



Lex Mercatoria in International Arbitration Theory and Practice

Volume I

Mert Elcin

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SUMMARY

This dissertation suggests a new theory of *lex mercatoria* that takes into account the complex and spontaneous order of international commerce. Since the emphasis is put on the nature of this order, the concept of *lex mercatoria* is examined as an *ex post* governance mechanism resolving contractual disputes with a view to maintaining and restoring the order of international commerce, without focusing on the traditional distinction of the doctrine between national and non-national legal rules applicable to the substance of such disputes in explaining the concept. The aim is to reflect *lex mercatoria*'s subtle effect on the practice of international arbitration, and to provide an explanation of *lex mercatoria* as a solution to the problems of the institution of international arbitration in terms of uncertainty and unpredictability of awards, rather than representing it as a factor aggravating those problems. *Lex mercatoria* is defined as the law of adjudication of the disputes arising from international commercial contracts on the basis of a few substantive and procedural principles, under which the reasonable expectations of the parties to a particular contract become the single source of their contractual rights, obligations and risk allocations. The argument is that *lex mercatoria* can be applied to both the choice of law analyses and the substance of the disputes in international arbitration. In choice of law analyses, *lex mercatoria* addresses specific difficulties relating to the conflict of laws through a principled decision making, such as the applicable conflict rules, and the interpretation of the parties' intentions as to the applicable substantive rules. In its substantive application, *lex mercatoria* deals with, either as *lex contractus* or as *lex fori*, the interpretation, supplementation and correction of the contract as well as the applicable national laws in accordance with the basic principles, on which the order of international commerce rests.

TABLE OF CONTENTS

| | |
|-----------------------------------------------------------------------|------------|
| 1. INTRODUCTION | 1 |
| 2. THE CONCEPT OF LEX MERCATORIA | 11 |
| a. The Evolution of Lex Mercatoria | 11 |
| i. Medieval Lex Mercatoria | 11 |
| 1. The Realist Vision of Medieval Lex Mercatoria..... | 12 |
| 2. The Romantic Vision of Medieval Lex Mercatoria | 17 |
| ii. Modern Lex Mercatoria Doctrine | 23 |
| 1. Transnational Arbitration | 23 |
| 2. Lex Mercatoria as an Autonomous legal system | 30 |
| a. Goldman and the Theory of Lex Mercatoria | 30 |
| b. Schmitthoff and the Theory of Law Merchant | 33 |
| 3. Lex Mercatoria as a Method of Decision Making..... | 37 |
| b. A New Theory of Lex Mercatoria | 43 |
| i. Liberal Order of International Commerce | 43 |
| ii. Appropriate Legal Norms Governing the Contract | 55 |
| iii. Dealing with Legal Uncertainty | 59 |
| iv. Confidence in a Legal System or a Decision Maker | 67 |
| v. Legal Character of Lex Mercatoria | 73 |
| c. Concluding Remarks | 79 |
| 3. SPHERE OF APPLICATION OF LEX MERCATORIA | 81 |
| a. Contractual Characteristics | 85 |
| i. Transactions Governed Through Legal Risk | 87 |
| ii. Transactions Governed Through Legal Uncertainty | 91 |
| b. Institutional Choice | 97 |
| i. Determination and Ascertainment of the Applicable Law | 101 |
| 1. National Courts | 101 |
| 2. International Arbitral Tribunals | 105 |
| ii. Relevance of Trade Usages | 113 |
| 1. National Courts | 113 |
| 2. International Arbitral Tribunals | 117 |
| iii. Role of General Principles of Law | 123 |
| 1. National Courts | 123 |
| 2. International Arbitral Tribunals | 136 |

| | | |
|-----------|--------------------------------------------------------------------------|-----|
| iv. | <i>Influential Factors in Judicial Behavior</i> | 143 |
| 1. | National Courts | 143 |
| 2. | International Arbitral Tribunals | 150 |
| v. | <i>Lex mercatoria in the Context of Litigation and Arbitration</i> | 179 |
| c. | Concluding Remarks | 185 |
| 4. | BASIC PRINCIPLES OF LEX MERCATORIA | 189 |
| a. | Freedom of Contract | 191 |
| b. | Sanctity of Contracts | 197 |
| c. | Good faith and Fair Dealing | 205 |
| d. | Procedural Principles | 225 |
| e. | Concluding Remarks | 237 |
| 5. | APPLICATION OF LEX MERCATORIA | 239 |
| a. | Choice of Law Analyses | 241 |
| i. | <i>Choice of National Law</i> | 243 |
| ii. | <i>Choice of Lex Mercatoria</i> | 257 |
| iii. | <i>Absence of choice</i> | 273 |
| 1. | Indirect Choice | 274 |
| 2. | Direct Choice..... | 280 |
| 3. | Implied Choice | 294 |
| iv. | <i>Amiable Composition</i> | 317 |
| v. | <i>Concluding Remarks</i> | 335 |
| b. | Substance of the Dispute | 337 |
| i. | <i>Interpretation of the Contract</i> | 341 |
| 1. | Common Intention of the Parties | 342 |
| 2. | Internal Context of the Contract..... | 348 |
| 3. | Extrinsic Factors..... | 353 |
| a. | <i>Subjective Considerations</i> | 353 |
| a. | <i>Objective Considerations</i> | 364 |
| 4. | Interpretative Presumptions..... | 368 |
| ii. | <i>Supplementation of the Contract</i> | 375 |
| iii. | <i>Intervention in the Contract</i> | 387 |
| 1. | Different Concepts of Public Policy..... | 388 |
| a. | <i>External Public Policy</i> | 389 |
| b. | <i>European Public Policy</i> | 394 |
| c. | <i>Transnational Public Policy</i> | 398 |

| | | |
|------|-------------------------------------------------------------------------------|------------|
| 2. | Lex Mercatoria in Public Policy Considerations..... | 404 |
| a. | <i>Conditions of Illegality</i> | 410 |
| b. | <i>Consequences of Illegality</i> | 444 |
| iv. | <i>Concluding Remarks</i> | 459 |
| c. | Several Instances of Substantive Application | 463 |
| i. | <i>Duty of Cooperation</i> | 469 |
| 1. | Sources of Abstractions..... | 469 |
| a. | <i>National Laws</i> | 469 |
| b. | <i>International Instruments</i> | 472 |
| c. | <i>Contracting Practices</i> | 475 |
| 2. | Arbitral Decision Making..... | 481 |
| a. | <i>Basis of Cooperation</i> | 481 |
| b. | <i>Costs of Cooperation</i> | 494 |
| 3. | Concluding Remarks | 504 |
| ii. | <i>Duty to Achieve a Certain Result and Duty of Best Efforts</i> | 507 |
| 1. | Sources of Abstractions..... | 507 |
| a. | <i>National Laws</i> | 507 |
| b. | <i>International Instruments</i> | 522 |
| c. | <i>Contracting Practices</i> | 525 |
| 2. | Arbitral Decision Making..... | 529 |
| a. | <i>Interpretation of Best Efforts Obligations</i> | 530 |
| b. | <i>Supplementation with Best Efforts Obligations</i> | 540 |
| 3. | Concluding Remarks | 542 |
| iii. | <i>Force Majeure</i> | 545 |
| 1. | Sources of Abstractions..... | 545 |
| a. | <i>National Laws</i> | 545 |
| b. | <i>International Instruments</i> | 555 |
| c. | <i>Contracting Practices</i> | 564 |
| 2. | Arbitral Decision Making..... | 570 |
| a. | <i>Requirements of Force Majeure Excuse</i> | 571 |
| b. | <i>Effects of Force Majeure Excuse</i> | 587 |
| 3. | Concluding Remarks | 598 |
| iv. | <i>Hardship</i> | 603 |
| 1. | Sources of Abstractions..... | 603 |
| a. | <i>National Laws</i> | 603 |

| | | |
|-----|---------------------------------------------------------------|------------|
| b. | <i>International Instruments</i> | 614 |
| c. | <i>Contracting Practices</i> | 619 |
| 2. | Arbitral Decision Making..... | 623 |
| a. | <i>Risk Allocation</i> | 625 |
| b. | <i>Renegotiation</i> | 640 |
| 3. | Concluding Remarks | 648 |
| v. | <i>Right to terminate the contract</i> | 651 |
| 1. | Sources of Abstractions..... | 651 |
| a. | <i>National Laws</i> | 651 |
| b. | <i>International Instruments</i> | 667 |
| c. | <i>Contracting Practices</i> | 685 |
| 2. | Arbitral Decision Making..... | 694 |
| a. | <i>Circumstances Justifying Termination</i> | 695 |
| b. | <i>Termination Process</i> | 706 |
| c. | <i>Effect of Termination</i> | 714 |
| 3. | Concluding Remarks | 719 |
| vi. | <i>Damages for non-performance</i> | 721 |
| 1. | Sources of Abstractions..... | 722 |
| a. | <i>National Laws</i> | 722 |
| b. | <i>International Instruments</i> | 741 |
| c. | <i>Contracting Practices</i> | 756 |
| 2. | Arbitral Decision Making..... | 765 |
| a. | <i>Principle of Full Compensation</i> | 765 |
| b. | <i>Established Limitations to the Amount of Damages</i> | 772 |
| 1. | Causation..... | 772 |
| 2. | Foreseeability | 774 |
| 3. | Certainty | 777 |
| 4. | Mitigation | 782 |
| 5. | Contribution | 789 |
| c. | <i>Contractual Limitations to the Amount of Damages</i> | 796 |
| d. | <i>Particularities of State Party Disputes</i> | 805 |
| 3. | Concluding Remarks | 841 |
| 6. | CONCLUSION | 849 |
| 7. | BIBLIOGRAPHY | 881 |

1. INTRODUCTION

This dissertation is intended to be a contribution to the theory and practice of *lex mercatoria* in the context of international arbitration. “*Lex mercatoria*” literally means “law merchant”. Although the views on *lex mercatoria* in the modern doctrine as to its terminology and legal nature diverge widely, it is generally conceived as a response to the problems resulting from the application of national laws to the disputes arising from international contracts. The traditional bipartite distinction between national legal systems, which deal with contractual disputes between private parties in a domestic setting, and international legal order, which is relevant mainly to the resolution of disputes between the states, has posed the question of how the contractual disputes between private parties in cross-border dealings or between a private party and a state should be resolved. Under this distinction, international commercial law has to be based on a paradigm of control by the national legal systems. According to this traditional paradigm, the conflict of laws rules, which are also of national origin, are to be applied to determine which national substantive law will govern the resolution of the disputes arising from international contracts.

Lex mercatoria doctrine, which consists of various and divergent theories, attempts to break this paradigm on the basis of the argument that those conflict of laws rules and national substantive laws are usually inadequate to solve the problems of international contracts and their application leads to inappropriate, uncertain or unpredictable consequences. Thus, there is some similarity in the starting points of all theories on *lex mercatoria*. It is frequently defined as a transnational law applicable to international contracts, instead of a national law. The most important aspect and distinctive nature of this law is usually considered to be its sources. Unlike a national substantive law, *lex mercatoria* does not arise from the functioning of a legal system created within the confines of a single state. The sources of *lex mercatoria* are found in non-national or international legal sources, and commonly include trade usages and customs, general principles of law, uniform laws and international conventions regulating international commerce, public international law, comparative analysis of national laws, rules and standard contracts issued by international organizations, and published arbitral awards. However, the list of sources constituting *lex mercatoria* varies greatly depending on the individual theory expressed under the doctrine of *lex mercatoria*. Some theories express the view that *lex mercatoria* is a form of regulating international commerce by the sole efforts of international merchants, who have developed their own legal norms according to their needs and expectations and, thus, exclude those sources, which contain the efforts of states to regulate this field, such as international conventions and uniform laws. Others view *lex mercatoria* as the product of joint efforts of international merchants and states to regulate international commerce in an economically sensible way.

Moreover, some theories maintain that *lex mercatoria* is an autonomous legal system alongside national laws and public international law. Some of those are based on the idea of self-regulation, where international merchants make their own rules, adjudicate their disputes according to those rules, and enforce the decisions rendered pursuant to those rules through their own reputation or fairness based mechanisms, outside of the national legal systems. Others present it as a method of substantive decision making in the resolution of contractual disputes, whereby the decision maker may ignore inappropriate rules of national legal systems on the basis of a comparative analysis of national laws. They emphasize the heterogeneous nature of the community of international merchants, where self-enforcement mechanisms may not perform satisfactorily, and adopt a different approach, under which *lex mercatoria* depends on national legal systems with respect to its enforcement due to the monopoly of

national legal systems in coercive enforcement of legal rules, thereby basing the legal nature of *lex mercatoria* ultimately on its enforceability by the national courts.

There is no authority to decisively define *lex mercatoria* and regulate international commercial law, due to the heterogeneous nature of both international mercantile community and international community of states. Thus, one can find a different understanding of *lex mercatoria* in almost any single doctrinal writing, arbitral award or court decision. The debate seems endless, considering that the concept of *lex mercatoria* has its origins in medieval times or, for some, even in Roman law. Apparently, no one will ever be able to say the last word on this concept. The existence of this debate for centuries shows that there has always been some degree of discontent with the way international commerce has been regulated under the traditional paradigm. This discontent has compelled many circles to devise ideas and arguments on the basis of the concept of *lex mercatoria*, some of which have indeed had practical effects on the regulation of the international commerce. However, in the modern doctrine of *lex mercatoria*, the discourses commonly combine theoretical, practical and ideological arguments into a single theory, which makes it harder to see to what extent they reflect actual and valid policy considerations.

This dissertation aims at presenting the concept of *lex mercatoria* in all its complexity and seeks its traces in the practice of international arbitration. In the end, this dissertation is one of those many attempts in the doctrine at answering the questions, which are likely to be asked by anyone, who encounters the concept for the first time: What is *lex mercatoria*? When does it apply? How does it apply? Nevertheless, the approach of this dissertation to answering these basic questions differs to some extent from those adopted by majority of the theories on *lex mercatoria* in the doctrine. *Lex mercatoria* is examined outside of its traditional confines, which are partly created by the doctrine itself, in order to reflect both *lex mercatoria*'s rather hidden existence in the arbitral practice and an understanding of *lex mercatoria* as a solution to the problems of the institution of international arbitration in terms of uncertainty and unpredictability of awards, rather than as a factor aggravating those problems. Thus, those questions are answered on the basis of a new theory of *lex mercatoria* and the practice of international arbitration.

The answer to the question of what is *lex mercatoria* undoubtedly requires a research into the historical evolution of the concept of *lex mercatoria*. For that purpose, the historical predecessor of the modern *lex mercatoria*, namely medieval *lex mercatoria*, is examined within its political and legal background. For the majority of the authors of modern theories on *lex mercatoria*, medieval *lex mercatoria* represents the romantic ideal of an autonomous and uniform law created by and for international merchants, independent from the contemporary legal framework. In this understanding, medieval *lex mercatoria* is an evidence of the viability and adequacy of an independent and exclusively mercantile legal system as a solution to problems of foreign trade. There are also others, who question this romantic vision and search for a realist understanding of medieval *lex mercatoria*. They highlight the importance of the consideration of political background in the historical sources, some of which cannot be regarded merely as historical statements, but also involving theoretical claims within a controversial legal discussion. Above all, the historical research concerning the medieval *lex mercatoria* shows that how certain procedural privileges granted to the merchants in order to adapt judicial proceedings to the needs of cross-border trade had implications for the law applicable to the substance of the contractual disputes in an era, where the idea of substantive law itself was in the process of creation through different schemes of law.

The romantic vision of medieval *lex mercatoria* was more influential in the emergence of the modern *lex mercatoria* doctrine after the Second World War, because the proponents of modern *lex mercatoria* doctrine used the concept not only as historical evidence, but also as the basis of theoretical and political claims of *lex mercatoria* as an autonomous legal system. This first generation of the proponents of modern *lex mercatoria* did not solely rely on the medieval *lex mercatoria* to support their claims, but also on the practice of transnational arbitration in the disputes arising from the contracts between states and foreign investors since the beginning of twentieth century. The transnational arbitration has served as a model, whereby the procedural privileges granted to the investors in state party disputes have had implications on the law applicable to the substance of the dispute. The practice of transnational arbitration has demonstrated the flexibility of arbitral proceedings and the possibility of avoiding the application of a national law, i.e. the law of host states, by referring to non-national legal sources. In this regard, theories of two of the founding fathers of modern *lex mercatoria* doctrine, namely Berthold Goldman and Clive Schmitthoff, are examined in detail. Their political and theoretical discourses on *lex mercatoria* have contributed to the modern regulation and practice of international arbitration as understood in the following decades.

The second generation of the proponents of modern *lex mercatoria*, since the beginning of 1990s, has been able to dispense with theoretical and political claims as to the nature of *lex mercatoria*, and instead focused on the practical issues, such as the conditions and circumstances under which it should be applied. This approach is concerned with *lex mercatoria* as a method of substantive decision making in international arbitration, and the various techniques derived from comparative analysis, enabling the arbitrators to disregard the outdated and idiosyncratic rules that may be found in the national legal systems. The method of decision making based on general principles of law and comparative analysis has been supported by the availability of extensive and accessible sources, i.e. international restatements of contract principles; the UNIDROIT Principles of International Commercial Contracts (UNIDROIT Principles), adopted in 1994, enlarged in 2004 and further expanded with new sections in 2010, and the Principles of European Contract Law (PECL), published in 1995, and followed by Part II in 1999 and the final Part III in 2003.

The modern *lex mercatoria* doctrine has effectively highlighted the necessity of the flexibility and practicality of approach in the resolution of contractual disputes in the order of international commerce. However, by arguing that *lex mercatoria* in practice, either as a legal system or as a method of decision making, may act as an equivalent to the national laws, the modern *lex mercatoria* doctrine has implicitly set the stabilization of normative expectations as an aim for *lex mercatoria* to have an *ex ante* effect on the incentives and behaviors of international merchants as well as their contracts, similar to the effect of national laws on their subjects. This approach has led to a vexing problem, since *lex mercatoria* constantly fails to achieve this aim set by the doctrine. *Lex mercatoria* exists in an order, where no authority may effectively claim to assume control over the normative expectations of international merchants, in a similar manner to those in the national legal systems.

The first generation of the proponents of *lex mercatoria* has suggested either that the community of international merchants may act as the authority, or that such an authority can be devised through international conventions or organizations, while the second generation of the proponents of *lex mercatoria* have mostly disregarded the question of such an authority in the order of international commerce, due to their practical approach that focuses on *ex post*

process of decision making. The heterogeneous nature of the mercantile community in the order of international commerce, the limited success of international initiatives in stabilizing the normative expectations through harmonization of national laws, and the risk of arbitrariness in the ex post decision making in the absence of an authority lead to reasonable doubts about the claim of the modern doctrine that *lex mercatoria* is more appropriate, in its content or methodology, than national legal systems, for the resolution of disputes, particularly in the context of international arbitration, where the flexibility of decision making itself is susceptible to considerable uncertainty and criticisms. Thus, the modern *lex mercatoria* doctrine has still not been able to provide a satisfactory answer to the problems created by the uncertainty of the contents and methodology of *lex mercatoria* and, perhaps inadvertently, has presented *lex mercatoria* as potentially exacerbating the problem of uncertainty inherent in the institution of arbitration as a result of the finality of awards and the limited scope of review of awards by the national courts.

Both the doctrine's presentation of *lex mercatoria* as a common ground for international merchants and the criticisms against *lex mercatoria* on the basis of its uncertainty originate in a failure to see the distinct nature of the legal order conceivably relevant to the concept of *lex mercatoria*. Despite the absence of an authority in charge of stabilizing the normative expectations of contracting parties and regulating their contracts, there is a going order of actions in the context of international commerce for centuries. The dissertation suggests a new theory of *lex mercatoria*, which accounts for the character of the spontaneous order of international commerce, mainly on the basis of a Hayekian insight into legal theory. The actions take place in the order of international commerce, where nobody has perfect knowledge about this order, but this order is still capable of enabling the individuals to make feasible plans for their particular purposes, through its spontaneity that disperses the bits of incomplete knowledge throughout the order, and allows the individuals to utilize their knowledge of particular circumstances of time and place. This spontaneous order arises as a state of affairs, in which a multiplicity of elements of various kinds, such as states, various organizations and merchants, are so related to each other that the individuals in this order may learn from their acquaintance with some spatial or temporal part of the whole to form reasonable expectations as to the success and effectiveness of their actions. This is an order of such complexity that can be designed neither as a whole, nor by shaping each part separately without regard to the rest, but only by consistently adhering to certain basic principles that establish abstract relations among the multiplicity of those elements.

Unlike a legal system mainly functioning through an organization stabilizing normative expectations *ex ante*, i.e. before an individual act, *lex mercatoria* functions through a judicial process *ex post*, i.e. after a particular contractual dispute disturbs the order of international commerce, due to its spontaneous and complex nature. Thus, the concept of *lex mercatoria* should be based on a judicial mechanism, whereby the decision maker exercises an abstract reasoning in order to determine and enforce the reasonable expectations of the parties to a particular contract in the context of the spontaneous order of international commerce. Due to its *ex post* nature, *lex mercatoria* is necessarily uncertain from an *ex ante* perspective. In the absence of an organization, which could acquire enough of the dispersed knowledge in the order of international commerce to provide legal structures stabilizing normative expectations, *lex mercatoria* is in the form of a few basic principles, which constitute the basis of the going order of international commerce and enable the contracting parties and the *ex post* decision makers to determine, at an abstract level, the reasonableness of expectations in the particular circumstances. It does not manifest itself in already articulated forms, but it has to be discovered and articulated by the *ex post* decision maker through "a technique of thought",

which materializes with new constellations of circumstances. *Lex mercatoria* requires the decision maker to decide the case as one of a kind, which might occur anywhere and at any time, and in a manner, which should maximize the possibility of expectations of the elements in the order being fulfilled, matched and not conflicting, in line with their common interest in the ability to make feasible plans for the achievement of their particular purposes, without impeding the very order providing this ability.

Under this theory of *lex mercatoria*, the restrictive approach of the modern doctrine to the sources of *lex mercatoria* is no longer adopted. The diversity of elements in the order of international commerce indicates that the sources of *lex mercatoria* cannot be limited to non-national or transnational rules, general principles of law, or comparative law, but it may include any material that may have a bearing on the reasonable expectations of the parties in a particular case, such as trade usages, contracting practices, general principles of law, national laws, public international law, and private international law, without making a distinction on the basis of its national or non-national character. Thus, probably, the most concrete difference of the theory of *lex mercatoria*, as advanced in this dissertation, from other theories so far emerged in the doctrine of modern *lex mercatoria* is the proposition that a particular national law may become a source of *lex mercatoria* in a particular case. This proposition indicates the possibility that *lex mercatoria* may require the decision maker to apply a particular national law, but the application of such a national law may no longer be treated as an activity of the relevant legal system, because he is not required to apply that law by that legal system, but by the reasonable expectations of the parties to a particular contract. It also indicates that *lex mercatoria* is not merely related to a question of applicable law to an international contract in the sense of a choice between a national law and transnational law as the governing law of the contract, although it has been traditionally understood as being so, but, in more general terms, how a dispute arising from an international commercial contract should be resolved with a view to maintaining and restoring the spontaneous order of international commerce, regardless of the conceptual distinctions between national and non-national legal sources.

The theoretical arguments surrounding modern *lex mercatoria* doctrine have consistently emphasized flexibility and adaptability of *ex post* judicial processes in the order of international commerce, but they have also limited the sources of *lex mercatoria* in the search for such mechanisms that stabilize the expectations in the order of international commerce in order to deal with the uncertainty arising from the absence of an effective authority in this order. The understanding of *lex mercatoria* in this dissertation embraces uncertainty and conceives it as a means for achieving fair and just outcomes in the disputes arising from international contracts. In this context, the fairness and justice mean the restoration of the order of international commerce, which has been disturbed by a particular dispute, and require the resolution of that dispute in a manner that maximizes the expectations of the elements of that order, which enables them to make feasible plans for the achievement of their individual purposes. In this understanding, *lex mercatoria* is neither a legal system nor a method of substantive decision making. It is the law of adjudication of the disputes arising from international contracts, on the basis of a few basic principles, which apply to the procedure of the decision making, the choice of law analyses and the substance of the dispute, thereby leading to the application of a body of more specific rules appropriate for a particular contract.

Under this theory, there are two conditions for the applicability of *lex mercatoria*. First, *lex mercatoria* as the law of principled adjudication applies when there are residual questions of

contractual rights, obligations and risk allocations arising from the imperfect knowledge of the parties, i.e. incompleteness of contractual clauses and default rules chosen by the parties. In the dissertation, international contracts are roughly divided into two categories on the basis of their characteristics. The first category comprises discrete and short term contracts, where the interests of parties are antagonistic and depend on the routine enforcement of contractual entitlements. In this category, the applicability of *lex mercatoria* is at minimum. The second category essentially covers “relational contracts”, which involve not merely an exchange but also a relationship between the contracting parties. They require context-specific legal norms, and utilization of the knowledge of particular circumstances of time and place. These contracts typically have longer duration, more complexity or innovation and contain such clauses that contain vague standards. The complexity or innovation may arise from the circumstances surrounding the transactions, such as when many legal systems are involved in the scope of transaction, from the status of the parties, such as when there is a contract between a private individual and a state or state enterprise, or from the atypical nature of the transaction. *Lex mercatoria* is mainly applicable to the resolution of disputes arising from this category of contracts.

