

Global Jurist

Advances

Volume 8, Issue 3

2008

Article 2

International Arbitration and the Quest for the Applicable Law

Giuditta Cordero Moss*

*University of Oslo, g.c.moss@jus.uio.no

Recommended Citation

Giuditta Cordero Moss (2008) "International Arbitration and the Quest for the Applicable Law,"
Global Jurist: Vol. 8: Iss. 3 (Advances), Article 2.
Available at: <http://www.bepress.com/gj/vol8/iss3/art2>

Copyright ©2008 The Berkeley Electronic Press. All rights reserved.

International Arbitration and the Quest for the Applicable Law*

Giuditta Cordero Moss

Abstract

A clearly recognisable trend of the past decades in the field of international commercial law and, in particular, in international commercial arbitration, is to avoid too precise references to the legal mechanisms for identifying which country's law governs an international legal relationship – legal mechanisms that usually go under the names of conflict of laws, private international law or choice of law. This article intends to show that private international law is not an anachronistic or redundant heritage of old fashioned, national sovereignty-obsessed lawyers without an understanding for international business transactions. The analysis will show that rules of choice of law contained in national laws are relevant to international arbitration, that disappearance from arbitration rules of reference to private international law may create unpredictable results and is not necessarily the optimal solution for business transactions. The relevance of private international law to international arbitration will be shown by identifying some of the main contract terms that, among those often used in various commercial contracts, run the risk of being governed by a law different from the law chosen by the parties. To this aim, the bases for restricting party autonomy need to be recognised, and this assumes an exercise of private international law. This will permit us to indicate not only which areas of the contract might be subject to a law different from the law chosen by the parties, but also which country's law may be applicable instead of the law that the parties had chosen. Finally, to verify whether these restrictions to party autonomy are relevant even though the contract contains an arbitration clause, the article will succinctly analyse the criteria that may make them applicable not only to a court of law, but even to international arbitration.

KEYWORDS: arbitration, private international law, choice of law, conflict of laws, party autonomy, enforcement, public policy

*Dr. Juris (Oslo), PhD (Moscow). Professor, University of Oslo. This article is based on a paper that I presented at the VIAC-UNCITRAL 2008 conference, Vienna, 13-14 March 2008.

Introduction

A clearly recognisable trend of the past decades in the field of international commercial law and, in particular, in international commercial arbitration, is to avoid too precise references to the legal mechanisms for identifying which country's law governs an international legal relationship – legal mechanisms that usually go under the names of conflict of laws, private international law or choice of law.

Thus, it is not unusual to see that arbitration laws or rules of arbitral institutions do not provide that the arbitral tribunal shall apply any conflict rules to determine the law governing the merits of the dispute.¹ Most recently, the UNCITRAL Working Group on Arbitration engaged in the modernisation of the UNCITRAL Arbitration Rules and discussed to what extent references to private international law in Article 33 shall be eliminated.

This article intends to show that private international law is not an anachronistic or redundant heritage of old fashioned, national sovereignty-obsessed lawyers without understanding for international business transactions. The analysis will show that rules of choice of law contained in national laws are relevant to international arbitration: deleting from arbitration rules any reference to private international law may create unpredictable results and is therefore not necessarily the optimal solution for business transactions.

The relevance of private international law to international arbitration will be shown by identifying some of the main contract terms that, among those often used in various commercial contracts, run the risk of being governed by a law different from the law chosen by the parties.

To this aim, the bases for restricting party autonomy need to be recognised, and this assumes an exercise of private international law (Part II below). This will permit indicating not only which areas of the contract might be subject to a law different from the law chosen by the parties, but also which country's law may be applicable instead of the law that the parties had chosen.

Finally, to verify whether these restrictions to party autonomy are relevant even though the contract contains an arbitration clause, this article will succinctly analyse the criteria that may make them applicable not only to a court of law, but even to international arbitration (Part III below).

¹ For a more detailed overview on the various approaches see below, Part III, section 3.

1. International arbitration and the need to choose a governing law

The approach criticised here, that questions the relevance of private international law, is twofold, and is based both on substantive and on procedural considerations.

1.1 *Lex mercatoria*

The substantive reasons for avoiding references to private international law are due to this branch of the law's assumptions and purpose. Private international law assumes that international legal relationships are governed by a national law, and its purpose is to permit identifying which country's law is applicable. These assumptions and purpose are sometimes rejected in order to grant preference to a non-national law for international contracts, often referred to as (new) *lex mercatoria*, trans-national law or, rather improperly, soft law. In the area of international contracts there are numerous sources that do not have national origin with force of law without being conventions with binding international character. Use of these sources aims both at enhancing uniformity or harmonisation of the law on a global level, and at preventing the differences that would follow the application of the various national laws. This article will not deal with the substance of the *lex mercatoria*. For the part that is relevant to the present topic, I will simply refer to the result of research that I have conducted elsewhere on this subject. In an ideal situation, the uniform law would cover all aspects of a legal relationship and would make the application of national laws redundant. The reality, however, seems for the moment to be quite distant from this ideal goal, since the uniform law is far from being exhaustive, systematic, easily ascertainable or uniformly applied. Hence, recourse to national sources or binding international sources is still necessary, at least in part, in most of the disputes, and the necessity to identify which country's law to apply is still present.²

It must be highlighted, however, that recourse to private international law and the consequent choice of a national governing law is not at all incompatible with the application of other, non-authoritative or non-national sources. For example, under most arbitration laws or contract laws, trade usages are to be

² See G. Cordero Moss, *International Contracts between Common Law and Civil Law: Is Non-state Law to Be Preferred? The Difficulty of Interpreting Legal Standards Such as Good Faith* (2007) *Global Jurist*: Vol. 7 : Iss. 1 (Advances), Article 3 and, more succinctly and updated, G. Cordero Moss, *The "Troika" and Its Effects On the Harmonisation of Contract Law –Illustrated By the Duty of Good Faith Between the Parties*, in *Colloquium of the International Association of Legal Sciences* 2007, forthcoming.

taken into consideration even if the law governing the dispute is a national law.³ Thus, recognising the ultimate applicability of a national law does not exclude application of trade usages.

Moreover, many sources of uniform rules, such as standard terms of contract, restatement of uniform commercial practices or similar sources of soft law, are usually fully compatible with national laws, in that they tend to regulate matters that are generally left to the parties' freedom of contract. Therefore, recognising the ultimate applicability of a national law does not prevent application of sources of soft law – although it can influence their interpretation and application.

Summing up, sources of trans-national law are not necessarily incompatible with national laws and may often be applied within the framework of the governing national law. However, sources of trans-national law do not have the ability to replace the national governing law in full. Therefore, the necessity to choose a national governing law is still relevant to international commercial transactions.

1.2 Delocalised arbitration

The ambition to detach international commercial arbitration from any national law and to see it as floating across the borders of national systems without ever being subject to any of them is the concern of the aforementioned procedural side of the striving towards a global harmonisation in international business law. In addition to the central role of the parties' agreement in international arbitration, a series of international instruments, and some successful institutions, contribute to enhancing the impression of a non-national character of international arbitration. In particular, the very restricted list of grounds upon which an arbitral award may be refused enforcement in accordance with the New York convention of 1958 on the Recognition and Enforcement of Foreign Arbitral Awards, contributes to separating international arbitration from the various national systems with which the dispute may come into contact. However, as the analysis below will show, there are still some points of contact between national courts and international arbitration disputes, and the application by international arbitral tribunals of national laws is not totally outside of the national court's control.

Appealing as the thought of a floating arbitration system may be, it seems to be counterproductive to attempt achieving it by ignoring or denying the barriers that may prevent a full effectiveness of the award. Therefore, the necessity to make a choice of law is not completely irrelevant to international arbitration.

³ See for example Article 28(4) of the UNCITRAL Model Law on International Commercial Arbitration and Article 9 of the 1980 Vienna Convention on the Contract for International Sale of Goods.

2. The parties' choice of law and the need to regard other rules of private international law

Leaving aside the obvious situation where the parties have not chosen the governing law and the arbitral tribunal must find which law is applicable, this article will focus on situations where the parties have made a choice of law, and it will show that conflict rules are relevant even then.

International contracts often contain a choice-of-law clause, and often the law that is chosen does not belong to the country of either party or of the place of performance, but rather is a neutral, third law. The choice of a neutral governing law is often intended to avoid application of the laws that otherwise might be applicable due to their connection with the legal relationship, be it as the respective law of the parties or the law of the place of performance. Avoiding application of either party's law, thus preventing the perceived advantageous position that would follow for one party having the contract governed by its own country's law, is sometimes deemed to be advisable. More compellingly, it is advisable to avoid applicability of a law belonging to a legal system which is unstable, not transparent or not subject to the rule of law.

The parties are often convinced that the choice-of-law clause in the contract excludes the applicability to any aspect of their relationship to any other country's law; even more so, when the contract contains an arbitration clause. Arbitration is based on the will of the parties, and the tribunal is supposed to follow the parties' instructions. Hence, a contract with an arbitration clause apparently enhances the parties' reliance on the choice of law they made in the contract and disregarding any other laws.

Choice-of-law clauses are, however, not always capable of fully achieving the results desired by the parties. There are several limits to the effects of these clauses that may depend on various elements: (i) the choice-of-law clause may not cover all aspects of the legal relationship regulated in the contract, for example in case the contract has implications of company-, labour-, property-, insolvency law or of any area where the party autonomy is restricted by specific private international law rules, such as questions about the legal capacity of the parties; (ii) certain rules belonging to laws different from the law chosen by the parties may be applicable because of their overriding character, for example rules of competition law; or (iii) the law chosen by the parties may give effect to rules belonging to a foreign law, for example when illegality in the place of performance renders the obligation invalid or unenforceable under the law chosen by the parties.

In these situations, the parties' expectations may be disappointed, as the contract will be subject to rules that they had intended to exclude. In particular, the parties may have drafted a contract that is enforceable under the law chosen

by them, yet some of the terms may turn out to be unenforceable because rules belonging to another law are applicable. The arbitration clause does not necessarily prevent the applicability of rules belonging to a law different from the one chosen by the parties. Some of these rules cannot be disregarded even by an international arbitral tribunal and, if they are, the award will be invalid or unenforceable.

It is in these situations that the awareness about private international law rules contributes to predictability for international business transactions. Rather than being ignored or denied as an element foreign to the uniformity aspirations of trans-national law, they should be appreciated as a useful tool that permits one to understand and predict results that otherwise may come as an undesired surprise.

I The scope of the choice of law made by the parties

As mentioned above, very often in international business relationships the parties subject their contract to a governing law of their choice. By so doing, they exercise a power that is granted to them by the vast majority of private international laws - the so-called party autonomy. Party autonomy is the name of a choice-of-law rule, conflict rule or private international law rule - all these being synonymous definitions of a rule which permits the identification of which country's law governs an international contract. If the parties do not exercise party autonomy, the applicable law will be determined by other choice-of-law rules.

The conflict rule of party autonomy enjoys extremely widespread recognition in legal systems from all over the world, and is therefore sometimes defined as a "universal principle" or language to that extent, thus giving the impression that the assumptions and modalities of its exercise as well as its effects are uniformly determined and conform to a standard that is independent of any set of conflict rules contained in any applicable private international law. A corollary of this approach is that the party autonomy has a presumption of validity and has to be respected in full, particularly by arbitrators. Most arbitration rules and arbitration laws do, as a matter of fact, provide for the tribunal's obligation to follow the choice of law made by the parties.⁴

Recognition of party autonomy and the judges' and arbitrators' obligation to give effect to it are, certainly, a widely recognised principle that can be deemed to be fundamental in the context of commercial contracts and international

⁴ See, for example, Article 28(1) of the UNCITRAL Model Law; for non Model countries, see section 46(1) of the UK Arbitration Act and Article 187(1) of the Swiss Private International Law Act.

arbitration. However, it is not useful and may even be counterproductive to assume that a clause in a contract choosing the governing law has effects in force of itself and that it is not subject to limitations of any kind or under any circumstances. Even though party autonomy is a conflict rule that enjoys wide recognition, the scope of the rule is shaped by the private international law that is being applied as a basis for that rule. It may be useful here to give a reminder that private international law, despite its name, is a branch of the national law of each country (the purpose of which is to identify the governing law in an international relationship, hence the word “international” in its name). It is highly desirable that private international laws are, to the extent possible, harmonised, and in some regions the degree of harmonisation reached is considerable – for example, in the European Union private international law is being Europeanised, and outside the European Union international instruments prepared, i.a., by the Hague Conference aim at harmonising specific areas. However, differences persist among the various conflict rules even among countries that have a uniform regulation, either because some rules fall outside of the scope of the uniform regulation,⁵ or because uniform rules are interpreted and applied differently.⁶ Where there is no uniform regulation to start with, differences in the scope and application of conflict rules are even more likely to occur.

