JAN PAULSSON | NIGEL RAWDING | LUCY REED

The Freshfields Guide to Arbitration Clauses in International Contracts

THIRD EDITION

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Law & Business

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About the authors

The first edition of this Guide was the creation of Martin Hunter, Jan Paulsson, Nigel Rawding and Alan Redfern at a time when they were all partners in Freshfields and members of the firm's international arbitration group. Since retiring from the firm, Martin Hunter and Alan Redfern continue to feature prominently in the practice of international dispute resolution, sitting frequently as arbitrators as well as writing and speaking on the subject. Eric Schwartz, a former Secretary-General of the ICC, contributed to the second revised edition whilst he was a partner in the firm, as did Lucy Reed. Jan, Nigel and Lucy continue as leading members of the firm's international arbitration group and as co-authors of this third edition.

Preface to the first edition

The dispute resolution clause is usually found near the end of a contract, alongside such innocuous items as addresses for serving notices. It may ultimately prove to be the most important provision of all. Rights and obligations carefully defined elsewhere in the contract are only as reliable as the courts or tribunals called upon to give effect to them.

Yet with astonishing regularity international contracts contain defective dispute resolution clauses. Even lengthy and complex agreements, drafted by negotiators whose understanding of everything else is highly sophisticated, often reflect ignorance of the mechanisms of international dispute resolution. Hence this concise Guide, designed for contract negotiators.

Other negotiating options are available in contemporary practice to those who are dissatisfied with traditional adjudicatory mechanisms. These options have in recent years been described by the acronym ADR ("alternative dispute resolution"). The Guide addresses some of the most important features of ADR and includes some suggested model ADR clauses.

Naturally, the Guide cannot be relied upon as a substitute for specialist professional advice as to the appropriate method of dispute resolution in the particular circumstances of any individual transaction. The international scene is constantly changing. Today's preferred solution will not necessarily be tomorrow's. However, the types of pitfalls tend to remain the same and one of the aims of this Guide is to help steer the reader away from them.

The focus of this Guide is *Chapter 7: Drafting the arbitration clause.* For the harried practitioner, it may be the first section to be consulted at the eleventh hour of a negotiation, together with the model clauses set out in Appendix 1. But with arbitration clauses, as with a balance sheet, to achieve a pre understanding requires more than looking at the bottom line.

Preface to the second edition

In introducing this second edition of the Guide it is tempting to say something which is at least new, even if not profound. There have been significant developments in the law and practice of international arbitration since the publication of the first edition in 1993, notably in the promulgation of new arbitration laws and new or revised international arbitration rules. Yet the considerations which prompted us to prepare the Guide in the first place have not changed. It is still true that relatively little attention is paid to the dispute resolution clause in otherwise lengthy, complex and heavily negotiated agreements. The *raison d'être* for the Guide therefore remains the same, as does the advice – albeit updated in order to take account of recent developments – that follows.

Preface to the third edition

In the decade since publication of the second revised edition of this Guide, the growth of international commercial arbitration has continued unabated. There has also been a notable increase in the number and variety of disputes referred to arbitration under investment treaties with state parties. Whilst that topic is, for the most part, beyond the scope of this Guide, we have drawn attention to some of the issues that may arise when contracting with a state party.

During 2010 alone, the arbitration community witnessed the promulgation of revised UNCITRAL Arbitration Rules (effective from 15 August), revised SCC Rules (in force from 1 January), amended IBA Rules of Evidence (published on 29 May) and new or amended rules published by regional institutions such as LCIA India (effective from 17 April) and SIAC (in force from 1 July). Revisions to other institutional rules, such as those of the ICC and the LCIA, are planned. Legislative and judicial developments have continued to influence the many substantive and procedural issues that arise in the law and practice of international arbitration.

Yet the more things change, the more they seem to stay the same. A further ten years of experience and observation reinforces the need for contract negotiators and their advisers to focus on the essential elements of the process. If well-informed choices in those key areas are made at the outset (for example as to the applicable law, the seat of arbitration and the procedural rules) the vagaries of the dispute resolution process can be much reduced, even if not eliminated altogether. We hope that users of this third edition will benefit from the lessons to be learned from the mistakes of others.

The authors wish to acknowledge the invaluable contribution made by Ashmita Garrett, a senior knowledge management lawyer in our firm's London office, assisted by trainees and paralegals, in compiling additional information

and providing suggestions for inclusion in this revised text. We have attempted to reflect the state of play in the arbitration world as at 31 August 2010. As usual, of course, any errors or omissions in the final product are the responsibility of the authors themselves.

