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Commercial Law Challenges in the 21st Century

Jan Hellner in memoriam

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Ethical Values and International Sales Contracts

I. Introduction

1. Business and Ethics?

Before turning to the subject-matter of this article, it is appropriate to explain what business or contract law has to do with ethics and how this issue becomes relevant in modern international sales contracts.

Years ago, business and ethics were as far apart as to be viewed as some kind of contradiction. According to leading economists – such as the “The Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel” winner Milton Friedman – “the business of business is business”.¹ Companies’ only social responsibility was thought to be to use their resources to make profits for their shareholders.² The corporation, as such, was simply

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¹ See MILTON FRIEDMAN, *The Social Responsibility of Business is to Increase its Profits*, The New York Times Magazine, 13 September 1970, online available at <<http://www.colorado.edu/studentgroups/libertarians/issues/friedman-soc-resp-business.html>> (23 March 2006).

² See MILTON FRIEDMAN, *Capitalism and Freedom*, Chicago/London 1982, p. 133. See also PETER MUCHLINSKI, *The Development of Human Rights Responsibilities for Multinational Enterprises*, in: Rory Sullivan (ed.), *Business and Human Rights*, Sheffield 2003, p. 33–51, p. 35, listing the arguments against the extension of human rights responsibilities to transnational corporations.

used as a means to an end.³ Human rights were seen as belonging to the realm of government concerns, not of companies, and human rights violations as internal political issues, with which companies should not, on principle, interfere.⁴

It is, therefore, no wonder that the early age of industrialization is known as one of the darkest chapters in history regarding human rights and the protection of the environment. In 1788, for example, children made up two-thirds of the workforce on powered equipment in 143 water mills in England and Scotland.⁵ Only slowly did governments start to realize that such corporate behavior was unsustainable and react with the enactment of legislation. Thus, first and foremost it was – and still is today – the duty of *states* and the *community of states* to legislate and then enforce such regulations in order to prevent unethical behavior by any actor of society, inclusive of business enterprises. But is that tool still efficient today? In an age of globalization and, most importantly, of so-called “failing states” – states in which the government is unwilling or unable to guarantee the rule of law by deciding and implementing state-of-the-art legislation –, reliance on the state has, in fact, lost its power to guarantee minimum ethical standards. “*Effective enforcement remains the crucial missing piece of the regulatory puzzle*”.⁶ This is one of the reasons why globalization is sometimes seen as causing a “race to the bottom”.⁷ But, failing action by the states, who is then responsible and powerful?

During recent years, publicly listed firms, especially those acting on a global level, have started to realize that ethical behavior can, in fact, have a positive impact and, conversely, unethical behavior a negative impact on their business. A recent study by Claude Fussler concluded that responsible

³ See MILTON FRIEDMAN, *Capitalism and Freedom*, op. cit. (fn 2), p. 135.

⁴ See GEOFFREY CHANDLER, *The Evolution of the Business and Human Rights Debate*, in: Rory Sullivan (ed.), op. cit. (fn 2), p. 22–32, p. 24.

⁵ Survey cited in DOUGLAS GALBI, *Child Labor and the Division of Labor in the Early English Cotton Mills*, in: J. Pop. Econ. 1997, Vol. 10, pp. 357–375, p. 357, available online at <<http://www.galbithink.org/child.pdf>> (23 March 2006).

⁶ See BETH STEPHENS, *The Amoralism of Profit: Transnational Corporations and Human Rights*, Stefan A. Riesenfeld Symposium 2001, in: Berkeley J. Int’l L. 2002, Vol. 20, pp. 45–88, p. 82.

⁷ See the study by ANITA CHAN, *Globalization and China’s ‘Race to the Bottom’ in Labour Standards*, Research School of Pacific and Asian Studies, online at <<http://rspas.anu.edu.au/ccm/morrison/morrison02.pdf>> (23 March 2006). But see the ‘race to the top’ noticed by the World Bank with regard to environmental standards in THE WORLD BANK (ed.), *Is Globalization Causing a ‘Race to the Bottom’ in Environmental Standards*, in: Assessing Globalization, World Bank Briefing Papers, Part 4, online at <<http://www1.worldbank.org/economicpolicy/globalization/documents/AssessingGlobalizationP4.pdf>> (23 March 2006).

excellence pays.⁸ According to his study, 76 companies publicly committed to social corporate responsibility made it to the Dow Jones Sustainability Index⁹ (DJSI World Index) and outperformed the Morgan Stanley Capital Index (MSCI) by 3.7% over the analyzed three-year period between June 2001 and June 2004. It has been statistically shown that corporate reputation does indeed translate into financial value.¹⁰ The problem is that measuring the return-on-investment with regard to ethical behavior is little more than guesswork. “*Investment is easier to quantify than increased opportunities from an enhanced reputation*”.¹¹ Given the different factors that also play a role in such studies and that influence the outcome and the performance, it is perhaps more convincing to take the opposite approach and show that unethical behavior does not pay: “*If you think compliance with ethical criteria is expensive, try non-compliance*”¹². Shell, for example, faced a tremendous loss of reputation in 1995 when the story was spread that it had tried to sink a platform – the “Brent Spar” – that was allegedly still contaminated with oil. In 1984, Union Carbide Corporation was ordered by the Indian Supreme Court to pay US\$ 470 million because of the release of methyl isocyanate that caused the death of 15,000 people and disabled another 170,000.¹³ Another example is Bridgestone: in November 2005, the International Labor Rights Fund filed an Alien Tort Claims Act case against Bridgestone before a US District Court in California based on alleged forced labor on the Firestone plantation in Harbel, Liberia. According to the claim,¹⁴ tappers on that plantation are required to tap more than 650 trees a day. This means that, in addition to other mandatory tasks, including cleaning the taps, applying pesticides and fertilizers to the trees, and carrying 75-pound buckets of latex to collection points up to a mile away – all for US\$ 3.19 a day –, they have

⁸ See CLAUDE FUSSLER, *Responsible Excellence Pays!*, in: JCC 16 (2004), pp. 33–44, online at <http://www.unglobalcompact.org/docs/news_events/9.5/jcc16fussler.pdf> (23 March 2006).

⁹ The DJSI track the financial performance of the leading sustainability-driven companies worldwide. For more details see <<http://www.sustainability-indexes.com>> (23 March 2006).

¹⁰ See RENÉ KIM/ERIK VAN DAM, *The Added Value of Corporate Social Responsibility*, 2003, online at <<http://www.triple-value.com/upload/docs/addedvalueofCSR.pdf>> (23 March 2006).

¹¹ See KLAUS LEISINGER/KARIN SCHMITT, *Corporate Ethics in a Time of Globalization*, 2nd ed., Basel/Colombo 2003, p. 78.

¹² See KLAUS LEISINGER, *Unternehmensethik in Zeiten der Globalisierung: Idealistische Verirrung, Wettbewerbsnachteil oder Marktchance?*, in: Schwäbische Gesellschaft (ed.), *Schriftenreihe* 44–47, Stuttgart 2003, pp. 49–89, p. 74.

¹³ See this case outlined by DAVID WEISSBRODT, *Corporate Human Rights Responsibilities*, in: zfwu 2005, pp. 279–297, p. 281. For more information regarding this case, see <<http://www.bhopal.com>> (23 March 2006).

¹⁴ See report online at <<http://www.institutionalshareowner.com/news/article.cgi?sfArticleId=1897>> (23 March 2006).

an eight hour day in which to tend to 650 trees twice. Even if these allegations turn out to be untrue, the financial consequences of such law suits can be – and usually are – considerable. In today’s connected world, not in the least due to the “world wide web”, unethical behavior by one company – or even that of a supplier or an associated company – in one country can have world-wide consequences, be they legal, financial or reputational.

