Law to Be Applied in International Arbitration

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Introduction

Business operators need to be able to settle their disputes by assessing the likely outcome of their situation. They can only do this if they are confident that the arbitrator will at least try to apply an objectively ascertainable system of law. They must recognize the possibility that the arbitrator will make a mistake, but this is not fatal to the settlement. What is not acceptable is that the arbitrator will "cut the baby in half", flip a coin or in some way depart from some recognized system of rules.

The International Chamber of Commerce (ICC) Rules[1] empower the court to scrutinize an arbitrator's draft award and, when necessary, bring points of substance to the arbitrator's attention. Nearly ten years ago, Fali Nariman, a vice-chair of the ICC Court of Arbitration, wrote of "an emerging . . . discernible pattern of transnational commercial jurisprudence . . . which can only be sustained if arbitrators of different nationalities and . . . legal systems continue rendering decisions which can be supported on some applicable law or principle".[2] The key principle here is predictability.

The outcome of a dispute can often depend on the solution offered by the law which applies to the contract. The law applicable to the contract is not just a guide for the person interpreting it. It also contributes to determining the extent of the parties' respective obligations by filling in gaps in the contractual provisions. In a Civil Law system the individual contract is linked to a general framework or code, such as that of sales or agency, whereas in Common Law jurisdictions the decision maker will speak of "implied terms". Also, of

1 ICC Rules 1998, Article 17.

2 ICC *Court Bulletin*, November 1991, at p. 7.

D. Campbell and S. Meek (eds.), The Arbitration Process, 77–87.

course, the law applicable to the contract may be needed to determine the validity of the contract itself.

Modern legal systems allow the parties to choose the law which they want to govern their relationship and, in most cases, they exercise that choice. Approximately seventy per cent of the cases referred to the ICC Court contain a choice of the law to be applied to the dispute.

In one arbitration award,[3] the arbitral tribunal referred to the general principle of international commerce that, where a contract designates an applicable law, either directly or by reference to a standard form contract, that law should be applied. Since there seemed to be no reason to derogate from that principle, the tribunal applied Algerian law as mentioned in the contract. The arbitrators observed that there were also substantial connections, citing as two major indicators the place where the contract was made and the place of performance, in this case oil to be delivered free on board (FOB) in Algeria.

In the other thirty per cent of cases, the parties can frequently agree on which law to apply but, in a few cases, it is the arbitral tribunal that must choose. Parties' failure to exercise the choice of law opportunity can lead to dangerous uncertainty, not only when a dispute arises, but also during the life of the contractual relationship. Yves Derains wrote that "ignorance of the law applicable to the contract not only complicates the settlement of any disputes, but may well even result in their occurrence. If they do not know which rule of law applies to their relationship, each party, in total good faith, will be tempted to perform the contract by reference to the law it knows best — its own — without perceiving that, in so doing, the parties are no longer performing the same contract.[4]

Once a dispute arises and one party requests arbitration, how is the arbitrator or chair of the tribunal to be chosen before the appointing authority knows which system of law is to be applied? In which jurisdiction should the parties or the appointing authority be seeking a competent decision maker? There have been cases where the tribunal has decided on the law of a state in which none of the arbitrators was an expert. They then had to consult an expert to see how the applicable law would apply to the case before them. This is not the most efficient use of resources.

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3 ICC *Court Bulletin*, December 1990, Number 5865.

4 ICC *Court Bulletin*, May 1995, at p. 10.

No wonder then that international experts recommend forcefully that parties choose the law which is to govern their contract at the time that the contract is concluded. The choice of law clause should be a separate clause in the contract. Incorporating it into the dispute resolution clause implies that the chosen law will have no role to play unless a dispute does arise. This, as has been pointed out above, is not necessarily so. Consider as well that a bad choice can have nasty results. Negotiators need to consider various factors in making an informed choice.

Possible Choices

National Law of One Party

Negotiators generally assume that their first choice should be their own national system. It is an understandable prejudice, in that one's own legal system is both familiar and predictable.

Nevertheless, experienced negotiators will not automatically assume that their own law is the most "favorable" to their side. Bernard Hanotiau tells the story of an arbitration in which an American manufacturer successfully insisted on Delaware law to govern its contract with a Belgian distributor. During the life of the contract, the American manufacturer wished to conclude additional distribution contracts for the same product with other Belgian distributors.