The applicability of *lex mercatoria* ultimately depends on the fulfillment of the second condition, which is the sufficient capacity of the decision maker for abstract reasoning. In this regard, the parties’ choice between litigation and arbitration plays the most determinative role. *Lex mercatoria* can be seen to a great extent as a privilege of international arbitration, which is granted by national legal systems through their policies favoring finality of arbitral awards and flexibility of procedures. Under this dissertation, “international arbitration” means the arbitration proceedings which owe no allegiance to any specific trade, and deals not only with cross-border private disputes but also state party disputes.¹ International arbitration mainly takes place ad hoc or in the context of such institutions as International Centre for Settlement of Investment Disputes (ICSID), Iran-United States Claims Tribunal, International Chamber of Commerce (ICC), American Arbitration Association (AAA), London Court of International Arbitration (LCIA), Arbitration Institute of the Stockholm Chamber of Commerce (SCC), or Chamber of Arbitration of Milan.

In the context of international arbitration, there is the issue of what motivates the reasoning of arbitrators and influences their judicial behavior in the absence of an organized hierarchy of an effective appeal mechanism focusing on and ensuring the full compliance of the awards with some kind of *lex fori*. The national court’s review of international arbitral awards mostly focuses on two issues: whether the procedural manner in which the arbitral award is rendered is in compliance with the parties’ intentions and the procedural public policy, and whether the enforcement of the award creates a situation that is unacceptable for the substantive public

¹ It should be noted that, there are two forms arbitration as far as international commercial contracts are concerned, namely “international arbitration” and “trade association arbitration”. In “trade association arbitration”, disputes among the members of a certain trade association are resolved by arbitral tribunals consisting of other members. It is different in certain aspects from “international arbitration”. In particular, trade association arbitration can be characterized by the existence of appeal mechanisms for arbitral awards, coherent and accessible case law for the members, effective reputation based enforcement mechanisms, homogenous nature of the relevant mercantile community and short-term nature of the relevant transactions. These differences in the context of trade association arbitration severely limit the application of *lex mercatoria*. However, as far as legal enforcement is concerned, there is no difference between trade association arbitration and international arbitration in institutional terms, and the awards rendered by trade association tribunals is not treated differently when it comes to the enforcement of arbitral award by the national legal systems. Therefore, trade association arbitration is not examined separately with regard to the sphere of application of *lex mercatoria*.

policy in the relevant legal system. Similarly, there is no authority to direct the arbitrators to resolve the disputes in accordance with *lex mercatoria*; in other words, with a concern for the preservation and restoration of the order of international commerce. The increased capacity of international arbitral tribunals for abstract reasoning leads to discussions about the factors, which may potentially be influential on their judicial behavior. The reasoning of arbitrators may be motivated by their reputation in the arbitration market and the prospect of future reappointments. Indeed, since there are many gray areas with regard to the independence, impartiality and the disclosure requirements of the arbitrators, the personal and professional links among the arbitrators, the parties, their counsels, the arbitral institutions and even political powers may become influential on the judicial behavior of the arbitrators. In this context, the arbitrators' judicial behavior arguably reflects either a tendency to "split the difference" between the parties in order to increase their chances of reappointment, or a concern for demonstrating their professional competence in rendering an award, retaining a sensitivity to the needs of speed, economy and proper case management in arbitration, in order to strengthen their reputation in the arbitration market.

The judicial behavior of arbitral tribunals under these circumstances may sometimes seem unprincipled and leading to compromise awards, either between the claims of the parties, or between the due process and efficiency. Thus, the fact that international arbitrators have the sufficient capacity to apply *lex mercatoria* does not mean that they will always utilize their capacity for abstract reasoning to apply *lex mercatoria* thereby maximizing the expectations of the elements of the order of international commerce. Even so, *lex mercatoria* theoretically reveals the significance of achieving justice in a particular case and of capitalizing on knowledge, which cannot be transmitted through a chain of command to authorities in organizations to stabilize normative expectations *ex ante*, for the functioning of the spontaneous order of international commerce. These theoretical revelations should motivate the reasoning of arbitral tribunals, rather than their reputation, income or personal connections to the circle of arbitrators, major law firms, political powers or arbitral institutions. The arbitrators should give effect to the reasonable expectations of the parties in a particular case, even if they consider themselves as service providers in the competitive market of arbitral services, as long as they are concerned with the impression they make on all participants in the process, including the various elements in the order of international commerce. The dissertation suggests that the proper understanding of the concept of *lex mercatoria* may motivate the arbitrators' reasoning and influence their judicial behavior by explicating the reason why the determination and enforcement of reasonable expectations of the parties to a particular contractual dispute matters and, thereby, guide them in achieving justice in a particular case through a principled exercise of an abstract reasoning that maximizes the possibility of correspondence of expectations in the order of international commerce.

Under this theory of *lex mercatoria*, the question of how *lex mercatoria* applies can no longer be answered solely on the basis of the methodology a decision maker refers to non-national legal sources in the resolution of substantive issues. *Lex mercatoria*, as the law of principled adjudication of contractual disputes, has a far greater significance in the order of international commerce than what would be expected from a mere option in the choice of law analyses. Under the modern *lex mercatoria* doctrine, the application of *lex mercatoria* in practice is generally sought in judicial decisions, which contain references to the terms, such as "*lex mercatoria*", "general principles of law", "comparative law" or "international trade usages", in resolving the substance of the dispute. Such labeling does not reflect the practical application of *lex mercatoria*, since it neglects the potential effect of *lex mercatoria* through the discretionary power or abstract reasoning of the decision maker on the cases even where a

national substantive law is applied and there is no reference to such terms. *Lex mercatoria*, as the law of principled adjudication, should not be limited to the considerations of national or non-national legal sources, since it is capable of permeating into the whole of adjudication process. When *lex mercatoria* is applicable, any national law, either alone or in combination with other national or non-national sources, may become a material to the ultimate purpose of the decision maker, which is to give effect to the reasonable expectations of the parties to a particular contract. It can be said that, in many cases, the arbitral tribunals actually apply *lex mercatoria*, as the law of principled adjudication, even without a proper understanding of the concept, as a result of their concern for giving effect to the reasonable expectations of the parties to a particular contract and by utilizing the finality and the flexibility of decision making, provided by the arbitration laws and rules, with regard to the determination of the applicable law, the ascertainment of its content, and the manner of its application to a particular dispute. The argument of the dissertation is that the arbitrators should be aware of the function of *lex mercatoria* in the preservation and restoration of the order of international commerce and, thus, follow its basic principles in rendering a final and binding decision.

The basic principles of *lex mercatoria* constitute the abstract schemata of thought that guides the decision maker resolving contractual disputes. First, the principle of freedom of contract requires the decision maker to respect the rules articulated by the parties in the contractual clauses and through their choice of a set of default rules, whether it is a national law or not, and refrain from imposing a different contract on the parties. The second basic principle is sanctity of contracts, which forms the basis of every contractual relationship. It is mainly a presumption leaning against the existence of any right of unilateral termination or modification of the contract by the parties. It dictates that the violation of the obligations arising from the articulated rules, which consists of the terms of the contract and the default rules chosen by the parties, will have consequences unless there is a valid reason under those rules or on the basis of the qualifying function of basic principle of good faith and fair dealing. The third basic principle is good faith and fair dealing under *lex mercatoria*, which denotes a contextual approach to the interpretation, supplementation and correction of the articulated rules. The function of the principle of good faith and fair dealing under *lex mercatoria* is to deal with the residual questions by providing a substantive framework for the decision maker's determination of such expectations that the parties in a transaction would have reasonably formed on the basis of their knowledge of the particular circumstances of time and place. The principle of good faith and fair dealing requires the decision maker to exercise the technique of thought that characterizes the application of *lex mercatoria* in the choice of law analyses, in the interpretation and supplementation of the articulated rules, and in the public policy considerations.

The basic principles of *lex mercatoria* also include some procedural safeguards that directly relate to the institution of international arbitration. Those safeguards are based on the premise that the utilization of the knowledge of particular circumstances of time and place is only possible if the decisions depending on such knowledge are made with the active cooperation of the actual holder of that knowledge. They ensure the meaningful utilization of knowledge and the integrity of judicial process. They arise from both the procedural public policy contents and the consensual nature of arbitration. These are the principle of due process, which mainly consists of the parties' rights to a reasonable opportunity to be heard with regard to the issues of fact and law and to equal treatment in both the constitution of the tribunal and the later proceedings, the prohibition of fraud, corruption or perjured evidence, and the decision maker's duty to comply with his mission, which, in most cases, includes his obligation to render a reasoned award.

On the basis of those basic principles of *lex mercatoria*, the dissertation demonstrates how *lex mercatoria* is applied in the choice of law analyses, and to the substance of the dispute. In the choice of law analyses, *lex mercatoria* represents the possibility for the arbitrators to resolve specific difficulties relating to the conflict of laws through a principled decision making, such as the applicable conflict of laws rules, and the interpretation of the parties' intentions as to the applicable law. The application of *lex mercatoria* at the conflict of laws stage results in two situations on the basis of the particular circumstances of the case, as far as the relevance of *lex mercatoria* to the substance of the dispute is concerned: Firstly, *lex mercatoria* as *lex contractus* may govern the substance of the dispute to the exclusion of any particular national law, while the articulated rules are limited to those expressed in the contract. Secondly, *lex mercatoria* as *lex fori* may govern the substance of the dispute in addition to the contractual terms and the rules of a national law, which become applicable either as a result of the choice of the parties or pursuant to the application the technique of thought under *lex mercatoria* to the choice of law analyses.

The application of *lex mercatoria* to the substance of the dispute denotes three activities of the decision maker: interpretation, supplementation and correction of the contract. In these activities, the reasonable expectations of the parties to a particular contract become the single source of their contractual rights, obligations and risk allocations. Thus, when interpreting or supplementing the contract through a contextual approach or correcting the contract on the basis of public policy considerations, the decision maker applying *lex mercatoria* interprets, supplements and corrects not only the terms of the contract, but also the national laws applicable to the contract, in the process, not for the purpose of the development of the particular national legal systems, but for maximizing the possibility of expectations of the elements of the order being fulfilled, matched and not conflicting. By means of these activities, the decision maker reveals and enforces the law between the parties to a particular contract, in order to give effect to the reasonable expectations of the parties in accordance with the abstract relations constituting the spontaneous order of international commerce.

The last part of the dissertation is devoted to the analyses of several instances of substantive application of *lex mercatoria*; (i) duty of cooperation, (ii) duty to achieve a specific result and duty of best effort, (iii) force majeure, (iv) hardship, (v) right to terminate the contract, and (vi) damages for non-performance. For these analyses, the dissertation identifies three sources for abstractions that should motivate the reasoning of the decision maker in applying to the substance of the dispute whatever rules or standards of contractual, national or transnational origin. These sources are national contract laws, international instruments relating to international commercial contracts, and contracting practices in the order of international commerce. The abstractions from these sources usually, but not necessarily, indicate the general principles of law. Even if the decision maker cannot articulate a general principle of law through such abstractions, the abstract reasoning is still important since it constitutes the background for the decision making on the basis of the application of *lex mercatoria* to the substance of the dispute either as *lex fori* or *lex contractus*. In those analyses, the arbitral awards are examined in the background of these sources of abstractions that should determine the reasoning of the decision maker applying *lex mercatoria*. Where possible and relevant, the arbitral awards and dissenting opinions are cited extensively in order to demonstrate to what extent the approaches of the arbitrators reflect the abstract reasoning and the principled decision making set forth by this theory of *lex mercatoria* in relation to those selected issues. The analysis of arbitral awards in this background also seeks the signs of the impression of splitting the difference and puts forward some possible explanations for such an impression.

The dissertation analyzes the practice of the international arbitration under its own theory of *lex mercatoria*. It should be noted that only a small fraction of awards are published due to the concerns of confidentiality. Moreover, even when published, the awards are usually made available only in excerpts, so there is the danger that the reasoning of the arbitral tribunal is not reflected in full and some excerpts may be out of context. Although, in many published awards, it is possible to observe the indications of *lex mercatoria*, as suggested in this dissertation, it can be plausibly argued that they do not necessarily constitute the approach of majority of arbitral tribunals in international arbitration. Thus, the dissertation seeks to avoid such generalizations that would picture *lex mercatoria* as the default law in the practice of international arbitration. Nevertheless, the two conditions for the applicability of *lex mercatoria* are established quite strongly and explicitly in the practice. The residual questions commonly arise in the context of international contracts, and the finality and flexibility in decision making in the international arbitration are recognized in the modern regulation of international arbitration by the majority of the national legal systems through international conventions and arbitration laws. In this context, the theory of *lex mercatoria*, as suggested by this dissertation, at least represents a potential that is available to the arbitrators, and some published awards, even if their reliability may be questionable, can be considered as the evidence of the actual use of this potential in practice.

2. THE CONCEPT OF LEX MERCATORIA

a. The Evolution of Lex Mercatoria

i. Medieval Lex Mercatoria

Medieval *lex mercatoria* represents a symbol for some legal scholars, who have sought from the Middle Ages evidence of an independent and exclusively mercantile law as a solution to problems of cross-border commerce. In their view, this law differed from the municipal laws of contemporary jurisdictions in that it was created autonomously by merchants and expressed in their customs, reflecting unwritten usages rather than the written command of a sovereign legislator. As the product of the cosmopolitan merchant community, it was universal, consisting of substantive principles and convenient procedures to govern commerce across borders. It came to represent the romantic ideal of an autonomous and uniform law created by and for international merchants, independent from the contemporary legal framework in the modern world.

There are also others who have questioned this “romantic” vision and sought for a more “realist” vision of medieval *lex mercatoria*. The different perspectives on medieval *lex mercatoria* result from the historical sources, which mention the phrase “*lex mercatoria*” or its variants in their contents. These sources can bluntly be divided into two categories in respect of their date of origin. In the pre-seventeenth century sources, the phrase “*lex mercatoria*” was not used in the sense of a system of substantive law. The historical research conducted into this category of sources suggests that *lex mercatoria* was not a substantive, but a procedural law, and it was not transnational or uniform. In the historical sources from seventeenth century and later, the phrase “*lex mercatoria*” mostly reflects a romanticized picture of early medieval *lex mercatoria* due to the political backgrounds of these sources, which should be taken into account when reaching conclusions about the nature of medieval *lex mercatoria*. Thus, a proper understanding of the context, from which these historical sources emerged, becomes imperative and a research that fails to provide such an understanding of the historical context may come to some misleading conclusions about the nature of medieval *lex mercatoria*.

It can be said that modern *lex mercatoria* doctrine mostly bases its historical account on the second category of sources while neglecting their political and historical context. Thus, the accuracy of different historical accounts of *lex mercatoria* was taken with suspicion by some writers of modern era. It is noted that the origins of the “new law merchant” have been discussed by many authors, but have rarely been subject to thorough analysis and the subject has largely remained obscure since there is hardly any evidence to determine whether the medieval law merchant had autonomous standing apart from the local municipal law.² In the end, the controversy about the nature of medieval *lex mercatoria* affects the concept of modern *lex mercatoria*, which has become representing both the romantic ideal of an autonomous and uniform law created by and for merchants, independent from the contemporary legal framework, and the realist understanding of an emerging set of specialized legal norms, procedures, and institutions within the contemporary legal framework.³

² De Ly Filip, *International business law and lex mercatoria*, T.M.C. Asser Instituut, 1992, at 17

³ Michaels, Ralf, *The True Lex Mercatoria: Private Law Beyond the State*, *Indiana Journal of Global Legal Studies*, 14 (2007), at 448

1. The Realist Vision of Medieval Lex Mercatoria

It is observed from the pre-seventeenth century sources that the phrase “lex mercatoria” was not used in the sense of a system of substantive law. Some historical research focusing on the pre-seventeenth century sources presents an understanding of medieval lex mercatoria in which the substantive law aspect cannot or can hardly be found. However, before understanding the nature of medieval lex mercatoria as reflected in the pre-seventeenth century sources, the general system of substantive law as applied in the territories where these sources emerged should be examined.

In England, the general system of substantive law began to be created in the twelfth century. The English monarchy of the twelfth century was more centralized than any of the other monarchies of Europe. Therefore, the twelfth-century monarchs in England were able to establish a system of central royal courts.⁴ The author of a short treatise entitled “Lex Mercatoria”, which was written in the late thirteenth century in England and the earliest known treatment of lex mercatoria, described it as the daughter of the common law which was applied by central royal courts. The author wrote that the common law endowed lex mercatoria with certain privileges in certain places, namely cities, fairs, seaports, market-towns and boroughs.⁵ Within these sites, mercantile law was always to be applied, unless both parties openly and expressly agreed on the common law.⁶ The most significant and distinctive feature of those sites was the existence of a special jurisdiction.⁷

It is observed that there were many references to the “ley marchaunt” or “lex mercatoria” to indicate that medieval English lawyers regarded it as something different from the common law.⁸ However, it is argued that the distinction between systems of law during the middle ages was usually made in procedural terms, due to the fact that medieval lawyers believed that substantive justice was immutable, invariable and unattainable on earth. The quality of justice depended on the available mechanisms and procedures.⁹ Therefore, it is deemed doubtful whether any distinctions were made at all between lex mercatoria and common law with regard to their substantive content. Moreover, most of the medieval literature consists in codes of mercantile procedure observed in particular cities, and towns and, far from being a universal law throughout the world, they had many local variations. The medieval sources support the idea that the law merchant was not so much a corpus of mercantile practice or commercial law, but an expeditious procedure especially adapted for the needs of merchants.¹⁰

⁴ Donahue Jr., Charles, Private Law without the State and During its Formation, *American Journal of Comparative Law*, 56 (2008), at 550

⁵ Basile, Mary E., Jane F. Bestor, Daniel R. Coquillette & Charles Donahue, *Lex Mercatoria and Legal Pluralism: A Late Thirteenth-Century Treatise and its Afterlife*, The Ames Foundation of Harvard Law School, 1st ed., 1998, at 27

⁶ *Ibid.*, at 24

⁷ Fortunati, Maura, The Fairs between Lex Mercatoria and Ius Mercatorum, in Vito Piergiovanni (ed.), *From Lex Mercatoria to Commercial Law*, Berlin: Duncker & Humblot, 2005, at 146

⁸ Baker, John H., Law Merchant and the Common Law before 1700, *Cambridge Law Journal*, 38 (1979), at 299

⁹ *Ibid.*, at 300

¹⁰ *Ibid.*, at 301

Hence, it is argued that *lex mercatoria* in the late thirteenth-century England was connected to a royal privilege, which partially freed the merchants from the jurisdiction of central royal courts thereby exempting merchants from rigid law of evidence of the common law. The law of evidence was also among the main subjects of the treatise “*Lex mercatoria*”. Similarly, the law book *Fleta*, a general treatise on English law compiled in around 1290, mentioned *lex mercatoria* as a royal privilege exempting all merchants trading in England from the archaic legal procedures.¹¹ *Fleta* provided that the plaintiff is granted a privilege by royal grace that under certain circumstances, namely disputes arising in towns or at markets and between merchants, he may bring forward proof according to *lex mercatoria*.¹²

On the other hand, the limited substantive aspect of medieval *lex mercatoria* was also mentioned in royal documents of England, such as *Carta Mercatoria* and *Statute of Staples*, which clearly described *lex mercatoria* as the proper means of deciding certain mercantile cases.¹³ *Carta Mercatoria*, issued by Edward I in 1303, promised foreign merchants, who complain before merchant courts in England, speedy justice without delay according to the *Law Merchant* touching all and singular complaints which can be determined by the same law with the exception that in contractual disputes, proof and inquiry should be made according to the usages and customs of the fairs and markets where the contract had been made.¹⁴ The *Statute of the Staple*, issued by Edward III in 1353, provided that the merchants coming to the staple towns “shall be ruled by the *Law-Merchant*, of all Things touching the Staple, and not by the common Law of the Land, nor by Usage of Cities, Boroughs, or other Towns.”¹⁵ In essence, these documents guaranteed a more rapid method of dispute resolution, which followed either the vague concept of “*Law Merchant*” in a sense of substantive justice or the various usages and customs of the commercial towns and fairs under certain circumstances.

In England, the fair court of St. Ives provided the primary sources for the study of medieval *lex mercatoria*, since the activity of the St. Ives court was uniquely well documented. The surviving rolls are dated between 1270 and 1324.¹⁶ It is argued that no source contains as complete a description of a medieval English fair as the St. Ives rolls.¹⁷ It was observed from the rolls that the term “*lex mercatoria*” was rarely mentioned in St. Ives records. Only eleven records of the entire set of court rolls contain the phrase “*secundum legem mercatoriam*”

¹¹ Volckart, Oliver and Antje Mangels, Are the Roots of the Modern *Lex Mercatoria* Really Medieval?, *Southern Economic Journal*, 65-3 (1999), at 443 fn. 44

¹² Cordes, Albrecht, The search for a medieval *Lex mercatoria*, *Oxford University Comparative Law Forum*, 5 (2003), at ouclf.iuscomp.org, text after note 17

¹³ Sachs, Stephen E., From St. Ives to Cyberspace: The Modern Distortion of the Medieval ‘*Law Merchant*’, *American University International Law Review*, 21 (2006), at 780

¹⁴ Mitchell, William, *An essay on the early history of the law merchant*, New York: Franklin, (Originally published Cambridge, 1904) 1976, at 6

¹⁵ Sachs, Stephen E., From St. Ives to Cyberspace: The Modern Distortion of the Medieval ‘*Law Merchant*’, *American University International Law Review*, 21 (2006), at 782

¹⁶ The Selden Society published a significant number of the rolls in facing-page translation. Although the cases are selective, the extracts were chosen with a view of elucidating law merchant practiced at St. Ives. Gross, Charles (ed.), *Select Cases Concerning the Law Merchant A.D. 1270-1638*, Vol. I, *Local Courts*, London: B. Quaritch, Selden Society 23, 1908, PREFACE

¹⁷ Sachs, Stephen E., From St. Ives to Cyberspace: The Modern Distortion of the Medieval ‘*Law Merchant*’, *American University International Law Review*, 21 (2006), at 685

(according to law merchant) or its variants.¹⁸ Moreover, since the king and abbot exercised significant influence over the principles applied in the fair court of St. Ives, customary principles were often combined with these authorities.¹⁹ Therefore, the rules applied by the fair courts were not merely grounded in the will of the merchant community; the abbot's dictates, the king's statutes, the residents' customs, the suitors' sense of justice participated in an organic law, as observed from the rolls of the court of St. Ives.²⁰ The St. Ives rolls also show that coercive power of the abbot to enforce decisions, to collect damages, and to assess fines was exercised routinely. The court was part of the abbey's patrimony, which included the manor of Slepe in which the village was located.²¹

Due to the procedural exemptions, the merchants in England were able to exercise some independent judicial authority in mercantile courts. The treatise "Lex Mercatoria" stated that, in market courts, "every judgment ought to be rendered by merchants of the same court and not by the mayor or by the seneschal of the market."²² Statute of Staples further allowed the foreign merchants on the juries.²³ The court rolls of St. Ives also recorded some occasions that "thereupon all the merchants of the said fair, both natives and foreigners, to whom judgments belong according to the law merchant, having been called for this purpose and consulted, say that" how an issue can be resolved "according to the law merchant".²⁴ The merchants in the court of St Ives were suitors and the abbot's steward presided over them. Although the steward presided over the court, the suitors found the judgment or declared the law.²⁵

¹⁸ *Ibid.*, at 730: Amisius v. Ralph 1 Gross, Charles (ed.), *Select Cases Concerning the Law Merchant A.D. 1270-1638*, Vol. I, Local Courts, London: B. Quaritch, Selden Society 23, 1908, at 5 concerning the number of oath-helpers required to claim the attachment of goods; Fulham v. Francis (St. Ives Fair Ct. 1311), at 89 concerning whether servants may provide oath in their master's place; Yarmouth v. Fick (St. Ives Fair Ct. 1300), at 81 and Fairhead v. Tankus (St. Ives Fair Ct. 1295), at 71 concerning the time period after which the goods may be sold to satisfy a debt; Tempsford v. Chaplain (St. Ives Fair Ct. 1291), at 45 concerning the conclusion of a sale through the payment of earnest money; Saddington v. Laungbaugh (St. Ives Fair Ct. 1287), at 22 concerning the need for pledges in a wager of law; Darlington v. Burser (St. Ives Fair Ct. 1302), at 85-86 concerning the need to specify the regnal year in which an offense occurred; Hoppman v. Welborne (St. Ives Fair Ct. 1302), at 86-87 concerning the admissibility of a sealed writing of debt; Bedford v. Reading (St. Ives Fair Ct. 1312), at 91 concerning the king's claim to fraudulently marketed licorice; Legge v. Mildenhall (St. Ives Fair Ct. 1291), at 46-47 and Bishop v. Godsbirth (St. Ives Fair Ct. 1315), at 97 concerning the right of a third-party butcher to intervene in sales of meat and fish.