Another reason for the growing awareness of ethical standards is that, in the long term, unethical behavior can have negative internal effects: talented and quality-focused employees – the most valuable “human resource” of a company – leave the company because they are unable to reconcile its activities with their own conscience.¹⁵ Furthermore, a company with a bad reputation is likely to find it more difficult to obtain and retain the best graduates.¹⁶ There are also additional external consequences: if consumers have the choice between two different, but equally expensive products, the social and ecological circumstances under which such products are manufactured are seen to influence the purchasing decision.¹⁷ In the case of Shell, and regardless of the facts that eventually evolved, consumers even started to boycott the company. According to a study in 1995, 78 % of U.S. consumers would avoid retailers if they knew they were dealing in sweatshop goods.¹⁸

In addition to this, there is also a more subtle benefit from ethical behavior: the rule of law is promoted. This can have positive effects on the development of legal systems in which contracts are enforced fairly, bribery and corruption are less prevalent, and all business entities have equal access to legal process and equal protection under the law.¹⁹ In such circumstances, a smoother and more profitable operation of business is thereby simultaneously promoted.²⁰

¹⁵ See KLAUS LEISINGER, *Unternehmensethik in Zeiten der Globalisierung*, op. cit. (fn 12), p. 76.

¹⁶ See PETER PRUZAN, *Corporate Reputation: Image and Identity*, in: *Corporate Reputation Review*, Vol. 4, 2001, No. 1, pp. 50–64, p. 53 et seq.

¹⁷ Cf. CAROLA GILINSKI/PETER ROTT, *Umweltfreundliches und Ethisches Konsumverhalten im Harmonisierten Kaufrecht*, in: *EuZW* 2003, pp. 649–654, p. 653.

¹⁸ See LAURA HO/CATHERINE POWELL/LETI VOLPP, *(Dis)Assembling Rights of Women Workers Along the Global Assembly Line: Human Rights and the Garment Industry*, in: *Harv. C.R.-C.L. L. Rev.* 1996, Vol. 31, pp. 383–414, p. 409, citing CHARLES KERNAGHAN, *A Call to Action/We Have More Power than We Realize*, in: *THE U.S. IN HAITI: How to Get Rich on 11 [Cents] an Hour*, *Nat’l Comm. Educ. Fund* 1996, p. 51 et seq., p. 60.

¹⁹ See KLAUS LEISINGER/KARIN SCHMITT, op. cit. (fn 11), p. 79.

²⁰ See DAVID KINLEY/JUNKO TADAKI, *From Talk to Walk: The Emergence of Human Rights Responsibilities for Corporations at International Law*, in: *Va. J. Int’l. L.* 2004, Vol. 44, pp. 931–1022, p. 953.

Another reason why ethical behavior pays – especially from a shareholder’s perspective – is that a considerable amount of money is invested based on social responsibility.²¹ In 2005, 375 so-called SRI – socially responsible investment – funds existed in Europe.²² According to a study by the European Social Investment Forum (Eurosif), socially responsible investment amongst European institutional investors in 2003 was as high as € 336 billion.²³ As early as 1999, socially responsible investment in the United States amounted to as much as US\$ 2.16 trillion,²⁴ growing to US\$ 2.29 trillion in 2005.²⁵

2. States – The Primary Duty Holder

As already mentioned above, it is, first and foremost, the task of public law-making bodies, established by states or the community of states, to deal with the attainment of ethical standards. They have to define which standards are to be applied to the respective labor market and concerning the environment. With regard to sales contracts, it is primarily up to the governments in the country where the incriminating behavior takes place to take appropriate action. However, these governments all too often fail in implementing and enforcing human rights, labor or environmental standards.

In the second place, it is arguably also the task of the community of states to react to unethical behavior and to force the failing states to comply, for example, by means of embargos and other trade sanctions. However, in many cases, the necessary majority cannot be obtained or applied sanctions are not sufficiently efficient, e.g. in the case of the oil-for-food program in Iraq. As all these traditional means have proven inadequate to achieve the intended goals, recent years have seen several initiatives implemented to shift the task from governments to private enterprises.

²¹ See KLAUS LEISINGER, *Unternehmensethik in Zeiten der Globalisierung*, op. cit. (fn 12), p. 77; CLAUDE FUSSLER, *Responsible Excellence Pays!*, op. cit. (fn 8), p. 35.

²² See the report of SIRI COMPANY (ed.), *Green, Social and Ethical Funds in Europe 2005*, October 2005, online at <http://www.siricompany.com/pdf/SRI_Funds_Europe_2005.pdf> (23 March 2006).

²³ The study is available online at <http://www.eurosif.org/media/files/eurosif_srireprt_2003_all/> (23 March 2006).

²⁴ See online at <<http://www.socialinvest.org/areas/research/trends/1999-Trends.htm>> (23 March 2006).

²⁵ See SOCIAL INVESTMENT FORUM (ed.), *2005 Report on Socially Responsible Trends in the United States – 10 Year Review*, 24 January 2006, p. iv, online at <http://www.socialinvest.org/areas/research/trends/sri_trends_report_2005.pdf> (23 March 2006).

3. “Non-voluntary” Initiatives

On an international level, so-called “non-voluntary” initiatives are taking shape with regard to corporations. One important example is the “Draft Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights” which have been approved by the United Nations Sub-Commission on the Promotion and Protection of Human Rights in its Resolution 2003/16.²⁶ The Draft Norms, in Article 1, quite traditionally note that “[s]tates have the primary responsibility to promote, secure the fulfillment of, respect, ensure respect of, and protect human rights recognised in international as well as national law [...]”. However, the Draft Norms also hold that “[w]ithin their sphere of activity and influence, transnational corporations and other business enterprises have the obligation to promote [...] and protect human rights [...]”. This initiative is “non-voluntary” because it places an “obligation” on corporations and not a mere voluntary commitment. Article 15, for example, states that each transnational corporation or other business enterprise shall apply and incorporate these Norms in their contracts. According to the Commentary²⁷ on this article, enterprises “shall ensure that they only do business with (including purchasing from and selling to) contractors, subcontractors, suppliers [...] or natural or other legal persons that follow these or substantially similar Norms”. The Norms are not a treaty. Nor are they mandatorily applicable to any state or company.²⁸ However, “the legal authority of the Norms derives principally from their sources in treaties and customary international law, as a restatement of international legal principles applicable to companies”²⁹.

²⁶ See U.N. Doc. E/CN.4/Sub.2/2003/L.11. The Norms submitted by the Working Group, E/CN.4/Sub.2/2003/12/Rev.2, can be found online at <<http://documents.un.org/>> (23 March 2006).

²⁷ See UNITED NATIONS SUB-COMMISSION ON THE PROMOTION AND PROTECTION OF HUMAN RIGHTS (ed.), *Commentary on the Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights*, UN Doc. E/CN.4/Sub.2/2003/38/Rev.2, online at <<http://documents.un.org/>> (23 March 2006).

²⁸ “The Norms do not change international law; they do not create new law. They bring together what already exists and point the direction towards a common, universal set of benchmarks.” See NICHOLAS HOWEN, *Business, Human Rights and Accountability*, Speech Delivered at the ‘Business and Human Rights’ Conference Organized by the Danish Section of the ICJ, Copenhagen, 21 September 2005, available online at <http://www.icj.org/IMG/pdf/NICK_Speech_DK_2.pdf> (23 March 2006).

²⁹ See DAVID WEISSBRODT/MURIA KRUGER, *Current Development: Norms on the Responsibilities of Transnational Corporations and Other Business Enterprises with Regard to Human Rights*, in: A. J. I. L. 2003, Vol. 97, pp. 901–922, p. 913.

The Commission on Human Rights in its decision 2004/116 of 20 April 2004 expressed the view that the draft norm document contained “useful elements and ideas” but had no legal standing.³⁰ To clarify the complex issues to be considered in the Business and Human Rights debate, the Commission requested the UN Secretary General to appoint a “Special Representative” who recently submitted a first interim report.³¹

4. The OECD Guidelines for Multinational Enterprises

An initiative that is also worth mentioning here is the OECD Guidelines for Multinational Enterprises, which form part of the OECD Declaration on International Investment and Multinational Enterprises.³² These rules set out recommendations made by governments to multinational enterprises. The governments are committed to promoting the Guidelines. The recommendations cover, among other things, human rights, labor standards, environmental standards, anti-corruption and bribery, and consumer protection. In order to implement the Guidelines, National Contact Points (NCP) have been established in participating countries. Their purpose is to “*contribute to the resolution of issues that arise relating to implementation of the Guidelines in specific instances. The NCP will offer a forum for discussion and assist the business community, employee organizations and other parties concerned to deal with the issues raised in an efficient and timely manner and in accordance with applicable law*”.³³ With the agreement of the parties involved, access to consensual and non-adversarial means, such as conciliation or mediation, is also facilitated.

