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LITIGATION OR ARBITRATION? THE INFLUENCE OF THE DISPUTE RESOLUTION PROCEDURE ON SUBSTANTIVE RIGHTS

Roy Goode*

Allan Farnsworth was one of the world's great contract and commercial lawyers. His textbook and separate casebook on contract law became classics, displaying enormous scholarship and extraordinary industry. So too did the American *Restatement (Second) of Contracts*, of which he was the Reporter. Allan is a huge loss to the Columbia Law School, where he laboured in the vineyards for over half a century. But his absence will also be keenly felt elsewhere, not least at UNIDROIT,[1] where he served with distinction as a member of the Governing Council for two decades and was a major influence in the shaping of the UNIDROIT Principles of International Commercial Contracts as a member of the Working Group so admirably chaired by Professor Michael Joachim Bonell. Allan had a gift for succinctly capturing the commercial realities underlying rule-mak-

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[1] The International Institute for the Unification of Private Law, an international intergovernmental organization based in Rome and devoted to the unification of private law at the international level.

ing. Writing of dispositive contract rules applicable in default of contrary agreement by the parties, he commented:

> Some default rules are intended to spare parties the cost of negotiating and drafting by providing the rules that they would probably have agreed upon had they taken the time to do so . . . . But many default rules have a different purpose. They are *not* the rules that the parties would probably have agreed upon; they are instead rules that will induce the parties – often one of the parties – to negotiate a more suitable rule for the particular transaction.[2]

This would have been the perfect answer to complaints by certain sectors of the leasing industry that the provisions of the 1988 UNIDROIT Convention on International Financial Leasing did not reflect the typical terms of a financial lease.

Allan was much in demand as an arbitrator in international commercial arbitrations, where his commercial grasp and trenchant style quickly demolished untenable propositions. I was once privileged to be invited by him and his co-arbitrator to be the Chairman of a tribunal in an arbitration in which they were engaged. The applicable law was that of the State of Illinois and the procedure was governed by the arbitration rules of the Arbitration Institute of the Stockholm Chamber of Commerce. The American party sought to have a substantial volume of evidence excluded on the ground that it contravened the Illinois parol evidence rule. Allan gave a snort of derision – and that was the end of the argument!

This short piece has no pretensions to profundity; it is written simply as a brief tribute to an outstanding scholar who could have written it so much better himself.

I. INTRODUCTION

Much has been written on the relative merits of litigation and arbitration. Advantages claimed for the latter are party selection of the tribunal, privacy, confidentiality, party control of the procedure, finality, speed and cost reduction. In relation to the first five of these, the claims are justified, though with the caveat that confidentiality and finality may be undermined by

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[2] E. Allan Farnsworth, *An American View of the Principles as a Guide to Drafting Contracts, in* UNIDROIT PRINCIPLES FOR INTERNATIONAL COMMERCIAL CONTRACTS: A NEW LEX MERCATORIA? 87 (1995).

judicial review, whilst in the case of international commercial arbitration, at least, it is often far from the case that the proceedings are quicker and less expensive than litigation.[3] What is interesting, however, is that in the decision whether to select litigation or arbitration as the mode of dispute resolution, the focus is almost exclusively on procedure and on the exclusion or restriction of judicial review. Relatively little attention has been paid to the potential impact of the choice of arbitration on the determination of substantive rights in international disputes. In particular, regard should be had to: (1) the determination of the applicable law, (2) the application of "rules of law," (3) the effect of failure to apply the applicable law correctly or at all, (4) the impact of a more relaxed approach to the admissibility of evidence, and (5) recognition and enforcement of a foreign arbitral award. Of course, the restriction of judicial review remains an important factor to be taken into consideration.

II. The Impact of Institutional Rules

In evaluating an arbitration clause providing for institutional arbitration – for example, arbitration under the aegis of the International Chamber of Commerce or the London Court of International Arbitration – it is all too easy to overlook the impact of the institutional rules by which the parties agree to be bound when submitting their request for arbitration. These rules, though primarily directed to the appointment of the arbitral tribunal and the conduct of the arbitration, may also contain important provisions which directly or indirectly affect substantive rights. For example, the determination of the applicable law, the power of the tribunal to draw on non-binding rules as sources of rights, the admissibility of evidence and the exclusion of judicial review may be affected. Therefore, institutional rules may, in various ways, expand the power of the tri-

[3] Whereas in judicial proceedings court fees are usually modest and no payment has to be made for the judge or the use of the courtroom, in the typical case involving a panel of three arbitrators the parties will be responsible for their travel costs, hotel accommodation, fees of the arbitrators, hire of rooms for the hearing and, in the case of an institutional arbitration, the fees of the institution administering the arbitration. Moreover, dates have to be fixed which accommodate the diaries of the three members of the arbitral tribunal, lawyers on both sides, the parties themselves and witnesses. This can result in substantial delays before the case is heard.