For party autonomy, as for any choice-of-law rule, the modalities of exercise, the scope of application and the effects, are regulated by the private international law to which it belongs. This does not in any way diminish the general principle that the parties shall be permitted to choose the law applicable to their international contract and that arbitrators shall respect and give effect to that choice. As the examples below will show, however, a principle that is expressed so generally needs further specification in order to be operative, and such specification is to be found in the applicable private international law. While

⁵ For example, company law and property law are not covered by the 1980 Rome Convention on the Law Applicable to Contractual Obligations, soon to be transformed into a European Regulation (so-called “Rome I”).

⁶ For example, Article 4 of the Rome Convention contains a conflict rule for the eventuality that the parties have not made a choice of law for their contract; the connecting factor for determining the applicable law is the closest connection between the contract and the country of the proper law (Article 4(1), and there is a presumption that the closest connection is with the country where the party making the characteristic performance has its main place of business (Article 4(2)). There is no agreement among interpreters on whether the presumption is to be deemed as a strong presumption or a weak presumption, and this prevents a uniform application of Article 4. This question is hopefully clarified with the Rome I Regulation, which is expected to come into force soon and replaces the Rome Convention. The Rome I Regulation converts the presumption into an absolute rule. See, for further details, the Green paper on the conversion of the Rome Convention of 1980 on the law applicable to contractual obligations into a Community instrument and its modernisation, COM (2002) 654 final, par. 3.2.5.

legislators and interpreters should strive for harmonising the various private international laws, differences still persist that make it impossible to specify the principle in a uniform way and irrespective of the applicable system.

1. Choice-of-law clauses and their scope

The first aspect that needs to be taken into consideration is the scope of the party autonomy's effects. Traditionally, private international laws permit the parties to choose the law governing contractual obligations. More recently, party autonomy is being extended to other areas of commercial relationships, such as obligations arising out of tort.⁷ There are a number of areas of the law, however, where the choice of law is based not on party autonomy, but on other connecting factors set in the relevant conflict rule of the applicable private international law.⁸

Generally, the need to preserve the certainty of title and of the legal relationships towards third parties is the reason for excluding the applicability of party autonomy in these areas. Whenever a contract has implications for the position of third parties (vested rights or legitimate expectations), the choice of a foreign governing law in the contract may affect the third parties' rights as they are regulated by the law that would otherwise be applicable. It would not be appropriate to permit the contract to affect these third parties' positions by excluding application of the law that created those rights or expectations. As will be seen below, these considerations are relevant particularly in areas such as company organisation or capitalisation, winding up or insolvency, encumbrances or other securities, real property or intellectual property.

1.1 *Classification of a legal relationship*

Traditionally, the classification of a subject-matter as belonging to one or the other area of the law is made on the basis of the categories as they are defined in the law of the court, the *lex fori*.⁹ A judge, thus, will apply the categories of his or her own law to classify the claim as, for example, contractual or based on

⁷ See chapter IV of the European Regulation 864/2007 on the law applicable to non-contractual obligations (so-called "Rome II").

⁸ This is indirectly reflected, for example, in Article 1(2) of the Rome Convention, listing the areas that fall outside of the scope of application of the convention's rules. The convention regulates the law applicable to contractual obligations, and party autonomy is its main rule (art. 3).

⁹ There is a large literature on the question of classification: see, for example, J. Kropholler, *Internationales Privatrecht*, 2006, 113ff., L. Collins et al., *Dicey, Morris, Collins: The Conflict of Laws*, 14th ed. 2006, §§ 2-006ff., E. Scoles, P. Hay, P. Borchers and S. Symeonides, *Conflict of Laws*, 4th ed., § 19.2, H.J. Thue, *Internasjonal privatrett*, 2002, 147ff. In respect of property matters, the general rule for classification is not the *lex fori*: see J. Carruthers, *The transfer of property in the conflict of laws*, 2005, 16 f., 114ff.

company law. Thereafter, the judge will apply the conflict rule that, in his or her own private international law, is applicable to that particular area of the law, and the connecting factor contained in that conflict rule will identify the law governing the substance of the claim.

1.2 Classification and arbitration

In the case of arbitration, it is tempting to resort to the classification made in the law of the place of arbitration, the *lex loci arbitri*. The *lex loci arbitri* governs many aspects of the arbitration, such as the powers of the arbitrators relating to production of the evidence, the powers of the judge to order interim measures, the arbitrability of the subject-matter, the validity of the arbitral award, etc. Notwithstanding the significance of these matters, and therefore the importance to the proceeding of the law regulating them, the law of the place of arbitration is often frowned upon as not relevant to international arbitration – on the basis of the assumption that the place of arbitration is chosen purely out of practical reasons and is not intended to have any legal implications for the dispute (an assumption that surprises considerably, given the afore mentioned wide range of legal implications determined by the arbitration law of the venue). We have already seen initially that some legal systems have eliminated references to conflict rules in their arbitration laws in order to give effect, albeit partially, to the purported delocalisation of arbitration. Moreover, even many of the systems that have maintained references to the private international law have loosened the link with the private international law of the *lex arbitri*, as will be seen in Part III, section 3 below. The classification of a subject-matter being the first step in the application of a conflict rule, it is reasonable to assume that this classification will be made on the basis of the same legal system to which the conflict rule belongs. In the context that interests us here, this means that the arbitral tribunal will classify the claim and choose the governing law according to what the relevant arbitration rules and arbitration law say about the applicable private international law. The classification may, thus, be made according to the *lex loci arbitri*, another legal system considered by the arbitrator to be more appropriate, a common core of the involved legal systems, or any other factor that identifies the applicable private international law to arbitration.

In the context of arbitration, however, it may be useful to advise against giving decisive importance to the taxonomy, and against deriving the applicable conflict rule simply from the classification of a subject-matter being contractual rather than belonging to the company law or the property law.¹⁰ As will be seen in

¹⁰ Classification has a more significant role in the conflict rules relating to family and inheritance matters.

detail in Part III below, arbitral awards are subject to control by courts of justice only to a restricted extent, and the wrong application of the law (or the application of the wrong law), let alone application of the wrong taxonomy, does not cause ineffectiveness of an arbitral award. There are, however, certain instances where failure to apply the proper law may lead to ineffective awards. Therefore, the quest for the criteria determining the proper law in arbitration should be steered by the enforceability of the award rather than by the classification of the dispute. If the parties choose a foreign law and the consequent regulation of their legal relationship is enforceable in the relevant jurisdictions, the classification made by the arbitral tribunal and leading to application of the party autonomy will not be reviewed by any courts, and there is no reason for limiting the party autonomy on the basis of a formal classification into one or the other area of the law. If, however, the regulation that follows the law chosen by the parties violates rules that render it ineffective in the jurisdiction where the award should be enforced, then party autonomy is restricted.

The sections immediately below will illustrate some examples of conflict rules that restrict party autonomy and may be relevant in this context. The enforceability of an award giving effect to the choice made by the parties and thus disregarding the conflict rules for the respective law areas will be analysed in Part III below.

1.3 Company law

To illustrate how the applicability of company law may remain unaffected by the choice of law made by the parties, a hypothetical case may be presented. Suppose that a Norwegian and a Russian company enter into various agreements regulating a co-operation between them. The two companies establish and jointly own a company in Latvia, which shall have its main place of business and its central administration in Russia. To regulate their cooperation, they enter into a shareholders agreement. The shareholders agreement contains a governing law clause choosing Swedish law and an arbitration clause submitting any disputes arising out of the contract to arbitration before the Stockholm Chamber of Commerce.

The shareholders agreement contains various commitments for each of the parties, such as the obligation not to disclose to third parties specific information, the obligation to meet periodically to ascertain the progress of the cooperation, the obligation to make funds available under certain circumstances, etc.

The shareholders agreement also contains some obligations regarding the jointly owned company, the operation or competence of its corporate bodies, its capitalisation, etc. For example, the shareholders agree to each appoint a certain number of members to the company's board of directors, they specify the areas of

competence that each member of the Board shall have and they commit to have the remaining Board members vote in the way that the competent Board member indicated. The shareholders agreement may further contain rules assessing the value of the respective contributions to the capital of the company and rules for assigning a percentage of the shares in capital increases that corresponds to the agreed assessment. The shareholders agreement may, finally, contain rules on the transfer of shares to third parties or pre-emptive rights for the existing shareholders.

While the commitments between the parties have a contractual nature and will thus be subject to the chosen Swedish law, the rules of the shareholders agreement that affect the role and responsibility of the members of the Board of Directors, the capitalisation of the company or the transfer of shares, have a different nature. Although the parties to the shareholders agreement have contractually committed themselves to a certain conduct in the Board, to a certain evaluation of the capital contributions and to a certain restriction in the sale of shares, these obligations do not have only a contractual nature. The function of the Board of Directors, the capital of a company and the transferability of its shares (at least under certain circumstances) have a larger significance than the mere balance of interests between the two contracting parties. They affect aspects of the legal personality of an entity that has implications towards third parties, such as the entity's employees, its creditors or the other shareholders.

There are, therefore, reasons for preventing that an agreement between two parties (the shareholders who signed the shareholders agreement) modifies third parties' position by changing the governing company law. In other words, party autonomy should not cover the matters that may affect third parties' interests; these matters are subject to the law identified on the basis of other connecting factors.

1.3.1 Which law governs company law matters?

Having established that party autonomy in a shareholders agreement primarily covers the contractual aspects, however, does not help to identify the law that governs the company-law aspects of the relationship. To this aim it is necessary to identify the choice-of-law rule that is applicable for company law.

There is no generally acknowledged rule on what law governs the establishment and organisation of legal entities. Broadly speaking, there are two different approaches: the conflict rule that designates the law of the state where the legal entity is incorporated or registered,¹¹ and the conflict rule that designates

¹¹ Such as English law, see Collins, cit., §§ 30-002ff., US law, see the Restatement, Second, Conflict of Laws §§ 296 f. (1971) and Scoles, Hays, et al., cit., § 23.2ff., the Swiss Private International Law Act, Article 154, the Italian Private International Law Act, Article 25.

the law of the state where the legal entity has its central administration or main place of business (the so-called “real seat”).¹² In the case described here, therefore, the applicable company law would be that of Latvia (place of registration) or of Russia (real seat) depending upon the applicable private international law.

The rationale for choosing one or the other connecting factor is clear. If the governing law depends on the place of registration, a company is recognised and can operate without having to adapt to company law rules of the countries where it has activity. The countries where the company carries out its activity are, in other words, ready to accept the criteria and rules of the company’s country of origin without questioning their suitability or expecting adjustment to their own standards.

On the contrary, if the governing law depends upon the law of the country where the company has its real seat, this country insists on imposing its own standards. The company law’s rules on the protection of the creditors, of the employees, of the minority shareholders are considered to be so important, that all companies carrying out their main activity in that country are expected to comply with them, irrespective of where they are registered and of what criteria their company law of origin has.

Traditionally, the place of registration is used as the connecting factor particularly in the Common Law countries, whereas conflict rules in many Civil Law systems, particularly those inspired by German law, are traditionally based on the main place of business.