The scope of the Guidelines was extended in 2000 to the supply chain. According to paragraph 10 of the General Policies of the Guidelines, businesses should “[e]ncourage, where practicable, business partners, including suppliers and subcontractors, to apply principles of corporate conduct com-

³⁰ See COMMISSION ON HUMAN RIGHTS (ed.), *Report on the Sixtieth Session* (15 March–23 April 2004), E/CN.4/2004/127 (Part I), p. 28, online at <<http://daccess-ods.un.org/TMP/213832.3.html>> (23 March 2006).

³¹ See COMMISSION ON HUMAN RIGHTS (ed.), *Promotion and Protection of Human Rights – Interim Report of the Special Representative of the Secretary-General on the Issue of Human Rights and Transnational Corporations and other Business Enterprises*, E/CN.4/2006/97, 22 February 2006, online at <http://www.corporate-accountability.org/eng/documents/2006/un_norms_interim_report.pdf> (23 March 2006).

³² The Guidelines that were revised in 2000 are available online at <<http://www.oecd.org/dataoecd/56/36/1922428.pdf>> (23 March 2006).

³³ See Implementation Procedures of the OECD Guidelines for Multinational Enterprises, Procedural Guidance, I. National Contact Points, C. Implementation in Specific Instances.

patible with the Guidelines". This weak formulation was heavily criticized by NGOs.³⁴ Unfortunately, the OECD Committee on International Investment and Multinational Enterprises (CIME) additionally applies a so-called "investment nexus". This requirement leads to the consequence that cases not concerning investment, but only trade, are rejected.³⁵ CIME held that the Guidelines have been developed in the specific context of international investment by multinational enterprises.³⁶

The combination of the voluntary nature of the guidelines and the narrow application unfortunately restrain the OECD Guidelines' power as an efficient tool to combat the violation of ethical standards.

5. Private Initiatives

As actions by governments and the community of states often, for example, due to their vagueness, lack the necessary power to bind, or take a considerable amount of time to actually come into force – in failing states, it is unlikely that the necessary regulations will come into existence at all –, and since ethical behavior is becoming increasingly more important to businesses, companies have started to take care of the problem themselves through founding private initiatives. As Mary Robinson has put it, "*business leaders don't have to wait – indeed, increasingly they can't afford to wait – for governments to pass and enforce legislation before they pursue 'good practices' in support of international human rights, labor and environmental standards [...]*"³⁷. Following her initiative, the "Business Leaders Initiative on Human Rights" (BLIHR) was founded.³⁸

³⁴ See OECD WATCH (ed.), *The OECD Guidelines for Multinational Enterprises and Supply Chain Responsibility – A Discussion Paper*, December 2004, p. 2, online at <http://www.corporate-accountability.org/eng/documents/2004/oecd_guidelines_and_supply_chain_responsibility.pdf> (23 March 2006).

³⁵ See CORNELIA HEYDENREICH, *Die Umsetzung der OECD-Leitsätze für Multinationale Unternehmen in Deutschland*, in: VENRO (ed.), *Unternehmensverantwortung zwischen Dialog und Verbindlichkeit*, p. 21 et seq., online at <<http://www.globalpolicy.org/eu/de/publ/venrocorpacc.pdf>> (23 March 2006).

³⁶ See OECD WATCH (ed.), op. cit. (fn 34), p. 3.

³⁷ See MARY ROBINSON, *Beyond Good Intentions: Corporate Citizenship for a New Century*, London, 7 May 2002. Speech available online at <http://www.unglobalcompact.org/NewsAndEvents/speeches_and_statements/rsa_world_leaders_lecture.html> (23 March 2006).

³⁸ For the results, see online at <<http://www.blihr.org>> (23 March 2006).

a. Know Your Business Partners

Businesses spend a considerable amount of money on so-called *ethics audits* before they actually begin cooperation with another company, such as a supplier. Some companies – for example, Puma³⁹ – even publish a list of all their suppliers to guarantee transparency. The Global Reporting Initiative⁴⁰ is one such measure undertaken in regard of guaranteeing transparency.

Additionally, standard norms have been created, such as the ISO 14000 family from the International Standardization Organization, which deal with – predominantly environmental – ethics in business and have been implemented by some 760 900 organizations in 154 countries.⁴¹ Another example is SA8000 from Social Accountability International (SAI), which operates as a business tool for defining and verifying compliance with key human rights norms.⁴² There are several organizations that are accredited to do SA8000 certification, which ensures the application of an independent and objective standard.⁴³ A further example, familiar to most consumers, is the labels on food products stating that the food was produced in an ecologically friendly manner.

b. United Nations Global Compact

On an international level, the UN Global Compact has to be specially highlighted as one of the most successful private initiatives. At the World Economic Forum in January 1999 in Davos, Kofi Annan addressed the business community and asked them to join an international initiative.⁴⁴ This initiative consists today of ten principles – covering human rights, labor, environment and anti-corruption –, and has a total of 2 774 participants, many of whom have more than 50 000 suppliers.⁴⁵

³⁹ This list can be consulted online at <<http://www.fairlabor.org>> (23 March 2006).

⁴⁰ The Global Reporting Initiative is a multi-stakeholder process aimed at the development and dissemination of globally applicable Sustainability Reporting Guidelines. For more information see <<http://www.globalreporting.org>> (23 March 2006).

⁴¹ For a brief introduction to these standards, see <<http://www.iso.org/iso/en/iso9000-14000/understand/inbrief.html>> (23 March 2006).

⁴² For an article giving an overview and showing concrete case-studies, see DEBORAH LEIPZIGER/EILEEN KAUFMAN, *SA 8000: Human Rights in the Workplace*, in: Rory Sullivan (ed.), op. cit. (fn 2), p. 197–206.

⁴³ For more information see <<http://www.sa-intl.org>> (23 March 2006).

⁴⁴ See UNITED NATIONS (ed.), *What is the Global Compact?*, online at <<http://www.unglobalcompact.org/AboutTheGC/index.html>> (23 March 2006).

⁴⁵ This is the status as of 10 January 2006. The members who participate but, however, do not communicate – i.e. with their stakeholders on an annual basis about the progress in implementing the Global Compact principles – are listed online at <<http://www.unglobalcompact>.

The UN Global Compact begins with a general part, Principles One and Two, which state that businesses should, within their sphere of influence, support and respect the protection of internationally-proclaimed human rights and make sure they are not complicit in human rights abuses. As the ethical commitment is, on the one hand, limited to the companies' sphere of influence and, on the other hand, extended to complicity, these terms need further clarification. The concept of "sphere of influence" is not defined in detail.⁴⁶ It is, however, safe to say that "sphere of influence" can be understood as the companies' responsibility for their own *employees*, their *next tier suppliers* and *direct business partners*. Conversely, complicity usually refers to corporate involvement in governmental action.⁴⁷ However, the exact meaning of this expression is a highly sensitive question which is yet to be adequately answered.⁴⁸

The second group of principles, Principles Three to Six, deals with labor standards. Issues addressed here are the freedom of association and the effective recognition of the right to collective bargaining, forced and compulsory labor, child labor⁴⁹, and discrimination in respect of employment and occupation. A corporation's commitment to freedom of association – to take up this example –, however, does not mean that workforces must be organized or that companies must invite unions in, but simply that employers should

org/ParticipantsandStakeholders/non_communicating.html> (23 March 2006) and amount to a total of 612 participants.

⁴⁶ See GLOBAL COMPACT & OFFICE OF THE HIGH COMMISSIONER FOR HUMAN RIGHTS (eds.), *The Global Compact and Human Rights: Understanding Sphere of Influence and Complicity – an OHCHR Briefing Paper*, p. 4, online at <http://www.unglobalcompact.org/Issues/human_rights/gc_and_human_rights.pdf> (23 March 2006). Also see PAUL WATCHMAN, *Complicity: Charting a Path Through the Conceptual Minefield*, The 2005 Business and Human Rights Seminar, 8 December 2005, London, speech available online at <<http://www.bhrseminar.org>> (23 March 2006).

