctuations. While the CISG courts have successfully effected renegotiation in this case, recourse needed to be had to external principles, i.e. the UNIDROIT Principles, instead of relying on the CISG itself. There is no option for deliberate open price. Even if the parties did opt for open price, Article 55 is often bound by the interpretation of Article 14(1), which

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<sup>63</sup> Polinsky has proven the effectiveness of an open price in a situation of uncertain risk on the part of the seller (and a neutral risk on the part of the buyer) to allow estimation of the cost in order to supply the goods to the buyer. If both buyer and seller are equally at risk, an open price with a floor or minimum price is agreed. If it is only the buyer who is at risk, and the seller could precisely determine his costs, then a fixed price term would have worked for the business relationships, regardless of duration of the contract (Polinsky, Chapter Two (n 116) 40).

means that the CISG court would not necessarily enforce the contract when circumstances changed. In fact, Article 55 applies ‘price generally charged at the time of the conclusion of the contract for such goods sold under comparable circumstances in the trade concerned’ which does not address the impact of the 70% price increase that has affected the seller in order to deliver the goods.

The English law would have not perceived the situation of *Scafom International* as to have been frustrated, at the same time it would not modify the contract for the parties as the price was agreed and fixed. In *Mamidoil*, the contract was enforceable because the parties left the price open. The court applied reasonable price (or rather the reasonable fee on the open handling fee) using the old legal maxim *certum est quod certum reddi potest* (that is certain which can be made certain) open term.<sup>64</sup> Open price has been an acceptable concept, although not expressly acceptable statutorily. More than eight decades ago, Scrutton LJ took a similar approach to secure the agreement to agree on a petrol price in *Foley v Classique Coaches*,<sup>65</sup> using the principle in *The Moorcock*.<sup>66</sup> As a commercial code, the UCC stood out in its efficiency with relational contracts; not only by securing the validity of relational sale during price fluctuations but by also providing the parties to flexibly price the goods, in lieu of the traditional fixed-price method, from the time parties enter into the contract. The UCC is not a flawless sales law but its trait of enabling a balance between flexibility and certainty of a contract is commendable. Clearly a similar concept is implementable by the SGA and the CISG, given the fact that these sales laws implement flexibility only to remedy hardships, rather than provide extensive flexibility as a method of contracting method for contracting parties.

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<sup>64</sup> Rix LJ directly applied the maxim to hold that there was a valid contract in *Mamidoil-Jetoil Greek Petroleum Co SA v Oka Crude Oil Refinery AD (No.1)* [2001] EWCA Civ 406 by stating that Lord Dunedin has invoked this maxim in *May and Butcher v The King* (1934) 2 KB 17, 21.

<sup>65</sup> *Foley v Classique Coaches Ltd* (1934) 2 KB 1, 10.

<sup>66</sup> (1889) LR 14 PD 64.

## Chapter Seven: Conclusion

The thesis has covered the issue of validity of open price in relational sales, and how open price benefits long-term businesses, yet secures the business relationships from being invalidated by the classic fixed-price requirement. The analysis proves that the UCC provides the advantageous open-price method for the parties in dealing with relational sales, and how the fixed-price method detrimented the parties in *Scafom International*, in that it imposed hardship for the seller in order to honour the contract.

Clearly not every sales law responded to the needs of relational contracts in the like manner to the UCC. Macneil explained the four ways in which a sales law that based its principles on presentation could respond to problems relating to relational contracts. A sales law may firstly, not apply at all to the relational sale, or may interpret a relational contract based on the presentation character of the sales law itself, or uphold its presentation characteristics as an integral part rather than its ultimate goal of the law, (which means that flexible interpretation of rigid provisions is allowed to fit with the relational element) and finally, a sales law may be changed in terms of its overall structure by merging both the presentation and the relational elements of its provisions, as seen under the UCC.