Within the European Union and the EFTA, however, a conflict rule based on the place of business has recently been deemed to be against the freedom of establishment.¹³ Hence, for companies registered in a EU or EFTA country, the system where they are carrying out their main activity cannot impose its own company law and has to recognise the capitalisation, transferability of shares and limits to the legal personality, as they are determined in the company law of the country of origin. Imposing, through the conflict rule of the place of registration, that all systems mutually recognise each other’s company laws is in compliance

¹² See Kropholler, *cit.*, 568ff. Where the real seat is deemed to be is not necessarily evident: While the Brussels Convention on Jurisdiction and The Recognition of Judgements, as well as the parallel Lugano Convention, left the criteria for determining where the seat is to the law of the forum, the Brussels Regulation EC 44/2001 has adopted a compromise solution for the purpose of determining where a legal entity is deemed to have a domicile, and makes reference to the state or states where the entity has any of its statutory seat, its central administration or its principal place of business. The New Lugano Convention, which is expected to come into force soon, reflects the Brussels Regulation.

¹³ The first decision that moved in this direction was the Daily Mail decision by the European Court of Justice (C-81/87). Thereafter followed the Centros decision (C-212/97), Überseering (C-208/00) and Inspire Art (C-167/01).

with the policy underlying the European co-operation and its work towards an internal market. Member states are supposed to share the fundamental principles upon which they regulate economic activity, and therefore they should accept each other's company laws without insisting on compliance with their own criteria. In respect to companies coming from outside the EU or EFTA area, conflict rules are not harmonised, and it is up to each private international law to decide whether to accept any other country's company law, and thus apply the connecting factor of the place of registration, or to consider its own rules as prevailing for companies having their main activity in that country, and thus apply the connecting factor of the real seat.

1.4 Legal capacity

Suppose that the Russian party in the above-mentioned example, by its statutes or the law that governs it, has a requirement that certain types of contract become binding on the company only if they have been signed by two authorised persons – one signature is not sufficient to create obligations. If the contract contains a clause subjecting it to Swedish law (which does not contain the same requirement) and is signed only by one person, which criterion applies to determine whether the company is bound: the criterion set by the chosen Swedish law (one signature, the contract is binding) or that set by the Russian law (two signatures, the contract is not binding)?

1.4.1 Which law governs the legal capacity?

There is no uniform conflict rule to identify which law governs the legal capacity of the party to a contract. In states of Common Law, the legal capacity is sometimes considered a question of contract, and is therefore governed by the law that governs the contract.¹⁴ More generally, however, the capacity to enter into a contract is regulated by the law governing the company.¹⁵ The Rome Convention has excluded, from its scope of application, the choice of law relating to whether an organ may bind a company, which means that within Europe there is no harmonisation of the conflict rule applicable to the legal capacity of the parties,

¹⁴See for the US Restatement, Second, Conflict of Laws, § 198 and Scoles, Hays et al., cit., § 18.2. A similar approach has English law, although only in respect of restrictions to the legal capacity, and without taking into consideration the law chosen by the parties: see Collins, cit., §§ 30-021ff.

¹⁵ See, for Germany, Kropholler, cit., 581 and for Switzerland the Private International Law Act, Article 155(c).

and each state has its own conflict rules to determine the law deciding whether the parties had the competence to enter into a contract.¹⁶

1.5 Winding up and insolvency

Suppose that the Russian party and the Norwegian party have a wider cooperation that creates various mutual payment obligations. The agreement provides that each party's payment obligations shall be set off against the other party's payment obligation, so that only the net amount shall be due. If one of the parties becomes insolvent, will its creditors be able to claim payment in full of the outstanding obligations from the other party, or will the set-off agreement be respected so that only the net amount exceeding the other party's claims will have to be paid?

Suppose that the agreement contains a so-called close-out netting arrangement, according to which all obligations of the debtor become immediately due and payable (even prior to their maturity) upon the default by that party of one of its obligations. A variation of this arrangement is the so-called acceleration, particularly wide-spread for loan agreements, according to which the loan shall be terminated and the whole outstanding amount shall become immediately payable if the borrower "threatens to become insolvent." The reason for these mechanisms is evident - the creditor wishes to ensure that the debtor has sufficient means to comply with its obligations. If the financial situation of the debtor is such that there is an imminent risk of becoming insolvent, the repayment of the loan may be affected. Moreover, if the borrower becomes insolvent, the insolvency proceeding will aim at redeeming all the borrower's liabilities, and there may not be sufficient means to repay the loan in its totality. To avoid this situation, the close-out netting arrangement aims at obtaining payment of all outstanding obligations prior to any financial difficulties that may arise as a consequence of the default and possible subsequent cross-defaults in other contracts, and the loan agreement has a mechanism that provides for repayment of the outstanding amount prior to the initiation of an insolvency proceeding, so that the lender does not have to divide the borrower's assets with the other creditors. Many legal systems have insolvency regulations that aim at preventing these mechanisms, and that permit reversing payments that were made within a certain period prior to the initiation of the insolvency proceeding. Can the lender avoid the application of these rules by submitting the close-out netting arrangement or

¹⁶ See, however, Article 11 of the Rome Convention, according to which, in the event of a contract entered into by persons located in the same state, the foreign party cannot invoke the foreign applicable law on legal capacity to assert his or her own legal incapacity, if that person had legal capacity under the law of the state where the contract was entered into (unless the other party was aware of the incapacity of that party). It is controversial whether this can be extended to companies, see Kropholler, cit., 581.

the loan agreement to a foreign law? If this was possible, the equality of treatment among the creditors, which is a fundamental principle of most insolvency regulations, would be considerably weakened, and the creditors would not be able to assess the assets that are available. This is not a recommendable situation, and for this reason the choice of law contained in the agreement, while fully effective for the contractual aspects of the legal relationship, may not have full effect for the part that has implications on the winding up or insolvency proceeding.

1.5.1 Which law governs winding up and insolvency matters?

As a general approach, the dissolution of a company is governed by the company law that is applicable to that company. In the case of companies having activity in more than one state, this raises the question of how to ensure a just and equal treatment for all creditors in respect of assets that may be located in various countries. The two opposite approaches are the territorial and the universal. According to the former, a state's law and jurisdiction extends only to the assets that are located in the state's territory. According to the latter, the competent state's law and jurisdiction is to be recognised by foreign states.¹⁷

To harmonise this area, the EU issued the European Insolvency Regulation (1346/2000), which determines that for a company with cross-border activities, insolvency is governed by law of the place where the main proceeding is carried out. In turn, the main proceeding is to be conducted in the country where the company has the centre of its main interests ("COMI"). The rebuttable presumption is that the COMI is where the company is registered.¹⁸ However, from the application of this connecting factor, the insolvency regulation carves out a series of situations that involve vested rights by third parties, such as property and security rights, set off and retention of title, and confirms for them the applicability of the governing law determined according to the respective conflict rule (which is not necessarily the law chosen by the parties, as will be seen below). To what extent this will be sufficient to prevent applicability of the insolvency rule reversing payments or transactions made in the last months or years(s) prior to the insolvency, depends on whether the rule is deemed to override the proper law or not (see Part II below).

¹⁷ See Scoles, Hays et al. cit., § 23.17, Collins, cit., §§ 30-010ff., Kropholler, cit., 582f., the Swiss Private International Law Act Article 155 (b).

¹⁸ It is to be noted that the same connecting factor is suggested in the the UNCITRAL Model Law on Cross-border Insolvency of 1997.

1.6 Property

Suppose that an English company transfers to a Russian company the possession of certain raw material, for example alumina, so that the Russian company may process it and produce aluminium of a certain quality, in order to make it available again to the English company against payment of a fee – a so-called tolling agreement. The tolling agreement specifies that title to the material does not pass at any time and that the English company remains the owner of the material even when it is located in the Russian party's premises. Suppose that the Russian party, while in possession of the material, goes bankrupt. Suppose that the trustee receives claims from various parties in respect of this material: from the English party, that according to the tolling agreement always had title to the material; from a Russian bank, that in the time during which the material was in the possession of the Russian party had granted a loan to this party and obtained a first priority pledge on the material as security; and from a trader, that had entered into a contract for the purchase of the material on the assumption that the Russian party was the owner and had the right to dispose of it.

There are, thus, potentially four claims on the same volume of material: (i) by the original owner, because the tolling agreement never transferred title, (ii) by the bank, because it registered a legal pledge on the material, (iii) by the purchaser, because it entered into a binding contract of purchase, and (iv) by the generality of the Russian party's creditors, because the material is in the possession of the debtor.

Which of these claims prevails, will depend on whether title to the material actually never passed. In turn, this will depend on the law governing the passage of title.

1.6.1 Which law governs the transfer of property?

The law governing the passage of title is not necessarily the law that the parties chose to govern the contract regulating the transfer. The choice of law made in the contract has effects for the obligations of the parties towards each other, but it does not necessarily have the ability to affect vested rights or legitimate expectations by third parties. For the effects towards third parties, the applicable law is not the law chosen to govern the contract, but the law of the place where the goods are located, so called *lex rei sitae*.¹⁹ Thus, if Russian law considers the rights of the third parties valid (assuming, for example, that the third parties were

¹⁹ See, for example, Articles 100 and 104 of the Swiss Private International Law Act and the comments made in H. Honsell, N.P. Vogt, A.K. Schnyder, S.V. Berti (eds.), *Basler Kommentar Internationales Privatrecht* 2nd ed. 2007, 648ff.; § 43(1) of the German EGBGB and Kropholler, cit., 559ff.; for English law, see Collins, cit., §§24-029ff.

acting in good faith and that the formal requirements are complied with), the bank and the purchaser may have a claim on the material, in spite of the fact that the contract expressly excludes any passage of title as a consequence of the delivery of the material, and notwithstanding that the law chosen by the parties to govern the contract permits such exclusion.

This latter observation deserves being commented upon. If the rights *in rem* by third parties are governed by the law where the goods are located, and if the law chosen by the parties in the contract (English law in our example) is the law of the same place (because the goods were located in England when the contract was entered into), does this mean that the third parties' rights are regulated by English law even after the goods were moved to Russia? The general rule is, as a matter of fact, that the law of the place where the goods were located at the time of entering into the contract governs; however, this rule is limited to the rights between the parties to the contract. Thus, if title to a good was validly retained under the *lex rei sitae*, the obligations between the parties are not affected even though the goods are transferred to a country where retention of title is not valid. However, towards third parties it will be the law of the place where the goods are located at any time, that governs. Thus, in spite of the circumstance that the title of the material is regulated between the parties by English law, even though the material is on Russian territory, it is Russian law towards third parties that will regulate the possibility of establishing a security right, purchasing goods, etc.²⁰

1.7 Assignment, security interests and collateral

Suppose that one of the parties assumes an obligation to pay a certain amount of money to the other party, for example, in the case of the tolling agreement made above. The Russian party issues a performance bond guaranteeing the proper performance of its obligations, and the English party requires a security for that payment. The parties agree that the debtor shall secure its obligations by pledging in favour of the creditor, the English party, all future products of the debtor's manufacturing plant in Russia, or the future proceeds that the Russian party will have for the sale of its future products. The parties choose to submit the contract to a law that permits the pledge of future (bulk) things or, as the case may be, of

²⁰ See, for US law, Scoles, Hay et al., cit., §§ 19.11ff; for German law, see Kropholler, cit., 560ff.; for English law, see Collins, cit., § 24-021. Swiss law makes a compromise in Article 102(3) Private International Law Act and permits that a retention of title perfected abroad maintains its effect for three months after the goods have entered the Swiss territory, however not in respect of third parties in good faith. For further comments on the opposed interests in security of title v. security of transaction see Carruthers, cit., 98 f. and particularly §§ 3.59 and 3.67ff.

future income. Are the parties justified in relying simply on the chosen law and disregarding the Russian law on pledge? If the pledge of bulk things or the pledge of future things or claims is not allowed under Russian law, is the choice of law made in the pledge sufficient to render the pledge valid between the parties and effective towards third parties?