⁴⁷ Cf. STEVEN R. RATNER, *Corporations and Human Rights: A Theory of Legal Responsibility*, in: Yale L.J. 2001, Vol. 111, pp. 443–545, p. 510.

⁴⁸ See KLAUS LEISINGER, *Opportunities and Risks of the United Nations Global Compact: The Novartis Case Study*, in: JCC 2003, Vol. 11, pp. 113–131, p. 122, online at <<http://www.novartisfoundation.org/platform/apps/Publication/getfmfile.asp?id=612&cel=1010&sc=417646659&doc=71&dse=5>> (23 March 2006).

⁴⁹ According to ILO Convention No. C138 from 1973, which has been ratified by 142 countries, child labor is the full-time employment of children that are – in general – under the age of 15 years, Article 2(3) ILO Convention. Labor which, by its nature or the circumstances in which it is carried out, is likely to jeopardise the health, safety or morals of young persons shall not be conducted by workers under the age of 18, Article 3(1) ILO Convention.

not interfere with an employee's decision to associate, nor should they discriminate against the employee or a representative of the employee.⁵⁰

The third part of the Global Compact, Principles Seven to Nine, addresses environmental issues. Principle Seven, for example, states that businesses should support a "precautionary approach" to environmental issues. This principle refers to the Rio Declaration, which – in its principle 15 – states that "*where there are threats of serious or irreversible damage, lack of full scientific certainty shall not be used as a reason for postponing cost-effective measures to prevent environmental degradation*".⁵¹

The last principle of the Global Compact, which was added at a later point in time – on 24 June 2004, during the UN Global Compact Leaders Summit –, deals with corruption. Principle Ten states that businesses should work against corruption in all its forms, including extortion and bribery. This principle enjoyed great support and "*sent a strong worldwide signal that the private sector shares responsibility for the challenges of eliminating corruption*"⁵² while also "*demonstrat[ing] a new willingness in the business community to play its part in the fight against corruption*"⁵³.

The UN Global Compact initiative is voluntary and imposes no sanctions if its members fail to comply with the standards. However, as there are reporting obligations associated with membership to the initiative, so-called "Communication on Progress" (COP), the behavior of the members becomes transparent. Those companies, who do not hand in their Communication on Progress for two years, are labeled "inactive".⁵⁴ According to a study by McKinsey, 15 % of the Global Compact participants did, indeed, change suppliers or other business partners due to concerns over human rights, environmental or labor standards.⁵⁵

⁵⁰ See comments to Principle Three at <<http://www.unglobalcompact.org/AboutTheGC/TheTenPrinciples/principle3.html>> (23 March 2006).

⁵¹ See online at <http://www.unep.org/dpdl/Law/PDF/Rio_Declaration.pdf> (23 March 2006).

⁵² See comments to Principle Ten at <<http://www.unglobalcompact.org/AboutTheGC/TheTenPrinciples/principle10.html>> (23 March 2006).

⁵³ *Id.*

⁵⁴ See online at <http://www.unglobalcompact.org/CommunicatingProgress/non_communicating.html> (23 March 2006).

⁵⁵ See MCKINSEY&COMPANY (ed.), *Assessing the Global Compact's Impact*, 11 May 2004, online at <http://www.unglobalcompact.org/docs/news_events/9.1_news_archives/2004_06_09/imp_ass.pdf> (23 March 2006).

c. Initiatives in Special Trade Branches

Apart from such initiatives on a global level, there are private initiatives in specific trade sectors. Examples are the “Equator Principles”⁵⁶, “Fair Labor Association”⁵⁷, the “Electronic Industry Code of Conduct”⁵⁸, or the “Kimberley Process”⁵⁹. The Electronic Industry Code of Conduct, for example, incorporates norms, such as setting a maximum number of working hours at 60 per week, and prescribing human treatment or non-discrimination in supplier contracts, as, according to the introduction of this code, the participants are under an obligation to, at least, require their *next tier suppliers* to acknowledge and implement the code.⁶⁰ Another example is the code of conduct implemented by “Yum!”. Yum! comprises All American Food, KFC, Long John Silvers, Pizza Hut and Taco Bell and, thereby, represents nearly 34 000 restaurants in more than 100 countries and territories.⁶¹

6. Problematic Cases

If one looks at the aforementioned initiatives, it may be surprising to learn that alarming events still occur in the world – especially in developing countries. Each year, several thousand children are forced to work on cocoa plantations in the Ivory Coast, who have been previously sold into slavery from one of the neighboring countries.⁶² In Indian cottonseed production, approximately 400 000 – mostly female – children are employed as “bonded laborers” and have to work between 9 and 11 hours a day for an average

⁵⁶ For the list of members and the principles, see online at <<http://www.equator-principles.com>> (23 March 2006).

⁵⁷ See online at <<http://www.fairlabor.org>> (23 March 2006).

⁵⁸ Companies like Celestica, Cisco, Dell, Flextronics, HP, IBM, Jabil, Lucent, Microsoft, Sanmina SCI, Seagate, Solectron and Sony have adopted and/or implemented these norms. This code is online at <http://www.eicc.info/downloads/EICC_English.pdf> (23 March 2006).

⁵⁹ See online at <<http://www.kimberleyprocess.com>> (23 March 2006).

⁶⁰ Similar code of conducts have been created and implemented by companies such as LEGO, (online at <http://www.lego.com/info/pdf/LEGO_Company_code_of_conduct_eng_2005.pdf> (23 March 2006)), Novartis (online at <http://www.corporatecitizenship.novartis.com/downloads/business-conduct/Novartis_TP_Code-pdf> (23 March 2006), and others.

⁶¹ Code of conduct online at <<http://www.yum.com/responsibility/suppliercode.asp>> (23 March 2006).

⁶² See U.S. DEPARTMENT OF STATE (ed.), *Country Reports on Human Rights Practices (2001)*, 4 March 2002, Section 6 (Workers Rights), online at <<http://www.state.gov/g/drl/rls/hrrpt/2001/af/8355.htm>> (23 March 2006). For a discussion on slavery in the chocolate industry in general, see MANUEL VELASQUEZ, *Business Ethics: Concepts and Cases*, 6th ed., New Jersey 2006, p. 51 et seq.

wage of US\$ 11 per month.⁶³ Another example regarding environmental issues is tuna: up until recent times, an estimated 300 000 dolphins were killed each year because of old fishing methods.⁶⁴ This number has now decreased considerably. However, the fishing-related death of dolphins still poses a problem.⁶⁵ Another critical subject is pesticides. By simply adding a few chemical components, dangerous chemical weapons can be – and are – produced.⁶⁶ Similar problems arise in connection with all so-called “dual-use goods”.

What can a buyer do if it realizes that the products it has purchased were produced under such conditions? What are the seller’s possibilities if it learns about serious human rights violations by one of its buyers, where one of its products is involved?

Some questions can be answered by referring the applicable public law. With regard to private law matters, these need to be resolved by applying the law governing the contract. In an international context, this is likely to be the Convention on Contracts for the International Sale of Goods – CISG. This convention has been ratified by 67 countries⁶⁷ and, according to its Article 1, is applicable to contracts of sale of goods between parties whose places of business are in different states when the States are Contracting States or when the rules of private international law lead to the application of the law of a Contracting State. If the CISG is indeed applicable, it is crucial to determine whether ethical standards have become part of the contract in the first place and, if so, what remedies the aggrieved party may resort to.

⁶³ See DAVULURI VENKATESWARLU, *Seeds of Bondage: Female Child Bonded Labour in Hybrid Cottonseed Production in Andhra Pradesh*, study online at <<http://www.indianet.nl/sob.html>> (23 March 2006).

⁶⁴ See Tuna GATT Case No. 72, available online at <<http://www.american.edu/TED/TUNA.htm>> (23 March 2006).

⁶⁵ See report by SERGI TUDELA, *Ecosystem Effects of Fishing in the Mediterranean: An Analysis of the Major Threats of Fishing Gear and Practices to Biodiversity and Marine Habits*, in: General Fisheries Commission for the Mediterranean Studies and Reviews No. 74, online at <<ftp://ftp.fao.org/docrep/fao/007/y5594e/y5594e00.pdf>> (23 March 2006).

⁶⁶ For further information see online at <<http://www.fluoridealert.org/pesticides/effects.chem.weapon.precurs.htm>> (23 March 2006).

