

# Applicable (Substantive) Law in International Commercial Arbitration Generally

When questions of procedure are settled, the principal task of any arbitral tribunal is to establish the material facts of the dispute. It does this by examining the agreement between the parties, by considering other relevant documents (including correspondences, minutes of meetings and so on), and by hearing witnesses if necessary. The arbitral tribunal then builds its award on this foundation of facts, making its decision either on the basis of what is considered to be fair and reasonable or, mostly on the basis of law. For determination of the dispute, the arbitral tribunal may not need to go further than the confines of the agreement that is originally made between parties, if the established relevant facts do not require so. These agreements, particularly in international commerce, will generally be pretty detailed.

For instance; international construction contracts consist of many hundreds of pages including detailed drawings, plans and specifications. Such details make the agreement obviously clear to understand what the parties intended, what duties and responsibilities they each assumed and, as a result which of the parties is to be hold liable for any failure of fulfilment. It is supported by a system of law that is also known as "the Governing law", "the Applicable law" or "the Proper law" of the contract. These various terms all denote the particular system of law that governs the interpretation and validity of the contract, the rights and obligations of the parties, the mode of performance and the consequence of breaches of the contract. "Accordingly, it is not enough to know what agreement the parties have made: it is also essential to know which law is applicable to that agreement. In a purely domestic contract, the applicable law will usually be that of the country concerned.

If a French woman purchases a dress in a Paris boutique, French law will be the applicable or proper law of that contract. However where the contract is in respect of an international transaction, the position is much complicated. There may then be two or more different national systems of law capable of qualifying as the proper law of the contract; and (although it is important not to exaggerate the possibilities) these different national systems may contain contradictory rules of law on the particular point or points in issue.

## Crossing National Frontiers:

"One who crosses a national frontier on foot or by transportation, passport in hand, realises the fact that he is moving from one country to another. After a moment's thought he will realise that he is transferring from one legal system to another; and that indeed what is lawful in one

country is not necessarily so in another.” For example, a British driver who is required by his own law to drive on the left-hand side of the road would be in serious trouble with the law (and fellow drivers!) in most other countries, if he takes the same practice abroad with him.

## The Autonomy of the Parties:

“So far as the law of contract is concerned, there is a generally accepted principle of law that directs international commercial arbitrations to the correct choice of the law applicable to an international commercial contract. This is the principle of the autonomy of the parties. By this is meant the freedom of the parties to choose for themselves the law applicable to their contract.” “The doctrine of party autonomy, which was first developed by academic writers and then adopted by national courts, has gained extensive acceptance in national system of law: “...despite their differences common law, civil law and socialist countries have all equally been affected by the movement towards the rule allowing the parties to choose the law to govern their contractual relations. This development has come about independently in every country and without any concerted effort by the nations of the world; it is the result of separate, contemporaneous and pragmatic evolutions within the various national systems of conflict of laws.”

## Recognition by International Conventions:

The international conventions and the model rules on international commercial arbitration bear witness to this freedom of the parties to choose the applicable law for themselves to their contract.

- **The European Convention of 1961 provides:**

“The parties shall be free to determine by agreement, the law to be applied by the arbitrators to the substance of the dispute.”

- **The Washington Convention provides:**  
"The Tribunal shall decide a dispute in accordance with such rules of law as may be agreed by the parties."
- **The UNCITRAL Rules provide:**  
"The arbitral tribunal shall apply the law designated by the parties as applicable to the substance of the dispute."
- **Amongst the rules of arbitral institutions, the ICC Rules provide:**  
"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..."

It will be seen that there is an astonishing consensus on the rule of party autonomy. Even though some conflicts between the law systems might require a connection of the chosen law and the transaction itself; Party autonomy is still one of the few principles of law which appears to be of general use if not universal.

### Restrictions on Party Autonomy:

"For lawyers who practice in the resolutions of international trade disputes, and who are accustomed to wending their way through a maze of national laws, the existence of a general transnational rule of law supporting the autonomy of the parties seems almost too good to be true. The natural inclination is to ask whether there are any restriction on the rule, and if so, what?" "However, as the intention expressed is (1) bona fide (2) legal and (3) there is no reason for avoiding the parties' choice on the grounds of public policy, it is difficult to see why the rule should be qualified."