bunal and limit the circumstances in which its award may be set aside or refused recognition.[4]

III. Determination of the Applicable Law

In cases involving a foreign element, the national judge frequently[5] has to determine what law governs the issue or issues before the court. For that purpose he is obliged to apply his own country's rules of private international law. The trend in arbitration is towards giving the arbitral tribunal greater freedom. This may be enshrined in legislation on arbitration or in institutional rules. Thus, under some of these rules, an arbitral tribunal, while obliged to respect party choice of law, may in the absence of such choice determine the law applicable to the substance of the dispute in accordance with the conflict rules it considers applicable[6] or appropriate.[7] Not all jurisdictions are quite so liberal. For example, where the seat of the arbitration is in Switzerland, section 187(1) of the Swiss Private International Law Act 1987 requires the arbitral tribunal to decide the case in accordance with the rules of law[8] with which the case has the closest connection. This is the approach taken by several other jurisdictions. In neither case, however, is the tribunal required to apply the conflict rules of the seat of the arbitration itself. This distinguishes the position of an arbitral tribunal from that of a national judge. So the applicable law as determined by an arbitral tribunal may well be different from that determined by a judge under national conflict of laws rules and may produce an entirely different outcome. However, in all these cases the tribunal must reach the applicable law through a conflicts rule. But some jurisdictions allow the tribunal to de-

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[4] *See infra* Parts VI, VII.

[5] But not always, because foreign law may not have been pleaded or because on the point at issue the laws of the different states may be the same.

[6] *See, e.g.*, UNCITRAL Model Law on International Commercial Arbitration, art. 28(2) (1994); UNCITRAL Arbitration Rules, art. 33(1) (1998); Arbitration Act, 1996, 23, § 46(3) (Eng.).

[7] *See, e.g.*, International Chamber of Commerce (ICC) Rules of Arbitration, art. 17(1) (Jan. 1, 1998) [hereinafter ICC Rules of Arbitration]; LCIA Arbitration Rules, art. 22(3) (1998).

[8] As to "rules of law," see *infra* Part IV.

termine the applicable law directly without going through a conflicts rule.[9]

IV. THE APPLICATION OF "RULES OF LAW"

The traditional conflict of laws doctrine is that only the law of a state can be selected to govern a transaction or issue. On this basis, a national court, unless otherwise empowered by its own law, cannot directly apply the *lex mercatoria* or rules based on a combination of national laws or non-binding rules of law, such as the UNIDROIT Principles of International Commercial Contracts (PICC) or the Principles of European Contract Law (PECL), though these may well serve as a reference point for the court in deciding in which direction its national law should develop. It is generally considered that the 1980 Rome Convention on the law applicable to contractual obligations,[10] in its references to "law," applies only to the legal system of a state, not to non-binding rules of law. However, the impetus in international commercial arbitration to free arbitral tribunals from the shackles of national law and enable them to draw on sources offering the best solutions to modern problems has led increasingly to the acceptance of "rules of law." These legal rules are drawn from a number of legal systems and are evolving as transnational rules, general principles or *lex mercatoria*, including formulations in non-binding instruments such as the PICC and PECL. The ICC Rules of Arbitration provide for the application of rules of law in the following terms:

> The parties shall be free to agree upon the rules of law to be applied by the Arbitral Tribunal to the merits of the dispute. In the absence of any such agreement, the Arbitral Tribunal shall apply the rules of law which it determines to be appropriate.[11]

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[9] *See* FOUCHARD, GAILLARD, GOLDMAN ON INTERNATIONAL COMMERCIAL ARBITRATION ¶¶ 1552-53 (Emmanuel Gaillard & John Savage eds., 1999).

[10] Now being converted into an EC regulation, an early draft of which would have empowered the parties, instead of choosing the law of a state, to "choose as the applicable law the principles and rules of the substantive law of contract recognised internationally or in the Community." *See* Proposal for a Regulation of the European Parliament and the Council on the Law Applicable to Contractual Obligations (Rome I), com (2005) 650 final (15 December 2005), ¶ 4.2. This provision, which would have allowed choice of the PICC and the PECL as the applicable law, proved too controversial and has been dropped.

[11] ICC RULES OF ARBITRATION, *supra* note 7, art. 17(1).