A further method to create a security interest is to assign to the creditor a claim that the debtor has towards another party (for example, the manufacturer assigns to its raw material supplier, as payment of the raw materials, the claims that the manufacturer will have in the future against the purchasers of the manufacturer's products). To consider the assignment valid in respect of third parties (the manufacturer's clients or the manufacturer's other creditors), is it sufficient to comply with the law chosen by the parties, or is the law governing the assigned claim also relevant?

Another method to create security interests is to deliver to the creditor, as so-called collateral, certain assets (usually cash or securities), providing that the creditor will be entitled to retain them upon default by the debtor of the secured obligation. Because the creditor already has the availability of the assets, this arrangement minimises the risk of loss in the case of default. Will the collateral need to be recognised as such under the law of the place where the assets are located, or is the recognition by the law chosen by the parties sufficient?

An encumbrance on an asset ensures the beneficiary that the proceeds from the sale of that asset will be used to satisfy its claim. Consequently, the encumbrance restricts the availability of that asset for the other creditors, who will be able to apply to their respective credits only that part of the asset's value that remains after the beneficiary has satisfied its claim. The general rule in respect of creditors is that they shall be treated equally, and the priorities that are given via pledges or other encumbrances are an exception regulated by mandatory rules of law and generally subject to publicity and registration. If a bank is considering giving a loan to a party and requires security, it must be allowed to rely on the formalities and procedures of the applicable law when verifying whether the debtor's assets are already subject to encumbrances in favour of other creditors. If it was possible for a debtor to avoid these requirements by choosing a foreign law for a contract containing an encumbrance, the bank would have to verify the status of the assets in all the world's jurisdictions in order to satisfy itself that the assets are free from encumbrances. This is obviously not a recommendable situation, and this is the reason why the creation of encumbrances or other security rights that may affect the position of third parties is not subject to the choice of law made by the parties in the agreement. The rights and obligations of the parties between each other are regulated by the law that they have chosen, but the enforceability of security rights that may affect third parties is not. Should the encumbrance turn out not to be effective under its proper law, the consequences

between the parties will be determined by the law they chose. While in some systems the debtor may be deemed to be in breach of its contractual commitment towards the creditor even though the performance of the obligation is illegal or ineffective under its proper law, under other systems the invalidity of one obligation may affect the validity of the whole contract, thus rendering the encumbrance a nullity even between the parties.

1.7.1 Which law governs assignment, security interests and collateral?

The law governing encumbrances on tangible goods is generally determined by the same conflict rule as the law of property seen above, i.e., the connecting factor is the state where the goods are located.²¹

The law governing assignability of claims or receivables and the effect of the assignment towards third parties and between the assigned debtor and the assignee is, generally, the law governing the claim that is being assigned, whereas the effect of the assignment between the assignor and the assignee are governed by the law governing the contract of assignment – see, for example Article 12 of the Rome Convention.²² However, the law of the place where the debtor is located is seen as applicable in some private international laws.²³ In other systems, the connecting factor determining the applicable law is the place of the creditor.²⁴ To harmonise this area, the UNCITRAL has prepared the 2001 Convention on the Assignment of Receivables in International Trade, but the instrument has so far not entered into force.

For the eventuality that the security interest or collateral is created with securities or other financial instruments, specific rules may be recommendable. Therefore, the EU has issued two directives,²⁵ and various other initiatives are

²¹ See, for Swiss law, Article 100 of the Private International Law Act; for English law, Collins, cit., §§ 24-035ff.; for US law, Uniform Commercial Code, Article 9-103(1); for Norwegian law, B.E. Konow, *Løsørepart over landegrensene*, 1999.

²² See the opposite applications by the German and Dutch courts of the two parts of Article 12: BGH 8.12.1998, XI ZR 302/97, IPRax 2000, 128f., and Brandsma g.g. v Hansa Chemie AG, Hoge Raad, 16 May 1997, *Nederlands Internationaal Privaatrecht* (1997) 15, 254ff.. See also Raiffeisen Zentralbank Oesterreich AG v Five Star General Trading LLC and others [2001] EWCA Civ 68, (2001).Q.B. 825, following the German approach. Extensively, see A. Flessner, H. Verhagen, *Assignment in European Private International Law*, 2006. See also Collins, cit., §§ 24-058ff. The corresponding Article 14 in the Rome I Regulation does not seem to contribute with a clarification.

²³ See the US 2001 reform of the Uniform Commercial Code, art. 9-103(3), and Scoles, Hays et al., cit., §§ 19.17ff.

²⁴ See Article 105 of the Swiss Private International Law Act and the notes on it in the *Basler Kommentar*, cit., nn. 14ff.

²⁵ See, for a clear analysis of the implementation of the Collateral Directive 2002/47, the Commission Evaluation at http://ec.europa.eu/internal_market/financial-

being pursued by international organisations such as the Hague Conference, the UNCITRAL and the UNIDROIT.

II Restrictions to the effects of the choice of law made by the parties

Part I above showed that the choice of governing law made by the parties in a contract does not necessarily cover all aspects of their legal relationship, and that there is a need to determine which law governs the legal issues that fall outside of the scope of party autonomy. In addition, the scope of party autonomy is restricted by the increased regulatory activity of states in areas where the policy interests at stake are deemed to be more important than the interests inspiring the party autonomy. This will be the subject-matter of Part II.

1. Overriding mandatory rules

Overriding mandatory rules will be applied notwithstanding the parties' choice of a different governing law, even though there are no specific conflict rules to restrict party autonomy such as those seen in the previous sections. Overriding mandatory rules apply even when the parties have chosen not to apply any state law. One of the major sources of trans-national law, the UNIDROIT Principles for International Commercial Contracts, expressly confirms, in Article 1.4, that mandatory rules of law prevail in the case of conflict with the Principles; even more so, this will apply to overriding mandatory rules.

These rules override the choice of law made in accordance with applicable conflict rules and become directly applicable on the basis of their function and the interests that they represent. It must be emphasised here that not all the rules that are mandatory are also overriding.²⁶ Where the answer is not given expressly in a

[markets/collateral/index_en.htm](#) and, in particular, the response to the questionnaire to the private sector on the implementation of the Directive written by ISDA, the branch association for the privately negotiated derivative industry, at http://ec.europa.eu/internal_market/financial-markets/docs/collateral/2006-consultation/isda_en.pdf.

²⁶ This follows from a systematic interpretation of private international law, see, for example for US law, Scoles, Hays et al., cit., § 18.4 (2). For European private international law, Article 7 of the Rome Convention, which regulates the overriding rules, adopts the terminology "rules that must be applied irrespective of the otherwise applicable law." This is an important qualification to the general definition of "mandatory rules," this latter to be found in Article 3.3 of the Rome Convention and regulating the eventuality that the parties to a domestic (not international) contract have chosen a foreign governing law. For domestic contracts the Rome Convention allows only a restricted choice of law that shall not affect the applicability of the mandatory rules of the law of the state with which all the elements of the contract are connected. These rules are defined in

statutory rule, it will be a matter of the interpreter's discretion to determine whether a rule is not only mandatory (in which case the choice of another law is sufficient to escape from its scope of application), but also has an overriding character (in which case the rule remains applicable in spite of the choice of a different law). The decision will have to be based on the function of the rule and the policy that underlies the regulation, as well as on the balancing of the various interests that are involved in the specific case. The private international law gives some guidelines as to the criteria on which the discretion shall be exercised, for example, the necessity of a particularly closed connection with the law in question, or to what extent rules belonging to foreign laws may be applied.²⁷

It is not always easy to determine whether a mandatory rule is overriding or not, and rules that are deemed overriding in one state might not be overriding in another state. Also, the overriding character of a rule should be evaluated in light of the protection that the same interest enjoys under the chosen law.

Moreover, not all substantive rules protecting particularly important interests become applicable by overriding the choice of law made by the parties on the basis of the interpreter's discretion. Sometimes the legislature finds that the policy upon which a certain rule is based and a certain connection between the legal relationship and that country are such, that it renders it desirable to automatically apply that rule. In such a case, the legislature may create a specific

Article 3.3 as "mandatory rules", and described as the rules "that cannot be derogated from by contract". In Article 3.3 there is no qualification of these mandatory rules as can be found in Article 7, stating that they should be the kind of mandatory rules that must be applied whatever the governing law. In other words, the Rome Convention operates with two different concepts of "mandatory rules": the "ordinary" mandatory rules, that cannot be derogated from by contract if they belong to the governing law (regulated in Article 3.3), and the "overriding" mandatory rules, that may be given effect to even if they do not belong to the chosen law (regulated in Article 7). That these two concepts are different is confirmed also by the other language versions of the convention: in the French version, for example, the mandatory rules of Article 3.3 are called "dispositions imperatives" and those of Article 7 are called "lois de police," whereas in the German version they are called, respectively, "zwingende Bestimmungen" and "zwingende Vorschriften." The difference between the two categories is confirmed in the Green paper prepared by the European Commission in connection with the transformation of the Rome Convention into a Regulation, COM (2002) 654 final, par 3.2.8, as well as in the draft Rome I.

²⁷ Application of the law chosen by the parties may also be limited by overriding mandatory rules belonging to laws different from the *lex fori*. A judge will normally apply the overriding mandatory rules of his own law; some systems of private international law recognise the possibility of giving effect to overriding mandatory rules of third states, if there is a sufficiently close connection between the dispute and the third state, for example Article 7.1 of the Rome Convention and Article 19 of the Swiss Private International Law Act. These aspects have rendered the rule of Article 7.1 quite controversial, and even the Rome Convention itself permits its signatories, in Article 22.1(a), to reserve against the application of this rule. Among others, England and Germany have reserved against the application of Article 7.1 of the Rome Convention.

conflict rule ensuring automatic application of that law. In these cases, the loose approach based on the functional evaluation of the rule and a balancing of the involved interests is replaced with more mechanical rules based on the application of pre-determined connecting factors. Thus, the same interest may be regulated by rules that are applicable on the basis of specific conflict rules in certain systems, whereas they may be applied directly as overriding rules in other systems. Application of a rule on the basis of a connecting factor is by far preferable, in terms of predictability, to application as a consequence of a functional analysis made by the interpreter. A widespread opinion (shared also by me), but not an uncontroversial one, is that predictability should be preferred to a functional analysis that ensures appropriate results in the specific cases.²⁸

One of the interests that is increasingly being considered as particularly important is the protection of the weaker contractual party. Overriding mandatory rules may be found in fields such as labour law,²⁹ consumer law,³⁰ insurance,³¹ carriage,³² or agency.³³ Specific conflict rules have been created for many of these rules, in which case their applicability is based on determined and predictable connecting factors (such as the place where the activity is carried out).

Another overriding interest is the protection of the security of rights and of third parties, such as in the fields of incorporation of legal entities, insolvency and

²⁸ See, for example, F.K. Juenger, *Choice of Law and Multistate Justice*, 1993, G. Kegel, *The Crisis of Conflict of Laws*, 112 *Recueil des Cours* 91, (1964), and S. Symeonides, *Material Justice and Conflicts Justice in Choice of Law*, in P. Borchers, J. Zekoll (eds.), *International Conflict of Laws For the Third Millennium: Essays in Honor Of Friedrich K. Juenger*, 2001, 125ff.

²⁹ The Rome Convention provides in Article 6 for an exclusive conflict rule in the event that the law chosen by the parties gives the employee a worse protection than the law that would otherwise have been applicable. In the US private international law, the overriding character of labour law seems to relate particularly to the statutory restrictions to non-competition agreements, see Scoles, Hays et al., cit., § 18.5. See, for Norwegian law, the Protection of Employees and Working Environment Act, section 5.

³⁰ The Rome Convention provides in Article 5 for an exclusive conflict rule in the event that the law chosen by the parties gives the consumer a worse protection than the law that would otherwise have been applicable. For US law, see Scoles, Hays et al., cit., § 18.4(3). See, for Norwegian law, the Financial Agreements Act, section 2.3 and the Consumer Sale Act § 3, based on the European regulation.