As profit clearly is the central aim of every sale, every effort, not only of the parties but also of the sales law, should respond to relational contracts in such a way that they realise the mutual goal of buyer and seller in obtaining profit as agreed from the contract. Neither party should be opportunistic of each other so that joint profits could be maximised in the fairest possible manner. This thesis recommends increasing the adaptability of a sales law with the unpredictable prices of goods during market price fluctuations. To enhance the adaptability of a sales law, this thesis accepts the implementation of presentation as an integral part, rather than an ultimate goal, of a sales law. If parties know the probability of all possible outcomes, they should be able to fix the price term with full certainty.<sup>1</sup> However, in cases where parties cannot easily predict the future price of goods, they could still enter into a contract with full certainty using an open price term. Using open price, the contract is secured from being invalidated by hardship caused by fluctuations of price. This idea is practical when a contract

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<sup>1</sup> Gergen, Chapter One (n 9) 1055 (n 173).

involves goods that have volatile price such as steel, oil and seasonal goods. The effectiveness of open price is thus tested by this thesis in three distinct sales laws.

The selected jurisdictions are the US, England and the international sales law of the United Nations. The UCC in the US was chosen as it demonstrates the fourth response listed by Macneil: it merges both relational and presentation elements, and overall, has been able to adapt to most relational contracts. The current thesis chose it as a model law because of its success in reviving the practice of the international community of merchants engaged in trade in the modern relational sales. The UCC expressly legalises 'open -ended' contracts, departing from the classical view that every sale must have a price term. Section 2-305 of the UCC clearly states that as long as parties intend to be bound by an open-ended contract, leaving a price term open based on the nature of the trade or a mere failure of an agreed price determination method should not vitiate a deal.

The second sales law namely, the SGA in England, was chosen by this thesis for its important role in the past, within the sale of international commodities involving multinational traders, who were not necessarily English. It also played a leading role in the sale of cotton and homogenous commodities to foreign parties and/or in contracts that did not take place in England. Based on Macneil's method of response, as a sales law, the SGA seems to respond to relational sale by maintaining its presentation characteristics. While it has had a long history of absorbing mercantile traditions into its body of law, the current Sections 8 and 9 of the SGA do not resolve situations of deliberate open price or of failure of the set price mechanism, even in cases where the parties do intend to be bound by the contract. Section 8(2) sets a limitation whereby the mercantile principle of reasonable price applies only in cases of the unintentional omission of a price term, excluding cases of intentional open price, which is often used to better adapt to price uncertainty. Although it seems that the English courts have been successful in interpreting Section 8(2) in a flexible manner (complying with Macneil's third method of response), the SGA in verbatim holds strong presentation characteristics that may have suited many transactions in the past, but are not necessarily appropriate for relational contracts, which are often long-term and involve the risk of price changes.

The third sales law chosen for the comparative study in this thesis was the United Nations CISG 1980. The CISG serves the development of international trade based on equality and

mutual benefit, promoting friendly relations between states. The CISG takes a dual approach to price fixing, under Articles 14 and 55. While the articles were drafted for various member states as part of the compromising nature of the CISG, open price terms under Article 55 are often considered sufficiently definite price terms under Article 14. This makes the concept of open price, in its truest sense, questionable under the CISG. The CISG addresses the issue of open price using two responses; firstly, by requiring the presentation of the price term under Article 14(1) and secondly, by allowing some form of price flexibility under Article 55, particularly in the case of unintended omission of price (but not necessarily of intentional open price in relational contracts).

This thesis has addressed the fact that open price is a practice that is tailored to meet the needs of certain industries and is derived from the principles of law merchants, where contracting parties have a duty to renegotiate the contract to adapt to changed circumstances. The relevance of open price continues not only to the trade of the merchants of the eighteenth century, but also to today's trades. However, the SGA and the CISG have been limiting the validity of intentional open price. The SGA was designed by Chalmers based on a small-scale basis that involved less complex markets, and the CISG has a compromising nature between fixed and open price policies in two distinguished provisions, namely Articles 14(1) and 55. As a result of these limiting features, the courts in both jurisdictions often resort to the external principles found in non-sales decisions in order to enforce open price; the CISG court for example, resorted to the external principle of Article 6.2.2 (1) of the UNIDROIT Principle,<sup>2</sup> while the SGA court resorts to principles found in non-sales decisions such as *The Moorcock*<sup>3</sup> to effect flexible open price terms. Both external rules have been used to depart from the presentational nature of the sales laws, by deriving the intention of the parties under the circumstances of relational trade.