The Belgian distributor insisted that its contract was exclusive and that the manufacturer had no right to license others in Belgian territory. Belgian law contained a provision that a distribution contract is presumed to be exclusive unless otherwise agreed, but Delaware law contained no such provision. Had the United States party researched both laws, it could have accepted Belgian law and taken advantage of its presumption of exclusivity. As it happened, the parties spent several days arguing the point before the arbitral tribunal.

However, there is, of course, a more obvious and frequent problem: one party's preference for its own law will be countered by the other party's preference for its own law. If the parties are of unequal strength, one will prevail. If a stalemate ensues, the contract may never be concluded. In many cases, the negotiators will arrive at some sort of compromise.

Neutral System of Law

Frequently, a compromise is the choice of a third system of law, a choice equally disadvantageous to both sides. Before choosing any neutral system, the negotiator should know something about it and how it will affect the contract, as well as the overall interaction of that contract with the company's other international obligations. Choosing a neutral law that belongs to the same "family" (Common Law or Roman law) will minimize the differences between the chosen system and the national law in question. Accessibility is also a factor. Can the laws be easily obtained and do official translations exist?

A company that has many similar contracts with nationals of many states should decide on one law to govern all of them; otherwise, it will have great difficulty in administering the varying rights and responsibilities under the various national interpretations of the same agreement.

Combination of Systems, Rules, Conventions and Accepted Behavior

The parties may agree to the simultaneous application of two or more systems or they may agree that only where gaps appear in the contract will any national legal system apply in order to fill them. They may agree that the contract should be performed and interpreted according to the "principles common to their two systems".

This was the solution adopted in the Channel Tunnel contracts, when neither the French nor the British would concede the point. While attractive, it has its own problems. Do common principles exist? How are they to be identified? This may be a recipe for a "battle of experts".

Dépeçage

Another possibility is that of making different parts of the contract simultaneously subject to different laws.

The 1980 Rome Convention[5] allows for this practice and it may prove to be a good solution where one party needs to have certain portions of all of its contracts subject to one single national law. The problem with *dépeçage* is the difficulty of delineating the issues.

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5 Article 3(1).

UNIDROIT Principles

Many legal systems, including France, Switzerland, Lebanon, Algeria and Tunisia, to name but a few, now specifically allow for contracts to be governed by rules which do not belong to any one national system. Jurists refer to *lex mercatoria* or the law of the marketplace. The main difficulty with this rather seductive solution is that it is hard to determine just what these rules are, and so choosing them entails a certain unpredictability. Legal philosophers can also argue for days about the character of *lex mercatoria* — whether it is prescriptive or merely descriptive.

One advance in this particular area was the publication in 1994 of UNIDROIT's Principles of International Commercial Contracts, touted as a codification or restatement of *lex mercatoria*. The UNIDROIT drafters' goal was to achieve a balanced set of rules designed for use throughout the world, irrespective of the legal traditions in the countries where they were to be applied. To that end, experts from over fifty countries labored for over twenty years to produce the UNIDROIT Principles. Even its drafters will admit, though, that in certain areas there were apparent contradictions and in others there were gaps. In both cases, the drafters had to go beyond the task of simple codification and make subjective choices as to the "best" solution. After five years, it is clear that acceptance of the UNIDROIT Principles is not universal and that they are vastly more popular among Europeans than with Americans or Asians.

Contract "Without Law"

Over the past decade or so, certain jurists have argued that it is possible to formulate an agreement that is explicitly detached from any national legal system. Skeptics reply that if one defines a contract as an agreement that is enforceable by law, this term is an oxymoron. In the context of arbitration, one might argue that the effect is the same as "turkey arbitration" described in the 1989 Freshfields Arbitration Lecture by Lord Bingham.

An impartial chairman sat at the head of a long table with the parties on each hand. Down the middle of the table were placed, at intervals of a few inches, grains of oats. A foot or so from the head of the table the line of grain stopped and two grains were placed, several inches apart, one in front of each party. A hen turkey was then placed at the far end of the table. She would peck her way to the other end of

the table until she reached the two at the top, at which point she would render her award in favor of one party by taking first the grain nearer to him.

No Choice of Law by Parties

If the parties have neglected to choose the applicable law or, being unable to agree, have decided to go ahead anyway and sign a contract without a choice of law clause, a number of results may ensue. The most attractive possibility is that, once the dispute has arisen, the adversaries will then be able to agree what was impossible to agree when they were friends. This does occur, but rarely. More often, the parties will spend the first several months or even years debating the point before the arbitral tribunal, an expensive and time-consuming exercise. In fact, as noted above, without knowing which law will apply, it is difficult to constitute the arbitral tribunal.