³¹ The European Community has issued several directives to harmonise this field, see especially directive 88/357 and 90/619. See, for Norwegian law, the Act on the Law Applicable to Insurance Agreements, section 5, based on the EC regulation. For US law see Scoles, Hays et al., cit., §18.5.

³² This area is regulated by a series of international instruments, such as the so-called Hague Rules of 1924, the Hague-Visby Rules of 1968 and the Hamburg Rules of 1978. See, for Norwegian law, the Maritime Code, section 430 and section 252 combined with section 310.

³³ The EC Directive 1986/653 related to self-employed commercial agency contains a series of rules for the protection of the agent. For Norwegian law, see the Agency Act § 3, based on the European regulation. In US law the commercial agents do not enjoy a particular statutory protection, but distributors and franchisees do, and these rules are deemed to be overriding: see Scoles, Hays et al., cit. § 18.5.

property. These areas are usually outside of the scope of party autonomy, therefore the proper law will be determined on the basis of other connecting factors, as seen above in Part I.

Mandatory rules that override the contractual regulation may also be found in respect of other interests, such as the protection of the national economy (for example, import-export regulations, foreign exchange regulations, securities exchange regulations, competition regulation, etc.), or public interest (for example, embargo).

Most of these rules have a public law character and are outside the scope of party autonomy, therefore it is quite natural that they are not affected by the choice of law contained in the contract. It may, nevertheless, be worthwhile mentioning them here, since the parties to a contract often tend to rely on the choice of law contained therein to such an extent that they expect no interference of any kind by any other laws, including public law rules.

Some illustrations may show the impact that overriding mandatory rules may have on the choice of law made by the parties.

1.1 Competition law

Suppose that two competing manufacturers enter into a contract for the licensing of certain technology, and that the transfer of technology is accompanied by a system for sharing the market between the two competitors, which violates European competition law. The contract contains a choice-of-law clause, according to which the governing law is a foreign law. If a dispute arises between the two parties, and one of the two parties alleges that the contract is null and void because it violates European competition law, the other party will allege that EC competition law is not applicable to the contract, that the choice of the foreign governing law was meant specifically to avoid applicability of EC law, and that the will of the parties shall be respected.

The purpose of the EC rules on competition is to ensure that business parties do not distort the market by, for example, sharing it between themselves. Practices such as market sharing have a negative effect on the offer and on the prices, and this negatively affects the buyers. If the parties could avoid applicability of these rules by subjecting the contract to a third law, their party autonomy would affect the position of the buyers, and this is not desirable. Hence, competition rules will apply to agreements and market practices that have effect on the relevant territory, irrespective of the law that governs the contract.

1.2 Labour law

Suppose that a Norwegian company agrees to contribute to the capital of a Russian company against the commitment by the latter to, among other things, reduce the number of its personnel by one third within a certain term. The contract is subject to Swedish law. Russian mandatory rules of labour law on the protection of employees provide for a lengthy and complicated procedure before the number of employees can be reduced. As a consequence, the Russian party is not able to perform the obligation that it assumed towards the Norwegian party. The Russian party will invoke Russian mandatory rules of labour law as an excuse for the delay in performing its obligations, and the other party will deny the relevance of rules of Russian law because the contract excluded its applicability by choosing Swedish law as governing.

Labour law is obviously aiming at protecting the employees, and a contract between the investor and the employer is not capable of excluding the applicability of the labour protection that the employees enjoy. Assuming that the investor and the employer, aware of this circumstance, had agreed to modify all the employment agreements so that each of the employment agreements contained a choice-of-law clause in favour of Swedish law, would the protection afforded by Russian labour law be excluded? Even a choice-of-law clause in each employment agreement would not be capable of achieving the exclusion of Russian labour law, partly because there is a special conflict rule for labour law,³⁴ and partly because these rules are typically considered to have an overriding character and remain applicable in spite of any contrary choice of law made by the parties.

1.3 Agency contracts

Suppose that an Italian producer enters into a contract with a Norwegian agent for the promotion of the producer's products and the development of a market in the Norwegian territory. In the contract, the parties provide that the agreement may be terminated at the discretion of the producer and that no compensation shall be paid to the agent upon such termination. The contract contains a choice-of-law clause determining the law of New York as governing, because this regulation of the parties' interests is allowed under that law. Under Norwegian law, however (as well as under Italian law), the agent is entitled to compensation upon termination of the relationship. Is the choice-of-law clause sufficient to exclude application of the Norwegian rule on compensation?

³⁴ See above, footnote 29.

The rule on compensation is part of a set of rules designed to protect the agent, which is deemed to be the weaker party in the relationship. An agency assumes that the agent exercises its activity for the benefit of the principal. On termination of the relationship, the results of the agent's activity benefit the principal, who will then enjoy the market and the goodwill developed for it by the agent. The agent, on the other hand, will not have any benefit from the activity carried out for the principal. Hence, the compensation upon termination is meant to balance the parties' interests. The protection regime is deemed to regard all commercial agents carrying out their activity within the territory, and the circumstance that the parties chose a different law to govern the contract should not exclude its application.³⁵

1.4 Insurance

Suppose that an English insurance company and a Norwegian ship owner enter into an insurance contract for the liability that the ship may incur towards third parties. The insurance contract contains a pay-to-be-paid clause, affirming that the insurer will make any disbursement only after the insured has reimbursed the damage caused to the third party. The contract contains a clause choosing English law to govern it, and the regulation contained in the contract is in compliance with English law. The pay-to-be-paid clause means, i.a., that in case the insured becomes insolvent or goes bankrupt before a reimbursement of damages was made to an injured third party, the insurance company will not be under an obligation to make any disbursement.

Assuming that the injured party is Norwegian, it will have, according to Norwegian mandatory law, a direct action against the insurer. Will the injured party be able to claim payment under the direct action, in spite of the circumstance that the insurance company is not obliged to make payment under the insurance contract or under the law chosen to govern the contract?

Contracts of insurance are widely regarded as adhesion contracts, drafted unilaterally by the insurance company and imposed on the insured, the weaker party without any real bargaining power. Therefore, statutes and regulations often contain detailed mandatory rules that the parties may not escape by subjecting the contract to a foreign law.³⁶ For special insurance contracts regarding large business activities, the mandatory regulation is less extensive. However, certain rules remain mandatory even in this context, for example, the rule on the direct

³⁵ See the European Court of Justice decision in *Ingmar* (C-381/98), where the question arose because the principal was located outside Europe. See also footnote 33 above.

³⁶ See footnote 31 above.

action in case of insolvency of the insured.³⁷ In the case described above, the choice of law made in the insurance contract might have been deemed overridden by the mandatory rule of the direct action. Alternatively, and preferably, it might have been deemed not to be relevant, since the rights exercised by the injured in the direct action are not contractual rights and are thus subject to another conflict rule.³⁸

1.5 Good faith and fair dealing

Some legal systems, particularly those inspired by German law, base their contract laws on the principle of good faith and fair dealing. This principle may be used to guide the interpretation and performance of the contract, in order to create ancillary obligations for the parties in spite of their not being expressly provided for in the contract, or even to correct the regulation contained in the contract. Contract clauses that expressly permit an interpretation or a performance that violate the principle of good faith and fair dealing, for example, exempting from liability even in case of gross negligence or wilful misconduct or permitting termination of the contract for capricious reasons, might be deemed to violate the principle of good faith and fair dealing. If the contract is subject to, for example, English law, which has no general principle of good faith for commercial contracts, there are no obstacles to a literal implementation of the contract's provisions, as long as they are sufficiently clear.³⁹

Would the literal implementation of these clauses be affected by an overriding principle of good faith and fair dealing in the law that would have been applicable if the parties had not chosen English law to govern the contract? The principle of good faith and fair dealing is considered to be central in the contract laws of civil law systems, and it has been transferred from there into various restatements of principles of contract law that have the ambition of being applicable to international contracts, such as the UNIDROIT Principles of

³⁷ Deemed to be overriding in the Norwegian preparatory works to the Act on the Law Applicable to Insurance Contracts, Ot prp nr 72 (1991-92), 66.

³⁸ The EU Regulation 864/2007 (Rome II) on the law applicable to non-contractual obligations opens for classification of a claim based on direct action as contract right or right based on tort, see Article 15. For a comment on a case similar to the one described here see G. Cordero Moss, *Direct Action Against the Insurer: a Recent Decision by the Norwegian Supreme Court Illustrates the Norwegian Approach to Private International Law*, in T. Einhorn, K. Siehr (eds.), *Intercontinental Cooperation through Private International Law - Essays in Memory of Peter Nygh*, 2002, 55-67.

³⁹ For a substantiation of this statement see, with further references, G. Cordero Moss, *Contracts Between Consumer Protection and Trade Usages: Some Observations on the Importance of State Contract Law*, in Schulze, R. (ed.), *Common Frame of Reference and Existing EC Contract Law*, 2007, 65ff., 72ff.

International Commercial Contracts and the Principles of European Contract Law. It has also been proposed that many overriding rules based on good faith, that so far have been applicable to consumer protection, also be extended to commercial contracts.⁴⁰ There are some indications that rules expressing this principle might have an overriding character and thus remain applicable in spite of a different choice of law made by the parties,⁴¹ although extreme cautiousness is recommended as will be seen in Part III below.

2. Public policy

For the sake of completeness, a further restriction to party autonomy must be mentioned: a foreign law chosen by the parties is not applicable to the extent that its application results in an intolerable violation of the basic principles on which the system of the *lex fori* is based (ordre public, or public policy).⁴²

The public policy clause is to be interpreted narrowly.⁴³ It is not intended to be used whenever there is a discrepancy between the foreign governing law and the legal system of the forum. The clause is to be used only under exceptional circumstances, when the result to which the judge would come by applying the rule of the foreign governing law would conflict with the basic principles upon which the society of the forum is based. A simple difference between a foreign rule and a mandatory rule of the forum, or even an overriding mandatory rule of

⁴⁰ For example, the Principles of EC Contract Law issued by the European Research Group on Existing EC Private Law (so-called “Acquis principles”), extend to commercial contracts various rules based on the protection of the consumer, for example imposing liability for having carried out negotiations in bad faith (Article 2:103), imposing a duty of information in the pre-contractual phase (Article 2:201), imposing performance in good faith (Article 7:101), providing that a right or a remedy shall be exercised in good faith (Article 7:102), providing that the terms of a contract are not binding if they have not been individually negotiated and if they have been incorporated by reference made in the contract (Article 6:201). Criticising these Articles see my writing mentioned in the above footnote, 66f., 71, 72, 74f.

⁴¹ The preparatory works to the Norwegian Act on Choice of Law in Insurance Contracts (see above, footnote 37), commenting on the act’s provision about overriding mandatory rules (a provision modelled on Article 7 of the Rome Convention, since the act is the implementation in Norway of the EC Directive on the same subject-matter), affirm that one of the rules of Norwegian law that might be deemed to have an overriding character according to that provision is § 36 of the Norwegian Contracts Act, imposing the principle of good faith and fair dealing on contracts.

⁴² The Rome Convention contains the same regulation in Article 16, and so do the Swiss Private International Law Act in Article 17, and, for example, the Russian Civil Code in Article 1193.

⁴³ See M. Giuliano, P. Lagarde, “Report on the Convention on the Law Applicable to Contractual Obligations”, OJ. C 282/80, A 5.76, representing a quite harmonised point of view.

the forum, therefore, would not in itself qualify as violation of the public policy of the forum.⁴⁴

3. Modality and assumptions of the exercise of choice-of-law clauses

It should be finally mentioned that not only the effects, but even the modalities and the assumptions for exercising party autonomy, are subject to different regimens according to the applicable private international law.

Thus, party autonomy may be permitted only for international contracts, and the definition of a contract as international may vary from system to system.⁴⁵ Moreover, the choice may need to be made expressly in some systems, whereas others recognise tacit choices. Again, some of the systems that permit a tacit choice may deem a clause choosing the forum as a tacit choice of the law belonging to the country of the chosen forum, whereas others would not.