¹⁹ The administration of the fair was in large part subject to the authority of the king of England and of the abbey of Ramsey, a powerful and wealthy monastic foundation that held both the St. Ives fair and the manor of Slepe in which the village was located. The abbey of Ramsey received a charter from Henry I granting the right to hold an annual fair at St. Ives in 1110, and the terms of the charter included the customary rights to take tolls in the fair and to hold a court to govern it. Gross, Charles (ed.), *Select Cases Concerning the Law Merchant A.D. 1270-1638*, Vol. I, Local Courts, London: B. Quaritch, Selden Society 23, 1908, at XVII

²⁰ Sachs, Stephen E., *From St. Ives to Cyberspace: The Modern Distortion of the Medieval 'Law Merchant'*, *American University International Law Review*, 21 (2006), at 739

²¹ *Ibid.*, at 699

²² Basile, Mary E., Jane F. Bestor, Daniel R. Coquillette & Charles Donahue, *Lex Mercatoria and Legal Pluralism: A Late Thirteenth-Century Treatise and its Afterlife*, The Ames Foundation of Harvard Law School, 1st ed., 1998, at 20 in the original text of the treatise

²³ Constable, Marianne, *The Law of the Other: The Mixed Jury and Changing Conceptions of Citizenship, Law, and Knowledge*, University Of Chicago Press; 1st ed., 1994, at 99

²⁴ Fulham v. Francis (St. Ives Fair Ct. 1311), in Gross, Charles (ed.), *Select Cases Concerning the Law Merchant A.D. 1270-1638*, Vol. I, Local Courts, London: B. Quaritch, Selden Society 23, 1908, at 90.

²⁵ Gross, Charles, *The Court of Piepowder*, *The Quarterly Journal of Economics*, 20-2 (1906), at 238 and 242

Thus, the medieval *lex mercatoria* in England was a general phrase for whatever law was appropriate to mercantile transactions, emerging from procedural exemptions and not necessarily a term for a specific body of principles actually applied to them.²⁶ As a result of procedural exemptions, the content of substantive law was constantly changing along with the mercantile customs applied to the case. In a context that the common law itself was little more than a series of technical rules of evidence and procedure, *lex mercatoria* indicated merely a different set of similar rules, established to ensure speedy justice for the foreign merchant and enforced in mercantile courts.²⁷ On the substantive side, it consisted of customs and equity, but it was not an organized body of rules, which had the quality of an autonomous legal system.²⁸ Moreover, the medieval *lex mercatoria* in England was apparently well integrated into the contemporary legal framework. Despite the existence of local courts to hear mercantile pleas, the king retained some jurisdiction over fairs and markets. It is observed that, in the rolls of the Common Pleas for the fourteenth and fifteenth centuries, there are many commercial cases involving city tradesmen and merchants, in addition to the foreign names, which imply the cross border character of some of the businesses.²⁹

In the continental Europe, the effort at building a system of substantive law focused on Roman law in the medieval period.³⁰ This effort was problematical in its relations to existing power structures. There was some connection with the Holy Roman Emperor, but, such a connection later became controversial when Roman lawyers sought to bring their ideas into monarchies, which did not recognize the authority of the emperor. Nevertheless, it is argued that the effort with Roman law succeeded because the church needed it to fill out its legal system, and because kingdoms and communities, principally in southern Europe, were willing to accept the learning of Roman lawyers as a default law.³¹

The influence of Roman law on the understanding of law to be applied to mercantile matters can be observed in Benvenuto Stracca's *De Mercatura* 1st ed. 1553, which is generally thought to be the first comprehensive treatise on the medieval mercantile law.³² *De Mercatura* described a separate set of mercantile courts which varied in their procedures from those that employed long-form Romano-canonical procedure. *De Mercatura* was composed of a series of short treatises on various aspects of the law merchant and did not provide a systematic exposition of commercial law.³³ It mainly provided a guide of sources for the voluminous works of Roman law from the point of view of merchant courts and merchant cases and some discussion on mercantile morality.³⁴ Since mercantile courts were sometimes unprincipled,

²⁶ Sachs, Stephen E., *From St. Ives to Cyberspace: The Modern Distortion of the Medieval 'Law Merchant'*, *American University International Law Review*, 21 (2006), at 788

²⁷ Isaacs, Nathan, *The Merchant and His Law*, *Journal of Political Economy*, 23 (1915), at 530

²⁸ Goode, Roy, *Usage and its Reception in Transnational Commercial Law*, *International and Comparative Law Quarterly*, 46-1 (1997), at 5

²⁹ Baker, John H., *Law Merchant and the Common Law before 1700*, *Cambridge Law Journal*, 38 (1979), at 302

³⁰ Donahue Jr., Charles, *Private Law without the State and During its Formation*, *American Journal of Comparative Law*, 56 (2008), at 562

³¹ *Ibid.*, at 562

³² Donahue, Jr., Charles, *Benvenuto Stracca's De Mercatura: Was There a Lex Mercatoria in Sixteenth-Century Italy?*, in Vito Piergiovanni (ed.), *From lex mercatoria to commercial law*, Berlin: Duncker & Humblot, 2005, at 76

³³ *Ibid.*, at 80

³⁴ *Ibid.*, at 106

Stracca called the judges of those courts to do better by making use of the persuasiveness of his arguments.³⁵ Thus, *De Mercatura* dealt rather with *ius commune*, a law that is known to combine local laws with the Roman law.³⁶ Accordingly, Stracca's methodology for dealing with legal questions reflected that of university trained jurists who developed *ius commune* when rendering legal opinions.³⁷ Stracca mainly compiled a set of legal opinions on mercantile matters by following a similar methodology: beginning with Roman law or occasionally with the canon law, then referring to local Italian statutes dealing with merchants and their courts, and, finally interpreting these statutes in light of the *ius commune*. Stracca referred to the customs of merchants relatively infrequently, and these customs varied slightly from the *ius commune* and could easily be accommodated within it.³⁸

It can be said that the effective legal system for the Italian merchants was *ius commune*. *Ius commune* was developed by university-trained jurists as a comprehensive system of substantive law in the fourteenth and fifteenth centuries. This system was notionally the default system of law not only in Italy, but also in Southern France and Spain. The local law and custom, as *ius proprium*, generally prevailed, but in the absence of local law, *ius commune* would apply. Moreover, *ius proprium* was interpreted in the light of *ius commune*, and harmonized with it when possible. The statutes in derogation of *ius commune* were strictly construed.³⁹ It is also observed that, in southern Europe, the phrase "*lex mercatoria*" was not so common, although all standard modern accounts assign a particular prominence to the late medieval and early modern Italians in the development of *lex mercatoria*.⁴⁰ For instance, in *De Mercatura*, the phrase was not commonly used. Moreover, prior to *De Mercatura*, there is so far no finding of historical sources in the continental Europe, which state generally the body of rules that apply to mercantile transactions.⁴¹ Thus, the investigation of the history of the phrase "*lex mercatoria*" reveals that *lex mercatoria* is not a term of European or international, but of English law.⁴² The phrase was used in thirteenth century in English law in the context of advantages and privileges granted to merchants in the field of civil litigation. Until seventeenth century, the phrase *lex mercatoria* did not gain any meaning beyond that.

³⁵ *Ibid.*, at 110

³⁶ Michaels, Ralf, *the True Lex Mercatoria: Private Law Beyond the State*, *Indiana Journal of Global Legal Studies*, 14 (2007), at 454

³⁷ Litigants and judges sought these opinions on difficult questions of law, and these jurists answered those questions in terms of the *ius commune*, except where a local statute or custom was called to their attention. Donahue Jr., Charles, *Private Law without the State and During its Formation*, *American Journal of Comparative Law*, 56 (2008), at 553

³⁸ Donahue, Jr., Charles, *Benvenuto Stracca's De Mercatura: Was There a Lex Mercatoria in Sixteenth-Century Italy?*, in Vito Piergiovanni (ed.), *From lex mercatoria to commercial law*, Berlin: Duncker & Humblot, 2005, at 110

³⁹ Donahue Jr., Charles, *Private Law without the State and During its Formation*, *American Journal of Comparative Law*, 56 (2008), at 553

⁴⁰ Donahue, Jr., Charles, *Benvenuto Stracca's De Mercatura: Was There a Lex Mercatoria in Sixteenth-Century Italy?*, in Vito Piergiovanni (ed.), *From lex mercatoria to commercial law*, Berlin: Duncker & Humblot, 2005, at 74

⁴¹ *Ibid.*, at 76

⁴² Cordes, Albrecht, *The search for a medieval Lex mercatoria*, Vito Piergiovanni (ed.), *From Lex Mercatoria to Commercial Law*, Berlin: Duncker & Humblot, 2005, at 61

There certainly must have been some degree of common understanding among merchants as to the effect of various kinds of transactions since, otherwise, cross-border commerce could not have existed. Even so, it is remarkable that in the period from 1100 to 1550, when so many other maritime customs were written down, *lex mercatoria* as such was not.⁴³ It is argued that the fact that a body of customary law was redacted tells something about the nature of the customary system that underlay the redacted custom. When a customary system avails itself to redaction, it may be argued that such a system was reasonably coherent and comprehensive. Thus, the conclusion under this view is that there is a reason to believe that such a system of customary law underlay the rules that were redacted in the maritime law, but there is no evidence that such a system of customary law underlay medieval *lex mercatoria*.⁴⁴ In essence, the absence of the redaction of a body of customary law implies that the understanding of such a law by its applicers and subjects was too complex and uncertain to be written down by others due to its organic nature, which consisted of equity, customs, local laws, common law or *ius commune* in different places and times.

The realist approach to medieval *lex mercatoria* presents a picture of medieval legal order where medieval merchants did participate in the operation of courts that dealt with mercantile matters, but not totally independently of local political power. As to the substantive content of medieval *lex mercatoria*, the realist approach maintains that there were probably some mercantile customs that made trading possible, some local and some of wider extent. However, these customs did not constitute a mercantile legal system since a legal system was tried to be created through different schemes of law that was not the creation of merchants but, in the case of England, of the customary courts of the realm, or, in the case of Italy, of the jurists of the *ius commune*.⁴⁵ Yet, those systems were adapted to the needs and desires of the merchants through procedural mechanisms for the sake of justice and economic interests. The merchants had to seek justice and defend their rights before foreign courts. Thus, the law of evidence and other procedural mechanisms, which speeded up the process of litigation and removed formalities, ultimately resulted in an organic substantive law, which was enriched with local laws, usages and equity.

2. The Romantic Vision of Medieval Lex Mercatoria

Since the seventeenth century, the arguments as to the nature of medieval *lex mercatoria* have not been made as merely historical statements, but also as theoretical claims within a controversial legal discussion.⁴⁶ This led to the emergence of a romantic concept of *lex mercatoria* on the basis of the idea that medieval *lex mercatoria* was not only procedural but also substantive law, which created by and for merchants. Therefore, in order to understand

⁴³ The most influential maritime codifications were the Laws of Oleron, used in northern and western Europe from the Atlantic coast of Spain to Scandinavia in the end of the twelfth century; the Consulate of Sea, applied to the maritime affairs in the Mediterranean Sea starting from the late thirteenth century; and the Laws of Wisby, based on the Laws of Oleron and printed in sixteenth century to govern trade in the Baltic Sea. Tetley, William, *The General Maritime Law - The Lex Maritima*, *Syracuse Journal of International Law and Commerce*, 20 (1994), at 110 et seq.

⁴⁴ Donahue, Charles Jr., *Medieval and Early Modern Lex Mercatoria: An Attempt at the Probatio Diabolica*, *Chicago Journal of International Law*, 5 (2004-2005), at 29

⁴⁵ Donahue, Charles Jr., *Medieval and Early Modern Lex Mercatoria: An Attempt at the Probatio Diabolica*, *Chicago Journal of International Law*, 5 (2004-2005), at 36

⁴⁶ Cordes, Albrecht, *The search for a medieval Lex mercatoria*, *Oxford University Comparative Law Forum*, 5 (2003), at ouclf.iuscomp.org, text after note 25

the nature of the concept *lex mercatoria* as reflected in the post-seventeenth century sources, the contextual controversies should also be taken into account.

In the seventeenth century, the status of the law merchant with regard to the common law became controversial in England.⁴⁷ Since the fourteenth century, it was common practice that the all types of mercantile cases had been handled by the court of Admiralty. However, the court was believed to be too close to the king during the struggle for power between the Stuarts and Parliament at the beginning of the seventeenth century.⁴⁸ With the aggressive expansion of the common law, the competence of the court of Admiralty was limited again to the law of the seas, and other commercial cases were referred to the common law courts.⁴⁹ In order to convince the common law courts to apply the well-tried rules that had been in use at the Admiralty court, the merchants argued their case on the basis of a new interpretation of the phrase “*lex mercatoria*”. They argued that this was a legal system that had been and remained in force in all countries and at all times, separately from the will of any sovereign legislator, and therefore separately from the will of Parliament.⁵⁰

One of the most cited sources as to the history of *lex mercatoria*, “*Constuendo Sive Lex Mercatoria*”,⁵¹ was written by Gerard Malynes, who was a merchant not a lawyer. Similar to other merchants, he sought to have mercantile cases treated independently of the common law. In order to make his argument, he had to confront the argument of the common lawyers that the common law was of venerable antiquity. The doctors of civil law, who sought commercial cases for their courts, had come up with the counterargument that the law merchant was of equal antiquity since it was drawn from Roman law, in which they were specialists. Malynes, on the other hand, argued further that the law merchant was the creation of merchants and of greater antiquity even than Roman law.⁵² Malynes wrote his work as a party supporter in a contemporary debate about the question whether or not mercantile affairs fell under the jurisdiction of the English common law courts.⁵³ Therefore, he argued in his work that “the said customary law of merchants hath a peculiar prerogative above all other customs, for that the same is observed in all places.”⁵⁴

⁴⁷ Donahue, Charles Jr., *Medieval and Early Modern Lex Mercatoria: An Attempt at the Probatio Diabolica*, *Chicago Journal of International Law*, 5 (2004-2005), at 26

⁴⁸ Cordes, Albrecht, *The search for a medieval Lex mercatoria*, *Oxford University Comparative Law Forum*, 5 (2003), at ouclf.iuscomp.org, text after note 24

⁴⁹ Glenn, H. Patrick, *Legal traditions of the world: sustainable diversity in law*, Oxford; New York: Oxford University Press, 2nd ed., 2004, at 256

⁵⁰ Cordes, Albrecht, *The search for a medieval Lex mercatoria*, *Oxford University Comparative Law Forum*, 5 (2003), at ouclf.iuscomp.org, text after note 24

⁵¹ It was first published in London in 1622.

⁵² Donahue, Jr., Charles, *Benvenuto Stracca's De Mercatura: Was There a Lex Mercatoria in Sixteenth-Century Italy?*, in Vito Piergiovanni (ed.), *From lex mercatoria to commercial law*, Berlin: Duncker & Humblot, 2005, at 71

⁵³ Cordes, Albrecht, *The search for a medieval Lex mercatoria*, *Oxford University Comparative Law Forum*, 5 (2003), at ouclf.iuscomp.org, text after note 24

⁵⁴ Malynes, Gerard, “*Constuendo Sive Lex Mercatoria*”, quoted by Kerr, Charles, *The Origin and Development of the Law Merchant*, *Virginia Law Review*, 15-4 (Feb. 1929), at 354. Malynes' writing was influential on many modern writers in reaching conclusions about the nature of the medieval *lex mercatoria*. For instance, Trakman, citing Malynes, argued in 2003 that “medieval writers envisaged the Law Merchant, somewhat grandiosely, as part of a 'Law of Nations' that enshrined 'the most ancient customs concurring with the Law of Nations of all Countrys.’” Trakman, Leon E., *From the Medieval Law Merchant to E-Merchant Law*, *The University of Toronto Law Journal*, 53-3 (Summer, 2003), at 265; The opening paragraph of Berger's prominent monograph,

Since the late nineteenth century, there has been a growing interest in *lex mercatoria* with the revival of romantic mercantilism. The concept was used for different purposes in different countries at different times. The issues in Germany were legal nationalism, commercialization, and the role of the Volk in the process of law making.⁵⁵ There was growing opposition against the use of Roman law among German lawyers who considered the use of Roman law an affront to the German Volk in the nineteenth century. These lawyers argued that the proper law grew out of the *Volksgeist*, the soul of the Volk, through the customary practices, and the use of Roman law displacing customary law had destroyed the legitimacy of the German legal order.⁵⁶

Romantic legal intellectuals in Germany were interested in *lex mercatoria* from the first years of the movement. In the 1780s, J.G. Büsch, a merchant from Hamburg and historian of commerce, used the concept of *lex mercatoria* to promote the idea that commercial cases had a special commercial nature, and that special commercial courts were indispensable for the adjudication of those cases. He argued that ordinary judges were only confused by commercial law because, in commercial matters, judges must distance themselves from all juristic notions and simply use their common sense, in order properly to grasp and master the nature of the transaction.⁵⁷ He regarded commercial law as customary law and as the creation of the community of merchants, an independent body with its own consciousness.⁵⁸ The efforts to expel Roman jurisprudence from German system of commercial law resulted in the codification of commercial law in 1861, under the leadership of Levin Goldschmidt, a leading nineteenth-century commercial lawyer, who followed the tradition of Büsch, adding Germanist nationalism into commercial law.⁵⁹

Goldschmidt argued that the medieval merchant courts were the true “judicial organs of merchant legal consciousness,” giving expression to the will of the merchant community because they relied on commercial custom.⁶⁰ In his view, it was imperative that commercial custom should take precedence over statutory provisions in case of conflict, since commercial custom represented the will of the Volk.⁶¹ Article I of Goldschmidt’s code made the priority of custom explicit: “Insofar as this Code does not determine an issue, commercial custom is to

which sets out his ‘Creeping Codification’ thesis, consists of the Malynes’ definition of *lex mercatoria*, followed by the statement that “With the codification wave of the 19th century, this ancient law merchant, based on the practices and statutes of powerful trade-guilds, customary law and the case law of the *curiae mercatorum*, had fallen into oblivion.” Berger, Klaus Peter, *The Creeping Codification of the Lex Mercatoria*, Kluwer Law International, The Hague, 1999, at 1

⁵⁵ Donahue, Charles Jr., *Medieval and Early Modern Lex Mercatoria: An Attempt at the Probatio Diabolica*, *Chicago Journal of International Law*, 5 (2004-2005), at 25

⁵⁶ Whitman, James, *Commercial Law and the American Volk: A Note on Llewellyn’s German Sources for the Uniform Commercial Code*, *Yale Law Journal*, 97 (1987), at 159

⁵⁷ *Ibid.*, at 162

⁵⁸ *Ibid.*, at 163

⁵⁹ *Ibid.*, at 165

⁶⁰ Goldschmidt, *Handbuch des Handelsrechts*, 2nd ed. (1864), at 242-243, cited in Whitman, James, *Commercial Law and the American Volk: A Note on Llewellyn’s German Sources for the Uniform Commercial Code*, *Yale Law Journal*, 97 (1987), at 165

⁶¹ Whitman, James, *Commercial Law and the American Volk: A Note on Llewellyn’s German Sources for the Uniform Commercial Code*, *Yale Law Journal*, 97 (1987), at 165

be applied. In the absence of commercial custom, the general civil law is to be applied.”⁶² Moreover, the new commercial order in Germany received the kind of special court that Goldschmidt desired.⁶³

Malynes’ and Goldschmidt’s understanding of the medieval law merchant influenced English and American historiography largely through the work of William Mitchell.⁶⁴ Mitchell’s essay on the early history of the law merchant, which was published in 1904, defined the medieval *lex mercatoria* as a body of customary rules and principles distinct from the ordinary law of the land. It was autonomous and uniform, yet differed on minor points from place to place. Mitchell quoted Goldschmidt’s statement that “the grandeur and significance of the medieval merchant is that he creates his own laws out of his own needs and his own views.”⁶⁵ He noted the “strongly marked international character” of the law merchant, asserting that “the main lines of [its] development were everywhere the same.”⁶⁶ Although he recognized that “each country, it may almost be said each town, had its own variety of Law Merchant,” Mitchell added that they were all “varieties of the same species. Everywhere the leading principles and the most important rules were the same, or tended to become the same.”⁶⁷ However, after a close investigation of the primary sources, the “broad general principles” of the law merchant, that were “clearly marked” by Mitchell, did not suggest any clear substantive rule.⁶⁸

The influence of Mitchell and Malynes was also apparent in the work of Wyndham A. Bewes, “The Romance of the Law Merchant”, which was published in 1923. He wrote that mercantile law was older and distinct from common law. It was a transnational body of law which was developed by the Phoenicians, the Greeks and the Romans, then by the Arabs, and finally by the Italian Merchants of the Middle Ages. From there, it passed to all countries of the west through the great international fairs, such as Saint Denis and Champagne, or St. Ives and Winchester.⁶⁹ Bewes defined *lex mercatoria* as the law administered between merchants in consular or commercial courts, some of it being substantive law and some rules of evidence

⁶² Goldschmidt, *Handelsgesetzbuch*, Article 1 (1861), cited in Whitman, James, *Commercial Law and the American Volk: A Note on Llewellyn’s German Sources for the Uniform Commercial Code*, *Yale Law Journal*, 97 (1987), at 172

⁶³ Whitman, James, *Commercial Law and the American Volk: A Note on Llewellyn’s German Sources for the Uniform Commercial Code*, *Yale Law Journal*, 97 (1987), at 166

⁶⁴ Sachs, Stephen E., *From St. Ives to Cyberspace: The Modern Distortion of the Medieval ‘Law Merchant’*, *American University International Law Review*, 21 (2006), at 801

⁶⁵ Mitchell, William, *An essay on the early history of the law merchant*, New York: Franklin, (Originally published Cambridge, 1904) 1976, at 10

⁶⁶ *Ibid.*, at 20

⁶⁷ *Ibid.*, 9

⁶⁸ *Ibid.*, at 10 et seq. First, the law merchant was “the main customary law. . . everywhere, in commercial transactions, custom held sway, and even where the State legislated it had often merely to confirm or slightly modify the rules that had long before been established through custom.” Second, “its justice was prompt, its procedure summary, and often the time within which disputes must be settled was narrowly limited.” Third, the law merchant “was characterized by the spirit of equity. . . Plain justice and good faith disregard of technicalities and regard for ‘the sole truth of the matter’ characterize alike England, France, and Italy” Fourth, the “most striking feature of the law merchant is its strongly marked international character.”

⁶⁹ Bewes, Wyndham A., *The Romance of the Law Merchant, Being an Introduction to the Study of International and Commercial Law with Some Account of the Commerce and Fairs of the Middle Ages*, Sweet and Maxwell, London, 1923, at 1

and procedure.⁷⁰ He argued that the medieval law merchant was customary law which was enforced in a summary manner by officials familiar with trade. He maintained that “there was no substantial difference in the customary law in the various trading nations. . . . It appears all at once, like Minerva sprung fully armed from the brain of Jove.”⁷¹

Goldschmidt’s ideas were also influential on the American jurist Karl Llewellyn, who brought them into the U.S. Uniform Commercial Code in 1940s.⁷² Llewellyn believed that the German merchants had preserved the medieval independence of *lex mercatoria* which did not survive in the United States and England.⁷³ He stated that “It is familiar that there was once in Western Europe a more or less common *lex mercatoria*. The rise of rationalism [meant] that on the Continent the development of this *lex mercatoria* into a local commercial law, set against the local civil law. In England and for us, Mansfield put the final stamp on the proposition that *lex mercatoria* was to be absorbed into the common law, and made part of the law for all.”⁷⁴ Llewellyn used *lex mercatoria* for promoting the Goldschmidt’s idea that law made by the sound instincts of merchant jurors, freed of constricting formalism, was true law of the people. Llewellyn attempted to design a legal mechanism which provided for the submission of a wide range of questions to merchant jurors on the motion of either party.⁷⁵ Although, his attempt with regard to merchant jurors was unsuccessful, Llewellyn’s Uniform Commercial Code expressly provides that “Unless displaced by the particular provisions of [the Uniform Commercial Code], the principles of law and equity, including the law merchant . . . supplement its provisions”⁷⁶.