In this thesis, the ideas of Llewellyn, Macneil and Scott have substantiated the need for open price in relational sales. Scholars unanimously agree that the extra-legal norm of flexibility is part of relational sales, which tend not to be as predictable as discrete transactions. Flexibility in setting the price allows restoration of the equilibrium of contracts so that one party does

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<sup>2</sup> As seen in *Scafom International* case analysed in Chapter Six. Belgium 19 June 2009 Court of Cassation [Supreme Court] < <http://cisgw3.law.pace.edu/cases/090619b1.html> >

<sup>3</sup> (1889) LR 14 PD 64.

not opportunistically gain from the excessive loss of another. If the price is rigidly fixed, the contract tends to be unbalanced when market price changes.

In *Westinghouse*,<sup>4</sup> the sale of fixed-price uranium was a burden upon the seller, who had to honour the contract when the price increased from 12 to 40 dollars. In such a situation, contractual adjustment by court was crucial to rebalance the contract. The uranium industry affected by price fluctuations from early 1970s is an example of a relational industry that experienced a shift from the fixed-price method, to open-price method based on the market price, price index and voluntary renegotiation clauses.<sup>5</sup>

Applying the UCC as a model law, the thesis statement found in Chapter Two proposed greater adaptability, and fewer presentational features under the SGA and the CISG in requiring a fixed price. Based on the self-enforcing nature of a relational, long-term contract between parties, as well as on the commercial context of trades, an open price rather than a fixed price is convenient, as long as parties are proven to have intention to be bound. Presentiating the future price, on the other hand makes the long-term, relational deal less viable in times of fluctuation, as the parties do not know the precise risks they are facing. A strict compliance with classical contract law that demands rigidity in price-fixing is ‘a convenient trap-door through which the imprudent or unscrupulous obligor can escape, which may leave the innocent obligee to suffer loss of expected benefits and also potentially, loss to subpurchasers’.<sup>6</sup>

Chapter One explained the history of the incompleteness of contracts that were common among merchants before the eighteenth century. Gradually, the law merchant became less influential in codified sales law, due to the efforts of national judges and legislators, and commercial law was nationalised and separated from the practice of the merchants, not only in England and the US, but also in France, Germany and other European countries. However, in the US, the UCC has fully upheld the traditions of the merchants. The practice of the international community of merchants engaged in trade across national boundaries has been well-absorbed by the UCC, proving the relevance of mercantile elements such as the use of flexible, open price term in sales contracts.

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<sup>4</sup> 580 Federal Reporter, Second Series 1311 (7<sup>th</sup> Cir), 99 Supreme Court Reporter 353 (1978).

<sup>5</sup> Polinsky, Chapter Two (n 116) 23.

<sup>6</sup> Berman, Chapter One, ‘Excuse for Nonperformance’ (n 2) 1437.

In Chapter Two, practices in industries such as natural gas, aluminium, petroleum coke, coal and uranium were summarised in terms of the shift of sales contracts from the traditional fixed-price method, to more flexible methods such as the use of a price index and voluntary renegotiations between the seller and the buyer. This change in method of contracting made agreements more workable, maintained co-operation between the parties, saved parties' costs and time of haggling over uncertainty of price and most importantly, ensured performance at a fair price. The extensive study by Macneil concludes that the failure of classical contract law was due to its unrealistic demands for presentiation. While presentiation works in discrete transactions, it barely works for highly planned, very extensive inter-firm contracts between large, legally independent yet economically interdependent firms. Parties will find it difficult to predict the future.

Chapter Three on the UCC began with an explanation of the Uniform Sales Act, which was not receptive of the practice of the merchants. This was due to the Willistonian formalism that originated from the common law principle, which could barely cope with the needs of the trade practice. Recognising the applicability of price flexibility in various industries, Llewellyn demonstrated that a deal between merchants is a matter of collective, rather than of individual self-interest.<sup>7</sup> The UCC was established based on the principle of the law merchants' principle that each party had a good faith obligation to renegotiate the contract if there was a need to adapt it to changed circumstances in order to ensure continued performance from both parties.<sup>8</sup> This is supported by Scott, who believed that the merchants typically entered into open term contract, relying upon the notion that their contracts were self-enforcing in nature.<sup>9</sup> According to Scott, self-enforcement is extensible to contracts between strangers, although this type of contract is not covered by this thesis.