4. Application of the chosen law and effects of other laws

Laws different from the one chosen by the parties may be given effect, indirectly, even by applying the chosen law. In these cases, the effects of the foreign rules will be considered as facts that are given the legal effects that the governing law gives to similar facts. The excluded rules will not be applied, but the factual consequences that the foreign rules have created in the foreign state will be taken into consideration when applying the law chosen by the parties. This is particularly relevant when the excluded law has created the impossibility or

⁴⁴ For some examples of cases where public policy has been considered violated, see Part III below.

⁴⁵ For example, according to the 1980 Vienna Convention on the Contract for International Sale of Goods, Article 1.1, a contract is international if it is concluded between two parties having place of business in different countries. The Hague convention on the Law Applicable to International Sale of Goods of 1955, does not define the term international, and simply states in Article 1 that the mere determination of the parties is not sufficient to give a sale the international character (indirectly accepting that a sale may be international if there are some foreign elements to the transaction, this not necessarily being the place of business of the parties). The Rome Convention speaks in Article 1.1 of any situation involving a choice between the laws of different states, thus indirectly opening even for the eventuality that the only foreign element to a transaction is the choice made by the parties of a foreign law (although, in such a situation, the applicability of the conflict rules contained in the convention is limited by Article 3.3 thereof). The UNCITRAL Model Law on International Commercial Arbitration defines in Article 1.3 an arbitration as international if one of more conditions are met, including also the mere determination by the parties that the subject-matter of the dispute relates to more than one state.

illegality of the performance, and the law chosen by the parties considers the circumstances as, respectively, an excuse for non-performance, or a reason for unenforceability or invalidity of the relevant obligation.

5. Party autonomy is shaped by the applicable private international law

The foregoing showed that the governing-law clause inserted by the parties in the contract is not a self-explanatory and self-sufficient term of contract. If the party autonomy is to be an effective choice of law, its interaction with the private international law to which it belongs has to be recognised. To what extent the private international law can restrict or affect the enforcement of party autonomy when the contract contains an arbitration clause, will be analysed in Part III below.

III Arbitration and choice of law

Arbitration is an out-of-court method of dispute resolution that is mostly based on the will of the parties. The tribunal is bound to follow the parties' instructions, because it does not have any powers outside of the parties' agreement. Tribunals are therefore, and correctly, very reluctant to deviate from the instructions of the parties.

Nevertheless, there might be situations where a tribunal is faced with the necessity or the opportunity to disregard the parties' instructions with respect to the applicable law. As an example, following the parties' choice might result in a violation of applicable fundamental principles (public policy), if the parties have made a conscious choice of law in order to avoid application of certain rules of the otherwise applicable law, for example, rules on export, taxes or competition regulation. The following sections will elaborate on this eventuality and on its consequences for the enforceability of an award that gives effect to the parties' choice.

1. The tribunal gives effect to the parties' choice: is the award valid and enforceable even though it violates the otherwise applicable law?

As long as the losing party voluntarily complies with arbitral awards, there is no point of contact between the national courts and the arbitration. Consequently, there will be no national judge that decides to override the parties' contract or

expectations by considering an agreement invalid because it violates EU competition law,⁴⁶ or a firm offer not binding because it does not comply with some formal requirements set by the chosen law.⁴⁷ The arbitrators may or may not decide to apply these rules, but, as long as the losing party accepts the result of the arbitration, there will be no possibility for any judge to verify the arbitrator's acts.

If the losing party does not voluntarily accept the award, there are two possibilities of obtaining judicial control on an award: (i) the losing party may challenge the validity of an arbitral award before the courts of the place where the award was rendered, and (ii) the losing party may abstain from carrying out the award, therefore inducing the winning party to seek enforcement of an arbitral award by the courts of the country (or countries) where the losing party has assets.

The validity of an award may be challenged before the courts of the place where the award was rendered. Because the challenge is regulated by national arbitration law, and may differ from country to country, it is impossible to make an analysis with a general validity. Suffice it to look here at the discipline contained in the 1985 UNCITRAL Model Law on International Commercial Arbitration, which is acknowledged as embodying a general consensus in the matter of arbitration, is adopted more or less literally in circa 50 countries,⁴⁸ and is used as a term of reference even in many countries that have not formally adopted it.⁴⁹

The grounds that may be invoked under Article 34 of the UNCITRAL Model Law to make an award invalid are the same grounds that may be invoked under Article 36 of the Model Law as defenses against the enforcement of an award. These are, in turn, the same grounds that are listed in the 1958 New York Convention on Recognition and Enforcement of Foreign Arbitral Awards as the only possible defenses against enforcement of an award. Both instruments, the UNCITRAL Model Law and the New York Convention, shall be interpreted autonomously in the interest of harmonisation, which is extremely important for the field of international arbitration and fully complies with the purposes of both. An autonomous interpretation aims at construing and applying a rule in a uniform

⁴⁶Violation of EU competition law is, according to a much discussed European Court of Justice decision, to be deemed as a violation of public policy, see footnote 57 below.

⁴⁷ Under certain circumstances acceptance by the offeree would be a prerequisite for the offer to be binding, in case the governing law was English. For more references see J. Beatson, *Anson's Law of Contract*, 28th ed., 2002, 88ff., 118f.

⁴⁸ Among the most recent arbitration laws that are based on the UNCITRAL Model Law is the Norwegian Arbitration Act. A list of the countries that have adopted the Model Law may be found on UNCITRAL's homepage, http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/1985Model_arbitration_status.html.

⁴⁹ For example, Sweden and England have Arbitration Acts that follow their respective legislative tradition and cannot be considered as having adopted the Model Law. However, the Model Law has consistently been taken into consideration in the drafting work.

way, common to all countries that have adopted or ratified the instrument. It assumes that a court avoids special interpretations due to peculiarities of its specific national system, as well as that it takes into consideration construction and application of the instrument in other countries, as a parameter for its own interpretation. Because of the identity of the criteria for challenging the validity and resisting the enforcement of an award, interpretation or application of Articles 34 and 36 of the UNCITRAL Model, as well as of Article V of the New York Convention, are relevant to each other. Therefore, we will deal with the grounds for invalidity and the grounds for unenforceability jointly, and the comments made on the Model Law will be applicable also to the New York Convention, and vice versa.

It is, however, important to bear in mind that, as mentioned above, invalidity of an arbitral award is regulated by the various national laws, and that there may be further grounds for invalidity in the countries that have not adopted the UNCITRAL Model Law.

Enforcement of an arbitral award is regulated, in the about 150 countries that have ratified it, by the 1958 New York Convention on Recognition and Enforcement of Foreign Arbitral Awards. In Article V, the New York Convention contains an exhaustive list of the grounds that may be invoked to prevent enforcement of an award. There is large consensus on the opportunity to interpret these grounds restrictively, i.e., to restrict the scope of judicial control.⁵⁰

The analysis below will show to what extent the rules on choice of law presented in Part II above may affect the validity or enforceability of an arbitral award.

1.1 No review of the application of law

The list of grounds for invalidity or unenforceability is, as mentioned, exhaustive and must be interpreted restrictively. Nothing in the wording of this list suggests that the courts have the authority to review the merits of the arbitral decision, either in respect of the evaluation of the fact, or in respect of the application of the law. Judicial control under the UNCITRAL Model Law and under the New York Convention, in other words, may not be used as a vehicle for the court to act upon an error in law incurred by the arbitral tribunal, no matter how evident the error is.

⁵⁰ See the most authoritative commentary on the New York Convention, A. J. van den Berg, *Consolidated Commentary on the New York Convention*, (2003) *ICCA Yearbook Commercial Arbitration* XXVIII, 501 A, with extensive reference to judicial practice. For a thorough analysis of the role of overriding mandatory rules within arbitration see L.G. Radicati di Brozolo, *Arbitrage Commercial International et Lois de Police: Considérations sur les Conflits de Jurisdictions dans le Commerce International*, in (2006) *Collected Courses of the Hague Academy of International Law*, vol. 315, 265ff., with extensive references to literature.

The impossibility of controlling the arbitral award in the merits, including also the application of the law, is generally acknowledged both in theory and in judicial practice.⁵¹

1.2 Legal capacity

Article 34(2)(a)(i) of the UNCITRAL Model Law and Article V(1)(a) of the New York Convention provide, as a ground for setting aside or refusing enforcement of an arbitral award, that a party to the arbitration agreement was under some incapacity under the law applicable to it.

The law applicable to a party, as seen in section 1.4 of Part I above, is not the law that the parties chose to govern the contract. The example presented above showed a contract signed by one authorised person for each of the parties in accordance with the requirements contained in the law chosen to govern the contract. However, one of the parties is, under the law applicable to it, not capable of being bound without the signature of two authorised persons. If the arbitral award follows the choice of law made by the parties and considers the contract as binding, then the award may be set aside or refused enforcement because the arbitral agreement has not properly come into existence.⁵²

1.3 Arbitrability

An award may be set aside or refused enforcement if the subject-matter of the dispute may not be subject to arbitration according to the law of the court of the place where the award was rendered or, as the case may be, where enforcement of the award is sought (see Article 34(2)(b)(i) of the UNCITRAL Model Law and Article V(2)(a) of the New York Convention).

National arbitration laws usually determine the arbitrability of disputes by making reference to concepts such as the possibility by the parties to freely dispose of the claims that the dispute is based on, or by defining the claims as

⁵¹ See van den Berg, *cit.*, 2003, 501 B and C. In Common Law countries there is a tradition for permitting a certain control of error in law in the phase of challenging the validity of an award, although it has been considerably restricted in modern legislation (see, for example, section 69 of the English Arbitration Act). This, however, does not affect the enforceability of a foreign award that is governed by the New York Convention. See G Born, *International Commercial Arbitration: Commentary and Materials*, 2.ed., 181, with references to the US doctrine of manifest disregard of the law, which may be used as a defense against enforcement of a US award, but not of a foreign award.

⁵² A recent decision of the Stockholm Court of Appeal set aside an arbitral award affirming, among other things, that the law of Ukraine is applicable to the question of the legal capacity of the Ukrainian party, notwithstanding that the contract contained a governing law clause choosing Swedish law: *State of Ukraine v Norsk Hydro ASA*, Svea Hovrätt, 17 December 2007.

commercial, contractual or having the character of private law. This would exclude from the scope of commercial arbitration, matters such as taxation, import and export regulations, currency or security exchange, concession of rights by administrative authorities, bankruptcy, the protection of intellectual property, etc. These matters are mostly regulated by mandatory rules from which the parties cannot derogate and must be decided upon by courts of justice - unless they are subject to special arbitration, for example, based on treaties or special legislation. Disputes concerning the other aspects of commercial transactions, which fall within the scope of the freedom to contract, are usually arbitrable.

The rationale for restricting arbitrability is to reserve the decision of disputes regarding particularly important interests and policies to courts of law, which are deemed to be more accurate than arbitral tribunals in the consideration and application of the relevant rules. Arbitration laws and court practice have become more and more liberal in their definition of what is arbitrable. Broadly speaking, the scope of applicability of the rule on arbitrability may be seen to largely overlap the rule on public policy, that will be examined immediately below.⁵³

1.4 Public policy

A highly relevant ground for setting aside an award or refusing its enforcement is that the award violates the public policy of the forum (Article 34(2)(b)(ii) of the UNCITRAL Model Law and Article V(2)(b) of the New York Convention). The exception of public policy (or *ordre public*) is, in the context of international arbitration, unanimously interpreted very narrowly. Its rationale is not to permit a judge to refuse enforcement or annul an international award on the basis of any difference between the result of the award and the result to which the judge would have come applying his or her own law. As will be seen below, this would run counter to the spirit of the New York Convention, of the UNCITRAL Model Law, of all practice that is generally recognised and legal doctrine in the international scale.