The romantic vision of medieval *lex mercatoria* as described in the secondary sources of medieval *lex mercatoria* from seventeenth century and onwards presents the medieval *lex mercatoria* as mostly a substantive field of law which consists of an autonomous and uniform body of transnational commercial rules, independent from the authority of any political power and governing the cosmopolitan community of merchants. This understanding has greatly shaped the modern doctrine of *lex mercatoria* during its emergence in the twentieth century. These historical accounts on medieval *lex mercatoria* have been used by modern writers, who conceived modern *lex mercatoria* as an autonomous and universal legal system for the regulation of international commerce.⁷⁷

⁷⁰ *Ibid.*, at 14

⁷¹ *Ibid.*, at 8

⁷² Whitman, James, *Commercial Law and the American Volk: A Note on Llewellyn’s German Sources for the Uniform Commercial Code*, *Yale Law Journal*, 97 (1987), at 157-158

⁷³ *Ibid.*, at 170

⁷⁴ Llewellyn, *On Scratching Acquaintance with the German Law of Sales* (1932) (unpublished fragment in Section D (German Materials), folder V of the KARL LEWELLYN PAPERS at the University of Chicago Law Library) (title of typescript, originally "Realism and Comparative Law," altered by hand) Whitman, James, *Commercial Law and the American Volk: A Note on Llewellyn’s German Sources for the Uniform Commercial Code*, *Yale Law Journal*, 97 (1987), at 170

⁷⁵ Whitman, James, *Commercial Law and the American Volk: A Note on Llewellyn’s German Sources for the Uniform Commercial Code*, *Yale Law Journal*, 97 (1987), at 171

⁷⁶ Uniform Commercial Code, Section 1-103

⁷⁷ Milgrom, Paul R., Douglas C. North & Barry R. Weingast, *The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges and the Champagne Fair Courts*, *Economics and Politics*, 2-1 (1990), at 5: Milgrom, North and Weingast argued that “by the end of eleventh century, the law merchant came to govern most commercial transactions in Europe, providing a uniform set of standards across large numbers of locations. . . . It thereby provided a means of reducing uncertainty associated with variations in local practices and

limited the ability of localities to discriminate against alien merchants.” Berman, Harold J., *Law and Revolution: The Formation of the Western Legal Tradition*, Cambridge: Harvard University Press, 1983, at 342: Berman saw in today’s patterns of global trade an echo of medieval universality; the “high degree of uniformity” observed in modern contract practices is not due only to “common commercial needs,” but also to the fact that merchants constitute a “transnational community which has had a more or less continuous history . . . for some nine centuries.” He stated that “the universal character of the law merchant, both in its formative period and thereafter, has been stressed by all who have written about it.” Benson, Bruce L., *Justice without Government: The Merchant Courts of Medieval Europe and their Modern Counterparts*, in David T. Beito, Peter Gordon, and Alexander Tabarrok (eds.), *The voluntary city: choice, community, and civil society*, Ann Arbor: University of Michigan Press, 2002, at 128: Benson presented a vision of medieval merchants who “wanted to expand international trade” but found highly localized legal systems standing in their way; to avoid these legal systems, they created their own, building an autonomous law merchant that was “voluntarily produced, voluntarily adjudicated, and voluntarily enforced.” Berger, Klaus Peter, *The New Law Merchant and the Global Market Place - A 21st Century View of Transnational Commercial Law* in Klaus Peter Berger, *The practice of transnational law*, The Hague; Boston: Kluwer Law International, 2001, at 3: Berger argued that the uniform legal structures in the trade relations of the Middle Ages were based on the practices and statutes of powerful trade-guilds, customary law and the case law of the *curiae mercatorum* and survived until the codification wave of the 19th century, whereby the ancient *lex mercatoria* was absorbed by the major codes of that time, and the old law merchant had fallen into oblivion.

ii. Modern Lex Mercatoria Doctrine

1. Transnational Arbitration

The roots of modern *lex mercatoria* doctrine can be traced back to the beginning of twentieth century, when the foreign investors sought the right and ability to pursue their legal claims against host states on their own behalf. The foreign investors were subject to national laws and private international law, but not strictly subjects of public international law, while the host states were clearly subject to public international law, but in their commercial activities, they could become subject to national laws and private international law.⁷⁸ Traditionally, international dispute resolution only took place between states, and the foreign investors had only two options for the resolution of disputes. They could either assert their right before the domestic courts of the host state, or attempt to exercise pressure on their home states to initiate legal proceedings on their behalf before an international tribunal.⁷⁹ Neither of these options was satisfactory for foreign investors, so they sought for neutral decision makers to decide their disputes with host states. However, there was the issue of state immunity and doctrinal doubt about whether private parties were properly considered to be subjects of international law capable of directly bringing claims before international tribunals.⁸⁰ There were nonetheless a number of examples from this early period of international tribunals resolving the disputes between a state and a foreign investor in arbitral proceedings.

While arbitration between states is governed by public international law, arbitration between a state and a foreign investor is considered as arbitration between private persons generally, and, thus, governed by a national system of law, namely the law of the country where the arbitration tribunal has its seat, “*lex arbitri*”.⁸¹ In this context, the private international law rules traditionally required the application of the law of host state as being the law of the place of performance or as the law of the state with which the contract is most closely connected. Thus, in those arbitral proceedings, foreign investors sought to internationalize their agreements in order to avoid the application of the law of the host states and to prevent host states from abusing their superior position, which could affect the applicable law in their favor. This was particularly necessary for establishing legal argumentation for the binding promises of states against the state’s claims of immunity. Thus, they advanced the argument that the laws of host states should be interpreted, supplemented and corrected, if necessary, by the general principles of law, which are neutral and unattached to any specific jurisdiction, but a common source of both national laws and public international law. This was mainly achieved on the basis of such clauses in state contracts that referred to general principles of law, sometimes in addition to the law of the host state, or to very vague criteria of good faith in the resolution of the disputes. In the absence of such clauses, the arbitrators referred to the basic foundations of the contract and relied on the general principles of *pacta sunt servanda* and good faith.

⁷⁸ Hight, Keith, *The Enigma of the Lex Mercatoria*, *Tulane Law Review*, 63 (1989), at 617

⁷⁹ Dimsey, Mariel, *The resolution of international investment disputes: challenges and solutions*, Eleven International Publishing, 2008, at 5

⁸⁰ Balch, Thomas Willing, *Arbitration as a Term of International Law*, *Columbia Law Review*, 15 (1915), at 601 (defining “international arbitration” as “International Courts and International judges chosen to function temporarily so as to pass judgment in the light of the Law of Nations upon some designated case of difference between two or more Nations”)

⁸¹ Mann, F. A., *State Contracts and International Arbitration*, *British Year Book of International Law*, 42 (1967), at 36

In the Lena Goldfields arbitration of 1930, the case involved a British concessionaire's challenge to the Soviet Union's repudiation of a mining concession that granted Lena "exclusive rights of exploration and mining over certain vast areas of territory" for up to fifty years.⁸² In the contract, it was mutually agreed that "the parties base their relations with regard to this agreement on the principle of good will and good faith, as well as a reasonable interpretation of the terms of the agreement."⁸³ The tribunal found that in repudiating the contract the Soviet Union had unjustly enriched itself. The tribunal stated that: "the conduct of the Government was a breach of the contract going to the root of it. In consequence Lena is entitled to be relieved from the burden of further obligations thereunder and to be compensated in money for the value of the benefits of which it had been wrongfully deprived. On ordinary legal principles this constitutes a right of action for damages, but the [tribunal] prefers to base its award on the principle of "unjust enrichment," although in its opinion the money result is the same."⁸⁴ The tribunal based its decision on "general principles of law" common across domestic legal systems that established unjust enrichment as a cause of action, rather than exclusively on Soviet law.⁸⁵ This approach of applying "general principles" to support contract enforcement has become influential in international arbitral practice, as it allowed the arbitral tribunals to cite widespread domestic legal support for the general sanctity of contractual obligations in order to justify enforcing state contracts involving nationalized property.

The arbitral support for the general principles of law continued to strengthen in the years immediately following World War II. In *Petroleum Development (Trucial Coast) Ltd. and the Sheikh of Abu Dhabi* in 1952, Lord Asquith, acting as a sole arbitrator, held that a petroleum concession granting the company exclusive rights to search for and exploit petroleum resources in the land and territorial waters of Abu Dhabi did not extend to Abu Dhabi's continental shelf. Lord Asquith decided the case, in favor of the Sheikh and against the investor, on the basis of general principles of law rather than in light of any particular body of municipal law. He stated that: "This is a contract made in Abu Dhabi and wholly to be performed in that country. If any municipal system of law were applicable, it would prima facie be that of Abu Dhabi. But no such law can reasonably be said to exist. The Sheikh administers a purely discretionary justice with the assistance of the Koran; and it would be fanciful to suggest that in this very primitive region there is any settled body of legal principles applicable to the construction of modern commercial instruments. Nor can I see any basis on which the municipal law of England could apply. On the contrary, Clause 17 of the agreement, ..., repels the notion that the municipal law of any country, as such, could be appropriate. The terms of that clause invite, indeed prescribe, the application of principles rooted in the good sense and common practice of the generality of civilized nations—a sort of "modern law of nature."⁸⁶

⁸² The Lena award is unpublished, but Nussbaum provides a partial translation and an important commentary. Nussbaum, Arthur, *The Arbitration between the Lena Goldfields, Ltd. and the Soviet Government*, *Cornell Law Quarterly*, 36 (1950), p. 31; Veeder provides interesting historical detail in Veeder, V. V., *The Lena Goldfields Arbitration: The Historical Root of Three Ideas*, *International and Comparative Law Quarterly*, 47 (1998), p. 747

⁸³ Nussbaum, Arthur, *The Arbitration between the Lena Goldfields, Ltd. and the Soviet Government*, *Cornell Law Quarterly*, 36 (1950), at 42

⁸⁴ *Ibid.*, at 51

⁸⁵ *Ibid.*

⁸⁶ In the translation relied upon by the claimants:- "ARTICLE 17. The Ruler and the Company both declare that they intend to execute this Agreement in a spirit of good intentions and integrity, and to interpret it in a

The basic premise in these cases was essentially that state contracts with investors could or should be governed, at least in part, by general principles of law, both to interpret the particular contract at issue, and to support their enforcement against the states' claims of a sovereign right to breach. In *Ruler of Qatar v. International Marine Oil Company, Ltd.* in 1953, the referee was asked, pursuant to an arbitration clause in the concession agreement, to decide a question of contract interpretation involving the concession's payment provisions. There was a question as to whether the concession was valid under Islamic law as the law of Qatar. The referee, citing Lord Asquith's Abu Dhabi award, argued that "I am satisfied that [Islamic] law does not contain any principles which would be sufficient to interpret this particular contract." The referee also argued that "I cannot think that the Ruler would have intended Islamic law to apply to a contract upon which he intended to enter, under which he was to receive considerable sums of money, although Islamic law would declare that the transaction was wholly or partially void." By referring to an explicit stipulation in the agreement which provided that "The Sheikh and the Company declare that they base action upon this Agreement on the basis of good faith and pure belief and upon the interpretation of this Agreement in a manner consistent with reason," the referee concluded that the parties must have intended the contract to be governed by "principles of justice, equity and good conscience."⁸⁷

In the Alsing award rendered in 1954, Greece was alleged to have breached a long-term contract with a Swedish match company to supply matches to the Greek government and the government's default on related loan obligations.⁸⁸ The contract did not contain a choice of clause and the Umpire decided to apply Greek law to the dispute, yet in determining the legal character of the supply contract, he also stated that "Even administrative contracts must be interpreted according to the norms of private law and by the application of the principles of good faith.... nothing therefore prevents the umpire from having recourse to Roman-Byzantine law-i.e., essentially to common law-in order to determine the sense and scope of the supply contract."⁸⁹

These awards created confusion among the public international lawyers about how they should fit into a system of international adjudication that had up to then primarily involved disputes between states rather than between a state and a private party. This confusion was apparent in Lauterpacht's note to the award of *Ruler of Qatar v International Marine Oil Company*, in which he observed that the award "is not an international arbitration in the accepted meaning" but had been included in his *International Law Reports* "as being of interest for the increasing number of arbitrations between Governments and private companies and individuals" and stated that "it is also of indirect interest for the interpretation

reasonable manner. The Company undertakes to acknowledge the authority of the Ruler and his full rights as Ruler of Abu Dhabi and to respect it in all ways, and to fly the Ruler's flag over the Company's buildings." In the translation relied upon by the respondents:- " ARTICLE 17. The Ruler and the Company both declare that they base their work in this Agreement on goodwill and sincerity of belief and on the interpretation of this Agreement in a fashion consistent with reason. The Company undertakes to acknowledge the authority of the Ruler and his full rights as Ruler of Abu Dhabi and to respect it in all ways, and to fly the Ruler's flag over the Company's buildings." In the matter of an Arbitration between Petroleum Development (Trucial Coast) Ltd. v The Sheikh of Abu Dhabi, *International and Comparative Law Quarterly*, 1 (1952), at 250

⁸⁷ Ad hoc Award of June 1953, *Ruler of Qatar vs. International Marine Oil Company, Ltd.*, *International Law Reports*, (1953), at 545

⁸⁸ Schwebel, Stephen M., *The Alsing Case*, *International and Comparative Law Quarterly*, 8 (1959), p. 320

⁸⁹ *Ibid.*, at 333-334

of the conception of “general principles of law” as it occurs in article 38 of the Statute of the International Court of Justice.”⁹⁰

This ad hoc arbitral practice, which heavily relied on the general principles of law in the resolution of state-investor disputes, was also followed by the arbitral proceedings under the auspices of the ICC. In a 1965 survey of ICC practice, it was noted that since the first state contract dispute was submitted to the ICC in 1922, “a whole series” of contracts between states and private firms had actually been submitted to the ICC for resolution.⁹¹ It was argued that the extensive recognition by states of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards⁹², and the experience gained in enforcing awards of the ICC Court of Arbitration, also showed that difficulties such as those experienced with the enforcement of ad hoc awards were not recurring.⁹³ In fact, there were still problems with regard to the enforcement of arbitral awards against a state even within the framework of New York Convention due to its silence about state immunity.⁹⁴ Nevertheless, these problems apparently did not affect the practice of those arbitrations and, eventually, those arbitrations promoted the dramatic growth of the ICC’s international arbitration business, as investors came increasingly to realize the great value of removing international commercial disputes from the reach of domestic legal regimes.⁹⁵

This series of arbitral awards continued to grow with the resolution of the disputes arising from the host states’ demands of renegotiation and expropriation in the natural resources arbitrations of the 1960s, 1970s and early 1980s.⁹⁶ Thus, the arbitral practice since the

⁹⁰ Ad hoc Award of June 1953, *Ruler of Qatar vs. International Marine Oil Company, Ltd.*, *International Law Reports*, (1953), at 547

⁹¹ Böckstiegel, Karl-Heinz, *Arbitration of Disputes between States and Private Enterprises in the International Chamber of Commerce*, *American Journal of International Law*, 59 (1965), at 581

⁹² *United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards*, June 10, 1958, *International Legal Materials*, 7 (1968), p. 1046

⁹³ Böckstiegel, Karl-Heinz, *Arbitration of Disputes between States and Private Enterprises in the International Chamber of Commerce*, *American Journal of International Law*, 59 (1965), at 586

⁹⁴ For example, in the arbitration between *Libyan American Oil Company (Liamco) and the Government of the Libyan Arab Republic*, the arbitrator decided damages in favor of Liamco. Liamco sought the enforcement of the award in US, Switzerland, Sweden and France through the attachment against Libyan assets in these countries. It could only succeed in Sweden. The others rejected enforcement due to State Immunity from execution for various reasons since the enforcement depends on the courts of the country, where enforcement is sought, to decide whether the State could raise the pleas of immunity. Sanders, Pieter, *Quo Vadis Arbitration?: Sixty Years of Arbitration Practice: a Comparative Study*, Kluwer Law International, 1999, at 194 For instance, in Switzerland, Liamco Award was rejected on the basis of the requirement of Swiss law’s sufficient domestic relationship, which was not deemed to be fulfilled by the fact that the award was rendered in Switzerland. *Switzerland, Tribunal Federal*, June 19, 1980 *Libya vs. Liamco*, *Yearbook Commercial Arbitration*, 6 (1981), p. 151. In US, the district court rejected the enforcement on the basis of the act of state doctrine, but then Liamco appealed and American Arbitration Association and US State Department filed amicus curiae briefs in support of Liamco. US Government particularly stated that the refusal offended the letter and spirit of New York Convention. Pending appeal, Liamco and Libya reached a settlement. *United States, District Court, District of Columbia*, 482 F. Supp. 1175 (D.D.C. 1980), January 18, 1980, *Liamco vs. Libya*, *Yearbook Commercial Arbitration*, 6 (1981), p. 248. US Federal Arbitration Act now explicitly provides in section 15 that Act of State doctrine does not apply in arbitration.

⁹⁵ Dezalay, Yves & Bryant G. Garth, *Dealing in Virtue: International Commercial Arbitration and The Construction of a Transnational Legal Order*, University of Chicago Press, 1996, at 75, 83-85, 101

⁹⁶ See, e.g. *Ad-Hoc-Award, Kuwait v. The American Independent Oil Company (AMINOIL)*, *International Legal Materials*, 21 (1982), p. 976; *Texaco Overseas Petroleum Company/California Asiatic Oil Company v The Government of the Libyan Arab Republic*, *International Legal Materials*, (1978), p. 1; *Libyan American Oil*

beginning of twentieth century, which established the universal applicability of the principles of *pacta sunt servanda* and good faith, contributed to the emergence of transnational theory of arbitration. Transnational theory was based on the argument that the institution of international arbitration is an autonomous juristic entity, which is independent of all national courts and all national legal systems.⁹⁷ Particularly, it maintained that transnational arbitration should be detached from the procedural laws of the country where the arbitration takes place, i.e. *lex arbitri*, or of any other country, except for, in some limited degree, the law of the country where the award is sought to be executed. The proponents of transnational arbitration asserted that the links should be no greater than are strictly necessary to ensure that, through the coercive powers of the national courts, a party who fails to honor the letter and spirit of his agreement to arbitrate can be brought into line.⁹⁸ The growth of institutionalized arbitration was also contributory to the progress of this theory since it could be more readily reconciled with transnational ideas than *ad hoc* arbitrations.⁹⁹

Company (LIAMCO) v The Government of the Libyan Arab Republic, *International Legal Materials*, (1981), p. 1; Saudi Arabia v. Arabian American Oil Company (ARAMCO), *International Law Reports*, (1963), p. 117; Sapphire International Petroleum Ltd. v National Iranian Oil Company, *International Law Reports*, (1967), p. 136; BP Exploration Co. (Libya) v. Government of the Libyan Arab Republic, *International Law Reports*, (1979), p. 297

⁹⁷ For example, the Arbitration Agreement signed between Aminoil and Kuwait on 23 June 1979 provided in Article IV(1) that “subject to any mandatory provisions of the procedural law of the place in which the arbitration is held, the Tribunal shall prescribe the procedure applicable to the arbitration on the basis of natural justice and of such principles of transnational arbitration procedure as it may find applicable, and shall regulate all matters relating to the conduct of the arbitration not otherwise provided for herein.” *Ad-Hoc-Award, Kuwait v. The American Independent Oil Company (AMINOIL)*, *International Legal Materials*, 21 (1982), at 980 The Tribunal found that apart from mandatory rules of French procedure, the *lex arbitri* was not automatically the law of its seat. Principles of transnational arbitration procedure were also relevant because “having regard to the way in which the Tribunal has been constituted its international or rather transnational character is apparent” *Ad-Hoc-Award, Kuwait v. The American Independent Oil Company (AMINOIL)*, *International Legal Materials*, 21 (1982), at 999. The arbitration proceeding itself drew much of its character from public international law dispute settlement procedures each party appointed an agent holding plenipotentiary powers, neither party was classified as claimant or respondent, and memorials were exchanged simultaneously. Hunter, Martin & Anthony Sinclair, *Aminoil Revisited: Reflections on a Story of Changing Circumstances*, in Todd Weiler (ed.), *International Law and Arbitration: Leading Cases from the ICSID, NAFTA, Bilateral Treaties and Customary International Law*, Cameron May, 2005, at 355-356; In the BP v. Libya arbitration, the sole arbitrator stated that: ‘In contradistinction to all national courts, the *ad hoc* international arbitral tribunal created under an agreement between a State and an alien, such as the present Tribunal, at least initially has no *lex fori* which, in the form rules or otherwise, provides it with the framework of an established legal system under which it is constituted and to which it may have ultimate resort. With respect to the law of the arbitration, the attachment to a designated national jurisdiction is restricted to what, broadly speaking, constitute procedural matters and does not extend to the legal issues of substance. It is erroneous to assume, as has been, done doctrinally, on the basis of the territorial sovereignty of the State where the physical seat of an international arbitral tribunal is located, that the *lex arbitri* necessarily governs the applicable conflicts of law rules. Even less does it necessarily constitute the proper law of contract. Instead, if the parties to the agreement have not provided otherwise, such an arbitral tribunal is at liberty to choose the conflicts of law rules that it deems applicable, having regard to all the circumstances of the case.... The contract containing the arbitration clause from which the Tribunal derives its jurisdiction is an elaborate document carefully drafted and conceived of by the Parties as a legal instrument binding upon them. Therefore primary reference must be made to that instrument itself in determining the law which governs the agreement.’ *British Petroleum Co Ltd v The Government of Libyan Arabic Republic*, *Yearbook Commercial Arbitration*, 5 (1980), at 148-149

⁹⁸ Mustill, Michael, *The New Lex Mercatoria: The First Twenty-five Years*, *Arbitration International*, (1988), at 89

⁹⁹ Mustill, Michael, *Transnational Arbitration and English Law*, *Current Legal Problems*, (1984), at 137

However, the transnational theory and its practice in arbitration contributed to the political reaction of the developing countries in the 1960s and 1970s. The developing countries, also supported by the communist regimes, expressed their anti-investor sentiment in the form of a series of United Nations General Assembly (UNGA) resolutions in order to counter the development of customary international law standards protecting foreign investments from uncompensated expropriation.¹⁰⁰ This movement was aimed at establishing “New International Economic Order”. The efforts to build this order culminated in UNGA’s adoption, by the developing countries despite the strong protests of developed countries, of the Charter of Economic Rights and Duties of States (CERDS) in 1974.¹⁰¹

In CERDS, there was an explicit attack to the theory and practice of transnational arbitration aiming at preventing its progress through establishing an international rule. Article 2(c) of CERDS declared that “Each State has the right...[t]o nationalize, expropriate, or transfer ownership of foreign property, in which case appropriate compensation *should* be paid...taking into account all circumstances that the State considers pertinent. In any case where the question of compensation gives rise to a controversy, it *shall be settled under the domestic law of the nationalizing State and by its tribunals*, unless it is freely and mutually agreed by all States concerned that other peaceful means be sought on the basis of the sovereign equality of States and in accordance with the principle of free choice of means.”¹⁰² By the use of the permissive “should” rather than the obligatory “shall”, it was implied that, “appropriate” compensation for expropriation is not necessarily required in all circumstances. Moreover, the transnational arbitration was tried to be ousted by the statement that host state “shall” decide what amount of compensation, if any, is appropriate, and that such decision shall be made under national law applied by national courts. The purported scope of application of CERDS extended to “all...wealth, natural resources, and economic activities” so that those declarations were not only relevant to the natural resources sector, but were also supposedly applicable to economic activities involving foreign investors in all other sectors of the economy.

However, CERDS could not succeed in negating the effect of transnational theory on international arbitration. For example, Dupuy considered the status of CERDS, as the sole arbitrator in the award of *Texaco Overseas Petroleum Company vs. Libyan Arab Republic*. He stated that: “a State cannot invoke its sovereignty to disregard commitments freely undertaken through the exercise of this same sovereignty and cannot, through measures belonging to its internal order, make null and void the rights of the contracting party which has performed its various obligations under the contract.”¹⁰³ He analyzed the legal validity of the UNGA resolutions on the basis of their voting conditions and relevant provisions.¹⁰⁴ He observed that CERDS and related resolutions were supported by a majority of States, but not

¹⁰⁰ Dugan, Christopher F., Don Wallace, Jr., Noah D. Rubins & Borzu Sabahi, *Investor-State Arbitration*, New York: Oxford University Press, 2008, at 23

¹⁰¹ UNGA Res. 3281 (XXIX), Charter of Economic Rights and Duties of States (Dec. 12, 1974). Other related resolutions: UNGA Res. 3171 (XXVIII), Permanent Sovereignty over Natural Resources, U.N. Doc. A/9030 (Dec. 13, 1973); UNGA Res. 3201 (S-VI), Declaration on the Establishment of a New International Economic Order (May 1, 1974); UNGA Res. 3202 (S-VI), Programme of Action on the Establishment of a New International Economic Order (May 1, 1974).

¹⁰² (Emphasis added)

¹⁰³ *Texaco Overseas Petroleum Company/California and the Government of the Libyan Arab Republic* (Jan. 19, 1977), *International Legal Materials*, 17 (1978), at para. 68

¹⁰⁴ *Ibid.*, at para. 83

by any of the developed countries with market economies which carry on the major part of international trade. With respect to the analysis of the provisions concerned, Dupuy considered CERDS as having nothing more than a *de lege ferenda* value only in the eyes of the States which have adopted it, while, as far as the others are concerned, the rejection of these principles implies that they consider them as being *contra legem*.¹⁰⁵ He also noted that CERDS Article 2 is inconsistent with “general practice of relations between States with respect to investment”, which provides for private investors the possibility of resorting to an international tribunal, and, in this regard, referred to the ICSID Convention of 1965.¹⁰⁶ Finally, Dupuy analyzed the whole text of the CERDS and stated that Article 2 must be viewed in light of the principle (j) headed “Fulfillment in good faith of international obligations”. He concluded that it would be against the principle of good faith that, in contracts between a State and a foreign party, only the latter would be bound.¹⁰⁷

Similar conclusion was reached in the dispute between Kuwait and Aminoil where the Concession contained provisions that were alleged, in their combined effect, to constitute a “stabilization clause”, by which it was argued, Kuwait had clearly undertaken not to annul the Concession or modify its terms. The tribunal considered UNGA Resolution 1803, which was adopted by a near unanimous Assembly in 1962 and affirmed that host state promises to investors were legally binding,¹⁰⁸ as reflecting the then state of international law. The tribunal was not persuaded that later UNGA Resolutions, including the CERDS, had the same degree of authority. The tribunal stated that: “even if some of its provisions can be regarded as codifying rules that reflect international practice, it would not be possible from this to deduce the existence of a rule of international law prohibiting a State from undertaking not to proceed to a nationalization during a limited period of time. It may indeed well be eminently useful that “host” States should, if they so desire, be able to pledge themselves not to nationalize given foreign undertakings within a limited period: and no rule of public international law prevents them from doing so.”¹⁰⁹ In its determination of the applicable standards of compensation, the tribunal also preferred to adopt the term “appropriate compensation” as used in the UNGA Resolution 1803, and explicitly rejected later UNGA Resolutions, which purported to weaken the customary international law standard of compensation for expropriation and leave the matter entirely for determination under domestic law.¹¹⁰

The persistent practice of transnational arbitration led to a series of theoretical discussions among private law professors in 1950s and 1960s about the need and possibility of extending this approach to the resolution of disputes arising from transnational contracts between private parties, as a result of their perception of the success of transnational arbitration in its capacity to render valid decisions on the basis of non-national legal sources. Those professors

¹⁰⁵ *Ibid.*, at para. 84-88

¹⁰⁶ *Ibid.*, at para. 89

¹⁰⁷ *Ibid.*, at para. 91

¹⁰⁸ Article 3 of UNGA Resolution 1803 (XVII), U.N. Doc. A/5217 (Dec. 14, 1962), reads: “In cases where authorization is granted, the capital imported and the earnings on that capital shall be governed by the terms thereof, by the national legislation in force, and by international law. The profits derived must be shared in the proportions freely agreed upon, in each case, between the investors and the recipient State, due care being taken to ensure that there is no impairment, for any reason, of that State’s sovereignty over its natural wealth and resources”

¹⁰⁹ *Ad-Hoc-Award, Kuwait v. The American Independent Oil Company (AMINOIL)*, *International Legal Materials*, 21 (1982), at 1021-1022

¹¹⁰ *Ibid.*, at 1032-1033

combined the approach of transnational arbitration with the discourse of medieval *lex mercatoria* in the sense of a customary mercantile law. They took into account the normative power of trade usages in private contracts in addition to the general principles of law. Thus, the doctrine of modern *lex mercatoria* was invented by the professors from Europe on the basis of the romantic vision of medieval *lex mercatoria* and transnational arbitral experience. The doctrine purported to show the possibility of providing a level playing field, disregarding the traditional conflict of laws, for the international merchants coming from different jurisdictions and legal cultures, in the context of political division between North and South on the one hand, and between East and West on the other.