⁶⁷ For a list of all states that have ratified the CISG, see <http://www.uncitral.org/uncitral/en/uncitral_texts/sale_goods/1980CISG_status.html> (23 March 2006).

II. Consequences of Public Law Regulations

1. Illegality

If, in a given case, there are indeed public law regulations that condemn certain behavior, it is up to state law to define the legal consequences of a violation of such a prohibition. Although it might be conceivable, albeit in rather rare cases, that a state declares a sales contract to be void if the goods in question have been manufactured by a means in violation of human rights – such as child labor –, this would not fall under the CISG. According to Article 4(a) CISG, the validity⁶⁸ of the contract is not governed by the Convention. Thus, the applicable law to the question of validity would have to be determined by private international law.

2. Prohibition of Import or Export

In cases in which the community of states or – as the case may be – even a single state announces an embargo, thus prohibiting either the import or export of goods from or to a state in which the enforcement of basic human rights is not ensured, questions of exemption from liability to perform contractual obligations may arise. State interventions preventing contractual performance, such as quotas, export or import embargoes or trade bans are – generally – outside the parties' sphere of control.⁶⁹ This leads to the following consequences: imagine a case where the community of states or a specific state prohibits the import of goods from a country where basic standards of human rights are constantly violated. A buyer who has a contract with a seller in such a state might be excused from paying damages for its failure to take over the goods and to pay the purchase price, in accordance with Article 79(1) CISG. Conversely, where export into a certain country is prohibited, a seller with a contract with a buyer in that country might be excused from paying damages for non-delivery.

⁶⁸ However, in order to ensure uniform application, the term “validity” has to be interpreted autonomously. See SCHLECHTRIEM in Schlechtriem/Schwenzer (eds.), *Commentary on the UN Convention on the International Sale of Goods (CISG)*, 2nd ed., Oxford 2005, Art. 4 para 7.

⁶⁹ Cf. HANS STOLL/GEORG GRUBER in Schlechtriem/Schwenzer (eds.), op. cit. (fn 68), Art. 79 para 37; DIETRICH MASKOW in Enderlein/Maskow/Strohbach (eds.), *Internationales Kaufrecht*, Berlin 1991, Art. 79 para 3.6. In a decision of the Bulgarian Chamber of Commerce and Industry Court of Arbitration, 24 April 1996, CISG-online 435, a Bulgarian buyer purchased coal from a Ukrainian seller. The seller relied on an export ban and a strike of miners. The Tribunal found that such circumstances could constitute impediments. However, in this case, the export ban as well as the strike was foreseeable at the time of the conclusion of the contract and the exemption was not granted.

The consequences in these cases might be questionable if the import or export ban was foreseeable – for example, because of the bad human rights record of the other state – at the time of the conclusion of the contract. The wording of Article 79(1) CISG provides for exemption only in cases where the supervening event was *not* foreseeable. However, it is doubtful whether the drafters of the CISG took these situations – situations where trade bans are installed because of unethical behavior of other states – into account at all.⁷⁰ The typical case in which the requirement of non-foreseeability seems to be appropriate – and actually could prevent the breaching party from relying on Article 79 CISG – is where the interests of the country, in which the party seeking to rely on the exemption has its place of business, are intended to be protected by the trade ban. In many cases, such interests are of economic nature and states want to protect the own market. In this case, it can well be argued that the party in question has to bear the risk⁷¹ of actions taken by its *own* government and, consequently, is not exempted from liability. The case that we are discussing here, however, is different. It does *not* fall within a party's sphere of risk if its *own* government implements a trade ban due to the behavior of a *foreign* state or party. The other party – directly or indirectly profiting from poor standards, for example, because of low wages – should bear the risk of trade bans due to its *own*, or its *own* government's, conduct or mistakes. Thus, this latter party may not argue that the breaching party could reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract. This result is in accordance with Article 7(1) CISG and the ideas underlying Article 80 CISG.

III. Incorporation of Ethical Standards in Sales Contracts

In most cases, however, there will be no relevant regulations of public law. The first question that then arises is whether and how basic ethical standards become a part of the contract.

⁷⁰ The examples of impediments given by the Commentary on the Draft Convention on Contracts for the International Sale of Goods prepared by the Secretariat ("Secretariat Commentary"), UN DOC. A/CONF. 97/5, are: wars, storms, fires, government embargoes and the closing of international waterways. See Secretariat Commentary, Art. 65 (now Art. 79) para 5, online at <<http://www.cisg-online.ch/cisg/materials-commentary.html#Article%2065>> (23 March 2006).

⁷¹ The possibility of exemption under Article 79 CISG is primarily one of distribution of risk. Cf. PETER SCHLECHTRIEM in Schlechtriem/Schwenzer (eds.), op. cit. (fn 68), Art. 8 para 8.

1. Express Terms

The first way to incorporate ethical standards into sales contracts is to stipulate that the seller, for example, has to abide by specific standards concerning human rights, labor conditions or the environment. By so doing, such norms become part of the contract and may be enforced, or their violation sanctioned, in the same way as with any other terms. It is highly advisable that the interested party insists on incorporating such express terms into the contract, in order to circumvent any later disputes in this respect and in order to “tailor”⁷² individual clauses to address specific human rights issues.

Novartis, one of the leading pharmaceutical companies, for example, includes the following clause in its contracts: “*Novartis gives preference to third parties who share Novartis’ societal and environmental values, as set forth in the Novartis Policy on Corporate Citizenship, Third Party Code: http://www.novartis.com/corporate_citizenship/en/10_2004_third_party_code.shtml. Accordingly, Seller represents and warrants this agreement will be performed in material compliance with all applicable laws and regulations, including, without limitation, laws and regulation relating to health, safety and the environment, fair labour practices and unlawful discrimination*”.

2. Other Means of Incorporation

Problems may arise where such express terms regarding ethical values are absent. Very often, particularly small and medium-sized companies do not have the bargaining power to insist on incorporating such express terms concerning ethical values into their contracts.⁷³ Here, however, contract interpretation and supplementation may well lead to similar results to those reached with express incorporation.

According to Article 9(1) CISG, the parties are bound by any usage to which they have agreed and by any practice which they have established between themselves. Thus, two situations have to be distinguished: the first one is where the parties have repeatedly⁷⁴ agreed on express terms setting up certain ethical standards; in such a case, a justified expectation might arise

⁷² Cf. KLAUS LEISINGER, *Are “Human Rights” the “Business of Business”?*, Comment to the Contribution of David Weissbrodt, in: *zfwu* 2005, pp. 298–303, p. 302.

⁷³ However, they sometimes confederate in order to have more market power.

⁷⁴ According to the prevailing view, at least some practice – i.e. a sequence of previous contracts – is necessary. Cf. WOLFGANG WITZ in Witz/Salger/Lorenz (eds.), *International Einheitliches Kaufrecht*, Heidelberg 2000, Art. 9 para 16; MARTIN SCHMIDT-KESSEL in Schlechtriem/Schwenzer (eds.), *op. cit.* (fn 68), Art. 9 para 8.

that the parties will continue to proceed accordingly in the future.⁷⁵ Thus, although an express term is lacking, the contract may be supplemented in accordance with the previous conduct of the parties. The second situation is the one where the parties have individually agreed to a certain usage. This may be presumed where both parties participate in one of the above-mentioned private initiatives, such as the UN Global Compact. Under these conditions, it is irrelevant whether the agreed usage could also fall under Article 9(2) CISG as an international trade usage. If both parties have agreed to certain standards on a broader scale, they must, consequently, be deemed to have, at least implicitly, agreed to such a usage in their individual contracts.

If neither of the foregoing situations is at hand, ethical standards might still become part of the contract via Article 9(2) CISG. This presupposes that they can be regarded as an international trade usage of which the parties knew or ought to have known and which in international trade is widely known to, and regularly observed by, parties to contracts of the type involved in the particular trade concerned. In this regard, first and primary consideration should be given to usages and practices that have been established in certain trade branches, such as the "Electronic Industry Code of Conduct" already mentioned above.⁷⁶ Such codes could even be used for evidentiary purposes in legal proceedings.⁷⁷ If there are no usages or practices prevalent in the specific sector, special regard can be given to general private initiatives, such as the UN Global Compact. Although its provisions are rather broad and unspecified, there can be no doubt, that – at the very least – minimum ethical standards are to be safeguarded. These include prohibition of child labor and forced and compulsory labor, as well as a minimum of humane labor conditions. Thus, via Article 9(2) CISG, these minimum ethical standards may form, as implied terms, part of every international sales contract.