### The Options:

Only those qualifications of bona fides, legality and of no public policy objection makes the conventions and rules on arbitration categorical in their affirmation that the parties may self determine the law for to be

applied in their contract. It is sensible for parties in an international commercial agreement to make use of this freedom and to insert a "choice of law" clause into their contract. If this is not done it is likely to be a cause for regret in case of an arisen dispute since (as will be seen) the search for the proper law can be a long and an expensive process. A "choice of law" clause may be drawn in very simple terms. It is usually sufficient to say: "This agreement shall in all respects be governed by the law of England" (or of Singapore, or the State of New York, or of any other suitable place).

The Options that may be available to the parties include:

- 1. National law
- 2. Public international law
- 3. Concurrent laws
- 4. Combined laws (or the *trunc commun* doctrine)
- 5. The Sharia (Islamic Law)
- 6. Transnational law (including the general principle of law; international development law: the *lex mercatoria*; codified terms and practices: and trade usages)
- 7. Equity and good conscience

## 1. National Law:

"In most international commercial contracts, including those where a state or a state entity is a one of the parties, it is usual for a given system of law to be chosen as the law applicable to the contract itself. such a choice is pretty meaningful. In most cases, parties who choose a law to govern their contract, or any subsequent dispute between them, will choose an autonomous system of law. Such a system is not merely a set of general principles or of isolated legal rules, but it is an interconnecting, interdependent collection of laws, regulations and ordinances, enacted by or on behalf of the state and interpreted and applied by the courts. It is a

complete legal system designed to provide an answer to any legal question that might be posed. Furthermore, a national system of law will be a known and existing system, capable of reasonably accurate interpretation by experienced practitioners.”

### Choice of a system of national law

As already stated, experience indicates that the choice of a suitable system of national law is the most common choice in international commercial contracts. The reason for the selection of a particular national law may be because of its connection with the parties to the contract; or it may be simply because the parties regard it as a system of law which is well suited to govern modern commercial relations. “Many contracts incorporate a choice of a particular country’s law although they have no connection with that country.” For example, construction contracts, commodity contracts, shipping and freight, unity and good conscience contracts and contracts of insurance often contain the choice of English law, because the commercial law of England is considered to reflect and to be responsive to the needs of modern international commerce.

However, in some cases, there might be arguments against the choice of a certain national system of law. Much will depend upon the circumstances of the particular disputes between the parties. However, four possible objections to the choice of a particular national system of law may be pinpointed;

- differences between national law
- national interests
- unsuitability for international trade
- unfair treatment

### Stabilisation Clauses:

"Another method that has been tried, particularly in oil concession agreements, is the inclusion of stabilisation clauses. These are undertakings on the part of the contracting state that it will not change the terms of the contract by legislative action, without the consent of the other party, a good example, to the contracting one of the arbitrations which arose out of the Libyan oil nationalisations, might be the arbitrator held that the Libyan government's act of nationalisation was in breach of certain stabilisation clauses and was accordingly an illegal act under international law, entitling the companies to restitution of their concessions... Stabilisation clauses, like provisions that seek to freeze the law, attempt to maintain a particular legal regime in existence, often for a considerable period of time, irrespective of any changes which may occur in the political, social and economic environment of the country concerned."

## 2. Public International Law:

The classical division of systems of law is between public international law and municipal (or national) law. In its celebrated decision in the *Serbian Loans* case, the Permanent Court of International Justice regarded a choice of law as being necessarily a choice between these two systems:

"Any contract which is not a contract between states acting in their capacity as subjects of international law, is based on the municipal law of some country." This traditional distinction is no longer accepted. First, public international law is no longer concerned (if it ever was) simply with states. It extends to international organisations such as the United Nations, and even individuals or groups of individuals. Secondly, the development of transnational law (or of a new international trade law) may lead to the establishment of a *tertium genus*, between public

international law on the one hand and national systems of law on the other.