There has been an increasing number of references to the UNIDROIT Principles in ICC awards, and in several of these cases the Principles have been directly applied as rules of law or as evidence of custom or usage or to supplement the applicable law.[12]

The concept of rules of law is seen as more responsive than national law to the needs and practices of international commerce and the identification of best solutions to given problems. The UNCITRAL Model Law,[13] the Washington Convention,[14] and the arbitration laws of a number of legal systems, including English law,[15] permit the parties to choose rules of law but, in the absence of choice, require the tribunal to apply "law" in the traditional way. Certain other systems, including French law, are more liberal, and empower the tribunal to apply the rules of law it considers appropriate.[16] Either approach gives the arbitrator a wider degree of freedom than that enjoyed by a judge applying national law and may lead to the application of rules different from that which the judge would apply and, in consequence, to a different result. So again, the choice of arbitration as the dispute resolution mechanism may affect not only the procedure to be followed, but the substantive result of the case.

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[12] *See* UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS: REFLECTIONS ON THEIR USE IN INTERNATIONAL ARBITRATION, A SPECIAL SUPPLEMENT TO THE ICC INTERNATIONAL COURT OF ARBITRATION BULLETIN (Int'l Chamber of Commerce 2002); Emmanuel Jolivet, *The UNIDROIT Principles in ICC Arbitration*, *in* UNIDROIT PRINCIPLES: NEW DEVELOPMENTS AND APPLICATIONS, ICC INTERNATIONAL COURT OF ARBITRATION BULLETIN 2005 SPECIAL SUPPLEMENT (Int'l Chamber of Commerce 2006).

[13] UNCITRAL MODEL LAW ON INTERNATIONAL COMMERCIAL ARBITRATION, art. 28(2) (1994).

[14] Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, International Center for Settlement of Investment Disputes, Washington 1965 [hereinafter Washington Convention]. *See infra* Part VI.

[15] Arbitration Act, 1996, 23, § 46(1)(b) (Eng.). This does not use the phrase "rules of law" but, after referring to the law chosen by the parties, empowers the tribunal, if the parties so agree, to decide the dispute in accordance with "such other considerations as are agreed by them or determined by the tribunal", which goes even wider than rules of law and enables the parties to give the tribunal power to decide *ex aequo et bono*.

[16] New Code of Civ. Pro., art. 1496.

V. Evidence

The admissibility of evidence in proceedings before a court is governed by the law of evidence, which may impose constraints on what can be admitted. Thus, many common law systems have or have had rules excluding the admissibility of hearsay evidence,[17] secondary evidence, such as a copy of a document when the original is available,[18] and parol evidence.[19] Though in modern times rules of this kind are of reduced importance, they may nevertheless from time to time operate to exclude evidence which, if admitted, might have led to a different outcome of the case. Arbitrators, however, are not bound by such rules except so far as the parties themselves agree to apply them. In practice, the strong tendency in arbitration is not to apply exclusionary rules but to evaluate the weight, rather than the admissibility, of evidence. Article 34(2)(f) of the English Arbitration Act leaves it to the tribunal to decide whether to apply strict rules of evidence (or any other rules) as to the admissibility, relevance or weight of any material (oral, written or other) sought to be tendered.

Again, the significance of any applicable institutional rules should not be overlooked. So Article 25(6) of the UNCITRAL Arbitration Rules provides that the arbitral tribunal shall determine the admissibility, relevance, materiality and weight of the evidence offered, and similar provisions are to be found in Article 34(1) of the ICSID Arbitration Rules, Article 22(1)(f) of the LCIA Arbitration Rules and Article 20(6) of the American Arbitration Association International Rules.

VI. Restrictions on Judicial Review of an Arbitral Award

One of the undoubted advantages of arbitration is the greater degree of finality that results from an arbitral award than from a court judgment. It is much harder to have an arbi-

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[17] An out-of-court statement offered in evidence to show the truth of the facts asserted in the statement.

[18] The so-called "best evidence" rule.

[19] Extrinsic evidence adduced to add to, contradict or vary the terms of a written contract. The parol evidence rule was traditionally formulated as one which excluded oral (parol) evidence but in fact applies to any evidence, written or oral. The rule is subject to numerous exceptions and has little to commend it.

tral award set aside or varied in court proceedings than it is to have a judgment upset or modified on an appeal to a higher court. Thus in principle it is not a ground for setting aside an award that the tribunal was guilty of errors of fact. However, under US law, an award may be set aside for "manifest disregard of the law," that is, an intentional disregard of the law agreed by the parties or found by the tribunal to be applicable, where, if the law had been applied, it would have led to a different result,[20] whilst English law allows an appeal on the grounds of want of jurisdiction, serious procedural irregularity and error of law, though in this last case only if the parties agree or the court gives leave (which it cannot do unless various conditions are satisfied) and the right of appeal has not been excluded by agreement.[21]

A distinctive feature of arbitration under the Arbitration Rules of the International Centre for the Settlement of Investment Disputes (ICSID) is that ICSID awards, though subject to an internal annulment procedure by an *ad hoc* committee appointed in accordance with Article 52(3) of the Washington Convention, are immune from judicial review in every Contracting State.[22]