It might be necessary to note here that, in cases where the buyer is only willing to pay a price that is so low that ethical production standards are impossible to be applied – and consequently cannot be expected –, the buyer cannot rely on an implied term of the contract.

⁷⁵ See LG Frankenthal (Germany), 17 April 1997, CISG-online 479, online at <<http://www.cisg-online.ch/cisg/urteile/479.htm>> (23 March 2006), stating: "Eine Gepflogenheit im Sinne des Artikel 9 CISG setzt nämlich eine gewisse Häufigkeit und Dauer eines Verhaltens voraus, so daß es berechtigt erscheint, wenn eine Partei auf ein solches Verhalten als üblich vertraut".

⁷⁶ For other examples of industry initiatives, see <<http://www1.umn.edu/humanrts/business/icgi.html>> (23 March 2006).

⁷⁷ See INTERNATIONAL COUNCIL ON HUMAN RIGHTS POLICY (ed.), *Beyond Voluntarism: Human Rights and the Developing International Legal Obligations of Companies*, Vernier 2002, p. 70; PETER MUCHLINSKI, *The Development of Human Rights Responsibilities for Multinational Enterprises*, in: Rory Sullivan (ed.), op. cit. (fn 2), p. 51.

IV. Consequences of the Failure to Comply with Ethical Standards

It is common place nowadays for corporations to take precautions to ensure that their contractual partners adhere to the required ethical standards. Usually, ethics audits as well as ecological audits are conducted *before* the corporations actually enter into a contract with a new business partner. This, however, cannot prevent ethical values from being violated in individual cases of performance. In such cases, the remedies available to the obligee, be it as a buyer or as a seller, are questionable.

1. Buyer's Remedies

The first question in cases where goods are or have been produced in violation of the ethical values requirement of the contract is whether this fact constitutes a non-conformity of the goods according to Article 35 CISG.

a. Non-Conformity of the Goods, Art. 35 CISG

The problem in this context is that, in most cases, the violation of ethical standards does not negatively influence the physical features of the goods. No third party would be able to ascertain the violation of ethical standards upon a mere examination of the goods. Still, the very way of producing the goods influences their value on the market.⁷⁸ Many buyers are willing to pay a higher price for goods produced under circumstances that safeguard ethical standards. This is an established fact with regard to goods produced by observing specific biological and organic standards.⁷⁹ However, the same holds true for other goods, for example clothes that are not produced under sweatshop conditions.

⁷⁸ Cf. JAN HEILMANN, *Mängelgewährleistung im UN-Kaufrecht*, Berlin 1994, p. 179: "Beschaffenheiten, für die der Verkäufer wegen Wertbeeinträchtigung haftet, sind nur die wertbildenden Faktoren wie Herkunft, Zusammensetzung [...]"

⁷⁹ Cf. OLG München, 13 November 2002, CISG-online 786, online at <<http://www.cisg-online.ch/cisg/urteile/786.pdf>> (23 March 2006). In this case, the buyer purchased organically produced barley from the seller. The seller did not provide the buyer with the necessary documents that showed that the goods had been produced in the appropriate way. The court held that it is almost impossible to establish, with reasonable expense, whether the barley had, in fact, been produced organically. It further held that organically produced barley is more than twice as expensive as normal barley, i.e. DM 625 instead of DM 290 per ton. The court emphasized that it was not a question of missing documents, but one of non-conforming goods, because the documents had no independent meaning ("Das Begleitpapier hat hier keine eigenständige Bedeutung. Vielmehr macht sein Fehlen die Ware selbst vertragswidrig [...]").

If an express or implied term can be derived from the contract itself, non-conformity of the goods already follows from Article 35(1) CISG. It must be remembered here that, in this day and age, the observance of, at least, basic ethical standards can be regarded as an international trade usage and, thus, as an implied term in every international sales contract. Goods processed under conditions violating the contractually fixed ethical standards are not of the *quality* asked for by the contract. Quality must be understood as not just the goods' physical condition, but also as all the factual and legal circumstances concerning the relationship of the goods to their surroundings. It is irrelevant whether those circumstances affect the usability of the goods due to their nature or durability. The agreed origin of the goods, which necessarily comprises issues of ethical standards, also forms part of the quality characteristics.⁸⁰

Insofar as the contract does not contain any, or only insufficient details in order to determine the requirements to be satisfied in producing the goods, recourse is to be had to the subsidiary determination of conformity set forth in Article 35(2) CISG.

First of all, the goods must be fit for any particular purpose according to Article 35(2)(b) CISG. In this context one may think of a buyer purchasing goods in order to sell them in specific markets, such as one specializing in organic food, biodynamic agriculture or fair trade. However, this particular purpose must be made known to the seller at the time of the conclusion of the contract, be it expressly or impliedly. This requirement may be fulfilled in cases where the buyer's firm, i.e. the company's name, contains information in this regard or where its reputation in context with ethical values is widely known in the trade sector concerned.

The further prerequisite laid down in Article 35(2)(b) CISG, namely that the buyer relied on the seller's skill and judgment and it was reasonable for it to do so, should not cause any problems in these cases.

If a particular purpose in the above-mentioned sense cannot be construed, it might be questionable whether fitness for the ordinary purpose, according to Article 35(2)(a) CISG, presupposes that the goods have been manufactured or processed in accordance with specific ethical standards. Ordinary purpose primarily means that the goods must be fit for commercial purposes.

⁸⁰ Bundesgerichtshof (Germany), 3 April 1996, CISG-online 135, online at <<http://www.cisg-online.ch/cisg/urteile/135.htm>> (23 March 2006): "Selbst wenn man davon ausgehe, daß die Lieferung englischer Ware vereinbart worden sei und Kobaltsulfat in England tatsächlich hergestellt werde, stelle die in Südafrika produzierte Ware zwar ein aliud dar. Dieses sei nach UN-Kaufrecht jedoch wie eine Schlechtlieferung zu behandeln [...]".

In the resale business, this means that it must be possible to resell them.⁸¹ In general, this purpose of the goods will not be influenced by the mere way in which the goods are manufactured or processed.⁸² Thus, in cases not covered by Article 35(1) CISG or Article 35(2)(b) CISG, there will be little chance for the buyer to allege non-conformity of the goods and to hold the seller responsible if ethical standards have not been met.

If the goods are non-conforming, the buyer must notify the seller in accordance with Articles 38 and 39 CISG. However, where the non-conformity results solely from the way in which the goods are manufactured or processed, any eventual examination of the goods themselves will not reveal this fact. Thus, notification can only be required from the buyer after it has actually learned about the violation of ethical standards. Such knowledge may, in an individual case, be inferred from missing certificates relating to the origin of the goods.⁸³ If the non-conformity is not discovered until more than two years have passed since the handing-over of the goods, however, Article 39(2) CISG prevents the buyer from relying on the non-conformity.

b. Possible Remedies

In the case of non-conforming goods, the buyer may resort to the usual remedies, namely avoidance of the contract, damages and price reduction; all such remedies raise special questions in connection with the violation of ethical standards.

Even if one finds that violation of ethical standards does not result in non-conformity of the goods in accordance with Article 35 CISG, if compliance with certain standards is a duty resulting from the contract, any non-compliance amounts to a breach of contract, giving rise to all remedies that are not specifically limited to cases of non-conformity.

⁸¹ Cf. JOHN O. HONNOLD, *Uniform Law for International Sales*, 3rd ed., The Hague 1999, Art. 35 para 225; INGEBORG SCHWENZER in Schlechtriem/Schwenzer (eds.), op. cit. (fn 68), Art. 35 para 14; HANNS-CHRISTIAN SALGER in Witz/Salger/Lorenz (eds.), op. cit. (fn 74), Art. 35 para 9. See also High Court of Auckland (New Zealand), 31 March 2003, CISG-online 833, online at <<http://cisgw3.law.pace.edu/cases/030331n6.html>> (23 March 2006).