1.4.1 Restrictive application

Many court decisions in the various states annulling an award or refusing to enforce it because the award is in contrast with the court's public policy, are reported in the ICCA Yearbook, Commercial Arbitration. A survey of these

⁵³ For a more extensive substantiation of this line of thought see G. Cordero Moss, *National Rules on Arbitrability and the Validity of an International Arbitral Award: The Example of Disputes Regarding Russian Petroleum Investments*, (2001) *Stockholm Arbitration Report*, 7ff.

decisions, from the first volume in the mid-seventies to present, shows that such decisions are not numerous. In some cases there is relative uniformity of consensus from state to state. Awards that violate rules on bribery or smuggling, for example, are usually considered in the international legal doctrine as being against public policy.

As known, there is no absolute criterion to determine public policy. What is fundamental may vary from state to state, and, even within the same state, the conceptions develop, and what was deemed public policy a decade earlier, may no longer be public policy.⁵⁴

Not every principle inspiring a mandatory rule can be considered a public policy principle. Not even every principle inspiring an overriding mandatory rule can be considered public policy. Only the fundamental ones, those that constitute the basis of the society, can be considered public policy principles. Rules that would at first sight seem to be public policy, like embargo, have, in several cases, not been considered as such, under the consideration that, even if embargoes are

⁵⁴ The example of swap agreements and other financial derivative instruments is quite descriptive: this kind of contract developed into a recognised financial activity in the course of the 1980s, and is not considered as being against fundamental principle. However, until as late as the 1980s, courts in Germany and in Austria were considering them against the basic moral principles of the system that forbid gambling (so-called *Differenzverbot*). See, for example, the decision of the Austrian Supreme Court No 3 Ob 30/83 of 1983, and of the German Supreme Court (Bundesgerichtshof) of 15 June 1987. Only a few years later, the Bundesgerichtshof did not consider these agreements as violating any fundamental principles of the German legal system (see for example the decision dated 26.2.1991, XI ZR 349/89). Regarding the notion of truly international public policy, a concept primarily recognised in some academic circles and sometimes proposed as more adequate to be applied to international transactions and international arbitration than the national public policy is that the usefulness of this concept may be questioned. The concept aims at having a legal system avoiding its own fundamental principles to declare a foreign award invalid or to refuse its enforcement (or to restrict application of the governing foreign law), if such principles are particular to that specific legal system and do not enjoy recognition internationally. In such a situation, the peculiarity of that legal system undermines the ideals of international uniformity that inspire international commercial law and international arbitration. The aim of the theory underlying the truly international public policy, therefore, is to disregard the fundamental principles that are proper only for one legal system, even if they represent the basic values upon which that society is relying. Instead, that legal system should look at what basic principles are recognised on a more international level, and prefer those principles to its own. It seems too ambitious to me, however, to expect that a state waives application of its own fundamental principles in the name of an ideal of harmonisation in international commerce. As long as the validity of an arbitral award is regulated by national arbitration laws, and the enforceability of an award is regulated by the New York Convention, the standard of reference will be the fundamental principles of the *lex fori* (though in the narrow sense described above): see, corroborating this position, A. Sheppard, *Public Policy and the Enforcement of Arbitral Awards: Should there be a Global Standard?*, in 2004 *Transnational Dispute Management*, vol I, issue 01, 7f., commenting the work on public policy made in the frame of the International Law Association, International Commercial Arbitration Committee.

important from a foreign policy point of view, they cannot be considered public policy.⁵⁵ Moreover, not any discrepancy with the text or technicalities of a rule based on such fundamental principle may be deemed a violation of public policy.⁵⁶

The sections below will discuss case law relating to the determination of public policy in respect of some of the rules that were presented in Part I above.

1.4.2 Company law

We saw in section 1.3 Part I above, that company law is an area where the parties' choice of law made in the contract does not have effects. Assuming that a contract contains a regulation that violates the applicable company law and a choice-of-law clause excluding that such law is applicable, and assuming that the arbitral award gives effect to the agreement of the parties, thus violating the applicable company law: will the award be valid and enforceable in the country to which the applicable company law belongs?

The nature of the public policy defense prevents making general assertions as to the quality with regard to public policy for a whole area of the law. While some rules of company law may protect interests that are deemed to be so fundamental that their disregard may contradict public policy, it will depend on the circumstances of the case as to what extent the result of a specific violation actually is in contrast with such fundamental principles. On a general basis, however, it seems legitimate to affirm that the policy upon which various rules of company law are based may be deemed so strong, that a serious breach of those rules may represent a violation of public policy.

Thus, an award disregarding the applicable company law to give effect to the parties' agreement may run the risk of being ineffective, if it is challenged or enforcement is sought before the courts of the place to which the disregarded company law belongs.⁵⁷

⁵⁵ *National Oil Corporation (Libya) v. Libyan Nun Oil Company*, 733 F.Supp. (1990), 800, and *Belship Navigation, Inc. v. Sealift, Inc.*, 1995, in (1997) *Yearbook Commercial Arbitration* XXII, 789 ff. See, however, *Karen Maritime Limited v Omar International Incorporated*, 322 Federal Supplement, Second Series, 224 ff., in (2005) *Yearbook Commercial Arbitration* XXX, 789 ff., where the District Court affirmed that "it might have found it appropriate to deny enforcement if the breach of contract had to do with the Arab boycott" (at p. 790). The contract in dispute contained a clause that referred to the boycott of Israel by Arab countries, but the court found that the dispute did not concern that clause and its compatibility with US public policy.

⁵⁶ See, for a parallel restrictive use of the public policy defense in respect of recognition of civil court decisions under the Brussels convention, The European Court of Justice decision in *Renault (C-38/98)*.

⁵⁷ See for example the decision of 31 December 2006, by the Federal Commercial Court of West Siberia regarding an arbitral award on a shareholder agreement between, among others, OAO

1.4.3 Insolvency

Section 1.5 in Part I above, mentioned some reasons for considering matters relating to insolvency as being not subject to the choice of law made by the parties. Do the same reasons constitute a sufficient basis for invoking the defense of public policy to set aside or refuse enforcement of an award that gives effect to the parties' agreement and thus violates the applicable insolvency law?

The question was answered affirmatively in the United States in a case regarding the enforcement of an arbitral award rendered in London that ordered a Swedish party to effect a certain payment. The debtor was subject to insolvency proceedings in Sweden, and the Court of Appeal found that "in light of Salen's bankruptcy, [the] enforcement would conflict with the public policy of ensuring equitable and orderly distribution of local assets of a foreign bankrupt."⁵⁸ The court balanced against each other, on one hand the interest in ensuring enforcement of international awards, and, on the other hand, the interest in ensuring an equal treatment to the creditors when an insolvency procedure had been opened. The court resolved not to enforce the award, thus preventing that one creditor be preferred to the detriment of the others.

Other court decisions have enforced awards in spite of pending bankruptcy proceedings, because the circumstances of the cases did not make enforcement incompatible with the principles underlying the bankruptcy proceedings.⁵⁹

Telecominvest, Sonera Holding B.V., Telia International AB, Avenue Ltd, Santel Ltd, Janao Properties Ltd, and IPOC International Growth Fund Ltd. The Court affirmed that the parties to a shareholders agreement may not choose a foreign law (in that case, Swedish law) to govern the status of a legal entity, its legal capacity, the function of its corporate bodies or the relationship to and within its shareholders. These matters are, according to the court, governed by mandatory rules of the law of the place of registration (in that case, Russian law). Violation of these Russian rules was defined as a violation of Russian public policy. A similar approach is followed in the Ukraine, see the Recommendation issued by the Presidium of the Higher Commercial Court of Ukraine on 28 December 2007 No 04-5/14, which advises the commercial courts of Ukraine that matters regarding the establishment of a company, the formation and competence of the corporate bodies, the convocation and voting procedure of the general meeting are regulated by mandatory rules that shall be considered public policy.

⁵⁸ Salen Dry Cargo AB v. Victrix Streanship Co, in (1990) *Yearbook Commercial Arbitration* XV, 534 ff., 825 F.2d 709 (2nd, Cir 1987).

⁵⁹ State Property Fund of Ukraine v TMR Energy Limited, United States Court of Appeals, District of Columbia Circuit, 17.6.2005, 2005 U.S. App. Lexis 11540, in (2005) *Yearbook Commercial Arbitration* XXX, 1178 ff., where the award was not directed at the party that was the object of bankruptcy proceedings. See also German Court of Appeal, Brandenburg, 2.9.1999, in (2004) *Yearbook Commercial Arbitration* XXIX, 696 ff., where the enforcement was deemed not to be an execution proceeding, but merely a preliminary measure without executory effect.

1.4.4 Property and encumbrances

Sections 1.6 and 1.7 in Part I above, showed how property rights and rights relating to encumbrances or security interests are not necessarily subject to the law chosen by the parties. Lacking any specific case law on the effectiveness of arbitral awards that give effect to the parties' agreement and violate applicable law on property, encumbrances or security interests, it seems advisable to refer to the reasoning made above in respect of company law and insolvency proceedings, that respond to the same logic.

1.4.5 Competition law

Recently, the European Court of Justice has determined that European Competition rules have to be considered part of public policy.⁶⁰ The European Court was acting upon a reference made by the Dutch Supreme Court in a case for the annulment of an arbitral award. The award had given effect to the agreement between the parties that violated the provision on competition of the EC Treaty, then Article 85. The Dutch Supreme Court had affirmed that an award violating Dutch competition rules would not be deemed against Dutch public policy, and requested a decision from the European Court as to whether European competition policy could be treated in the same way or not. The ECJ ruled that the rule on competition contained in the then Article 85 of the EC Treaty is a fundamental provision which is essential for the accomplishment of the tasks entrusted to the Community and, in particular, for the functioning of the internal market. Based on this, the Court explicitly affirmed: "The provisions of Article 85 of the Treaty may be regarded as a matter of public policy within the meaning of the New York Convention."⁶¹

Applied to the case described in section 1.1 of Part II above, the ECJ decision in *Eco Swiss China Time Ltd. v. Benetton International N.V.* means that the arbitral tribunal risks rendering an award that will be deemed invalid and refused enforcement by European courts. If the award gives effect to the choice of law made by the parties in the contract, and this leads to violating the otherwise applicable European competition law, the award will be deemed to conflict with European public policy. This, in turn, is a ground for setting aside the award if the award was rendered in a European country and was challenged before the court of that place, and a ground for refusing enforcement if enforcement is sought before a European court.

That the European Court of Justice has defined European competition law as public policy does not mean that other systems outside of Europe will do the

⁶⁰ *Eco Swiss China Time Ltd. v. Benetton International N.V.* C-126/97.

⁶¹ *Ivi*, Par 39

same. In the United States, for example, a Court of Appeals enforced an award that gave effect to a market allocation agreement on the basis that the compatibility with US competition law had already been evaluated by the arbitral tribunal and the court could not review such evaluation.⁶²

1.4.6 Agency

Applying the rationale of *Eco Swiss* might also lead to considering the European rules protecting commercial agents as public policy. This is because the European Court of Justice affirmed in the *Ingmar* case that the purpose of these rules is to “protect freedom of establishment and the protection of undistorted competition in the internal market.”⁶³ This is suggestive of the formula of *Eco Swiss* that defined as public policy, all that is essential for the accomplishment of the tasks entrusted to the Community and, in particular, for the functioning of the internal market.

Applied to the case described in section 1.2 of Part II above, the ECJ decision in *Ingmar* means that an arbitral tribunal that gives effect to the contract’s choice of law, risks rendering an award that will be deemed invalid and refused enforcement by European courts.

1.4.7 Labour law, insurance

For want of specific case law on the rules of labour law and of insurance law as discussed in sections 1.2 and 1.4 in Part II above, it may be useful to refer to the rationale of the above-mentioned *Eco Swiss* and *Ingmar* decisions. To the extent that mandatory rules of labour law and of insurance law may be deemed to be essential for the functioning of the internal market (including freedom of establishment and of movement), an award that gives effect to the parties’ agreement and thus violates these rules might run the risk of being ineffective if presented to a court within the European Community or the EFTA.