VII. Recognition and Enforcement of Awards

While there are only limited arrangements in force for the international recognition and enforcement of judgments in civil cases,[23] the position is otherwise in the case of international commercial arbitration, which is governed by the United Nations Convention on the Recognition and Enforcement of For-

[20] In a recent decision, the Eleventh Circuit Court of Appeals reviewed the "manifest disregard of the law" standard and held that the case fell far short of what was required to show a breach of that standard: B L Harbert Int'l LLC v. Hercules Steel Co., 441 F.3d 905 (11th Cir. 2006); *see also* Eric D. Dunlop, *Setting Aside Arbitration Awards and the Manifest Disregard of the Law Standard*, 80 Fla. B.J. 51 (2006).

[21] Arbitration Act, 1996, 23, §§ 67-69 (Eng.).

[22] Washington Convention, art. 53(1). The grounds for annulment are laid down in art. 52(1) and are very restricted.

[23] Within the European Community mutual recognition and enforcement are provided by Council Regulation (EC) No 44/2001, Dec. 22, 2000 (commonly known as "Brussels I") on the recognition and enforcement of judgments in civil and commercial matters. Outside the European Community, recognition and enforcement are dependent on bilateral treaties.

eign Arbitral Awards,[24] which has been ratified by no fewer than 137 states. Under the Convention, a party receiving an arbitral award in one state is entitled, on complying with the requisite formalities, to have the award recognized and enforced in another state, provided that state is a party to the Convention.[25] Such recognition and enforcement may be refused only in the restricted circumstances laid down in Article V.[26]

VIII. Implications for the Drafting of Arbitration Agreements

I have often felt that insufficient attention is given to dispute resolution clauses, which tend to be treated as boilerplate. Typically, the parties opt either for litigation in a selected forum under an exclusive or non-exclusive jurisdiction clause or for arbitration, often under institutional rules, by arbitrators appointed pursuant to those rules or some other given procedure. However, at the time of their agreement the parties may not be well placed to predict in advance the form of dispute resolution best suited to their case. It would often be preferable to specify an interim procedure, such as negotiation followed by a mechanism to determine the most appropriate means of resolving the dispute. But whatever procedure is agreed upon, it is important, when drafting the dispute resolution clause, to take into account the different ways in which, as described above, the choice may impact on the parties' substantive rights.

So when an arbitration clause is being drafted the parties need to consider to what extent they wish either to expand or to constrain the powers of the arbitral tribunal. In particular, should the tribunal be free to have recourse to soft law embodied in non-binding rules either to supplement or to supplant the otherwise applicable law? Should the parties consider the inclusion of an express provision dispensing with strict rules of evidence rather than leaving themselves in the hands of the arbitral tribunal? Should they not ensure, when adopting institu-

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[24] United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 330 U.N.T.S. 38.

[25] *Id.* arts. III, IV.

[26] However, a state, when signing, ratifying or acceding to the Convention, may declare that it will apply the Convention only to awards made in the territory of another Contracting State. *Id.* art. I(3).

tional rules, that there are no default rules which need to be excluded or varied? Moreover, in fixing the seat of the arbitration, the parties need to consider the law of the intended forum governing judicial review and the extent to which they are content to have any award subjected to an appeal to the courts in accordance with that law.

There is one final point. In some jurisdictions, such as France, the courts consider that an award in an international commercial arbitration is autonomous in character, so that where, for example, the seat of the arbitration is Switzerland, a French court is nevertheless entitled to enforce an arbitral award that has been set aside by Switzerland's highest court because the award, being international, is not "integrated into the legal system" of Switzerland.[27] The parties need to consider whether, in the interests of preserving the finality of the award, which as noted earlier is one of the key attractions of arbitration, they should agree that no application will be made in a foreign court to enforce an award set aside under the *lex loci arbitri*.

[27] Hilmarton Ltd. v. Omnium de Traitement et de Valorisation (OTV), Cass. le civ., Mar. 23, 1994, 1994 REV. ARB. 327. *See also* Pabalt Tikeret Sirketi v. Norsolor, Cass. le civ., Oct. 9, 1981, 1985 REV. ARB. 431; Polish Ocean Line v. Jolasry, Cass. le civ. Mar. 10, 1993, 1993 REV. ARB. 255; Arab Republic of Egypt v. Chromalloy Air Services, CA, Paris, Jan. 14, 1997, 1997 REV. ARB. 395. *See* Roy Goode, *The Role of the Lex Loci Arbitri in International Commercial Arbitration*, 17 ARB. INT. 19, 32-33 (2001) (provides a detailed criticism of the concept of delocalization of the award reflected in these decisions).