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Chapter 1

Choosing the method

In broad terms, contract disputes may be resolved by:

- direct negotiation,
- one of the many forms of alternative dispute resolution,
- litigation before national courts, or
- arbitration.

In contrast to *domestic* contracts (where all concerned expect the local national courts to have jurisdiction, even in the absence of a contractual provision to that effect), parties to *international* contracts need to agree on what will happen if a dispute cannot be resolved by negotiation or other means. This is best done at the time of negotiating the contract.

Direct negotiation

Parties are always free to discuss issues or disputes which arise during the course of a contract. There does not have to be a clause allowing (or requiring) them to do this. However, in complex contracts, more than one method of resolving disputes will often be identified, in a so-called tiered or staged dispute resolution clause. The first stage of such a process can be direct negotiation at party level. For example, in long-term infrastructure projects, there may be a stipulation to the effect that the project managers of both parties must first attempt to diffuse the situation before it reaches more senior levels of management. If this fails then other dispute resolution methods will follow, as described below.

ADR

Although arbitration itself is an alternative to recourse to the courts, it should be distinguished from methods of dispute resolution conventionally designated as alternative dispute resolution or "ADR".

Arbitration is intended to lead to a binding determination of a dispute, by means of an award enforceable if necessary against the assets of the losing party. Only in limited circumstances, in order to prevent injustice, may the courts set aside or refuse to enforce awards when the arbitral tribunal has not complied with certain essential requirements of natural justice or due process, such as treating the parties with equality and giving each an adequate opportunity to present its case.

By contrast, ADR (in the conventional sense, excluding arbitration) is not usually intended to result in a *binding* determination of rights and obligations. Broadly speaking, the courts will not intervene to protect related procedural rights. This is so because in ADR, the victim of an abuse of process may simply reject the outcome of an ADR procedure, or refuse to participate in it at all.

The use of ADR has grown significantly in some countries, often as part of a formal dispute resolution process initiated either by the parties themselves or at the direction of a court. In England, for example, before parties issue proceedings in the courts, they must have made efforts to resolve their differences. The judge will ask to see evidence of this. Sometimes, a failure to explore alternative solutions may result in a costs penalty even if a party is successful in later proceedings. In the United States, the courts regularly refer parties to arbitration.

ADR procedures may take many forms, from third-party assisted negotiation to "mini trials". The procedures may be more or less sophisticated and more or less formalised or structured. They may be described as facilitative or evaluative, interest-based or rights-based. They may take the form of contractual obligations to have personnel of a certain level participate in discussions in the early stages of a dispute, or to seek an "early neutral evaluation" of the merits of each party's case, by an independent third party.

Contracts often simply provide for a "cooling off" period in which parties agree not to take any formal step (such as commencing an arbitration) in order to allow an opportunity for their dispute to be resolved by other means. This

may be direct negotiation or involve an informal, non-binding assessment by a respected third party. In many cases, a perceptive, diplomatic and businesslike outsider may tilt the discussions toward accommodation rather than discord.

Some ADR methods commonly used as part of a tiered dispute resolution process are discussed briefly in *Chapter 8: Choosing ADR/tiered dispute resolution methods*.

As the acronym ADR includes the concept "alternative", it may induce the belief that an ADR clause is a *substitute* for a traditional forum clause. It most certainly is not. Theodore Roosevelt gave the advice long ago to speak softly but carry a big stick. There have been many instances since then of the use of diplomacy coupled with the threat of force.

Speaking softly will often do the job if both parties proceed in good faith. That is what ADR is all about. Nonetheless, most parties will ultimately wish to be able to rely upon their contractual rights, as determined by litigation or arbitration. However willing they may be to pursue negotiations, they understandably have no intention of giving up the stick of a binding procedure if they feel that they are entitled to recover substantially more than the other party is willing to offer.

ADR procedures do not usually provide a mechanism to obtain a binding result. That does not, however, mean parties can ignore valid clauses requiring that they negotiate or mediate. A recent Australian Court of Appeal decision[1] held that a clause requiring party representatives to "meet and undertake genuine and good faith negotiations with a view to resolving the dispute or difference" was not too uncertain in law, but was valid and enforceable. The more the ADR process is successful in reaching settlement, the fewer arbitrations there will be. But it is just as true that greater use of ADR clauses should have no effect on the frequency of the inclusion of arbitration clauses in international contracts. A disputes clause without an ADR clause may perhaps not be ideal, but at least it can be made to work irrespective of the objections of a recalcitrant party. An ADR clause without a traditional binding disputes clause, at least in the international context, is a recipe for disaster.