2. Lex Mercatoria as an Autonomous legal system

a. Goldman and the Theory of Lex Mercatoria

Berthold Goldman argued that the application of national laws, designated by the conflict of laws that each state had established for itself, to international commercial contracts was not an appropriate method of regulating international commerce.¹¹¹ His theory of modern *lex mercatoria* was directly influenced by the postcolonial conflicts between North and South and the success of transnational arbitration.¹¹² His approach focused on providing a theoretical background, whereby the applicable substantive rules in the context of transnational arbitration was transformed into an autonomous legal system governing the resolution of private cross-border disputes. Thus, he diverged from the approach of transnational theory of arbitration to some extent. While the debate on transnational theory was practical, the debate on *lex mercatoria* started with the discussions about whether it can and does exist as a viable system in view of the traditional conflict of laws regime relevant to private disputes, which admitted solely the application of a legal system. Thus, Goldman was trying to establish the legal character of the norms of modern *lex mercatoria*, which emerge from non-national legal sources, and which are applied through the autonomous conflict of laws rules. For that purpose, he used a romantic vision of medieval *lex mercatoria* in order to show that *lex mercatoria* simply exists, and it should be conceived to be a growth, not a creation.

In Goldman's narrative of the history of *lex mercatoria*, the first predecessor was not medieval *lex mercatoria* but the Roman *ius gentium*. Goldman understood *ius gentium* as a formally autonomous source of law, customary and international in nature and proper to the economic relations between Roman citizens and foreigners.¹¹³ According to Goldman, *ius gentium* lost this distinctive feature when the Antonian Constitution extended *ius civile* to all private relations in the Empire. In his view, this was the first death of *lex mercatoria* in the sense of customary transnational law. It was, however, not a real death, because *ius gentium* had by then penetrated the domain exclusively reserved for *ius civile*. It thereby enriched and

¹¹¹ Goldman, Berthold, *Lex mercatoria*, Forum Internationale No. 3, Deventer, November 1983, at 4

¹¹² For instance, the first piece of Goldman, that was associated with his theory of *lex mercatoria*, was written during the Suez crisis which was triggered by Egypt's decision of 26 July 1956 to nationalize the Suez Canal Company. This article dealt with the problem of nationality of the Suez Canal Company and presented the Suez Canal Company as a truly international legal entity, rather than one of Egyptian, English, French, or mixed nationality. Goldman, *La Compagnie de Suez, société internationale*, Le Monde, October 4, 1956, 3, available at <http://tldb.uni-koeln.de/static/monde.shtml>

¹¹³ This view of Roman *ius gentium* is also considered as a precursor in other doctrinal writings about *lex mercatoria*. Berman, Kaufman, *The Law of International Transactions (Lex Mercatoria)*, Harvard International Law Journal, 19 (1978), at 224; Trakman, *The evolution of The Law Merchant: Our Commercial Heritage (Part I)*, Journal of Maritime Law & Commerce, 12 (1980), at 4

supplanted the traditional institutions of *ius civile*. Goldman argued that *ius gentium* suffered from the political circumstances with the breakup of the Roman world and its legal system, and the disintegration of international economic relations during the early Middle Ages led to the real death of this customary transnational law.¹¹⁴ In the twelfth century, according to Goldman, the medieval *lex mercatoria*, as the customary transnational law in Europe, was the rebirth of the ancient cosmopolitan law.¹¹⁵ However, in his view, the progressive affirmation of the power of individual states beginning from seventeenth century led to the second death of *lex mercatoria*. In the nineteenth century, the emergence and reinforcement of national particularities completed the process of death with the subjection of international economic relations to national laws. These national laws were designated by conflict of laws rules which had been established by each nation state itself.¹¹⁶ Thus, in Goldman's narrative, *lex mercatoria* was lost when the international community disintegrated and competing political entities claimed control over international commerce and mercantile law. His historical narrative and use of romantic vision of *lex mercatoria* aim at legitimating the direct application of non-national legal sources and avoiding traditional conflict of laws rules.

As the most suitable forum to reflect such a theory into practice, Goldman emphasized the importance of arbitration and considered the international arbitral tribunals as the jurisdictional power of the mercantile community.¹¹⁷ In order to establish *lex mercatoria* as a positive law applicable to the substance of the dispute in arbitration, he focused on the applicable conflict of rules in the context of arbitration. He argued for autonomous conflict rules leading to the application of *lex mercatoria* to the substance of the dispute. He was in favor of the "direct choice" ("voie directe") method in arbitration, which allows the arbitrator to designate the applicable rules of law without referring to traditional conflict of laws.¹¹⁸

According to Goldman, on the basis of these autonomous conflict rules, there can be two different conceptions of *lex mercatoria* applicable to international commercial contracts. One may define *lex mercatoria* by the object of its sources, namely on the basis of the sources of law aiming at regulating international commerce. This definition would lead to a wider understanding, which describes *lex mercatoria* as the law proper to international economic relations, regardless of the origin and nature of its sources. According to this understanding, the sources will not only encompass transnational customary law, but also international legislation in the form of international conventions and national rules, which aim to regulate international commerce. On the other hand, Goldman argued for the possibility to define *lex mercatoria* not only on the basis of the object of its sources, but also the origin and nature of its sources. This understanding of *lex mercatoria* is based on the argument that *lex mercatoria* comprises rules the object of which is mainly transnational, and the origin is customary and spontaneous, notwithstanding the possible intervention of national authorities. The national interventions, such as uniform laws or international conventions, are not origin, but merely means of implementation and/or elaboration of existing customs.¹¹⁹

¹¹⁴ Goldman, Berthold, *Lex mercatoria*, Forum Internationale No. 3, Deventer, November 1983, at 3

¹¹⁵ *Ibid.*, at 3

¹¹⁶ *Ibid.*, at 4

¹¹⁷ *Ibid.*, at 8

¹¹⁸ *Ibid.*, at 13

¹¹⁹ Goldman, Berthold, *The Applicable Law: General Principles of Law - the Lex Mercatoria*, in Julian D. M. Lew (ed.), *Contemporary Problems in International Arbitration*, London, 1986, at 114

His insistence on non-national sources led his theory not to admit the standard contracts formulated by some international organizations as the source of *lex mercatoria*, when those were established by the collective decision of a certain number of nations, such as those formulated by the Council for Mutual Economic Aid (COMECON), which was composed of countries of centrally planned economy. On the other hand, he considered the standard contracts provided by United Nations Economic Commission for Europe (UNECE) as the source of *lex mercatoria*, since they were prepared by the representatives of the concerned business sectors and they are offered to businessmen who are free to refer to them or not. In his view, such standard contracts can be elevated to the status of customary law provided that they are used in mercantile practice with such a degree of frequency that it may be concluded that there is an implicit reference in a particular dealing.¹²⁰ He argued that the mere fact that in the very great majority of cases businessmen refer to such rules and apply them suffices to demonstrate their effectiveness and thus their actual fulfillment of the function of a rule of law.¹²¹

His theory about the sources of *lex mercatoria* also included the general principles of law. According to Goldman, since the gaps in *lex mercatoria* are greater than those of national legal orders, *lex mercatoria* is open to the principles derived from national legal orders and international legal order. He argued that general principles of law are a genuine source, although their origin is ambiguous. There are, firstly, principles common to all, or to a large majority of national legal systems, such as *pacta sunt servanda*. Secondly, there are principles progressively established by general and constant usages of international trade and not embodied in the majority of the national legal systems, such as the mitigation of damages. In his view, the first group of principles also constitutes a part of *lex mercatoria*, since those principles are not referred to by the parties as a principle taken from a particular national law, but as a principle dominating transnational law, when a transnational contract is governed by *lex mercatoria*.¹²² Therefore, in his view, both groups of general principles of law can be used as gap fillers in transnational disputes without reference to any national laws.

Goldman insisted on the idea that *lex mercatoria* is acquiring the characteristics of a legal order (*ordre juridique*), which he defined as the body of specific rules and institutions that emerge from the formation and activity of a specific social group. He argued that the merchants involved in international commerce constitute a specific social group. Although a heterogeneous group, the various merchant communities of international commerce comprise a worldwide society whose needs and customary rules are determined by the economic and international character of the relationships that are created within it. However, he argued that this society does not dispose of an organization as complete, or means of coercion as effective as those of nations. Therefore, he argued that *lex mercatoria* along with the institutions of the merchant community constitute an incomplete or imperfect legal order, similar to international legal order: *lex mercatoria* is part of a distinct legal order, which needs and depends on national legal orders for a coercive mechanism of enforcement. On the other hand, he argued that the application of *lex mercatoria* should not depend on its compatibility with all mandatory provisions of the laws of the nations that are interested in the case, but at most

¹²⁰ Goldman, Berthold, *Lex mercatoria*, Forum Internationale No. 3, Deventer, November 1983, at 6

¹²¹ *Ibid.*, at 8

¹²² Goldman, Berthold, *The Applicable Law: General Principles of Law - the Lex Mercatoria*, in Julian D. M. Lew (ed.), *Contemporary Problems in International Arbitration*, London, 1986, at 115

with international public policy of these nations, and perhaps only with a truly international public policy which is common to all nations, or a great majority of them.¹²³

b. Schmitthoff and the Theory of Law Merchant

Clive Schmitthoff was less interested than Goldman with postcolonial conflicts between North and South. The expansion of international trade in a favorable period of economic recovery after the Second World War led Schmitthoff to question the adequacy of national laws in regulating international commercial contracts in view of the divide between the legal systems of the countries of planned economy and free market economy.¹²⁴ Schmitthoff's theory of law merchant concerned the Cold War divide between East and West, and the contrast between continental law and common law.

Schmitthoff wrote about the relationship between comparative law and conflict of laws as early as 1939.¹²⁵ In his view, comparative study of laws could negate the need of conflict of laws, and conflict avoidance could be practiced only with an intensive comparative study of the laws of the various legal units concerned. He argued that the comparative method is the theoretical foundation of modern private international law and it may lead to the development of a uniform law of international trade, which is one of the most effective means of avoiding a conflict of national laws.¹²⁶ He argued that the international organizations used comparative law in preparing standard contract texts through a consolidating method, which is to ascertain the common content of various legal regulations and thus to define 'the common core of law' of them. He argued that this consolidating method culminated in the production of synthetic non-national legal concepts, which is the greatest contribution that comparative law can make to the unification or harmonization of the law of international trade.¹²⁷

Schmitthoff believed that standard contract texts developed through the consolidating method and international arbitration as understood by the transnational theory are two conditions for the success of attempts to have self regulatory transactions, namely transactions independent of any municipal legal system. Thus, he argued that, first, the parties must agree on an arbitration clause giving the arbitrators fairly wide powers to settle disputes according to commercial fairness and reasonableness rather than strictly according to the law and, secondly, the parties must adopt a standard contract or a set of standard conditions, produced by one of the international organizations, unless the transaction is of sufficient magnitude to warrant the elaboration of a special set of terms intended to be "self regulatory".¹²⁸ Thus, it was probably not a coincidence that the London Conference on the Sources of the Law of

¹²³ Goldman, Berthold, *Lex mercatoria*, Forum Internationale No. 3, Deventer, November 1983, at 21-22

¹²⁴ Schmitthoff, Clive M., *The Law of International Trade*, in Chia-Jui Cheng (ed.), *Clive M. Schmitthoff's Select Essays on International Trade Law*, Graham & Trotman, 1988, at 219

¹²⁵ Schmitthoff, Clive M., *The Science of Comparative Law*, *The Cambridge Law Journal*, 7 (1939), pp. 94-110 reproduced in Chia-Jui Cheng (ed.), *Clive M. Schmitthoff's Select Essays on International Trade Law*, Graham & Trotman, 1988, at 764

¹²⁶ Schmitthoff, Clive M., *International Trade Law and Private International Law*, in Chia-Jui Cheng (ed.), *Clive M. Schmitthoff's Select Essays on International Trade Law*, Graham & Trotman, 1988, at 540

¹²⁷ Schmitthoff, Clive M., *The Unification or Harmonization of Law By Means of Standard Contracts and General Conditions*, in Chia-Jui Cheng (ed.), *Clive M. Schmitthoff's Select Essays on International Trade Law*, Graham & Trotman, 1988, at 200

¹²⁸ Schmitthoff, Clive M., *International Trade Law and Private International Law*, in Chia-Jui Cheng (ed.), *Clive M. Schmitthoff's Select Essays on International Trade Law*, Graham & Trotman, 1988, at 543

International Trade in September 1962 which was convened with a view to finding ways to bridge the gap between the legal systems in East and West¹²⁹ took place right after the European Convention on International Commercial Arbitration of 1961, which was also intended to promote trade between East and West.

In London Conference of 1962, the scholars from both countries of planned economy and countries of free market economy observed that although the internal commercial laws in these countries were very different, the law of external trade of the countries of planned economy did not differ, in its fundamental principles, from the law of external trade of other countries.¹³⁰ In the countries of planned economy, although the internal commercial law was pre-eminently mandatory, external commercial law was, to a large extent, founded on the party autonomy of the contracting parties. The rules of internal commercial law were not applicable to fill gaps in a contract concerning external transactions even if the external transaction was concluded between enterprises of two different countries of planned economy.¹³¹ Thus, it was concluded, in the Conference, that a new concept of *lex mercatoria* was emerging with its universal character. This new concept was common to countries of different economic and social order and their different legal traditions. The legal techniques of regulating international trade were considered to be the same everywhere, irrespective of political, ideological or economic orientation of the countries in question.¹³² The new law merchant was argued to be applicable in every national jurisdiction through the authority of the national sovereign. It was also argued that this new law merchant might be the beginning of an autonomous international mercantile law, which would be no longer shaped by the national laws.¹³³

For Schmitthoff, the romantic vision of medieval *lex mercatoria* also served as an example and justification for the modern *lex mercatoria*. According to Schmitthoff, international commercial law developed in three phases.¹³⁴ It arose in the Middle Ages in the form of the law merchant, which was the universally accepted practice and usage of a cosmopolitan community of merchants, who traveled through the civilized world from port to port and fair to fair. The law of the fairs, Schmitthoff argued, was almost as universal as the law of the church. The medieval law merchant was developed by the international business community itself and applied in the courts by international merchants.¹³⁵ The second phase began with the incorporation of the law merchant into the national systems of law, a process which, though universal, was carried out in the various countries at different times and for different reasons. Even in this period of national incorporation, commercial law did not lose entirely its international character, and the law creating power of international business community was

¹²⁹ Schmitthoff, Clive M., *The New Sources of the Law of International Trade*, in Chia-Jui Cheng (ed.), Clive M. Schmitthoff's *Select Essays on International Trade Law*, Graham & Trotman, 1988, at 131

¹³⁰ Schmitthoff, Clive M., *The New Sources of the Law of International Trade*, in Chia-Jui Cheng (ed.), Clive M. Schmitthoff's *Select Essays on International Trade Law*, Graham & Trotman, 1988, at 132

¹³¹ Schmitthoff, Clive M., *The Law of International Trade, Its Growth, Formulation and Operation*, in Chia-Jui Cheng (ed.), Clive M. Schmitthoff's *Select Essays on International Trade Law*, Graham & Trotman, 1988, at 139

¹³² *Ibid.*, at 138

¹³³ *Ibid.*, at 138

¹³⁴ Schmitthoff, Clive M., *The Unification of the Law of International Trade*, in Chia-Jui Cheng (ed.), Clive M. Schmitthoff's *Select Essays on International Trade Law*, Graham & Trotman, 1988, at 206

¹³⁵ *Ibid.*, at 207

still as active as in the middle ages.¹³⁶ The third phase aimed at the unification of international trade law on an international level and gave rise to a new law merchant. Third phase emerged as the synthesis of the first and second phases. It combined the customary character of the first with the national character of the second phase. Therefore, Schmitthoff argued that the modern *lex mercatoria* is not a branch of international law, but it is applied in every national jurisdiction by the tolerance of the national sovereign, whose public policy may override or qualify a particular rule of that law.¹³⁷

Schmitthoff argued that the law merchant in its third phase is derived from two sources, namely international legislation and international commercial custom. International legislation covers the international conventions and model laws, so they are deliberate normative regulations agreed by states.¹³⁸ International commercial custom, on the other hand, consists of commercial usages and practices, which are so widely accepted that it has been possible to formulate them as authoritative texts. According to Schmitthoff, international commercial custom has two characteristics; first, it has been expressed by an international formulating agency or trade association; and, secondly in principle, such a formulation applies only if adopted by the parties to the contract.¹³⁹ The commercial custom not formulated by an international agency is considered to be at a preliminary or experimental stage, which may or may not lead eventually to the formulation of commercial custom, and therefore it is not considered as a law creating source.¹⁴⁰

According to Schmitthoff, the parallel development of the law of international trade has been observed as to both of these sources in various countries. However, the criterion of similarity and not that of uniformity is adopted by Schmitthoff in order to observe the developments more realistically.¹⁴¹ The uniformity is set as an aim and Schmitthoff believed that the evolution of an autonomous law of international trade, founded on universally accepted standards of business conduct would constitute a common platform for commercial lawyers from all countries, which would enable them to co-operate in the perfection of the legal mechanism of international trade.¹⁴² According to Schmitthoff, unification of international trade law should proceed through the work of various institutions, some of which are intergovernmental agencies and others are voluntary organizations of non-governmental character.¹⁴³ However, despite some great successes, he observed that each of these

¹³⁶ *Ibid.*, at 208

¹³⁷ *Ibid.*, at 209

¹³⁸ *Ibid.*, at 210

¹³⁹ Schmitthoff, Clive M., *Nature and Evolution of the Transnational Law of Commercial Transactions*, in Chia-Jui Cheng (ed.), *Clive M. Schmitthoff's Select Essays on International Trade Law*, Graham & Trotman, 1988, at 236

¹⁴⁰ Schmitthoff, Clive M., *The New Sources of the Law of International Trade*, in Chia-Jui Cheng (ed.), *Clive M. Schmitthoff's Select Essays on International Trade Law*, Graham & Trotman, 1988, at 149

¹⁴¹ Schmitthoff, Clive M., *The Law of International Trade, Its Growth, Formulation and Operation*, in Chia-Jui Cheng (ed.), *Clive M. Schmitthoff's Select Essays on International Trade Law*, Graham & Trotman, 1988, at 138

¹⁴² *Ibid.*, at 139

¹⁴³ As intergovernmental agencies, he listed the Institute for the Unification of Private Law (UNIDROIT), the Hague Conference on Private International Law, the Council for Mutual Economic Aid (COMECON), and the United Nation Economic Commission for Europe. As the nongovernmental organizations, he listed the International Chamber of Commerce, the Comité Maritime International, and the International Law Association.

organizations had a limited aim and a limited membership.¹⁴⁴ For example, during 1960s, International Chamber of Commerce (ICC) consisted of business organizations and businessmen of practically all countries of free market economy, while the Council for Mutual Economic Aid (COMECON) was composed of countries of centrally planned economy.

Schmitthoff identified the lack of purposeful co-operation between the formulating international agencies as the main defect in the sources of the law of international trade. In line with the aim of uniformity in international trade law, he argued that a progressive liaison and co-operation between the formulating international agencies should be the next step in the development of an autonomous law of international trade. In his view, international trade law required an international agency of the highest order, which should be charged with the task of coordinating the various activities of existing formulating agencies and suggesting to them suitable extensions of their work without actually interfering with them.¹⁴⁵ Schmitthoff eventually was involved in attempts by the United Nations to build a new framework for international economic relations. He was the main drafter of the 1966 Report of the UN Secretary-General to the UN General Assembly on the Progressive Development of the Law of International trade.¹⁴⁶ This report eventually led to the establishment of the United Nations Commission on International Trade Law (UNCITRAL), undertaking, as one of its primary tasks, the furthering of the “progressive harmonization and unification of the law of international trade by coordinating the work of organizations active in this field and encouraging co-operation among them”.¹⁴⁷

Schmitthoff based his theory of modern *lex mercatoria* on the autonomy of the parties’ will in the law of contract, which he considered as the foundation on which an autonomous law of international trade can be built. Therefore, in his view, the modern *lex mercatoria* is ultimately founded on national law, but has been developed by international business in an area in which all national sovereigns are, in principle, disinterested and leave to the parties to arrange their own legal regulation within the limits set by the requirements of municipal public policy of the *lex fori* and, possibly international public policy. Thus, it consists of uniform rules admitted by national sovereigns and developed by international commercial custom, given a definite content by the formulating agencies. This law is founded on a parallelism of national laws, but it is not derived from a supranational source.¹⁴⁸

In his view, international arbitration has made a great contribution to the development of an autonomous law of international trade due to the flexibility of arbitral approach whereby the arbitrators are inclined to take into account the trade usages more readily than the courts.¹⁴⁹ This flexibility of arbitral approach was mainly due to the uniformity as to certain principles

¹⁴⁴ Schmitthoff, Clive M., *The Unification of the Law of International Trade*, in Chia-Jui Cheng (ed.), Clive M. Schmitthoff’s *Select Essays on International Trade Law*, Graham & Trotman, 1988, at 212

¹⁴⁵ *Ibid.*, at 214

¹⁴⁶ Secretary-General, *Progressive Development of the Law of International Trade: Report of the Secretary-General of the United Nations*, U.N. Doc. A/6396 (1966).

¹⁴⁷ Article 8 (a) of the UN General Assembly Resolution 2205(XXI) of 17 December 1966

¹⁴⁸ Schmitthoff, Clive M., *Finality of Arbitral Awards and Judicial Review*, in Julian D. M. Lew (ed.), *Contemporary Problems in International Arbitration*, London, 1986, at 231

¹⁴⁹ Schmitthoff, Clive M., *The New Sources of the Law of International Trade*, in Chia-Jui Cheng (ed.), Clive M. Schmitthoff’s *Select Essays on International Trade Law*, Graham & Trotman, 1988, at 159

in arbitration laws, which has been achieved considerably through international conventions.¹⁵⁰ However, according to Schmitthoff, the contribution which arbitration makes to the maintenance of uniformity in the interpretation of international commercial customs has been negative. Since arbitration proceedings are confidential and awards are usually not published, divergences in the interpretation of international commercial customs do not become widely known. He argued that the most satisfactory solution would be the establishment of an international court of commercial arbitration as an appeal tribunal from all types of international arbitration tribunals. Such a court would be entrusted, *inter alia*, with the uniform interpretation of international standard contracts.¹⁵¹

3. Lex Mercatoria as a Method of Decision Making

Despite its romantic vision, the modern *lex mercatoria* doctrine as established by Schmitthoff and Goldman has performed an extremely important function in practice by supporting and highlighting the flexibility and practicality of dispute resolution under international arbitration. This has been conducive to the occasional application of *lex mercatoria* in international arbitration during late 1970s and 1980s.¹⁵² Some national courts have increasingly shown their willingness to acknowledge the application of *lex mercatoria* by international arbitrators.¹⁵³ Moreover, Goldman's discourse on autonomous conflict of laws was influential on a new terminology, which was first used by the 1981 French decree on international arbitration, and provided in Article 1496 of the New Code of Civil Procedure that the parties were to select the "rules of law" applicable to their dispute.¹⁵⁴ This terminology was partly followed by UNCITRAL Model Law on Arbitration 1985.¹⁵⁵ The use of "rules of law" as opposed to "the law" or "laws" when describing the rules applicable to

¹⁵⁰ Schmitthoff, Clive M., *The Unification of the Law of International Trade*, in Chia-Jui Cheng (ed.), Clive M. Schmitthoff's Select Essays on International Trade Law, Graham & Trotman, 1988, at 184

¹⁵¹ Schmitthoff, Clive M., *The Unification or Harmonization of Law By Means of Standard Contracts and General Conditions*, in Chia-Jui Cheng (ed.), Clive M. Schmitthoff's Select Essays on International Trade Law, Graham & Trotman, 1988, at 202

¹⁵² E.g. ICC Award in Case No. 3572 of 1982, *DST vs. Rakoil*, *Yearbook Commercial Arbitration*, 14 (1989), p. 111 (Absence of contractual choice of law); ICC Final Award in Case No. 3131, October 26, 1979, *Pabalk vs. Norsolor*, *Yearbook Commercial Arbitration*, 9 (1984), p. 109 (Absence of contractual choice of law); *Ad hoc Award*, November 3, 1977, *Mechema Ltd vs. S.A. Mines, Minerais et Metaux*, *Yearbook Commercial Arbitration*, 7 (1982), p. 77 (Amiable composition); ICC Award in Case No. 3540, October 3, 1980, *French Enterprise vs. Yugoslav Subcontractor*, *Yearbook Commercial Arbitration*, 7 (1982), p. 124 (Amiable composition); ICC Final Award in Case No. 3380, November 29, 1980, *Italian Enterprise vs. Syrian Enterprise*, *Yearbook Commercial Arbitration* 7 (1982), p. 116 (ambiguous choice of law)

¹⁵³ French Cour de Cassation, *Société Fougérolle v. Banque de Proche Orient*, *Revue de l'Arbitrage* 1982, p. 183; Cour d'Appel de Paris of July 13, 1989; *Compania Valenciana de Cementos Portland S.A. v. Primary Coal Inc.*, *Yearbook Commercial Arbitration*, (1991), p. 142; Austrian Supreme Court of November 18, 1982, *Norsolor S.A. v. Pabalk Ticaret Ltd.*, *Yearbook Commercial Arbitration*, (1984), p. 159; English Court of Appeal, *Deutsche Schachtbau- und Tiefbohrergesellschaft m.b.H. v. R'as al Khaimah National Oil company ('Rakoil')*, (1987) 2 Lloyd's L. Rep. 246

¹⁵⁴ Gaillard, Emmanuel & John Savage (eds.), *Fouchard, Gaillard, Goldman on International Commercial Arbitration*, Kluwer Law International, 1999, at 802, French Code of Civil Procedure (1981) Art. 1496 (1): the arbitrator shall decide the dispute in accordance with the rules of law chosen by the parties or, in the absence of such choice, in accordance with the rules of law he considers appropriate.