⁸² But see FRITZ ENDERLEIN in Enderlein/Maskow/Strohbach (eds.), op. cit. (fn 69), Art. 35 para 8, who agrees that goods are not fit for the ordinary purpose under Article 35(2)(a) CISG if their commercial value is reduced considerably because of the lack of conformity.

⁸³ OLG München, 13 November 2002, CISG-online 786, online at <<http://www.cisg-online.ch/cisg/urteile/786.pdf>> (23 March 2006).

aa. Avoidance of the Contract, Art. 49(1)(a) and Art. 25 CISG

Avoidance of the contract is possible only in cases where the non-conformity amounts to a fundamental breach of contract. This presupposes a substantial deprivation of what the buyer is entitled to expect under the contract. Such deprivation can be ascertained, in the first place, from the terms of the contract.⁸⁴ If the parties stipulate that certain ethical standards have to be adhered to, the parties have, thereby, sufficiently made clear that compliance is of special interest to the buyer and, therefore, such deprivation can be assumed in the event of a breach. In cases where *basic* ethical standards have been violated, such a fundamental breach also exists, having regard to the fact that damages in these cases are often not sufficient to sanction this breach of contract.⁸⁵ Furthermore, if the buyer is not allowed to avoid the contract, its reputation may still be endangered, because the buyer could be seen to be associated with the seller and its unethical behavior. In all other cases, where the alleged violation does not concern *basic* ethical values, whether or not the breach is fundamental has to be determined on a case-by-case basis.

cc. Damages, Art. 45(1)(b) and 74 CISG

The easiest way for the buyer to obtain financial redress in case of violation of ethical standards is where the parties have agreed upon a liquidated damages clause or a contractual penalty, whereby the latter generally functions as both a compensatory remedy as well as a deterrent.⁸⁶ Such a clause releases the buyer from its – maybe difficult – obligation of proving whether or not it suffered damage at all and, if so, in what amount. However, parties may not think of such a clause in connection with compliance with ethical standards, or the buyer may not be in a position to force such a clause on the seller. Therefore, it is important to examine what can be considered to be damage within the meaning of Article 74 CISG.

In the first place, if the goods have not been sold before the violation of ethical standards is discovered, lost profits will be likely to occur. This may be because the goods are no longer resalable, or because the buyer decides not to resell them under the given circumstances. The latter behavior cannot

⁸⁴ Cf. PETER SCHLECHTRIEM in Schlechtriem/Schwenzer (eds.), op. cit. (fn 68), Art. 25 para 9; CISG-AC OPINION No 5, *The Buyer's Right to Avoid the Contract in Case of Non-Conforming Goods or Documents*, 7 May 2005, Badenweiler (Germany). Rapporteur: Professor Dr. Ingeborg Schwenzer, LL.M., Professor of Private Law, University of Basel, para 4.2, online at <http://www.cisg-online.ch/cisg/docs/CISG-AC_Op_no_5.pdf> (23 March 2006).

⁸⁵ Cf. CISG-AC OPINION No 5, op. cit. (fn 84), para 4.1.

⁸⁶ See HANS STOLL/GEORG GRUBER in Schlechtriem/Schwenzer (eds.), op. cit. (fn 68), Art. 74 para 49.

be sanctioned as a violation of the buyer's general duty to mitigate damages according to Article 77 CISG, at least not where the buyer cannot be expected to sell the goods elsewhere, possibly at a lower price. This, i.e. whether the buyer can be expected to sell the goods, in turn, has to be decided by taking all the circumstances into account, such as the respective weight of the breach.⁸⁷ In addition, further damages accruing from substitute transactions can be recoverable under Articles 75 and 76 CISG in these cases.

If the goods have already been resold prior to discovering the breach, damage in the form of loss of reputation may come into play.⁸⁸ As Article 74 CISG recognizes the principle of full compensation, there is no question that loss of goodwill can be recovered under this article.⁸⁹ Such a loss should always be foreseen or ought to be foreseen according to Article 74 CISG. It might, however, be difficult to financially quantify a loss of goodwill in an individual case. In assessing the amount, due regard is to be given to the level of public ethical commitment by the individual buyer, such as, for example, participation in one of the above-mentioned private initiatives.

Problems arise, however, where all goods have been resold and the violation of ethical standards by the buyer's supplier has never become public knowledge. Although, even in such a case, one might argue that there is a loss of goodwill that could perhaps materialize in some future sale of the business itself, for example during due diligence proceedings, the loss becomes more and more elusive. Therefore, in these cases, another method of calculating damages is called for if one does not want to allow the seller to get off scot-free. One possibility could be to assess the decrease in value of the goods on an abstract level. The purchase price always reflects the costs of producing the goods and a profit for the seller. If the seller, by violating ethical standards, substantially reduces the costs in production and thus respectively maximizes its own profit, the equilibrium of the contract has become unbalanced. One may well argue that the real value of the goods is decreased by the amount of the – unethically – reduced production costs.

⁸⁷ In this regard, several aspects have to be taken into account. One is the very nature of the ethical standard. Another aspect is whether the breach is merely an anomaly, or occurs regularly.

⁸⁸ For a study concerning the value of brands by Newsweek and Interbrand, see online at <http://www.ourfishbowl.com/brand_val/best_brands_05/2005_rankings_dollars.pdf> (23 March 2006).

⁸⁹ See HANS STOLL/GEORG GRUBER in Schlechtriem/Schwenzer (eds.), op. cit. (fn 68), Art. 74 para 21; HERBERT SCHÖNLE in Honsell (ed.), *Kommentar zum UN-Kaufrecht*, Berlin/Heidelberg/New York 1996, Art. 74 para 13; CHRISTOPH BRUNNER, *UN-Kaufrecht – CISG*, Bern 2004, Art. 74 para 8; WOLFGANG WITZ in Witz/Salger/Lorenz (eds.), op. cit. (fn 74), Art. 74 para 12.

The buyer may claim this margin as minimum damages. Although this might appear to be a windfall profit for the buyer, it is the only way to secure that – in the long term – ethical standards can be and actually are enforced by buyers having an incentive to do so. Moreover, in many legal systems today – at least in scholarly writings – the law of damages is regarded as a means for *prevention* and not only for compensation.⁹⁰

cc. Price Reduction, Art. 45(1)(a) and Art. 50 CISG

Finally, the possibility of a price reduction according to Article 50 CISG exists. As has been set out, any reduction of the production costs resulting from a violation of ethical standards can be regarded as causing a decrease in the value of the goods. Thus, the buyer may reduce the purchase price in proportion to the lower value that the goods actually delivered had at the time of the delivery.

2. Seller's Remedies – Avoidance of the Contract and Damages, Art. 45(1) CISG

The factual situations for sellers who want to assure that their contract partners comply with certain ethical standards are different. As has been shown above, the main sphere of application for the seller is the sale of so-called dual-use goods that can be misused in violation of basic ethical values, such as to produce chemical, biological or nuclear weapons. If compliance with ethical standards has become part of the contract in the way described above⁹¹, any non-compliance would amount to a breach of contract. If such a misuse becomes apparent, the question again arises as to what remedies the seller has.

In relation to both avoidance of the contract and damages, the same considerations as those concerning the buyer apply.

Again, it has to be established that the breach by the buyer is fundamental in order to give rise to the remedy of avoidance. A claim for damages will predominantly depend on the question of whether lost profits and loss of

⁹⁰ For Germany, see REINHARD MÖLLER, *Das Präventionsprinzip des Schadensrechts*, Berlin 2006; THOMAS DREIER, *Kompensation und Prävention*, Tübingen 2002, p. 500 et seq. For developments on an European level, see ULRICH MAGNUS, *Comparative Report on the Law of Damages*, in: Magnus (ed.), *Unification of Tort Law: Damages*, The Hague/London/Boston 2001, p. 185 para 8 et seq. See also WALTER VAN GERVEN/JEREMY LEVER/PIERRE LAROCHE, *Cases, Materials and Text on National, Supranational and International Tort Law*, Oxford/Portland 2000, p. 25.