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1 *United Group Rail Services Limited v Rail Corporation New South Wales* [2009] NSWCA 177.

Litigation before national courts

Parties occasionally designate a national court as the forum for resolving disputes. But in most international transactions (with the possible exception of those concerned solely with lending or other standard form transactions), it is unlikely that the same national court will be accepted by both sides. Understandably, parties are often unwilling to allow disputes to be determined in the other side's home territory. Nor are the national courts of a third, neutral, country likely to be appropriate, for several reasons.

First, it may be unwise to entrust a dispute governed by a different, or "foreign", system of law to national judges whose qualifications and training are deeply rooted in their own legal systems. The need to present evidence of such foreign law may be cumbersome and expensive.

Secondly, the contract, as well as correspondence and other documents relating to the dispute, may have to be translated into the working language of the judge of the national court. Furthermore, the oral proceedings will necessarily have to be in the judge's own language, which means that those most closely connected with the transaction may not understand what is being said, or may not be able to make themselves understood. Advocates unfamiliar with the parties and the transaction may have to be retained to play the lead role.

Thirdly, it is not always certain that the courts of a country having no connection with either the parties or the subject matter of the dispute will allow their judicial resources (generally paid for by that country's taxpayers) to be used to resolve disputes between foreign parties. The jurisdiction of a chosen national court may also be open to attack by one of the parties on grounds of *forum non conveniens*, notwithstanding the parties' agreement to refer the dispute to those courts.

Fourthly, with some exceptions such as cases within the European Union, the network of treaties for the recognition of national court judgments is far from complete. By contrast, arbitration awards are more readily enforceable across national frontiers than judgments of national courts.

Fifthly, court actions are generally open to public scrutiny.

Arbitration

By contrast with litigation before national courts, arbitration is a private, consensual process (in the sense that it is derived from the parties' agreement to refer disputes to arbitration). It is nevertheless intended to result in a binding, enforceable award.

Although circumscribed by the parties' agreement, most standard form arbitration clauses cover claims for breach of contract, specific performance, misrepresentation and other claims "arising out of or in connection with" the contract. Examples of such standard clauses are included in Appendix 1.

The main advantages of international arbitration over litigation before national courts may be summarised as follows:

- *Enforcement of awards*: Foreign arbitration awards are enforceable in more than 140 countries which are parties to the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (*New York Convention*). See *Chapter 3: Choosing the place of arbitration*, and Appendix 6. By contrast, many countries which have ratified the New York Convention are not party to treaties or other arrangements which facilitate enforcement of court judgments. Arbitration will be a more effective dispute resolution method if it becomes necessary to enforce the award in one of those countries. For example, the People's Republic of China has signed up to the New York Convention but not to enforcement of judgment treaties with countries such as the US, Germany or the UK. The US has also signed up to the New York Convention but has no treaties for enforcement of US judgments with other states (or vice versa).
- *Neutrality*: The arbitral tribunal and the procedure for the arbitration can be chosen so as to have a non-national character, acceptable to parties and their representatives, regardless of their different backgrounds.
- *Confidentiality*: Arbitration is a private process and the confidential nature of the dispute and the proceedings may be protected (although cannot be assumed).
- *Procedural flexibility*: The parties are free to choose the procedure which suits them best. They are not bound by national procedural rules. There is

also increasing use of internationally accepted supplementary materials, such as the International Bar Association Rules on the Taking of Evidence in International Commercial Arbitration, commonly referred to as the "IBA Rules of Evidence". (The Rules were first published in 1999 and a revised edition was adopted in May 2010.)

- *Expert arbitrators*: Arbitrators can be selected to meet the particular needs of the case, for example, where specific technical knowledge, qualifications or experience are required.
- *Speed and cost?* The flexibility of the arbitration procedure can lead to savings of both time and money. However, the time and cost involved will depend on the procedure adopted, the degree of co-operation between the parties, the availability of the arbitrator(s) and the fees charged by them as well as any arbitral institution involved. For complex commercial disputes, especially where the amounts at stake are high, arbitration should not necessarily be regarded as a quicker and cheaper alternative to litigation.
- *Finality of awards*: Appeals or other recourse to national courts by a losing party may be excluded or restricted, either by law or by prior agreement between the parties.