¹⁵⁵ UNCITRAL Model Law on Arbitration (1985) Article 28 (1) & (2): The arbitral tribunal shall decide the dispute in accordance with such rules of law as are chosen by the parties as applicable to the substance of the dispute.... Failing any designation by the parties, the arbitral tribunal shall apply the law determined by the conflict of laws rules which it considers applicable.

the substance of the dispute indicated not only the admissibility of a “dépeçage”, but also the applicability of *lex mercatoria*.

Consequently, the second generation of the proponents of modern *lex mercatoria* did not necessarily rely on the historical arguments as to the concept of *lex mercatoria* and the renewed doctrine is not based on the argument that *lex mercatoria* is an autonomous legal system. In essence, the discourses of transnational theory of arbitration and modern *lex mercatoria* converged during this period. Thus, it is argued that, whereas the initial focus was on the very existence of rules other than those found in a given legal system, after wide acceptance of the existence of various rules of *lex mercatoria* in arbitral practice, the debate has refocused on issues of sources and methodology.¹⁵⁶

Focusing on the international arbitration, the pragmatic approach of the renewed doctrine intends to determine how far the arbitrator may ignore inappropriate rules of national legal systems without jeopardizing the validity of his decision in view of its enforcement by nation states.¹⁵⁷ This approach no longer maintains the claim that national laws, by nature, are inappropriate and unable to accommodate adequately the specific needs of international commercial transactions.¹⁵⁸ Its claim is that *lex mercatoria* as a method of decision making enables the arbitrator to reject the outdated and idiosyncratic rules which may be found in certain national legal systems.¹⁵⁹ It is argued that in international arbitration, it is not important to know whether *lex mercatoria* is a legal system, since arbitrators are mostly concerned with specific problems asking for specific solutions and these solutions can be reached by using *lex mercatoria*.¹⁶⁰ According to this approach, *lex mercatoria* can be conceived as an autonomous legal system only to the extent that the term “legal system” is defined as a system of norms, which renders judicial decisions possible, and the term “autonomous” is defined as relatively independent from national laws.¹⁶¹ Thus, it is rather concerned with *lex mercatoria* as a method of decision making in international arbitration.

However, in response to the risk of arbitrary decision making under the renewed doctrine of *lex mercatoria* whereby the arbitrators are invited to ignore idiosyncratic rules of national

¹⁵⁶ Gaillard, Emmanuel, *Transnational Law: A Legal System or a Method of Decision-Making*, in Klaus Peter Berger, *The Practice of Transnational Law*, Kluwer Law International, 2001, at 54. For the same view see; De Ly Filip, *International business law and lex mercatoria*, T.M.C. Asser Instituut, 1992, at 315

¹⁵⁷ López Rodríguez, Ana M., *Lex Mercatoria and Harmonization of Contract Law in the EU*, Copenhagen: DJØF Pub., 2003, at 112

¹⁵⁸ See, in contrast, Note, *General Principles of Law in International Commercial Arbitration*, *Harvard Law Review*, 101-8 (Jun., 1988), at 1820-1821 (arguing that national laws may be inadequate for international commercial contracts since national laws may suffer from a variety of shortcomings in the context of international trade and investment, e.g. some national laws may not be sufficiently developed to provide a basis for international transactions; even sophisticated national systems may be conducive only to domestic transactions; other national laws may promote the national interest at the expense of private parties; the political realities in some nations make resort to national law unacceptably risky from the standpoint of a private contracting party, even though the law is acceptable at the time of contracting .)

¹⁵⁹ Gaillard, Emmanuel, *Transnational Law: A Legal System or a Method of Decision-Making*, in Klaus Peter Berger, *The Practice of Transnational Law*, Kluwer Law International, 2001, at 55

¹⁶⁰ Frick, Joachim G., *Arbitration and Complex International Contracts: with special emphasis on the determination of the applicable substantive law and on the adaptation of contracts to changed circumstances*, The Hague, Kluwer Law International, 2001, at 110

¹⁶¹ Mertens, H.J., *Lex Mercatoria: A Self-applying System Beyond National Law?*, in Gunther Teubner (ed.), *Global Law Without a State*, Dartmouth, 1997, at 32

laws, it is argued that the mere absence of an express choice of law clause does not necessarily imply that the parties intended to withdraw their relationship from national laws or that they meant that *lex mercatoria* should apply. Accordingly, it is submitted that even if the choice of law rules of the applicable arbitration law allows the arbitrator to apply *lex mercatoria* as the governing law, there should be other possible reasons for such application; either no national law should clearly be the governing law or the interpretation of parties' intention should indicate that they do not want any national law to govern their contract.¹⁶²

In general, the proponents of *lex mercatoria* as a method of decision making generally agree on the sources of *lex mercatoria*, namely the general principles of law and trade usages. There is also a general distinction between these sources. While general principles of law, or more generally transnational legal rules, arise out of international commerce and their application is enabled by the terminology of "rules of law", trade usages normally constitute part of the parties' agreement through their implied intentions, unless they are excluded by the parties. Thus, unlike transnational rules of law, trade usage is internal, not external to the parties' agreement. For some, trade usages, in this sense, do not even constitute a source of *lex mercatoria* in a strict sense.¹⁶³ Others argued that the expression *lex mercatoria* may only cover the notion of international trade usages sufficiently established to warrant that parties to international contracts be considered bound by them. In the latter view, *lex mercatoria* may thus be seen essentially as an expansion of the notion of usages to encompass particular contracts whose specificity is that they are international. Accordingly, *lex mercatoria* simply requires the recognition of the transnational context of the underlying transactions in the interpretation of international contracts by arbitral tribunals.¹⁶⁴

Apart from such strict understandings of *lex mercatoria*, the proponents of *lex mercatoria* in the second generation are generally more interested in the question of which method of decision making the arbitrator should use in order to find and ascertain the rules of *lex mercatoria*, which would be in line with the intentions and expectations of merchants. The method to be used for the application of *lex mercatoria* is particularly deemed important considering the fact that the application of *lex mercatoria* rules always needs specific justification, since these rules have not been passed by way of traditional legislative procedure.¹⁶⁵ The proposed methods by the second generation have mostly focused on the specific techniques derived from comparative analysis.

Gaillard argues that *lex mercatoria* as a method of decision making consists "in deriving the substantive solution to the legal issue at hand not from a particular law selected by a traditional choice of law process, but through a comparative law analysis which will enable the arbitrators to apply the rule which is the most widely accepted".¹⁶⁶ In his view, the task of

¹⁶² Lowenfeld, A. F., *Lex Mercatoria: An Arbitrator's View*, *Arbitration International* 1990, at 146

¹⁶³ Derains, Yves & Eric A. Schwartz, *A Guide to the New ICC Rules of Arbitration*, Kluwer Law International, 1998, at 225

¹⁶⁴ Craig, W. Laurence, William W. Park & Jan Paulsson, *International Chamber of Commerce Arbitration*, Oceana Publications, 3rd ed., 2000, at 633-634

¹⁶⁵ Mertens, H.J., *Lex Mercatoria: A Self-applying System Beyond National Law?*, in Gunther Teubner (ed.), *Global Law Without a State*, Dartmouth, 1997, at 40

¹⁶⁶ Gaillard, Emmanuel, *Transnational Law: A Legal System or a Method of Decision-Making*, in Klaus Peter Berger, *The Practice of Transnational Law*, Kluwer Law International, 2001, at 56

the arbitrator should be to assess whether or not the rule invoked by a party reflects a norm supported by a sufficiently wide recognition of national legal systems.¹⁶⁷

Langen sets forth certain steps of a method of decision-making. First, the arbitrator should ascertain the pertinent facts, including the meaning of agreements, by means of transnationally valid rules of interpretation.¹⁶⁸ Secondly, the arbitrator should discover the applicable transnational rules by means of the comparative method from the national legal orders of the parties to the transaction to the extent that they are similar or harmonious.¹⁶⁹ Finally, the arbitrator should tailor a proper transnational rule for issues where there is an irreducible difference in the national legal systems of the parties by searching for a middle ground or resorting to the transnationally-accepted general principles of law.¹⁷⁰

According to Rubino-Sammartano, transnational disputes may be solved by reference to the *trunc commun* of the national legal systems involved, i.e., application of principles common to these legal systems. The *trunc commun* consists in identifying a tacit choice by the parties when the parties choose none of their respective national laws nor the laws of a third country. This is based on the assumption that each party to an international commercial contract would choose its own national law to govern that contract and avoid finding himself subject to a legal system that he did not know. Thus under *trunc commun*, the common parts of parties' respective legal systems will remain applicable. The arbitrator will take aspiration from the principles of those legal systems and, in the absence, from the current usages in the countries to which the parties belong in order to find a solution which is as near as possible to the expectations of the parties. If this were not achievable, the arbitrator might apply, as to each contractual duty, the national law of the party which is under such a duty.¹⁷¹ Essentially, in this view, the concept of *lex mercatoria* is a residual notion, namely in the absence of the possibility of identifying an express or tacit choice of the parties.

Berger considers the "functional legal comparison" of national laws as the methodical foundation of the *lex mercatoria* doctrine.¹⁷² The method of functional legal comparison starts with the examination of concrete commercial realities of a certain legal problem. Then it collects and selects the functionally similar solutions to be found in various major national legal systems and presents a solution that is based on a synthesis of the various domestic laws.¹⁷³ In his view, functional legal comparison has also a sociological nature since the legal institutions and provisions under review are not considered in an isolated manner, but are seen as part of the overall context of the legal and social order in which they are embedded. Thus, particular needs, usages, customs and practices of commerce are automatically included in this comparative analysis.¹⁷⁴

¹⁶⁷ Ibid., at 58

¹⁶⁸ Langen, Eugen, *Transnational Commercial Law*, A. W. Sijthoff, 1973, at 203-211

¹⁶⁹ Ibid., at 211-214

¹⁷⁰ Ibid., at 221-225

¹⁷¹ Rubino-Sammartano, Mauro, *International Arbitration Law and Practice*, Kluwer Law International, 2nd rev. ed., 2001, at 446-455

¹⁷² Berger, Klaus Peter, *The Creeping Codification of the Lex Mercatoria*, Kluwer Law International, The Hague, 1999, at 44

¹⁷³ Ibid., at 48

¹⁷⁴ Ibid., at 53

The case for method of decision making based on general principles of law and comparative analysis has been supported by the availability of more extensive and accessible comparative law sources.¹⁷⁵ It is argued that both the UNIDROIT Principles of International Commercial Contracts (UNIDROIT Principles), and the Principles of European Contract Law (PECL), offer “a solid argument to counter the frequently stated objection by its detractors that the *lex mercatoria* is a vague and elusive piece of theory.”¹⁷⁶ To this list, one may add the principles provided by the Transnational Law Database (TLDB or TransLex) which was launched in 2001 by the Center of Transnational Law (CENTRAL) hosted by the University of Münster, under the auspices of Berger and his team. This online database, whose access is free of charge, contains a list of principles and rules of *lex mercatoria* with concrete examples of their application in practice.¹⁷⁷ It is believed that those principles and rules can provide international arbitrators with a perfect and eminently practical tool for their comparative decision making.¹⁷⁸

The specific justification for the comparative approach and use of general principles is not clearly described in the doctrine, in contrast to the approach of the first generation of the proponents of *lex mercatoria*, which sought the sources of *lex mercatoria* primarily in the collective will of the mercantile community or in the workings of transnational organizations. Lord Mustill, a critique of modern *lex mercatoria* doctrine, states that the justification should be “found in the idea that the rules of the *lex mercatoria* exist in *gremio legis* as a complete, albeit inexplicit, and evolving whole; that they are received, at least in part, into individual national laws or are reflected by them; and that by careful analysis the dross of the rigidities, impracticalities, and distinctions imposed by each individual national law can be purged away, leaving behind the pure gold of the underlying international legal order.”¹⁷⁹ Berger explains the justification for this approach primarily by the importance attached to the cultural and legal diversity in the international arbitration and by the ability of comparative law to provide justice to the parties from different cultural and legal backgrounds and to all legal systems involved. He argues that this comparative approach may avoid problems about the enforcement of the award by the states or will even lead to voluntary compliance with the award in the pre-enforcement stage.¹⁸⁰ Alternatively, Blessing states that it is “necessary for an arbitral tribunal to seek a resolution and decision which is in harmony with fundamental notions and with those generally recognized principles of law in which both parties have confidence when entering into contract.”¹⁸¹

¹⁷⁵ It has been observed that arbitrators have made use of the International Encyclopedia of Comparative Law to find the general principles of the major legal systems of the world, e.g. ICC Award No. 4505 (1984) (unpublished) cited by Lando, Ole, *The Lex Mercatoria in International Commercial Arbitration*, *International and Comparative Law Quarterly*, 34 (1985), at 750

¹⁷⁶ Boele-Woelki, Katharina, *Principles and Private International Law*, *Uniform Law Review*, (1996), at 658

¹⁷⁷ <http://www.trans-lex.org/>

¹⁷⁸ Berger, Klaus Peter, *International Arbitral Practice and the UNIDROIT Principles of International Commercial Contracts*, *American Journal of Comparative Law*, 46-1 (1998), at 149

¹⁷⁹ Mustill, Michael, *The New Lex Mercatoria: The First Twenty-five Years*, *Arbitration International*, (1988), at 92

¹⁸⁰ Berger, Klaus Peter, *International Arbitral Practice and the UNIDROIT Principles of International Commercial Contracts*, *American Journal of Comparative Law*, 46-1 (1998), at 131

¹⁸¹ Blessing, Marc, *Choice of Substantive Law in International Arbitration*, *Journal of International Arbitration*, 14-2 (1997), at 42

b. A New Theory of Lex Mercatoria

i. Liberal Order of International Commerce

The concept of *lex mercatoria* has been used for the support of political arguments as to the legal regulation of mercantile matters since the seventeenth century. In the modern doctrine, although both Goldman and Schmitthoff implied that *lex mercatoria* transcends the political barriers due to its universal nature by adopting the romantic vision of the medieval *lex mercatoria*, *lex mercatoria*, in their understanding, still exists in a political context, in a particular form of liberalism, which relies on the primacy of the freedom of the individuals and individual choice that distinguishes liberalism from socialism or nationalism.

Schmitthoff's approach can be defined as neoliberal institutionalist, which puts emphasis on mechanisms of intergovernmental policy cooperation in order to achieve and maintain a liberal order in the context of international commerce.¹⁸² This perspective is concerned with what governments do in the international order, and not within the state. The institutional mechanisms seek to manage the establishment of liberal internationalism, regardless of the political division at the level of nation state. In Schmitthoff's understanding, *lex mercatoria* is an intended product of the merchants, who developed rules for international commerce in international organizations, and of the states which planned the partial opening of their legal systems to such rules. He believed that the international institutions, from conventions to non-governmental or intergovernmental organizations, make a difference in international commerce by stabilizing expectations of international merchants, who would use their party autonomy to achieve an autonomous law of international commerce. The most concrete achievement of the liberal discourse of Schmitthoff's law merchant is the establishment of UNCITRAL which have contributed to achieving a liberal order of international commerce through the harmonization of some important parts of national laws concerning international commerce, such as the Model Law on International Commercial Arbitration and the Convention on Contracts for the International Sale of Goods (CISG).

Goldman considered *lex mercatoria* as a remedy against the disintegration of international community of merchants and transnational customary law. It represents a solution against the control claims of political entities over the order of international commerce. Due to the unsatisfactory results arising from these control claims, he advocated the role of transnational actors being directly instrumental in reintegration of transnational customary law. In his view, transnational actors should participate directly and decisively in the development of international commerce, while states should play a role of limited significance by policing through the concepts of international or transnational public policy or by elaborating default rules through international conventions. His approach can be defined as transnational liberalism. In his view, transnational institutions, such as the mercantile community, transnational customary law, non-governmental organizations and the concept of transnational public policy, become the main means of stabilizing the expectations of international merchants. His liberal discourse of *lex mercatoria* has been surely influential on the conflict of laws methodology in international arbitration in those national legal systems and arbitral institutions, which admit the applicability of non-national legal norms.

¹⁸² Sally, Razeen, *Classical Liberalism and International Economic Order: Studies in Theory and Intellectual History*, Routledge, 1998, at 177

Both Schmitthoff and Goldman argued in favor of the values of liberalism and their discourses have had some material effects on the regulation of international commerce. However, in their search for simple and uniform sources of law applicable everywhere and in all ages, they seem to have neglected the complexities of history and circumstance, and overlook differences of time and place. They used ambitious theoretical devices to determine and stabilize the expectations of international merchants. Their ambition is understandable in view of the political division of the world at their time. However, the experience with *lex mercatoria* in practice since late 1980s requires a more realist approach and an understanding of classical liberalism.

Classical liberalism does not implicitly assume that the international commercial order operates autonomously under its own laws. It takes into account the “interdependence of orders”.¹⁸³ In this context, such interdependence reveals itself through the interpenetration and mutual reinforcement among the transnational customary law, general principles of law and national legal orders as well as international legal order. The pragmatic approach of the proponents of *lex mercatoria* as a method of decision making aligns itself with classical liberalism to some extent. However, their discourses apparently are based on the assumption that the applicability of *lex mercatoria* was enabled solely by the use of ‘rules of law’ terminology in arbitration laws. Thus, some still consider the situations in which arbitrators are required to apply, in the absence of a choice expressed by the parties, a ‘law’ and not mere ‘rules of law’, and assess whether *lex mercatoria* as a method of decision making could nonetheless qualify as a substantive law and be applied as the ‘law’ selected by the arbitrators. In such assessments, *lex mercatoria* is compared to national laws, leading to the conclusion that *lex mercatoria* is able to stabilize the normative expectations of international merchants. For instance, it is argued that *lex mercatoria*, even if not a genuine legal system, do perform, in actual practice, a function strikingly similar to that of a genuine legal system by performing four characteristics that are generally found in a legal system: its completeness, its structured character, its ability to evolve and its predictability.¹⁸⁴ In general, the proponents of *lex mercatoria* as a method of decision making argue for the application of rules in the form of general principles of law, derived from comparative analysis of national laws. In their view, the contractual intentions and expectations of the international merchants would be respected through the application of common rules in the form of general principles of law by arbitral tribunals. These common rules, restated by international organizations and concretized by arbitral awards, would ultimately stabilize the expectations of merchants.

The modern *lex mercatoria* doctrine, either as a legal system or as a method of decision making, sets the stabilization of mercantile expectations as an aim for *lex mercatoria* to have an *ex ante* effect on the incentives and behaviors of international merchants as well as their contracts, similar to the effect of national legal systems on their subjects. Therefore, the concept of *lex mercatoria* is always closely connected to the harmonization and unification of the law.¹⁸⁵ This understanding is supported by the allegedly common or universal nature of *lex mercatoria*, which is seen as a prerequisite for the development of international commerce under the influence of the romantic vision of medieval *lex mercatoria*. The merchants themselves are considered as the main potential source of legal uniformity for such

¹⁸³ *Ibid.*, at 18

¹⁸⁴ Gaillard, Emmanuel, *Transnational Law: A Legal System or a Method of Decision-Making*, in Klaus Peter Berger, *The Practice of Transnational Law*, Kluwer Law International, 2001, at 65

¹⁸⁵ Berger, Klaus Peter, *The Creeping Codification of the Lex Mercatoria*, Kluwer Law International, The Hague, 1999, at 44

development.¹⁸⁶ However, the realist vision of medieval *lex mercatoria* shows that the gist of *lex mercatoria* during the Middle Ages was how the whole diversity of needs and expectations of merchants could be accommodated in and reconciled with the contemporary legal framework through the general concept of *lex mercatoria*.

Under classical liberalism, it is possible to understand such an interdependent legal order that the diversity of the needs and expectations of merchants can thrive, since classical liberalism requires a complex and realistic model of merchant in mind. One should not presuppose an *ex ante* rationality motivating all international merchants. It should be considered that the elements of the order drive them into gradually becoming more rational in matching means to ends, and that rationality improves *ex post* by force of knowledge of circumstance.¹⁸⁷ A classical liberalist account of *lex mercatoria* highlights the impossibility of perfect knowledge in the context of a spontaneous legal order, which does not have a deliberate purpose, and where the stabilization of expectations is not an aim, but may or may not occur as a result.