Recent amendments to the ICC Rules, effective from 1 January 1998, provide for direct choice by the tribunal of the law applicable to the merits, rather than the rule of conflict of laws that had previously dictated the applicable law. In every case, according to the ICC Rules, the arbitrator will take into account the terms of the contract and the customs of the trade.

A 1988 interim decision,[6] which was decided under the old ICC Rules, concerned a contract that did not contain a choice of law provision. The claimant argued that, since there was no agreement on the applicable law, principles of international law and *lex mercatoria* should apply. The respondent countered that the choice of London as the site and English as the language of the contract indicated a choice of English law to govern the merits. The tribunal decided that the choice of site and language did not necessarily point to the use of English law, noting that the parties had agreed only on a "neutral" law. The tribunal used the "center of gravity" approach recognized in England, Liechtenstein and France to indicate the law of the jurisdiction having the closest connection to the case. Since the case centered on the return of documents from a bank in Geneva and there were several other factors pointing towards Switzerland, the tribunal in London applied Swiss law.

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6 ICC *Court Bulletin*, December 1990, Number 5717.

In a case under Article 3.1 of the Hague Convention of 1955 on International Sales,[7] a purchaser argued that Bangladeshi law should apply. The contract was formed in Bangladesh, and the merchandise was to be delivered to Bangladesh. The tribunal nevertheless used English law, as the law of the domicile of the seller was an important connecting factor. In this case, the Bangladeshi party had failed to provide information about how Bangladeshi law would deal with the merits of the case, relying instead on a presumption that Bangladeshi law was the same as the general principles of international law.

One might suspect that perhaps the tribunal simply chose the most accessible body of law. Under the successor convention, the Convention of Vienna of 1980, the result would be identical, but for different reasons. The Vienna Convention specifies that, where the parties do not choose, the law of the jurisdiction where the "characteristic performance" takes place should apply to the merits.[8]

The Arbitrator and the Law Chosen by the Parties

Once the applicable law is chosen, thought needs to be given to how an arbitrator might treat that choice.

The parties' freedom is not without limitations and, occasionally, even an informed choice can produce surprises.

Limits to Parties' Freedom of Choice

It is difficult to imagine the parties being able to agree as to capacity to sign the contract, for example. Another example is the effect of bankruptcy on the rights under the contract.

These issues involve third parties and need to be subject to one legal system — not open to forum shopping at the whim of the parties.[9]

Avoiding Nasty Surprises by Careful Drafting

Clearly, the arbitrator will look first to the provisions of the contract itself to see whether they contain the solution to the dispute. It is when they are absent or ambiguous that the tribunal will need to look at the

7 Number 5885.

8 United Nations Convention of Rome on the International Sale of Goods 1980.

9 Derains *Court Bulletin*, May 1995, at p. 16.

contract in the context of the law to be applied. In fact, perhaps the parties will have even agreed to exclude certain national laws or parts of them, or they may stipulate that it is the law of a certain jurisdiction at a particular point in time that should govern their relationship. If they wish to make such provisions, they must be clear and unambiguous, leaving the tribunal in no doubt as to their intention.

Yves Derains cites a case[10] concerning a clause stipulating, "this agreement shall be performed and interpreted in accordance with French law". The tribunal held that that meant that the contract provisions applied only insofar as they did not run counter to the mandatory provisions of French law. Thus, if the contract contained stipulations contrary to public policy under French law, those parts of the contract could not be performed. Had the parties intended to exclude French public policy so that their entire contract was valid under the rest of French law, they should have made it clear.

Severability of the Arbitration Clause

This is another *caveat*. There has been a great deal of discussion about the severability of the arbitration clause from the rest of the contract. This introduces the possibility that the arbitrator will look first to the provisions of the contract itself to see whether they contain the solution to the dispute. It is when they are absent or ambiguous that the tribunal will need to look at the contract in the context of the law to be applied.

In fact, perhaps the parties will even have agreed to exclude certain national laws or parts of them, or they may stipulate that it is the law of a certain jurisdiction at a particular point in time that should govern their relationship. If they wish to make such provisions, they must be clear and unambiguous, leaving the tribunal in no doubt as to their intention. In an ICC decision of 1990,[11] the tribunal stated:

> "The autonomy of the arbitration clause, widely recognized nowadays, is justification for referring to a non-national rule deduced solely from international trade usages. In particular, it is justifiable to separate the substance of the contract from the validity and scope of the arbitration clause."

10 Number 2119.

11 Number 5721.

This opinion was echoed a few years later by the French *Cour de Cassation*[12] and has come to be the generally accepted international norm.

