Logistically Speaking: Using Delivery Terms to Allocate Supply Chain Risks

Allen L. Anderson, Lawyer
FEES & BURGESS, P.C.
256/536-0095; anderson@feesburgess.com

Jeffrey L. Roth, Lawyer
FEES & BURGESS, P.C.
256/536-0095; jroth@feesburgess.com

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Abstract: Commercial contracts involving transportation customarily contain abbreviated delivery terms, or trader's shorthand, that seek to allocate among buyer and seller any multitude of risks within an applicable supply chain. Specifically, these abbreviations, which may be only three letters in length, can conclusively define when, where, and how a buyer takes delivery; who arranges for, and the actual manner of, transportation; price and place of payment; time when risk of loss shifts from seller to buyer; who bears costs associated with freight and insurance; and who is ultimately responsible for export and/or import compliance. Failure to understand the applicable delivery term governing any shipment may expose your company to undue risk and unanticipated expense. This paper seeks to avoid such by discussing the current and changing landscape regarding delivery terms, and then offering some practical advice on usages of such terms in connection with your particular supply chain.

Longstanding Inconsistency Among Delivery Terms: Within the United States, domestic law traditionally defined the delivery terms applicable to domestic sales. Most often, those terms could be found in various state enactments of the Uniform Commercial Code (UCC). However, other versions of delivery terms, that may or may not be consistent with those appearing in the UCC, might also derive, in part, from National Motor Freight Classification or even industry practice. Worst yet, some states have also defined additional or alternative delivery terms for international sales, that, again, may or may not be consistent with those appearing in the UCC or deriving from National Motor Freight Classification or industry practice. To add to the inconsistency, many contracting parties – particularly those in an international context – simply defined for themselves the applicable delivery term by incorporating definitions from foreign legislation or private rules, including the "Incoterms," published by the International Trade Commerce. Mistakes in definition or express clarification of the precise source of the delivery term utilized has given rise to unknown risks and danger in more than one commercial contract involving transportation.

Changes in Domestic Law: The American Law Institute and the National Conference on Commissioners on Uniform State Laws deleted from the newest proposed version of the UCC the shipping and delivery provisions previously governing domestic commerce, describing the use of such domestic terms as inconsistent with modern usage in our ever-expanding global-trade economy. There were no recommended substitutes for the deleted provisions. Some members of the supply chain have responded by using the old, now-outdated, UCC terms. However, as state legislatures ratify the newest version of the UCC, users of old UCC terms will gradually lose the benefit of generally accepted definitions, and usages will become increasingly vague, inviting even greater risks of misunderstanding, controversy, or worse. Many will seek a replacement for deleted UCC provisions. We believe the most suitable replacement to be the most widely used private trader terms – Incoterms.

Are UCC Delivery Terms Really Gone: So far, no state legislature has adopted the most recent revisions of the UCC. However, the American Bar Association endorsed the revisions, which may provide some impetus for action by state legislatures.

International Commercial Terms of Sale ("Incoterms"): Incoterms were prepared by the International Chamber of Commerce. They are not law, and merely function as custom. Incoterms 2000 is the current, and sixth revision, of the original that was first published in 1936. Although Incoterms are specifically designed for international trade, they have been used for domestic business within the European Union and elsewhere for many years. Incoterms should work well for domestic trade in the United States if one simply ignores the references to export and import clearance.

There are 13 Incoterms that describe responsibility for arranging shipment; who pays for shipment; how far goods will be shipped by one party before the other party takes control; where risk of loss passes; responsibility for insurance; and responsibility for export/import customs. Notably, Incoterms do no determine when title passes. They do however determine when delivery is made and when risk passes.

Under Incoterms, the seller always bears responsibility to have the goods packaged for export and ready on time; to meet quality assurance to sample or specification; and to make delivery in accordance with the Incoterm used. The seller also always prepares invoices; packing lists; and other documents at buyer's "request, risk, and expense." The buyer, meanwhile, has responsibility to accept delivery in accordance with the Incoterm used. The buyer also has the right to inspect goods to ensure conformance with specification or sample. Export and import clearance, insurance, carriage, loading and unloading – and virtually everything else – are areas of negotiation under Incoterms 2000. To that end, Incoterms are separated into four different groups (E, F, C, and D), which increasingly shift the level of responsibility for transportation risks from buyer to seller.

E-Term, a/k/a Departure Term (Incoterms 2000): In an Ex-Works or "EXW" contract, seller delivers when it places goods at "disposal of buyer," and all responsibility, costs, and risk pass to buyer immediately upon such delivery. This term, the only E-Term, represents the minimum obligation for seller.

<u>Beware</u>**:** A U.S. Principal Party in Interest ("USPPI") is that U.S. party benefiting most from the transaction, and is the party ultimately responsible, under U.S. law and regardless of contract, for export clearance. Moreover, a USPPI cannot generally delegate such responsibility. Yet, in an international sale negotiated EXW, buyer is contractually required to handle export clearance. Accordingly, if seller is the USPPI, it will bear regulatory responsibility for export clearance, but without having control of same. This issue can best be avoided by utilizing FCA, or another Incoterm, as discussed below.