As an influential proponent of classical liberalist ideas, Hayek argues that, the knowledge of the circumstances of which an individual must make use in a society never exists in concentrated or integrated form, but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess. The knowledge is so widely distributed throughout the society that no single person or single organization could acquire enough of it to establish an order of actions in such a society under a specific and deliberate purpose.¹⁸⁸ The division of labor has brought about this fragmentation of knowledge, whereby each member of society can have only a small fraction of the knowledge possessed by all, and that each is therefore ignorant of most of the facts on which the working of society rests.¹⁸⁹ Hayek distinguishes between scientific knowledge and unorganized knowledge of the particular circumstances of time and place, which cannot possibly be called scientific in the sense of knowledge of general rules. According to Hayek, so far as scientific knowledge is concerned, a body of suitably chosen experts may be in the best position to command all the best knowledge available. However, in the case of knowledge of the particular circumstances of time and place, practically every individual has some advantage over all others in that he possesses unique knowledge, of which beneficial use might be made, but of which use can be made only if the decisions depending on it are left to him or are made with his active cooperation.¹⁹⁰

In Hayek's view, the order in a society, which greatly increased the effectiveness of individual action, is not due only to institutions and practices, which was designed for an explicit purpose on the basis of scientific knowledge, but is largely due to a process where practices, which was first adopted for other reasons, or even purely accidentally, were

¹⁸⁶ Bruce L. Benson The Spontaneous Evolution of Commercial Law, *Southern Economic Journal*, Vol. 55, No. 3 (Jan., 1989), at 659

¹⁸⁷ Sally, Razeen, *Classical Liberalism and International Economic Order: Studies in Theory and Intellectual History*, Routledge, 1998, at 19

¹⁸⁸ Posner, Richard A., Hayek, Law, and Cognition, *NYU Journal of Law & Liberty*, 1 (2005), at 157

¹⁸⁹ Hayek, Friedrich A. von, *Law, Legislation and Liberty: A New Statement of the Liberal Principles of Justice and Political Economy*, Vol. 1: Rules and Order, London: Routledge, 1998, at 14

¹⁹⁰ Hayek, Friedrich A. von, The Use of Knowledge in Society, *American Economic Review*, 35-4 (Sep., 1945), at 521

preserved because they enabled the group in which they had arisen to prevail over others.¹⁹¹ Thus, the order is a process of the observance, spreading, transmission and development of practices, which have prevailed because they increased the chances of achieving diverse and respective aims of the individuals who belong to a society. According to Hayek, this process does not result in articulated knowledge in the first instance, but produces a knowledge, which the individual does not or cannot state in words, but is always able to honor them in practice. Thus, the actions of individuals owe their effectiveness not only to articulated knowledge governing those actions by known aims or known connections between means and ends, but also to tacit knowledge in the form of rules of conduct, whose purpose or origin is often unknown to individuals, and which have been neither invented nor have to be observed with any such purpose in view.¹⁹²

The individuals in a society need those rules of conduct in order to overcome the deficits in their knowledge. In this context, Hayek mainly attributes the success of an individual's actions in achieving his aims to his capacity to adapt his actions both to the particular facts which he knows and to other facts he does not or cannot know. According to Hayek, this adaptation to the general circumstances that surround an individual is caused by his observance of rules of conduct, which he has not designed and often does not even know explicitly. While complete rationality of action demands complete knowledge of all the relevant facts, the success of individual action in a society, in this understanding, depends on more particular facts than anyone can possibly know, so most of the rules of conduct, which govern actions of individuals, are in fact adaptations to the impossibility of anyone taking conscious account of all the particular facts, which enter into the order of society.¹⁹³

These ideas influenced Hayek's legal theory. He drew attention to the necessity of an insight, in legal theory, into the limitations of the powers of conscious reason and into the assistance the individuals obtain from processes of which they are not aware. Such an insight leads to the recognition that abstract concepts are a means to cope with the complexity of the concrete, which the mind is not capable of fully mastering, and reveals that abstractions are the indispensable means of the mind, which enable it to deal with a reality it cannot fully comprehend. In this sense, abstractness is a characteristic possessed by all the processes, which determine action long before they appear in conscious thought or are articulated in language. The abstractions help the individuals to understand the basic principles on which the order rests and give an idea about the success of individual action. These basic principles enable the individuals to honor the rules of conduct in practice and form the basis of individual's capacity to act successfully in a world very imperfectly known to him by adapting to his ignorance of most of the particular facts of his surroundings.¹⁹⁴ While the intellect is not capable of grasping reality in all its complexity and the use of basic principles extends the scope of phenomena which can be master intellectually, this necessarily limits to certain general features the degree to which individuals can foresee the effects of their actions, and the degree to which they can shape the world to their liking. However, this resulting uncertainty is a consequence of liberalism in the sense of a restriction of the deliberate control of the overall order of society to the enforcement of such general rules of conduct as are

¹⁹¹ Hayek, Friedrich A. von, *Law, Legislation and Liberty: A New Statement of the Liberal Principles of Justice and Political Economy*, Vol. 1: Rules and Order, London: Routledge, 1998, at 9

¹⁹² *Ibid.*, at 11

¹⁹³ *Ibid.*, at 13

¹⁹⁴ *Ibid.*, at 29-30

necessary for the formation of a spontaneous order, the details of which individuals cannot foresee.¹⁹⁵ For Hayek, the abstractions and the inarticulate knowledge provided a reason why a liberal order is superior to alternatives since a liberal order creates an appropriate environment for making use of the knowledge of particular circumstances of time and place. The spontaneous order is both a means and an end, because of the dispersed and tacit nature of most knowledge that keeps a society together.¹⁹⁶

In the society, where international merchants operate, the spontaneous order arises as a state of affairs, in which a multiplicity of elements of various kinds, such as states, transnational organizations and merchants, are so related to each other that the individuals may learn from their acquaintance with some spatial or temporal part of the whole to form correct expectations concerning the rest, or at least expectations which have a good chance of proving correct.¹⁹⁷ For the effective pursuit of his aims, an individual merchant in such a society depends on the correspondence of the expectations concerning the actions of others on which his plans are based with what they will really do. This correspondence of the expectations that determine the actions of different individuals is the form in which order manifests itself. This order of meaningful actions does not manifest itself to an individual's senses, but has to be based on abstract relations, which can be traced and reconstructed by his intellect. The spontaneous order, not having been made, does not have a particular purpose, but the individuals' awareness of its existence may be extremely important for their successful pursuit of a great variety of different purposes.¹⁹⁸

Accordingly, *lex mercatoria*, as the law of the spontaneous order of actions, need not exist in articulated forms that stabilize expectations of international merchants *ex ante* since it is sufficient that they actually behave in a manner which can be described by some rules, making it possible to discover such rules that the actions of the individuals in fact follow.¹⁹⁹ These rules of *lex mercatoria* can be discovered through an abstract reasoning that mentally reconstructs the knowledge of circumstances of time and place possessed by the parties to a particular dispute on the basis of the basic principles on which the order of international commerce rests. The function of *lex mercatoria* is the preservation and restoration of this order, which consists of a system of abstract relations between elements, whose abstractness enables the order to persist while all the particular elements it comprise change. The order will always be an adaptation to a large number of particular facts which will not be known in their totality to anyone. In this order, there will naturally be some rules, which are the products of deliberate design, and there will always be deliberate organizations in which groups of individuals will join for the achievement of some particular ends. However, those rules and organizations will be integrated into a more comprehensive spontaneous order, and the coordination of the activities of all these separate organizations, as well as of the separate individuals, will be brought about by the forces making for a spontaneous order.²⁰⁰

¹⁹⁵ *Ibid.*, at 32

¹⁹⁶ Oguz, Fuat, Hayek on tacit knowledge, *Journal of Institutional Economics*, 6-2 (2010), at 159

¹⁹⁷ Hayek, Friedrich A. von, *Law, Legislation and Liberty: A New Statement of the Liberal Principles of Justice and Political Economy*, Vol. 1: Rules and Order, London: Routledge, 1998, at 36

¹⁹⁸ *Ibid.*, at 38

¹⁹⁹ *Ibid.*, at 43

²⁰⁰ *Ibid.*, at 46

For the regulation of international commerce, there is no authority or organization capable of achieving a coherent whole by just fitting together any elements it likes, since the appropriateness of any particular arrangement within a spontaneous order will depend on all the rest of it, and that any particular change an organization makes in it will tell little about how it would operate in a different setting. An order of the complexity of international commerce can be designed neither as a whole, nor by shaping each part separately without regard to the rest, but only by consistently adhering to certain principles throughout a process of evolution.²⁰¹ Thus, *lex mercatoria* mainly consists of principles helping individuals to discover such rules that govern their conduct towards each other, apply to an unknown number of further instances, and enable an order of actions to form itself, in which the individuals can make feasible plans. Unlike a legal system functioning through an organization *ex ante*, i.e. before an individual act, *lex mercatoria* functions through a judicial process *ex post*, after a particular dispute between the elements disturbs the spontaneous order. The applicable rules will be discovered, articulated and applied through a judicial mechanism by the decision maker, exercising an abstract reasoning that utilizes the knowledge of particular circumstances of time and place with the cooperation of those who possess it, for the purpose of preserving an order of action which nobody had created, but which was disturbed by certain kinds of behavior that made it necessary to define those kinds of behavior which had to be repressed on the basis of its basic principles.²⁰² Due to its *ex post* nature, it is necessarily abstract and uncertain from an *ex ante* perspective.

Essentially, since the seventeenth century, the romantic vision of medieval *lex mercatoria* have been developed in response to the disturbances in the spontaneous order, because the authorities, who tend to try to turn their domain into an organization, have attempted to make laws without taking into account the basic principles on which this order rests and by substituting their knowledge articulated in their laws for the knowledge of particular circumstances of time and place. In the sixteenth and seventeenth centuries, the proponents of *lex mercatoria* opposed to the rise of constructivist rationalism, in domestic laws, which assumed that all law should be the product of a deliberate construction based on empirical knowledge of the effects it would have on the achievement of desirable purposes, but it was realized that it would be impossible to make the social order wholly dependent on design without at the same time greatly restricting the utilization of available knowledge.²⁰³ Thus, these early proponents of *lex mercatoria* tried to protect the capacity for abstractions possessed by the medieval mercantile courts, which took into account or articulated the knowledge of the parties to a particular dispute, applied such rules that were not developed with any deliberate purpose, but served to maintain and improve the order of actions, which the already existing rules made possible and in which the individual merchants were able to make feasible plans. In the nineteenth century of Germany, the lawyers thought that the use of Roman law displacing customary law that grew out of the soul of the Volk similarly restricted the utilization of knowledge of particular circumstances of time and place on the basis of the capacity of decision makers for abstractions, and they argued, on the basis of the concept of *lex mercatoria* that, in commercial matters, judges must be able to use their common sense and to disregard all juristic notions arising from Roman law in order properly to grasp and master the nature of the transaction. Later, some lawyers from common law tradition opposed to its constricting formalism and promoted *lex mercatoria* as the customary law discovered by the sound instincts of decision makers specialized in commercial matters.

²⁰¹ *Ibid.*, at 60

²⁰² *Ibid.*, at 88

²⁰³ *Ibid.*, at 5, 21

In the twentieth century, the modern *lex mercatoria* doctrine emerged for the restoration of the liberal and spontaneous order of international commerce, which was greatly disturbed by the political divisions and conflicts between the states. The traditional conflict of laws was indifferent to these issues in the determination of the applicable law. In this context, the spontaneous international commercial order was most obviously attacked when some states attempted to repudiate their contractual obligations towards foreign investors in contravention to the liberal principles of contract law. These host states claimed the application of the laws made by their own organizations in an attempt to overcome the liberal principles of contract law, which bound them to freely undertaken contractual obligations. The arbitral tribunals resolved the disputes between those states and private parties on the basis of abstract reasoning and applied general principles of law by disregarding the traditional conflict of laws regimes and the collective actions of some states to change the existing order profoundly. The practice of transnational arbitration found support from the first generation of the proponents of *lex mercatoria* doctrine, which used the concept of *lex mercatoria* in order to extend this practice to the resolution of disputes between private parties. The second generation also followed this approach with their understanding of *lex mercatoria* as a method for decision making whereby the idiosyncratic or outdated rules of law found in a national law can be disregarded in order to preserve the spontaneous order of international commerce. Idiosyncrasies in a national law occur when the law maker in promulgating rules follows a purpose, which upholds the interests of its organization in a manner incompatible with the abstract relations constituting the spontaneous order of international commerce. Thus, although the proponents of the second generation were not clear on the justification for the application of the comparative legal analysis and general principles of law, such applications reflect the essence of the decision maker's exercise of abstract reasoning in utilizing the knowledge of the parties to a particular contract, for discovering such rules that are common to the expectations of both parties in the particular circumstances of the case, and enforcing this established manner of doing things in the order of international commerce.

The decision maker applying *lex mercatoria* is committed to maintaining a going order of action. However, this does not mean that his aim is to preserve any status quo in the relations between the elements of that order. On the contrary, an essential attribute of the order which *lex mercatoria* serves that the order can be maintained only by constant changes in the particulars. The decision maker applying *lex mercatoria* is concerned only with the abstract relations, which must be preserved while the particulars change. This is a dynamic order which will be maintained only by continuous changes in the positions of particular elements. Thus, although the decision maker is not committed to upholding a particular status quo, he is committed to upholding the principles on which the existing order is based. The decision maker serves an existing but always imperfect abstract order which is not intended to serve a particular purpose. It is only the abstract features of the order which can serve as the basis of the decisions of individuals in unforeseeable future conditions, and which therefore can determine an enduring order.²⁰⁴ Only these abstract features can constitute a true common interest of the members of an international mercantile community, who do not pursue any particular common purposes but merely desire appropriate means for the pursuit of their respective individual purposes.

The main concern of the decision maker applying *lex mercatoria* must be the expectations which the parties in a transaction would have reasonably formed on the basis of their

²⁰⁴ *Ibid.*, at 121

knowledge of the particular circumstances of time and place and the basic principles that the ongoing order of actions rests on. In deciding what expectations were reasonable, the decision maker takes into account such rules that could determine the expectations of the parties to a particular transaction and such facts that may be presumed to have been known to them. The parties to a particular dispute would have been able to form common expectations if they interpreted the situation in terms of what was thought to be appropriate conduct and which need not have been known to them in the form of a rule articulated *ex ante*. In case of disagreement between the parties, the task of the decision maker will be to tell them what ought to have guided their expectations, not because anyone had told them *ex ante* that this was the rule, but because this was the established rule in the particular circumstances which they ought to have known.²⁰⁵ The order that the decision maker applying *lex mercatoria* is to maintain is not a particular state of things, but the regularity of a process which rests on some of the expectations of the acting individuals being protected from interference by others. The decision maker applying *lex mercatoria* decides in a manner which will correspond to what the reasonable people of the same kind as the actual parties would have expected in the same circumstances. He will have to draw his conclusions from a sort of situational logic, based on the requirements of an existing order of actions which is the undesigned result of all the established rules which he must discover.

However, the spontaneous process of growth in such liberalism may lead into an impasse from which it cannot extricate itself by its own forces or which it will, at least, not correct quickly enough.²⁰⁶ This situation may require the deliberate actions of organizations to interfere in the order. Particularly, the state measures, which are deliberately taken for the preservation or improvement of the internal order of the state or the overall order of international commerce, may help the spontaneous order of international commerce to find a direction in reflecting the conditions that have changed. However, while the states are one of the elements of the spontaneous order of international commerce, it can never be advantageous to interfere in the rules governing a spontaneous order by the isolated commands of individual states concerning those activities where the actions are guided by the established rules. Such isolated commands requiring specific actions by members of the spontaneous order can never improve but disrupt that order since they will refer to a part of a system of interdependent actions determined by knowledge and guided by purposes known only to the several acting persons but not to the directing authority. The spontaneous order arises from each element balancing all the various factors operating on it and by adjusting all its various actions to each other. This balance will be destroyed if some of the actions are determined by another agency on the basis of different knowledge and in the service of idiosyncratic ends. Thus, although it is possible to improve a spontaneous order by revising the rules on which it rests, and to supplement its results by the efforts of various organizations, the results cannot be improved by isolated commands that deprive its members of the possibility of using their knowledge for their purposes.

This does not necessarily mean a neoliberal institutionalist stance, which would argue that the states should act collectively in each instance of interfering in the spontaneous process of international commerce. There should at least be some form of correspondence between the measures that are taken by individual states for the purpose of protecting their internal orders or the order of international commerce. Some aspect of those measures should be identifiable, as having effect, in the form of established rules, on the expectations of the parties to a

²⁰⁵ *Ibid.*, at 86

²⁰⁶ *Ibid.*, at 49

particular international commercial contract, on the basis of the basic principles that the going order of international commerce is based. The proponents of modern *lex mercatoria* doctrine, since the beginning, have been aware of the necessity of state action for improving the existing order of international commerce, and they have argued in favor of those intellectual mechanisms for the decision makers to distinguish between isolated commands and established rules, such as through the concepts of external, transnational or international public policy. These mechanisms, in the end, are fundamental to the peaceful development of the order of international commerce.

While modern *lex mercatoria* doctrine has reached some conclusions that correctly identified the problems with the order of international commerce in the paradigm of liberalism, its theoretical background, which reflects the romantic vision of medieval *lex mercatoria*, explains the concept of *lex mercatoria* on the basis of its customary and universal character. However, in the absence of an organization, which regulates the actions of individual members, each member's knowledge about the law of this order is restricted to the general character of the order. The members can know at most the rules observed by the individuals of various kinds, but not all the individuals and never all the particular circumstances in which each of them is placed. In this spontaneous order, all of its elements, including the states and international merchants, determine its abstract features, and leave the particulars to circumstances which they do not know. Thus, by relying on the spontaneously ordering forces, they can extend the scope or range of the order which they may induce to form, because its particular manifestation will depend on many more circumstances than can be known to them. Such an order will utilize the separate knowledge of all states and merchants, without this knowledge ever being universal in the sense of concentrated in a single mind.²⁰⁷ Consequently, the degree of power of *ex ante* control over the extended and more complex order will be much smaller than that which could be exercised over a made order. There will be many aspects of it over which the states and merchants will possess no control at all, since the control will be deferred to the *ex post* processes, which utilize the dispersed knowledge when confronted with a particular case. If any authority claims to assume control on those aspects, it shall not be able to do so, without interfering with and impeding the forces producing the spontaneous order.²⁰⁸

Accordingly, the society of international commerce and *lex mercatoria* can only be seen as the product of the individuals' capacity for abstract thought and individual's growing capacity to communicate abstract thought.²⁰⁹ However, the failure to recognize that abstractions in *ex post* processes help the reason go further than it could if it tried to master all the particulars *ex ante* has led to the claims of the modern *lex mercatoria* doctrine that are inimical to abstract reason and overlook the abstract character of *lex mercatoria*. The failure to understand this abstract character has led to inapt comparisons of *lex mercatoria* to national laws and defining *lex mercatoria* by means of a restrictive approach to its sources. For instance, Schmitthoff's theory of law merchant is strict about the articulation of trade usages by international organizations for their normative force as rules of *lex mercatoria*. On the other hand, Goldman restricts the sources of *lex mercatoria* to customs and general principles of law originating in transnational institutions and denies any role to states in promulgating default rules which can become a source of *lex mercatoria*. Finally, the proponents from second generation of modern

²⁰⁷ *Ibid.*, at 41

²⁰⁸ *Ibid.*, at 42

²⁰⁹ *Ibid.*, at 33

lex mercatoria doctrine, much like their predecessors, limit their analysis of sources of lex mercatoria to the non-national sources in arbitration. Thus, modern lex mercatoria doctrine does not consider comparative analysis or general principles of conflict of laws as a potential source of lex mercatoria in the form of established rules that produce and maintain a spontaneous order. In general, modern lex mercatoria doctrine neglects the possibility that the abstract and ex post character of lex mercatoria may lead the decision maker to apply even national rules as indications of the reasonable expectations of the parties in the particular circumstances of the case.

In essence, the “universality” depends on the universe; each contractual dispute exists in its own universe, which can be determined by the knowledge of the particular circumstances of the time and place and which, therefore, contains a particular set of circumstances, such as different nationalities of the parties, different places of performance, different trade usages and customs, different trade sectors and different contractual purposes. But each of these universes, which are guided by purposes known only to the several acting persons but not to the entire society, exists within the same system of abstract relations, where the particularities have constantly interacted. Much of the knowledge that is actually utilized in each universe consists in a technique of thought, which requires the individual decision maker to resolve disputes by mentally reconstructing this technique when he is confronted with the actual constellations of circumstances. Thus, lex mercatoria can only be defined by this abstract form of reasoning rather than its sources or other ex ante characteristics. The function of lex mercatoria is to enable individuals to make feasible plans in the context of the spontaneous order of international commerce by directing the ex post decision makers towards finding the established rules for the parties to a particular transaction in resolving their dispute, but this function does not depend on the existence of common rules for all international merchants or a certain group of international merchants, other than a common desire of international merchants for the appropriate means for the successful pursuit of their individual purposes, which is the essence of liberalism.

Thus, the theory of lex mercatoria should account for the character of the spontaneous and liberal order of international commerce, which it serves to maintain and restore. Modern lex mercatoria doctrine particularly tends to miss the tacit and dispersed nature of the knowledge in this order, of which international merchants have to make use in order to achieve their various aims. The dispersed and tacit nature of such knowledge creates difficulties in stabilizing expectations before individuals act and determining appropriate and common rules, which are to regulate the international contracts. The main problem of the modern lex mercatoria doctrine as it has developed so far is that international merchants have been treated as if they belong to a relatively homogeneous group of individuals with perfect knowledge as to their dealings. Thus, the concept of lex mercatoria has been treated as possessing certain organizations to collect and direct all necessary knowledge in the form of non-national legal sources, such as general principles of law and trade usages, for the functioning of international commerce. It is expected to provide international merchants with the necessary knowledge when they are dealing with each other. The international merchants are expected to have a unified and thorough understanding of lex mercatoria, which is thought to be basically their own law and to perform functions similar to national laws, regardless of whether it is conceived as a legal system or as a method of decision making in the doctrine.

This treatment is in contradiction with the classical liberalist argument that perfect knowledge as to the functioning of international commerce is not possible for either organizations or individuals, and the mercantile activities take place in the presence of dispersed knowledge

with a tacit aspect. The doctrine of modern *lex mercatoria* requires an understanding that suggests that international merchants may vary in some systematic ways in the use of their knowledge and that research that fails to appreciate the different ways that international merchants can organize their relationships in transactional and institutional terms may come to some misleading conclusions about the concept of *lex mercatoria*. Particularly, such an approach may obstruct seeing the genuine effect of *lex mercatoria* on the international contracts in the sense that *lex mercatoria* has an *ex post* effect on the contract, as the articulated form of the knowledge of the parties, through the resolution of disputes, regardless of the application of national laws, general principles of law or trade usages.

ii. Appropriate Legal Norms Governing the Contract

The inadequacy or inappropriateness of national laws for the resolution of disputes arising from international contracts is not a convincing argument for the advocacy of *lex mercatoria*. In many national legal systems, the parties to international contracts are allowed to choose any national law regardless of whether there is a connection between the contract and the chosen national law. For instance, it is observed that the laws of New York or England have been commonly chosen as the applicable law in international loan agreements.²¹⁰ Any set of default norms can be appropriate in view of the parties' knowledge of the particular circumstances of time and place, since they constitute the part of the bargain that is contemplated by the parties under a particular contract. In view of a particular bargain, any default norm, much like any particular contractual clause, can be more favorable, or appropriate, to one party rather than to the other party to the contract. The appropriateness or adequacy of a default norm can only be determined with respect to a bargain contemplated in the contract and by means of the utilization of the knowledge of particular circumstances of time and place.

The appropriate *ex post* default norms are the established rules in the particular case, which need to be discovered in each single case to the extent that they are not articulated by the parties themselves in the form of contractual clauses or through a chosen set of default rules. The determination of appropriate of legal norms is related to understanding the bargain and giving effect to the reasonable expectations of the parties from that bargain in line with their knowledge of particular circumstances of time and place and the basic principles of *lex mercatoria*. Once we dispense with the restrictive approach of the modern doctrine to the sources of *lex mercatoria*, it becomes apparent that there may be such established rules that can be derived from the national conflict of laws thereby directing the decision maker to apply a national substantive law, in the context of the particular circumstances, on which expectations of the parties could be based. The individual provisions of the national law that is designated by such established rules of conflict can be presumed to indicate the reasonable expectations of the parties in the context of a particular transaction, as long as the individual rules of the designated national law are not overridden by the established rules that can be directly applied to the substance of the dispute, when the national rules are idiosyncratic, or by the express or implied intentions of the parties, which will be determined through interpretation and supplementation of the contract according to the basic principles of *lex mercatoria*. It should always be kept in mind that in view of the impossibility of perfect knowledge, there is no *ex ante* appropriate set of default norms for each and every international mercantile bargain since it would require the complete knowledge of the particular circumstances of time and place in the order of international commerce, and it is preferable to have as many alternatives as possible in this spontaneous order to enable the international merchants to choose from in achieving their individual purposes.

The problems with the order of international commerce have been created by the traditional approach of conflict of laws regimes, which lie at the root of the development towards modern *lex mercatoria*, rather than the inadequacy of national laws for governing the international contracts. The traditional approach of conflict of laws require the *ex post* decision maker to apply the rules of conflict of laws of the forum without questioning whether the conflict rule that needs to be applied reflects an established rule of conflict, or an isolated

²¹⁰ Betto, Jean-Georges., *International Arbitration and Projects Finance: The Viewpoint of Practitioners*, *International Business Law Journal*, (2003), at 832

command of the authorities in that jurisdiction. Moreover, the traditional approach does not allow the decision maker to ponder on whether some of the rules of the designated national law can be overridden by the tacit knowledge of the parties in the form established rules, or whether the parties consider the application of some of the rules of the designated national law as being inappropriate for the bargain contemplated in their transaction. The traditional approach is more interested in an orderly application of conflicts of laws and the decisional harmony than the particularities of a transaction and the parties' knowledge of the particular circumstances.

The traditional approach to the conflict of laws has always been a major concern of those who advocate the existence of a transnational commercial law.²¹¹ Thus, there have been efforts to establish transnational substantive law, which would have ex ante effect on the contracts and avoid the need to refer to conflict of laws rules through the direct application of uniform and appropriate rules. For that purpose, some fields of substantive law have been harmonized by means of international conventions. For example, the United Nations Convention on Contracts for the International Sale of Goods of 1980 ("CISG") provides that the convention must be interpreted with a view to maintaining its uniformity in its application, since the lack of uniformity in interpretation would have the consequence of reintroducing the traditional conflicts methodology that the convention was meant to reduce.²¹²

The modern *lex mercatoria* doctrine also seeks the solution in a body of appropriate and uniform transnational legal norms, which would stabilize the expectations of merchants ex ante. Schmitthoff argued that the development of an autonomous law of international trade founded on uniform rules of wide acceptance would narrow down the ambit of the conflict of laws and give its rules the character of fall-back rules to be invoked if the uniform regulation fails to provide a solution.²¹³ Goldman argued in favor of autonomous conflict rules leading to the direct application of the non-national sources of the modern *lex mercatoria*, which creates a common ground for international merchants through transnational customary rules and general principles of law. The proponents of *lex mercatoria* as a method of decision making also try to circumvent traditional conflict of laws rules by directly applying such rules derived from national legal systems on the basis of comparative analysis to disregard the idiosyncratic rules of the applicable national law.

²¹¹ Berger, Klaus Peter, *The Creeping Codification of the Lex Mercatoria*, Kluwer Law International, The Hague, 1999, at 10

²¹² Audit, Bernard, *The Vienna Sales Convention and the Lex Mercatoria*, in Thomas E. Carbonneau (ed.), *Lex mercatoria and arbitration: a discussion of the new law merchant*, Kluwer Law International, Rev. ed., 1998, at 188; The Uniform Law on Bills of Exchange (the Geneva Convention of 1930) did not provide a clear rule for uniform interpretation, and, therefore, the national courts, by applying their conflict of laws rules, determined the applicable national law and conformed to the interpretation of the Convention as found in the applicable national legal system. It is argued that conflict of laws approach and the elaboration of uniform laws are two different methods of regulating international legal relations and, in the fields where uniform law exists, there is no longer a place for the application of the conflict of laws approach. David Rene, *The International Unification of Private Law*, International Encyclopedia of Comparative Law, Vol. 2, Ch. 5, Tubingen: Mohr, 1971, at para. 269-270. As a reaction after the experience with Geneva Convention, the Hague Uniform Law on International Sale of Goods of 1964 provided in Article 2 that "Rules of private international law shall be excluded for the purposes of the application of the present Law."