### 3. Concurrent Laws:

"As already indicated in the discussion of contracts to which a state entity is a party, one of the main anxieties of commercial organisations that are engaged in trading or other business relationships with a sovereign state is that after the bargain has been struck and the contract has been signed, the state may change its own law to the disadvantages of the private party." Accordingly, one solution is to apply national law only insofar as it accords with either public international law or some other system with accepted minimum standards.

### 4. Combined Laws (or the *tronc commun* doctrine):

One important reason for choosing arbitration in an international commercial contract is that neither party wishes to end up in the other party's national court. In much the same way, having chosen arbitration as a "neutral" method of resolving disputes, parties may search for "neutral" rules of law rather than submit to the national law of the opposing party. The previous discussion has shown where this search for a neutral law leads, particularly in relation to state contracts. However, it is not confined to such contracts. "One solution, which has been canvassed in theory, and occasionally adopted in practice, is to choose the national laws of both parties and so obtain the best (or possibly the worst) of both worlds. This *tronc commun* doctrine, as it is sometimes called, is based on the proposition that if free to do so, each party to an international commercial transaction would no doubt choose its own



national law to govern that transaction.”

## 5. The Sharia (Islamic) Law:

The Sharia is the Islamic law applied in Muslim countries to disputes involving Muslims. In contemporary terminology the word Sharia embodies not only the Quran but also all the other terms and sources of Islamic law. “The modern codes of law in Islamic states take account of the Sharia, often as the principal source of law.” However, as far as arbitrations are concerned strict application of the Sharia has diminished with the emergence of international arbitration rules, such as the UNCITRAL Rules and the Model Law. Indeed, many Muslim states have either adopted the Model Law or based their legislation on it. Additionally, as far as the recognition and enforcement of awards is concerned, the majority of Islamic states have adopted the New York Convention. Nonetheless, the following general principles should be noted.

### **Arbitration in the Sharia: General Principles:**

In most Islamic countries the agreement to arbitrate must be in writing; additionally, although the Sharia does not recognise an agreement to arbitrate in the future, in the majority of Islamic countries their new legislation recognises such an agreement as valid and binding. In theory, the consent of the parties to the arbitration must continue until the award is issued and until that point, the appointment of the arbitrator is revocable. However, most Islamic states have enacted provisions to allow confirmation of the arbitration’s appointment by the judge in order to ensure the irrevocability of the agreement. An arbitration award made in accordance with the laws of the Sharia is binding as soon as it is made by the arbitrator and is generally accepted as having all the effect of a judgement. It is subject to the same grounds of a judgement. It is subject

to the same grounds of challenge as a judgment, for example, if it violates or misinterprets a Sharia rule. A request to set aside an award or to refuse enforcement, to enforcement of it is made to the appropriate court or, at the time of enforcement, to the judge in charge of enforcement. Under the Sharia, as a "foreign award" is an award made under a law other than the Sharia; indeed, if even one condition required by the Sharia is not fulfilled, the award will be considered a foreign award. A judge, who is not entitled to review the merits of the dispute, nor the reasoning of the arbitrator, may also enforce these awards. The judge can, however, examine the formal conditions such as the existence of a valid agreement to arbitrate, whether the award has been made by all the arbitrators and whether it deals with all the matters in dispute. The rules of the Sharia as complex as any set of laws and they vary from state to state. As is apparent, the above is only a generalised summary of the relevant principles for further dealt, the reader is referred to the more specialised texts on the topic.

## 6. Transnational Law (Including the General Principle of Law; International Development Law: The *lex mercatoria*; Codified Terms and Practices: and Trade Usages):

"The reference to such rules of international law as may applicable (as for example, in the Washington Convention), or to the relevant principles of international law, (as in Channel Tunnel Treaty) serve to remind us that it is not the whole corpus of law, but only certain specific rules of law that are likely to be relevant in any given dispute. For example, an international contract for the sale of goods governed by the law of Austria will usually bring into consideration only those provisions of Austria law which deal with the sale of goods. International constructions project that

special area of law which is concerned with construction contracts. This breaking down of the whole body of the law into specific, discrete sections is reflected by increased specialisation of lawyers such as the International Bar Association, there are specialist groups whose primary expertise is in energy law or intellectual property, construction law and so forth."