F-Terms a/k/a Main Carriage Unpaid Terms (Incoterms 2000): Several of the common trade terms begin with the word "free," meaning seller has the obligation to deliver goods to named place for transfer to carrier.

- **Free Carrier, or Free Carrier Alongside ("FCA"):** FCA requires seller to deliver goods, cleared for export, to a particular carrier at a named terminal, depot, airport, or other place carrier operates. Risk of loss and liability for cost of transportation shifts from seller to buyer upon making delivery.

- **Free Alongside, or Free Alongside Ship Contracts ("FAS"):** FAS requires seller to deliver goods to a named port alongside a vessel to be designated by buyer and in a manner customary to a particular port. "Alongside" means goods are within reach of ship's lifting tackle. It can be difficult to obtain a document that shows goods were brought alongside a ship. Accordingly, FCA is generally a better term.

- **Free on Board ("FOB"):** FOB requires seller to deliver goods on board a vessel that is to be designated by buyer and in a manner customary at a particular port. "On board" means goods have been appropriated to the contracts and have crossed rail. FOB is limited to seaborne commerce in most of the world, and Incoterms uses FOB only in connection with carriage of goods by sea. In common-law countries, FOB also applies to inland carriage aboard any "vessel, car, or other vehicle."

  <u>Beware</u>: Much of the inconsistency and confusion described earlier in this paper results from many would-be U.S. sellers utilizing an FOB Incoterm. Too often, U.S. buyers assume "FOB" UCC, but it has an entirely different meaning from its Incoterm counterpart. The misunderstanding may place undue risk or expense on one party, or may undermine the entire transaction.

C-Terms a/k/a Main Carriage Paid Terms (Incoterms 2000):

- **Cost, Insurance, and Freight ("CIF")**: CIF requires seller to arrange for carriage of goods by sea to the port of destination, and to turn over to buyer documents necessary to obtain goods from carrier or to assert a claim against the insurer if goods are lost or damaged. Three documents represent the CIF contract: invoice; insurance policy; and bill of lading. Seller's duty is to deliver documents to the buyer. The buyer's responsibility is to pay seller upon delivery of documents.

- **Cost and Freight ("CFR"):** CFR is the same as CIF, except seller does not have to procure marine insurance against risk of loss or damage to goods during transit.

- **Carriage Paid To ("CPT"):** In a CPT contract, risk passes when goods are on board carrier. Seller selects the carrier and pays freight to a named point. CPT applies to any mode of transportation.

- Λ **Cost and Insurance Paid To ("CIP"):** In a CIP contract, risk passes when goods are on board carrier. Seller selects carrier and pays freight to named point. CIP applies to any mode of transportation.

D-Terms a/k/a Arrival Terms (Incoterms 2000):

- Λ **Delivered Ex-Ship ("DES"):** DES requires seller to deliver goods to buyer at an agreed port of destination. Seller remains responsible for goods until they are delivered. Seller is not obligated to obtain insurance for buyer's benefit. DES applies to goods shipped on water only.

- Λ **Delivery Duty Unpaid ("DDU"):** In a DDU contract, risk passes when goods are unloaded at a named point. Seller selects carrier and pays freight to the named point. DDU applies to any mode of transportation.

- Λ **Delivery Duty Paid ("DDP"):** In a DDP contract, seller selects carrier and pays freight to a named point. Risk passes when goods are unloaded at named point, goods clear customs, and duty is paid. DDP applies to any mode of transportation.

  Beware: It can be excessive risk for seller to be responsible for customs clearance in buyer's country. This is essentially the opposite of EXW.

- Λ **Delivery Ex Quay ("DEQ"):** DEQ is generally used only for ocean charter shipments. Seller delivers when goods placed at disposal of buyer not cleared for import on the quay (wharf) at named port of destination. Seller bears all costs and risks involved in bringing goods to named port of destination and discharging goods on quay. DEQ requires buyer to clear goods for import and to pay for all formalities, duties, taxes, and any other charges upon import.

- Λ **Delivered at Frontier ("DAF"):** FCA border point accomplishes the same result as DAF. Buyer acquires risk and responsibility for clearance with import customs. DAF applies to any mode of transportation.

Choosing the Right Incoterm: When choosing the right Incoterm, it is important to keep in mind shipping costs, political considerations, and how much shipper/buyer is willing to pay to minimize risk.

Famous Last Words: Unlike the UCC, Incoterms distinguish among modes of shipping. FAS, FOC, CFR, CIF, DES, and DEQ are applicable only to water. If shipment involves intermodal transportation, especially in the supply management organization's country, or is going to be entirely on land, stick to EXW, CPT, CIP, DAF, DDU, and DDP to avoid surprises when it comes to paying for shipping, customs clearance, or insurance.

Also, beware of previous versions of Incoterms. Previous versions of FAS imposed responsibility on buyer to arrange export customs clearance, but the 2000 version puts that burden on seller. Similarly, previous versions of DEQ imposed the burden on seller to arrange for import customs clearance, but the 2000 version puts that burden on buyer.

Conclusion: Using the correct delivery term does not guarantee a profitable commercial transaction. However, a mistake in the delivery term will almost guarantee lowered profits, through inefficient logistics and/or higher prices or lower margins. Fortunately, a thorough understanding of this paper, and its subject matter, should assist in avoiding any number of surprises in your transaction.