There are also potential disadvantages in the use of arbitration as opposed to litigation, their significance depending upon the circumstances of each case:

- *Limited powers of arbitrators*: Arbitrators lack effective powers of compulsion. In certain cases it may be necessary for the parties to have recourse to the national courts, for example, to seek injunctions or other forms of interim relief which carry effective sanctions and can bind third parties. (Many arbitration rules expressly provide that applications to the courts for interim relief are not incompatible with the agreement to arbitrate.)
- *Multi-party and multi-contract disputes*: Multi-party disputes can arise where more than two parties (or groups of parties) are involved from the start of proceedings; or a third party wishes to join existing proceedings; or one of the parties to existing proceedings (usually the respondent) wishes to join a third party with whom to share any liability that may arise.

Multi-contract disputes can arise where the issues in one set of proceedings are similar to those in another set of proceedings and it makes legal and practical sense to combine them. Numerous examples arise in large-scale infrastructure projects, involving the project owner, contractor, sub-contractors and lenders.

In general, an arbitral tribunal has no power to join third parties (that is, those who are not parties to the arbitration agreement) into arbitration proceedings against their will, nor to order the consolidation of two or more arbitrations without the consent of all parties, even where common questions of fact or law arise which affect all parties. Moreover, even where all parties agree to the consolidation of separate arbitration proceedings, practical difficulties can arise, since workable procedures for multi-party arbitrations are rarely provided for in pre-existing arbitration rules. The problems posed by multi-party and joinder issues in particular have been a feature of consultations undertaken as part of the revision of the International Chamber of Commerce (*ICC*) Rules (presently underway) and the United Nations Commission on International Trade (*UNCITRAL*) Arbitration Rules (adopted with effect from 15 August 2010).

- *Awards not binding on third parties*: An arbitral award cannot generally bind a third party who has not participated in the proceedings, nor establish a binding legal precedent for future proceedings.

- *A compromise solution?* To some extent, the perception remains that a major disadvantage of arbitration is that arbitrators may try to reach a compromise decision and be reluctant to find unequivocally in favour of one party or the other. In reality, the fear that arbitrators have a tendency to "split the baby" is, at least in the authors' experience, unwarranted. Unless expressly authorised to do otherwise (for example to decide the dispute *ex aequo et bono*), arbitrators can be expected to decide the case in accordance with the rights of the parties under the contract and the applicable law. Arbitration statutes (such as the English Arbitration Act 1996, section 46) and many institutional rules (such as the ICC Rules, Article 17) impose a specific requirement to that effect.

Institutional or *ad hoc* arbitration?

Arbitrations may be conducted under the auspices of one of a number of international arbitral institutions or may be handled *ad hoc*, using rules tailored to the specific requirements of the parties and the circumstances of the case.

Institutional arbitration

Among the best known, and most frequently called-upon, international arbitral institutions are the ICC and the LCIA (formerly known as the London Court of International Arbitration). Both the ICC and the LCIA have amended their arbitration rules, effective from 1 January 1998. The operation of both sets of rules is routinely monitored, and both are currently under review again.

Other prominent institutions include the International Centre for Settlement of Investment Disputes (*ICSID*) for use in investment disputes between states or state agencies and nationals of other states; the American Arbitration Association (*AAA*) and its international section, the International Centre for Dispute Resolution (*AAA/ICDR*); the Arbitration Institute of the Stockholm Chamber of Commerce (*SCC*); and a variety of national or regional institutions such as the Deutsche Institution für Schiedsgerichtsbarkeit (*DIS*), the Chinese International Economic and Trade Arbitral Centre (*CIETAC*), the Hong Kong International Arbitration Centre, (*HKIAC*), the Singapore International Arbitration Centre (*SIAC*), the Dubai International Finance Centre in association with the LCIA (*DIFC-LCIA*) and the International Commercial Arbitration Court in Russia (*ICAC*).

The selection of appropriate arbitration rules, including those published by the ICC, the LCIA and UNCITRAL, is addressed in *Chapter 5: Choosing the rules*.

There are also a number of institutions catering for disputes arising in a particular trade area or industry, such as the Arbitration and Mediation Center of the World Intellectual Property Organisation (*WIPO*), the Insurance and Reinsurance Arbitration Society (*ARIAS (UK)*) for insurance disputes, the London Metal Exchange (*LME*) for commodities disputes and the London Maritime Arbitrators Association (*LMAA*) for commercial maritime disputes.