1.4.8 Good faith and fair dealing

The principle of good faith and fair dealing, a central principle in many legal systems particularly of Civil Law, is also the basis for many provisions of the

⁶² United States Court of Appeals, Seventh Circuit, 16.1.2003, 315 Federal Reporter, Third Series (7th Cir. 2003), 829ff, in (2003) *Yearbook Commercial Arbitration* XXVIII, 1153 ff., but see the dissenting opinion by Cudahy, CJ, 1159 ff. In the Ukraine, rules of competition law are deemed to be public policy, see the Recommendation by the Presidium of the Higher Commercial Court of Ukraine mentioned in footnote 57 above.

⁶³ *Ingmar* (C-381/98), par 24

EEC Directive 93/13 on unfair consumer terms. In the Claro case,⁶⁴ the European Court of Justice ruled on the question of whether Article 6 of the Directive represents public policy and thus can be a basis for setting aside an arbitral award. Article 6 of the Directive provides that contract terms that are defined as unfair under the Directive shall not be binding on the consumer.

The ECJ found that, “as the aim of the Directive is to strengthen consumer protection, it constitutes, according to Article 3(1)(t) EC, a measure which is essential to the accomplishment of the tasks entrusted to the Community and, in particular, to raising the standard of living and the quality of life in its territory.”⁶⁵ The ECJ concluded thus that the rule on unfair contract terms is to be deemed to be public policy.

The Claro decision was rendered in a case involving a consumer, and its rationale is based on consumer protection. It is, therefore, quite doubtful, whether corresponding rules may be deemed to be public policy when the award regards a commercial dispute. It was seen in section 1.5 of Part II above, that restatements of trans-national contract principles tend to give good faith and fair dealing a central significance, that statutory rules on good faith and fair dealing are in some systems said to have an overriding character irrespective of the quality of the involved parties, and that voices are raised for extending mechanisms of consumer protection to commercial contracts.

This trend, based on the principles known in Civil Law systems but quite strange to Common Law systems and particularly English law, does not seem to find support in widespread contract practice in commercial transactions. International contract practice, at least for contracts regulating transactions of a certain value, adopts models based on English or Common Law contract practice – these contract models are tailored for a system where there is no general principle of good faith in commercial contract law. Therefore, they expressly regulate, in all possible details, any and all rights, obligations and assumptions, and usually contain clauses instructing interpretation of the terms literally and considering the terms exhaustive.⁶⁶ These models are adopted in commercial practice even when the contract is governed by the law of a civilian system.

On the basis of the foregoing, it does not seem advisable to extend the consumer protection approach to commercial contracts and define as public policy the rules and principles that might exist in various civilian systems on good faith and fair dealing (unless the circumstances of a particular case would make it

⁶⁴ C-168/05

⁶⁵ Ivi, Par 37

⁶⁶ More extensively on this subject-matter, see G. Cordero Moss, *Contracts Between Consumer Protection and Trade Usages*, cit., and G. Cordero Moss, *Harmonised Contract Clauses in Different Business Cultures*, in T. Wilhelmsson, (ed.), *Private Law and the many Cultures of Europe*, 2007 221ff.

intolerable to uphold an award giving effect to the parties' agreement). There is a certain case-law in support of the restrictive approach recommended here.⁶⁷

2. The tribunal disregards the parties' choice in favour of the applicable law: is the award valid and enforceable?

Generally, the parties (or, rather than both of them, the party that would have an advantage from it) expect that their will is respected by the arbitral tribunal. In the situations described in the sections above, however, following the choice of law made by the parties may mean that the award is not effective. Consequently, the tribunal might be inclined to take into consideration the applicable law, thus avoiding rendering an invalid or unenforceable award.

Does the tribunal have the power to disregard the will of the parties? Normally, if it disregards the parties' instructions, an arbitral tribunal runs the risk of exceeding its power or of incurring in a procedural irregularity. Excess of power and procedural irregularity are both grounds for setting aside or refusing to enforce an arbitral award (respectively, Articles 34(2)(a)(iii) and 34(2)(a)(iv) of the UNCITRAL Model Law and Article V(1)(c) and V(i)(d) of the New York Convention).

In other words: is the arbitral tribunal forced to choose between two grounds for invalidity or unenforceability of the award, i.e., conflict with public policy or inexistence of the arbitral agreements on one hand, and excess of power or procedural irregularity on the other hand? Or, is there a legitimate basis for the tribunal to apply a law different from the one chosen by the parties without incurring an excess of power or procedural irregularity?

⁶⁷ See a United States court decision, affirming that it did not have the power to review whether the arbitral tribunal had correctly applied the Illinois Beer Industry Fair Dealing Act: United States District Court, Northern District of Illinois, Eastern Division, 29.9.2004, 2004 U.S. Dist. LEXIS 19728, in (2005) *Yearbook Commercial Arbitration* XXX, 922 ff. The Supreme Court of Canada, Province of Prince Edward Island, 23.3.2001, in (2005) *Yearbook Commercial Arbitration* XXX, 459 ff., dismissed the allegation (albeit on an evaluation of the specific circumstances in that case) that it would be against public policy to give effect to certain agreements entered into by a franchisee because of the unequal bargaining power of the parties. A German Court dismissed that the size of a fee requested for certain services was excessive and against good morals, Hamburg Court of Appeal, 12.3.1998, IPRspr 1999No 178, in (2004) *Yearbook Commercial Arbitration* XXIX, 663 ff. See, however, an Austrian decision considering an interest rate too high and therefore in contrast with public policy: Supreme Court of Austria, 26.1.2005, in (2005) *Yearbook Commercial Arbitration* XXX, 420 ff. The Recommendation by the Presidium of the Higher Commercial Court of Ukraine mentioned in footnote 57 above, affirms that rules on the invalidity of contracts are public policy; to the extent Ukrainian law considers a contract term invalid if it violates the principle of good faith, therefore, an award that gives effect to the terms of the contract will not be enforceable in the Ukraine.

As Part I above has shown, private international law permits applying the proper law in spite of what the parties might have chosen in their contract, because it determines the scope of application of the parties' choice. Within the party autonomy's scope of application, arbitral tribunals do not have the power to disregard the parties' instructions. Beyond the party autonomy's scope of application, the parties' instructions do not have effect and do not limit the arbitral tribunal's power to determine the applicable law.

Private international law, thus, gives a solution to the arbitrator's dilemma by redefining it. It is not a question of having to choose between conflict with public policy and excess of power, it is a question of recognising how far party autonomy reaches.⁶⁸

3. The tribunal wishes to apply the applicable law: how shall it choose it?

We have seen that a choice of law made by the parties in a contract that contains an arbitration clause is not totally independent from the applicable private international law. The next question is, therefore, how to determine which private international law is applicable in international commercial arbitration.

The overview made in Part I above, showed that it is in no way indifferent to which private international law is applied. Conflict rules vary from system to system, and consequently the law designated as applicable varies depending on which country's conflict rules are applied. Therefore, it is necessary, but not sufficient to refer to private international law as a tool to avoid surprises with respect to the enforceability of the award. In addition, it is also necessary to specify which private international law the arbitral tribunal shall use in order to assess the party autonomy's borders and the applicability of other laws in specific areas of the legal relationship in dispute.

In respect of courts of law, it is generally recognised that judges always apply the private international law of their own country to designate the applicable substantive law. In respect of international commercial arbitration there is no corresponding automatic and absolute reference to the private international law of the place where the arbitral tribunal has its venue. The arbitration law of the place of arbitration has, as a matter of fact, a considerable significance for the arbitration proceeding, in that it governs important aspects such as the arbitrability of the dispute, the regularity of the arbitral procedure, the powers of the arbitrators, the possibility by the courts to interfere, the validity of the award, and

⁶⁸ For a more extensive analysis of this question see G. Cordero Moss, *Can an Arbitral Tribunal Disregard the Choice of Law Made by the Parties?*, in *Stockholm International Arbitration Review*, 2005:1, 1ff.

the fundamental principles of public policy. Therefore, it seems only natural to look to the law of the place of arbitration even when it comes to finding the applicable conflict rules. However, the already mentioned eagerness to enhance the international character of international arbitration has led various legislatures and arbitral institutions to loosen the link between the place of arbitration and the applicable private international law. Hence, there is no uniform answer to the question of which private international law is applicable to an arbitral dispute. The various arbitration laws and rules of institutional arbitrations present a series of solutions, ranging from the application of the private international law of the place of arbitration,⁶⁹ to the application of the private international law that the arbitral tribunal deems most appropriate,⁷⁰ the application of conflict rules specifically designed for arbitration,⁷¹ or the direct application of a substantive law without considering choice-of-law rules.⁷²

If the applicable arbitration law or arbitration rules do not give precise guidelines as to which private international law is applicable to the arbitration, it will be up to the tribunal to decide. The various solutions outlined above, give a sliding scale from the most predictable (and thus preferable) regime where the applicable private international law is determined in advance, via the mixed solutions where the identification of the applicable private international law is left to the discretion of the tribunal or is only implicitly mentioned by stating a conflict rule, to the least predictable regime that does not mention private international law at all. It is not unusual that arbitral tribunals exercise their discretion so as to enhance predictability and to look to the private international law of the place of arbitration. However, in the systems that do not make express reference to the applicability of the conflict rules of the *lex loci arbitri*, this depends on the tribunal's discretion and it cannot be excluded that the tribunal decides to apply other conflict rules. This has a negative effect on the predictability of the applicable law, which in turn may be decisive for the outcome of the dispute. As long as a private international law is in the picture,

⁶⁹ This is the traditional approach that is still followed in some modern arbitration legislation, for example Article 31 of the 2004 Norwegian Arbitration Act.

⁷⁰ This approach is followed, among others, by the UNCITRAL Model Law and the English Arbitration Act, and it can result in the application of the private international law of the country where the arbitral tribunal has its venue, of another law that seems to be more appropriate, or even, of no specific law (often arbitrators compare the choice-of-law rules of all laws that might be relevant, and apply a minimum common denominator).

⁷¹ For example, the Swiss arbitration law contains a choice-of-law rule that designates as applicable the law of the country with which the subject-matter of the dispute has the closest connection.

⁷² French arbitration law, as well as the rules of the International Chamber of Commerce, of the London Court of International Arbitration and of the Arbitration Institute of the Stockholm Chamber of Commerce, give the arbitral tribunal the authority to apply directly the substantive law that it seems more appropriate, without going through the mediation of a choice-of-law rule.

however, the interpreter will, in any case, have to choose the proper law by applying a conflict rule. The determination of the law, in other words, will be based on the application of a connecting factor. While the *a priori* identification of the applicable private international law is preferable because it permits creating certainty as to which connecting factor that will be used (for example, the place of registration or the seat in case of company the law), a discretionary choice of which private international law is applicable will at least ensure that the proper law will be chosen on the basis of a connecting factor. In the absence of any reference to a private international law, there is no indication that the tribunal will apply a conflict rule to identify the proper law. It may identify the proper law on the basis of completely different criteria, such as, for example, the law that the members of the tribunal happen to know best. This is certainly not a recommendable solution from the point of view of predictability.

Conclusion

The approach to private international law that is usually considered to be the most progressive is an approach of denial: the purpose and the method of private international law are looked upon as some relics of the past that do not belong in modern commercial and arbitration instruments. This is based on the assumption that international commercial transactions do not need national laws but are better served by trans-national uniform laws, and that international arbitration is delocalised and is based simply on the will of the parties without the interference by any national laws.

The first assumption, about the prevalence of trans-national uniform law for commercial transactions and the consequent irrelevance of national laws and of mechanisms to choose the applicable national laws, was not the object of this article (but reference was made here to other articles challenging the correctness of this assumption).

The second assumption, about the delocalisation of arbitration and the consequent irrelevance of rules of national laws, has been analysed here. While this assumption is correct whenever the party that loses the arbitration voluntarily carries out the award, it must be considerably qualified when such voluntary compliance does not take place.

This article has tried to show that private international law may be a useful and even necessary tool to avoid rendering awards that, albeit fully reflecting the will of the parties, may be set aside or refused enforcement.