⁹¹ *Supra* III: Incorporation of Ethical Standards in Sales Contract.

goodwill are present. Here, however, any abstract calculation of damages based upon the equilibrium of the contractual obligations is likely to fail. The only way to construe damages mirroring the buyer's solution outlined above would be to speculate that goods for the intended unethical use would have a higher value on the international market. The loss of the seller would then be that, in relying upon the buyer's contractual promise to comply with ethical standards, the purchase price did not reflect the real value of the goods.

3. Hardship, Art. 79 CISG and Art. 6.2.1 et seq. Unidroit Principles 2004

Ethical questions may also arise where it is not one of the contracting parties that violates ethical standards and thereby breaches the contract, but where the political situation in the buyer's or the seller's country changes in a way that basic ethical standards are disregarded. Although it must be mentioned again that it is the primary task of the community of states to take the appropriate political measures, prompt action by private companies may be called for prior to such – often time-consuming and long-winded – endeavors. Otherwise, companies carrying on business with partners from states violating basic human rights may be later blamed for being complicit with human rights abuses, be it actively or passively.⁹² In this regard, the discussions with regard to doing business in South Africa under the Apartheid-Regime come to mind.⁹³

Reasonable action that could be taken by sellers and buyers concerning their contractual relationship with their business partners would be, primarily, to suspend the performance of the contract. In order to escape liability for damages, suspending performance is only possible if the requirements for an exemption under Article 79 CISG are met. According to this Article, firstly, there must be an impediment beyond the party's control. Impediments are usually defined as external circumstances or exogenous causes that impair

⁹² According to Principle Two of the UN Global Compact, for example, businesses should make sure they are not complicit in human rights abuses.

⁹³ See NARANDRAN JODY KOLLAPEN, *Human Rights and Business: The Apartheid Experience*, Speech given at the Novartis Symposium "Human Rights and the Private Sector", available online at <<http://www.southcentre.org/info/southbulletin/bulletin69/bulletin69-03.htm>> (23 March 2006). For further information, see online at <<http://www.business-humanrights.org/Categories/Miscellaneous/Historical/Businessduringapartheid>> (23 March 2006).

the promisor's ability to perform.⁹⁴ Taken at face value, such an impediment could not be assumed in the cases discussed here. However, there can be no doubt that it would be commercially unreasonable to continue performance of the contract where this would risk causing detriment to one's business reputation. The management may even be under a duty of corporate law, e.g. towards their shareholders, to suspend the performance of such contracts. Whether *ethical hardship*, as present in the described cases, is an impediment within the meaning of Article 79(1) CISG has never been discussed, neither in case law nor in scholarly writing.

To answer this question, recourse is to be had to the legislative intention underlying Article 79 CISG. Although, admittedly, the provision's history, systematic placement and wording imply that an exemption comes into consideration only under very narrow conditions,⁹⁵ it reflects the intention of reasonable parties who are willing to take responsibility for risks that are outside their sphere of control only to the extent that they are able to insure against these risks or can take them into account when drafting the contract.⁹⁶ The fact that, after the conclusion of the contract, grave violations of basic ethical values – such as human rights – in the country of the obligee occur, certainly falls outside the sphere of risk of the promisor. If, for ethical reasons, it cannot reasonably be expected of the obligor to perform the contract, this certainly amounts to an impediment.

Finally, it has to be stressed, that – assuming that the level of violation of ethical values is sustained – whether the community of states has already reacted by imposing trade bans, or whether such measures are only in their initial phases, cannot make any difference.

The other prerequisites set out in Article 79(1) CISG, namely that the obligor could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences, do not pose any major problems in connection with the cases discussed here.

⁹⁴ See HANS STOLL/GEORG GRUBER in Schlechtriem/Schwenzer (eds.), op. cit. (fn 68), Art. 79 para 11. Impossibility, however, is not required as even laws can be evaded. See JOHN O. HONNOLD, op. cit. (fn 81), Art. 79 para 432.1.

⁹⁵ See HANS STOLL/GEORG GRUBER in Schlechtriem/Schwenzer (eds.), op. cit. (fn 68), Commentary Art. 79 para 1.

⁹⁶ Cf. PETER SCHLECHTRIEM in Schlechtriem/Schwenzer (eds.), op. cit. (fn 68), Art. 8 para 8; HANNS-CHRISTIAN SALGER in Witz/Salger/Lorenz (eds.), op. cit. (fn 74), Art. 79 para 5 et seq.

If, in a given case, the contract could be reasonably performed by, for example, changing the place of performance or origin⁹⁷ of the goods without posing undue burden upon the parties, an adaptation of the contract may be called for, if not under CISG then possibly under Article 6.2.3 Unidroit Principles 2004.⁹⁸

V. Conclusion

As has been shown, ethical behavior is becoming increasingly important for businesses and for conducting business. Such importance must necessarily translate into appropriate action, for example, as prescribed in codes of conducts or in contracts.

A crucial question is how those ethical values can be realized and upheld in daily commercial business transactions. In contracts governed by the CISG, ethical norms can be incorporated by several different means. Either they are expressly incorporated into the contract, or they are – in specific cases – incorporated as usages to which the parties have agreed or as practices which they have established between themselves pursuant to Article 9(1) CISG. Fundamental ethical standards – such as the prohibition of forced or child labor – are incorporated into the contract in any case. Such standards can be considered as being applicable to the contract by implication according to Article 9(2) CISG as a usage of which the parties knew or ought to have known and which in international trade is widely known to, and regularly observed by, parties to contracts of the type involved in the particular trade concerned.

The violation of – express or implied – contractual ethical duties by the seller usually leads to non-conformity of the goods under Article 35 CISG. Consequently, the party in breach can face remedies, such as a claim for damages, price reduction or – in the event of a fundamental breach under Article 25 CISG – avoidance of the contract.

If a party wants to claim damages, however, problems can arise. If the buyer has already re-sold the goods and has not yet suffered any loss of

⁹⁷ Under the CISG this would be possible if, for example, goods from another origin would be a ‘commercially reasonable’ substitute that satisfies the purpose of the contract just as well as the original goods intended. *See* HANS STOLL/GEORG GRUBER in Schlechtriem/Schwenzer (eds.), *op. cit.* (fn 68), Art. 79 para 23.

⁹⁸ Art. 6.2.3. Unidroit Principles states that in case of hardship the disadvantaged party is entitled to request renegotiations. According to the commentary, hardship consists in a fundamental alteration of the equilibrium of the contract. The renegotiations should be conducted with a view to adapting the contract to the new circumstances. *See* UNIDROIT (ed.), *Unidroit Principles of International Commercial Contracts 2004, Rome 2004*, Art. 6.2.3., p. 188.

goodwill, a basis upon which to claim damages would not appear to be established. However, it is submitted that, in such cases, the buyer can claim damages in the amount by which the actual value of the goods is reduced. This amount equals the amount by which the seller reduced its production costs by producing the goods in an unethical way – for example, by using forced labor. The same is true if a seller – who is interested in compliance with ethical standards – wants to claim damages from the buyer who does not use the goods in an ethical way. In this regard, it is submitted that the loss of the seller equals the eventual difference between the contractual value of the goods – i.e. the purchase price – and the real value of the goods, taking into account the unethical use that is intended and the possible consequences arising therefrom. Such claims for damages serve two functions. First, the equilibrium of the contract is reestablished. The seller's unethically generated profit is transferred to the buyer who – hypothetically – either would not have concluded the sales contract or would have bought the goods at a much lower price. With respect to unethical behavior by the buyer, any negative external effects on society at large would be internalized and imposed upon the buyer. Second, the objective of observance of ethical standards in international trade would be achieved as, on the one hand, one party loses its interest in unethically maximizing its profit and, on the other hand, the other has a financial incentive to enforce ethical standards.

In cases where the external circumstances change in a way that third parties – such as governments or rebels – severely violate ethical standards, this amounts to an impediment under Article 79(1) CISG. Here, sanctions by the community of states are likely to occur, and – for ethical reasons – it cannot reasonably be expected of the obligor to perform the contract. The obligor, in such cases, is entitled to suspend the performance of the contract without having to fear liability for damages.

Whether the respective prerequisites are actually met in a specific case is, of course, left to be decided by judges or arbitrators. However, the more that care is exercised in drafting the contract and in allocating the risks under it, the more that legal certainty and predictability of the outcome and legal position can be achieved and ensured.