### **The General Principles of Law:**

The general principles of law are frequently referred to choice of law clauses, either alone or in conjunction with some national system of law, or as forming part of international trade law. The Statute of the international Court of Justice refers to the general principles of law recognised by civilised nations as forming part of international law; but the intentions that these general principles should serve as a source of law, and not as a system of law *stricto sensu*.

### **The Lex Mercatoria:**

"The modern concept of the *lex mercatoria* is that of rules of law which have been developed by the international business community so as to regulate commercial activities within that community. Professor Goldman, who named the concept and contributed greatly to its development, refers to it as having had "an illustrious precursor in the Roman *ius gentium*, which he describes as" an autonomous source of law proper to the economic relations (*commercium*) between citizens and foreigners."

### **The UNIDROIT Principles:**

A more ambitious attempt to bring uniformity both of drafting and of meaning to international contracts has now been completed, after many years of work and consultation. The International Institute for the

Unification of Private Law (UNITROIT), which is a specialised agency of the United Nations based in Rome, has published a set of "Principles of International Commercial Contracts" which are in the nature of an international restatement of the general principles of contract law. "The principles are comprehensive. They cover not only the interpretation and performance of contractual obligations, but also the conduct of negotiations leading to formation of a contract -with the emphasis, not surprisingly, on good faith and fair dealing."

## 7. Equity and Good Conscience:

"Arbitrators may from time to time be required to settle a dispute by determining it on the basis of what is "fair and reasonable", rather than on the basis of law. Such power is conferred upon them by so-called "equity clauses" which state for example, the arbitrators shall "decide according to an equitable rather than a strictly legal interpretation" or, more simply, that they shall decide as amiable compositeurs. This power to decide "in equity", as it is sometimes expressed, is open to several different interpretations. It may mean for instance that the arbitral tribunal:"

- should apply relevant rules of law to the dispute, but may ignore any rules which are purely formalistic (for example, a requirement that the contract should have made in some particular form); or
- should apply relevant rules of law to the dispute, but may ignore any rules which appear to operate harshly or unfairly in the particular case before it; or
- should decide according to general principles of law or
- may ignore completely any rule of law and decide the case on its merits as these strike the arbitral tribunal.

"Commentators generally reject this fourth alternative. To the extent that they do agree, the commentators seem to suggest that even an arbitral

tribunal that decides “in equity” must act in accordance with some generally accepted legal principle. In many (or perhaps most) cases this means, as indicates at the outset of this Chapter, that the arbitral tribunal will reach its decision based largely on a consideration of the facts and on the provisions of the contract, whilst trying to ensure that these provisions do not operate unfairly to the detriment of one or the other of the parties. For an “equity clause” to be effective, there are in principle two basic requirements. First that the parties agree to it and, secondly, that it should be permitted by the applicable law. Both requirements are seen in such provisions as the UNCITRAL Rules that provide: “The arbitral tribunal shall decide as amiable compositeur or ex aequo et bono only if the parties have expressly authorised the arbitral tribunal to do so and if the law applicable to the arbitral procedure permits such arbitration”. (Some systems of law (including English law in the past) regard equity clauses with disfavour, on the basis that, if applied, they would in effect exclude the court’s power to review arbitral awards, since such awards would no longer be based on “a fixed and recognisable system of law”. However, the Model Law allows an arbitral tribunal to decide in equity if the parties expressly authorise it to do so. It says much for the influence of the Model Law that, for instance, English law now states that, if the parties so agree, the tribunal may decide the dispute” in accordance with such other considerations as are agreed by them or determined by the tribunal”. This plainly opens the way for the application of the *lex mercatoria* or for determination *ex aequo et bono* if the parties so agree.

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