The mercantile manner of business practice is practical and convenient, and, more importantly, saves on costs for both buyer and seller. Without court adjustment to contracts, they could be designed to be adaptable to the changing market in the first place. Both Chapters Four and Five explained the limitations under the SGA and CISG respectively. Firstly, Chapter 4 explained the limitation of the SGA on open price. The current Section 8(2) of the SGA limits the application of reasonable price to cases of unintentional omission of the

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<sup>7</sup> Scott, Chapter Three 'The Rise and Fall of Article 2' (n 23) 18.

<sup>8</sup> Lando, Chapter One (n 53) and Mustill, Chapter One (n 54).

price term. If the UCC is not adopted, English courts will struggle to distinguish cases like *May and Butcher*, from cases like *Foley*. Persistent mistake for courts was applying the ‘presentation’ method under Section 8 in cases where the trade does not require parties to presentiate. Factors such as parties’ experiences, established practices and intentions are less prioritised, and English courts continue to decide cases based on their facts and circumstances. While this method is workable, it cannot allow for market changes.

Chapter Five explained the limitations of the CISG with regard to open price. While Article 55 of the CISG allows open price to be determinable by operation of law, it is often bound by Article 14’s interpretation of what amounts to a sufficiently definite contract. Often, the CISG courts decide whether a contract contains an implicit price instead of using Article 55 to determine the reasonable price for the parties.

Chapter Six analysed *Scafom International* and found that, a fixed price is not the ideal method in the case of long-term steel trading contracts, which are highly relational in nature. In this case, the parties made the mistake of presentiating the price for the steel tubes. The contract was risky due to price fluctuations. To rebalance the contract, clearly renegotiation is the ideal solution *post* the agreement, but open price is the more useful alternative when comes to deciding the *ex ante* profits of an agreement. An open price could have prevented the parties from needing to haggle, and they may have avoided incurring court costs. If the price had been open, it could have been determined using the agreed method. If the price of the goods had been fixed, it would nevertheless have required adjustment at a later stage in order to ensure that no profit was gained through excessive loss of the other.

In conclusion, where full adoption of the UCC’s approach does not take place, the provisions of Section 8(2) of the SGA and Article 55 of the CISG could be flexibly interpreted to allow parties to make contracts more suited to the situations in cases such as *Westinghouse* and *Scafom International*. Although it is arguable that in risky trades the duration of a contract could be reduced by terminating the agreement in times of market volatility, an open price stands as a useful alternative and avoids unnecessary termination. It reduces the conflict between the need to fix responsibilities at the outset and the need to readjust them over the duration of a long-term contractual relationship. Excluding situations of frustration of contract, where performance of a deal is entirely impossible, parties may still be bound by an

open-price contract. Such an arrangement would make a deal enforceable in times of price fluctuation and leave no room for opportunism.

Macneil stated that the need for a contract law system that enhances discreteness and presentation would never disappear. However, Macneil also pointed out that such a system ‘may rub in an unnecessarily abrasive manner against the realities of coexistence with relational needs for flexibility and change’.<sup>10</sup> The reason for such abrasion is that relational contracts require the flexibility to adapt to changes. To minimise unnecessary abrasion between relational contracts and the presentational nature of classical contract law, it is preferable to view elements of presentation as integral parts of overall contract law rather than as an independent system. The abrasion would not disappear, but abrasion resulting from the application of contract laws based on the assumption that contractual relationship is entirely based on written contract would disappear.<sup>11</sup>

Therefore, a flexible interpretation of the current provisions under the SGA and the CISG with regards to open price is warranted. This means that, even if full adoption of the UCC’s concept of open price does not take place, the English and the CISG courts may still play crucial roles in interpreting Section 8 and Article 55 flexibly. As a result, the validity of intentional open-price contracts within specific, long-term trades would not be unnecessarily impeded by presentation. Thus far, the UCC has been an exemplary model permitting open price based on ‘reasonable price’ and on prices set in ‘good faith’- both concepts being very much anti-presentiating in nature.<sup>12</sup>

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<sup>10</sup> Macneil, Chapter One ‘Adjustment of Relations’ (n 108) 888.

<sup>11</sup> *ibid* 888.

<sup>12</sup> *ibid* 885.

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