Arbitrator as *Amiable Compositeur*

In a 1988 decision,[13] the terms of reference stipulated that the tribunal should designate the law they would apply to the merits of the case. In addition, the tribunal was to have the power to act as *amiable compositeur.* The claimants argued that it was the parties' intention to remove the case from any national law and to refer instead only to Incoterms, the customs of international commerce and the designation of the ICC as arbitral institution. The defendant never contested these points. Nevertheless, both parties in their written submissions referred frequently to French law and occasionally to Tunisian law, but never argued the issue of which law should apply.

The contract had connections to both legal systems. The tribunal decided that the best way to meet the expectations of the parties was to judge the merits on "principles common to French and Tunisian law" as well as principles of international commerce and that, if necessary, it would use its powers as *amiable compositeur.* As *amiable compositeur*, the arbitrators, although not absolved from the duty to search out applicable law in accordance with the rules of international private law, may be authorized not to apply either the indicated law, or the solution dictated by that law, if it would be too inequitable in the particular circumstances of that case.

International Public Policy

Parties planning to perform a contract in a foreign jurisdiction need to be aware of the potential effects of mandatory legislation either in that country or in a third country which has some interest in the contract's effects. The clearest examples are found in the application of European Union competition laws to agreements between parties.

Derains describes a hypothetical situation where a German and a Belgian subject their agreement to Swiss law, even though performance is to be within the European Union. If the parties do not

12 Derains *Court Bulletin*, May 1995, at p. 17, citing *Dalico*, Cass.Civ. Iere, 20 December 1993.

13 Number 5103.

specifically exclude the intervention of mandatory European laws, their contract will still be subject to them. In a notorious case of the European Court, two companies, neither of which was from a European Union country, made an agreement under one of their national laws for the distribution of pulp and paper products within the European Union.

The European Commission successfully prosecuted these non-European parties for contravention of European competition law. That type of result is less likely in an arbitral decision but, if their purpose was to exclude mandatory European competition legislation, the parties would need to state that expressly, in which case the arbitrator is faced with a decision of whether to respect that choice and thus to give effect to a deliberate fraud against the law of the European Union.[14]

Unlike a national court judge, the international arbitrator represents no one legal system. The authority and powers of the tribunal depend not on a state, but on the parties' will to create them. Consequently, the arbitral tribunal does not and should not cleave to any one system of law. Derains argues for limiting public policy exceptions in the international arbitration context exclusively to issues of "international public policy", that is, principles that the arbitral tribunal considers as truly international, such as combating corruption.

Only in these cases should the arbitrator override the clearly expressed intentions of the parties. This, the modern and liberal view, is unfortunately not shared by the judiciary of every trading nation around the globe. Checking with local counsel as to judicial attitudes to arbitration is not an "extra precaution". It needs to be part of the basic research when the contract is being drafted.

Conclusion

Parties negotiating an international contract are frequently tempted to relegate the choice of applicable law to the bottom end of their priority list. Much more interesting are the issues of quantity, quality, price, service and profit margins — the "meat" of their contract — and its *raison d'etre*. In the enthusiasm for their new partnership, or in the heat of tough negotiations, it is all too easy for parties to think of

14 Derains *Court Bulletin*, May 1995, at p. 17.

applicable law as just lawyers' business — a theoretical consideration, one that will only be important if a dispute arises. Also, human nature being what it is, the parties are usually optimistic, even naive, about that possibility. Choice of law is, therefore, forgotten, neglected, carelessly worded or even sacrificed as a *quid pro quo* to obtain a concession in some other area of the discussions. The business partners themselves can be forgiven for such an attitude. Their lawyers cannot, for this is indeed, "lawyers' business".

It is counsel's responsibility to investigate carefully the various legal systems that may affect the interpretation, performance and general success of the contractual relationship. One needs to ensure that not only the contract, but also its legal context, are clear and unambiguous and understood by both partners. It needs to be pointed out that, even having chosen one law as applicable, the partners cannot absolutely exclude the influence of another system.

One needs to be familiar not only with the letter of the laws in question, but also with the likely interpretation and implementation of those laws, first by the arbitrator and, finally, by a national judge. That responsibility covers not only disputes relating to the contract, but also applies to issues of capacity and validity and of the likely treatment of the resulting award by the judges of the country where it will need to be enforced.

It may take much persuasive power to convince a client — who has eyes only for that signature on the dotted line, the celebratory champagne cork and the pot of profit at the end of the negotiation — that these questions are important, but an ounce of prevention will eliminate the need for a ton of cures.