²¹³ Schmitthoff, Clive M., *Nature and Evolution of the Transnational Law of Commercial Transactions*, in Chia-Jui Cheng (ed.), *Clive M. Schmitthoff's Select Essays on International Trade Law*, Graham & Trotman, 1988, at 234

The argument that *lex mercatoria* would stabilize the expectations of the merchants and have *ex ante* effect, similar to a national legal system, rendered the doctrine vulnerable to the attacks of its opponents due to the lack of precision and completeness of *lex mercatoria*, which is the main cause that gives rise to doubts as to its viability as a complete and self-sufficient body of law. Thus, it is strongly argued by the opponents that *lex mercatoria*, because of its inherent uncertainty, fails to provide the international merchants with a set of rules which is sufficiently accessible and certain to permit the efficient conduct of their transactions and leads to doubts about its claim that it is more appropriate, in its content or methodology, than national legal systems.²¹⁴ Under this understanding, *lex mercatoria* increases the likelihood of an unreasonable application of governing law with uncertain results, while the wide acceptance of the principle of party autonomy by national legal systems is essentially aimed at reducing the uncertainty created by the territoriality of institutions.²¹⁵ However, both the doctrine's attempts of defining *lex mercatoria*, as a common ground for international merchants, and the criticisms against *lex mercatoria* on the basis of its uncertainty result from failure to see the distinct nature of the order of international commerce from the internal orders of the national legal systems, which requires an understanding of the concept of *lex mercatoria* as a different method from the national legal systems in dealing with uncertainty.

²¹⁴ *Ibid.*, at 118; Hight, Keith, *The Enigma of the Lex Mercatoria*, *Tulane Law Review*, 63 (1989), at 627-628: "The *lex mercatoria* is not at all a precise body of law or principles, with clearly definable limits and parameters. It is impossible to conceive of a draftsman inserting a reference to *lex mercatoria* in an agreement with any sense of confidence that the reference will cover anything more than the very essential rules of reason. Those rules would have been covered even without the reference to *lex mercatoria*... I would suggest that they are a quasi-legal recognition of rules of common sense, equity, and reasonableness that would probably have been suggested, and used, even in the absence of any reference or thought of a *lex mercatoria*."

²¹⁵ Park, William W., *Control Mechanisms in the Development of a Modern Lex Mercatoria*, in Thomas E. Carbonneau (ed.), *Lex mercatoria and arbitration: a discussion of the new law merchant*, Kluwer Law International, Rev. ed., 1998, at 143; Vischer, Frank, *The Antagonism between Legal Security and the Search for Justice in the Field of Contracts.*, *Recueil des Cours*, 142 (1974), at 38

iii. Dealing with Legal Uncertainty

In general terms, the uncertainty arises from imperfect knowledge.²¹⁶ There are two almost diametrically opposed views about the required action in the presence of uncertainty under the reality of globalization. Firstly, some view uncertainty arising from imperfect knowledge as a source of pessimism and, thus, argue that potential and actual harms that may arise from uncertainty require more research and development.²¹⁷ This view calls for ex ante action through more scientific knowledge in order to reduce the uncertainty and to prevent descent into chaos. The first view advocate the precautionary principle that in case of doubt about an activity with potential for severe consequences, it must be pre-empted through heavy preventive and regulatory efforts and, in case of failure in those efforts, it must be banned.²¹⁸ Secondly, some view uncertainty as a source of optimism, and in this view, uncertainty becomes an opportunity for innovation and profit, requiring foresight in enterprising ways.²¹⁹ Second view promotes the utilization of knowledge of the particular circumstances of time and place in order to thrive on chaos.²²⁰ In this understanding, uncertainty involves the techniques of flexibility and adaptability and of entrepreneurial creativity.²²¹

²¹⁶ Knight, Frank H., *Risk, uncertainty and profit*, University of Chicago Press, (1971), Reprint of the 1921 ed., at 199

²¹⁷ Beck, Ulrich, *World Risk Society*, Cambridge: Polity, 1999, at 143 “A characteristic of the global risk society is a metamorphosis of danger which is difficult to delineate or monitor: markets collapse and there is shortage of in the midst of surplus. Medical treatments fail. Constructs of economic rationality wobble. Governments are forced to resign. The taken-for-granted rules of everyday life are turned upside down. Almost everyone is defenseless against the threats of natures as re-created by industry. Dangers are integral to normal consumption habits.”

²¹⁸ Ewald, F., *The Return of Descartes’s Malicious Demon: An Outline of a Philosophy of Precaution*, in T. Baker and J. Simon (eds.), *Embracing Risk: The Changing Culture of Insurance and Responsibility*, University of Chicago Press, 2002, at 286: “the precautionary hypothesis puts us in the presence of a risk that is neither measurable nor assessable – that is, essentially a nonrisk. While the logic of insurance and solidarity had reduced uncertainty to risk, in order to make former systemically assessable, the logic of precaution leads us once again to distinguish between risk and uncertainty. Precautionary logic does not cover risk (which is covered by prevention); it applies to what is uncertain – that is, to what one can apprehend without being able to assess.”

²¹⁹ Bernstein associates uncertainty with the category of individual freedom. Bernstein, Peter L., *Against the Gods: The Remarkable Story of Risk*, J. Wiley, 1996, at 229: “tremendous idea lies buried in the conclusion that we simply do not know. Rather than frightening us, [these] words bring great news: we are not prisoners of an inevitable future. Uncertainty makes us free... Our decisions matter we can change the world.” Knight associates uncertainty with the unique case or the experience of the entrepreneur. Knight, Frank H., *Risk, uncertainty and profit*, University of Chicago Press, (1971), Reprint of the 1921 ed., at 226: “[Each] “instance” in question is so entirely unique that there are no others or not a sufficient number to make it possible to tabulate enough like it to form a basis for any inference of value about any real probability in the case we are interested in. The same obviously applies to the most of conduct and not to business decisions alone.” Giddens associates uncertainty with the growth and innovation. Giddens, Anthony, *The Third Way and Its Critics*, Cambridge; Polity, 2000, at 67-68: “most of the key sources of growth... are also sources of uncertainty, and anyone who wants to contribute to them must engage with it... as the uncertainties grow so too do the opportunities for innovation and profit.”

²²⁰ Peters, Thomas J, *Thriving on Chaos*, Perennial, 1988, at 6 “[The] strategy is paradoxical – meeting uncertainty by emphasizing a set of basics: world class quality and service, enhanced responsiveness through greatly increased flexibility, and continuous short cycle of innovation... If the word “excellence” is to be applicable in the future, it requires wholesale redefinition. Perhaps: “Excellent firms don’t believe in excellence-only in constant improvement and constant change.” That is excellent firms of tomorrow will cherish impermanence- and thrive on chaos.”

²²¹ O'Malley, Pat, *Risk, Uncertainty, and Government*, GlassHouse, 2004, at 5

An important function of the law is to deal with a specific form of uncertainty, which arises from the imperfect knowledge of individuals about when and under what conditions the coercive power of the legal system is exercised. This form of uncertainty can be called “legal uncertainty”. With respect to legal uncertainty, we can observe the impressions of the two views about uncertainty mentioned above on legal thinking. In line with the first view’s pessimistic argument, it can be said that the reduction of legal uncertainty prevents chaos and enables the individual to be in a position to ascertain the law and to maximize his freedom. Thus, the reduction of legal uncertainty requires rules of law characterized by exactness and unequivocal meaning and understood both by the individuals and by those administering the law.²²² However, the reduction of legal uncertainty may conflict with justice in the individual case, and thus unreasonably limit the individual freedom since the clear, unambiguous and steady rules of law can take into account only the average and typical expectations of those concerned, and lead to the danger that, in change of circumstances, the expectations of the individuals must be disregarded, no matter how reasonable these expectations may seem.²²³ In other words, when only the average and typical expectations of those concerned can be taken into account, the expectations arising from the individual’s knowledge of the particular circumstances of time and place may be disregarded, so the law should provide some mechanisms involving the techniques of flexibility and adaptability in line with the second view’s optimistic approach to uncertainty in order to achieve justice in particular cases.

There is a tension between reducing legal uncertainty and providing justice in a particular case under a legal system. A legal system emerges, when a governance regime is able to stabilize the normative expectations of individuals by establishing a self-referential structure.²²⁴ These normative expectations should be coherent and consistent for the system to provide legal certainty. However, the tension is related to the change and the need for adaptation in a given society. The expectations of an individual may change in particular circumstances and diverge from the average and typical expectations. In these cases, justice re-opens the space that has been closed by the routine of legal decisions and asks whether, in the light of the change in the expectations of individuals under new circumstances, the case needs to be decided differently.²²⁵

In view of the contradicting needs of adaptation to particular cases and reduction of legal uncertainty, national legal systems consist of rules and standards. The distinction between rules and standards is the extent to which efforts to give content to the law are undertaken

²²² Raz, Joseph, *Legal Principles and the Limits of Law*, Yale Law Journal, 81 (1972), at 841-842: “Since the law should strive to balance certainty and reliability against flexibility, it is on the whole wise legal policy to use rules as much as possible for regulating human behavior because they are more certain than principles and lend themselves more easily to uniform and predictable application. It is on the whole advisable to limit the use of principles to govern the creation and application of rules in order to ensure adequate flexibility in changing them and to prevent some of their unforeseen and undesirable effects. Some areas, such as governmental activities, cannot be adequately regulated by rules, and they must be directly governed by principles. But these cases are exceptional.”

²²³ Vischer, Frank, *The Antagonism between Legal Security and the Search for Justice in the Field of Contracts.*, *Recueil des Cours*, 142 (1974), at 9

²²⁴ Calliess, Galf-Peter & Moritz C. Renner, *Between Law and Social Norms: The Evolution of Global Governance*, *Ratio Juris*, 22 (2009), at 261

²²⁵ Teubner, Gunther, *Self-subversive Justice: Contingency or Transcendence Formula of Law?*, *Modern Law Review*, 72-1 (January 2009), at 13

before or after individuals act.²²⁶ The choice between rules and standards mainly depends on the frequency of the actions they aim to regulate. The sufficient frequency of similar actions allows the law maker to group them and articulate the relevant knowledge in the rules.²²⁷ Rules, which are given content by the law maker ex ante, reduce the legal uncertainty and stabilize the expectations of individuals by providing a credible mechanism of legal enforcement against the violator. On the other hand, standards, which are given content by the decision maker ex post, require him to take account of the knowledge of particular circumstances of the time and place and to give effect to reasonable expectations of individuals in a particular case by providing legal enforcement. Since the legal uncertainty problem is mainly related to the rapid adaptation to changes in the particular circumstances of time and place, standards leave the ultimate decisions to the ex post decision makers, who become familiar with such circumstances, when confronted with particular cases, and can obtain the knowledge of the relevant changes and of the sources available to meet them.²²⁸ Moreover, standards help the decision maker in determining the exact meaning of the individual rules.²²⁹ This is because standards target the utilization of the tacit aspect of the knowledge in a society and require abstract reasoning. They are effective guides for action when they appear as no more than a means for utilizing the knowledge of particular circumstances of time and place since, as soon as they are explicitly stated in terms of rules, speculation begins about their correctness and their validity.²³⁰ Thus, the interplay between rules and standards is an essential feature of any legal system.

The division between rules and standards in national legal systems reflects Knight's two fundamental sets of conditions, which determine the possibility of meeting uncertainty: consolidation and specialization. Firstly, Knight argues that uncertainties are less in groups of cases than in single instances, so consolidation of similar cases reduces uncertainty. Consolidation in the presence of legal uncertainty results in the articulation of knowledge and promulgation of rules, and depends upon the amount of similar cases and their frequency with which a legal command will apply to those cases. However, in the legal regulation, consolidations are made not merely by seeking and relying on the specified instances of similarities in a society, but on the basis of broader considerations that take into account such materials as usage, custom or case law. Secondly, according to Knight, some individuals become specialized about certain problems in the presence of uncertainty. The specialized individuals naturally know more about a specific problem emerging under uncertainty since they deal with that problem more often than another individual who dealt with that problem only occasionally. Specialization implies concentration, and concentration involves consolidation.²³¹ Therefore, under the conditions of uncertainty, some individuals show greater ability in articulating the tacit aspect of knowledge and meeting uncertainty through

²²⁶ Kaplow, Louis, Rules Versus Standards: An Economic Analysis, *Duke Law Journal*, 42 (December, 1992), at 562

²²⁷ *Ibid.*, at 577

²²⁸ Hayek, Friedrich A. von, The Use of Knowledge in Society, *American Economic Review*, 35-4 (Sep., 1945), at 524

²²⁹ Bonell, Michael Joachim, *An International Restatement of Contract Law: the UNIDROIT Principles of International Commercial Contracts*, Transnational Publishers, 3rd ed., 2005, at 62

²³⁰ Hayek, Friedrich A. von, *Law, Legislation and Liberty: A New Statement of the Liberal Principles of Justice and Political Economy*, Vol. 1: Rules and Order, London: Routledge, 1998, at 60

²³¹ Knight, Frank H., *Risk, uncertainty and profit*, University of Chicago Press, (1971), Reprint of the 1921 ed., at 238

their own consolidation of similar instances, due to their concentration on and frequent interaction with larger number of those instances. Standards in a legal system authorize the decision makers to exercise abstract reasoning, i.e. the power of discretion, and gives legal character to their own consolidations of relevant materials on the basis of their specialization. Employing standards in a legal system makes room for such specialization through the concentration of the decision maker, who is required to give content to those standards *ex post* by weighing all essential facts, interests and expectations of the parties to a particular case and ascertaining justice in each individual case.

However, the national legal systems tend to deal with legal uncertainty mainly on the basis of formal consolidation thereby converting it as much as possible into legal risks. Formal consolidation achieves *ex ante* stabilization of expectations through certain legal structures, such as legislation or case law, and the emerging *ex ante* effect turns uncertainty into risk. The classification of legal risk and legal uncertainty should be understood as a matter of degree, not dichotomy. The distinction between legal risk and legal uncertainty is based on the degree of knowledge of the contracting parties as to the applicability and impact of a norm. Legal risk is an issue, where the parties more easily foresee or they are expected to more easily foresee the likelihood of the applicability of a norm to their contract and the results of such application. This feature is absent in legal uncertainty due to the imperfect knowledge about the applicability of a norm and/or the results of its application to a particular case. The legal risk implies an *ex ante* effect on the contents of the contract, in the sense of a foreseeable contingency, which affects the bargain under the contractual relationship and, requires the parties to assess the legal risk and make necessary adjustments in their contract if they wish to avoid or mitigate its effect on their bargain. When the legal risk materializes, if the parties have failed to either contract out such a norm or shape the bargain otherwise, the relevant legal norm will apply regardless of its effect on the bargain. Thus, the conversion of legal uncertainty into legal risk forms an obstacle to the utilization of the parties' knowledge of the particular circumstances of time and place, most of which is dispersed and tacit, in the *ex post* decision making process by complicating the verifiability of reasonable expectations of the parties to the decision makers.

An expectation is verifiable if a party can establish its existence to a third party decision maker.²³² The verifiability is related with the capacity of decision maker for abstractions. If the decision maker is strictly required to follow the legal structures reducing legal uncertainty, he may not fully take into account the particular circumstances of the case, due to the presumptions arising from those legal structures, which are deemed to have consolidated the relevant materials and stabilized relevant expectations of the contracting parties. Such presumptions set verifiability thresholds and make mostly exceptional the verifiability of a diverging, yet reasonable expectation from an *ex post* perspective considering tacit knowledge through abstract reasoning and the knowledge of the particular circumstances of time and place. Such an expectation may exceptionally be given effect to when the application of those legal structures results in grave and evident injustice in a particular case. Injustice in this sense means such an application must result in a great disturbance in the order of the system. In those situations, most of the national legal systems allow the decision maker to use his power of discretion within their framework and decide in accordance with the standards of that system thereby utilizing the tacit knowledge that is instrumental in keeping a society together. However, in general, the power of discretion cannot be used in a way to consider

²³² Schwartz, Alan & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, Yale Law Journal, 113 (Nov/Dec 2003), at 605

such injustice as a result of an unjust norm of a legal system. Within the framework of a legal system, the decision maker cannot disregard a legal norm merely on the basis of his personal, moral or political views about whether a legal norm is just or unjust. This would lead to arbitrary decisions from the perspective of the legal system. The decision maker can only determine through an abstract reasoning whether the legal system intends such a legal norm to cover this particular case, which raises the issue of adaptation, and, if he determines that that legal rule does not cover the issue at hand, he will consider that the application of that norm to that particular case would create injustice. In such cases, the decision maker is forced to transcend the law by using his power of discretion within the framework of the legal system in order to achieve justice in a particular case, and to translate this experience into legal decisions for the self-referential structure of the legal system.²³³

The power of discretion, i.e. the capacity for abstractions, of decision makers is generally enabled by the standards in the legal system. Since the standards require the decision maker to give them content during the legal enforcement, the legal uncertainty in its most strict sense can be conceived as the uncertainty as to how the decision maker will give content to such standards. Under national legal systems, due to their general tendency to convert legal uncertainty into legal risk, the actions of judges with regard to the application of standards more or less become predictable with formal consolidations, such as well established precedents, legislation and other legal structures, in line with aim of a legal system to stabilize expectations. Thus, legal uncertainty in national laws has been tried to be overcome by converting standards into rules, through such formal consolidations. This effort in turn is to have ex ante effect on the contents of the contracts by stabilizing the expectations of the parties and enabling legal risk assessments.

However, there is no perfect uniformity and mechanical certainty of results since the workings of decision makers are not totally mechanical.²³⁴ In contrast to the formal processes of concrete logic, the decision making in the adjudication is partly based on tacit knowledge and abstract reasoning, which appears in decisions, as “estimate”, “judgment,” “common sense,” or “intuition”, enabling the decision makers to convert their imperfect knowledge into a form that can be used for action. Therefore, the realist approach to legal theory argues that the administration of justice, or the legal adaptation of relations, or the working out of devices for the better functioning of a system in a legally ordered society, is something more than a mere aggregate of rules and standards.²³⁵ The recognition of the existence of an abstract reasoning in judicial action goes along together with the recognition of the significance of the individual case, as contrasted with the absolute certainty.²³⁶

It can be said that a legal system ensures the legal certainty by running the risk that the judgment which is most in conformity with the rules of law may be in contradiction with the sense of justice, i.e. “*summum ius summa injuria*”.²³⁷ The Roman adage “*summum ius summa injuria*” is the basic motif of equity; when law is reduced to an ex ante form through legislation or precedent, the legal norms must be interpreted on grounds of equity so as to do

²³³ Teubner, Gunther, *Self-subversive Justice: Contingency or Transcendence Formula of Law?*, *Modern Law Review*, 72-1 (January 2009), at 21

²³⁴ Pound, R., *A Call for a Realist Jurisprudence*, *Harvard Law Review* 44 (1931), at 706-707

²³⁵ *Ibid.*, at 708

²³⁶ *Ibid.*, at 710

²³⁷ Bourdieu, Pierre, *In Other Words: Essays Towards a Reflexive Sociology*, Oxford: Polity Press, 1990, at 84

justice to the individual case in the light of changing conditions.²³⁸ The equity is about giving effect to the reasonable expectations of individuals through consolidation on the basis of an abstract reasoning of the ex post decision maker; it implies the decision maker's competence of making use of tacit component in the knowledge of the particular circumstances of time and place possessed by the parties. Thus, it can be said that any national law can only temporarily fix its system of norms in a code or a precedent in which the system is articulated, and changes in the society lead to new ramifications of the system.²³⁹ This reflects the inability of a law maker to formulate and direct all the necessary knowledge for the functioning of a society due to the impossibility of anyone taking conscious account of all the particular facts, which enter into the order of society, even within the internal order of a legal system.

The fact that, in all legal systems, the law makers at a certain point in time has fixed the system does not mean that it will remain unchanged and closed. In the context of any liberal order, which rests on the opportunities it provides for unforeseen and unpredictable actions, any measure reducing legal uncertainty will aim at the achievement of some foreseeable particular result, but what is prevented by it will usually not be known. Thus, all beneficial improvement to be made to the existing order must be piecemeal and guided by a body of coherent principles.²⁴⁰ Law-making is necessarily a continuous process in which every step produces hitherto unforeseen consequences for what it can or must be done next. The parts of a legal system are gradually adapted to each other by the successive application of general principles to particular problems. These principles are often not even explicitly known but merely implicit in the particular measures that are taken, but the legal system constantly endeavors to clarify the framework of general conceptions, into which the decision maker must fit his decision, as explicitly as possible.

This understanding is an acknowledgement of the inability of a legal system to provide a complete ex ante effect on the contents of the contracts due to the lack of perfect knowledge. Thus, the control of the part that will have ex post effect, i.e. legal uncertainty, becomes the most important feature of a body of norms, which determines its appropriateness for a particular international commercial contract. As far as the control of legal uncertainty is concerned, *lex mercatoria* emerges as an alternative to a legal system in dealing with legal uncertainty to the extent that *lex mercatoria* depends on the national legal systems for the coercive enforcement of legal rules. It provides the opportunity to turn legal uncertainty into a gain in the sense of restoration of the spontaneous order of actions in the context of international commerce, which has been disturbed by the contractual dispute, but not a risk for other transactions, since there is no organization in the order of international commerce, whose task is to provide formal consolidations and to ensure that each ex post decision maker translates his experience with legal uncertainty into some legal structures so as to turn *lex mercatoria* into a legal system stabilizing expectations. *Lex mercatoria*, which allows different criteria of verifiability through specialized consolidations on the basis of the abstract reasoning of the decision maker, achieves this result by providing an ex post effect on the contents of the contracts in the form of appropriate legal norms, discovered from the

²³⁸ Yntema, Hessel E., *Equity in the Civil Law and the Common Law*, *American Journal of Comparative Law*, 15-1/2 (1966-1967), at 67

²³⁹ Calliess, Galf-Peter & Moritz C. Renner, *Between Law and Social Norms: The Evolution of Global Governance*, *Ratio Juris*, 22 (2009), at 268

²⁴⁰ Hayek, Friedrich A. von, *Law, Legislation and Liberty: A New Statement of the Liberal Principles of Justice and Political Economy*, Vol. 1: *Rules and Order*, London: Routledge, 1998, at 55-56

established rules, for a particular international commercial contract within a framework of basic principles.

If *lex mercatoria* could have been established as a legal system of its own, there would have been no difference between national legal systems and *lex mercatoria* as to their method of dealing with legal uncertainty. *Lex mercatoria* as a legal system would require an organization so that it could have a deliberate purpose in order to function in a similar manner to other national legal systems through formal consolidations. It would provide rules that are appropriate only for some bargains but not for others due to the verifiability thresholds arising from the legal structures established by an organization that is unable to attain perfect knowledge. However, *lex mercatoria* has never attained such a function throughout its history and existed as an *ex post* judicial process because, even in a legal system, there is always a need for such mechanisms involving the techniques of flexibility and adaptability that allows the *ex post* decision maker to utilize the tacit component in the knowledge of the particular circumstances of time and place possessed by the parties for the adaptation of the legal system to the ongoing, imperfect and spontaneous order of actions that take place in any society of individuals. This need is greater in the order of international commerce since the amount of knowledge that is common to the individuals is much more limited. This situation results from the heterogeneous nature of the elements of the relevant society, and requires each case to be judged on its own merits.

Therefore, *lex mercatoria* has never been successfully redacted or articulated as the common law of merchants, other than in certain homogeneous groups of merchants, such as the maritime codes or certain trade usages of particular industries. However, these codified trade usages are not the legal structures of *lex mercatoria*. They are components, which are integrated into and coordinated by a more comprehensive spontaneous order as potential sources of *lex mercatoria*, much like the general principles of law or even national laws, which may become relevant to the resolution of a particular dispute. *Lex mercatoria* has always been providing international merchants with an appropriate method of dealing with legal uncertainty in the order of international commerce, on the basis of the flexibility and adaptability in the resolution of contractual disputes, which recognizes the significance of the individual case and utilizes the knowledge of the particular circumstances of time and place, by putting the emphasis on the specialization in the decision making.

iv. Confidence in a Legal System or a Decision Maker

The national legal systems, which provide self-referential legal structures that establish formal consolidations, have generally a restricted approach to specialization in consolidations whereby the decision maker exercises its abstract reasoning and utilizes the knowledge of particular circumstances of time and place in the control of legal uncertainty. It is true that national legal systems provide for special courts or special divisions within a court to deal with commercial cases.²⁴¹ However, the judges use their discretionary power under guidance, tradition and experience provided by a national legal system.²⁴²

In dealing with disputes arising from international contracts, the decision makers' consolidations on the basis of the abstract reasoning require the consideration of all materials that might have a bearing on the reasonable expectations of the parties to a particular case, such as national laws relevant to the dispute, contracting practices or trade usages in the relevant sector, for discovering the established rules in that particular case. Thus, in this context, consolidation on the basis of abstract reasoning may be regarded as similar to what Schmitthoff argued with regard to the preparation of standard contract texts by the international organization, namely the ascertainment of the common content of various legal sources, and as its application to the particular circumstances of a contractual dispute by the ex post decision maker. The national courts, however, are rather reluctant to consider those materials from outside of the legal system, such as foreign laws, foreign court decisions, arbitral awards, international restatements of contract principles or conventions, in order to take into account the knowledge of particular circumstances of time and place when resolving a dispute arising from an international transaction.²⁴³ Particularly, the national legal systems require the decision maker exercising his discretionary power to refer to their own principles rather than the established rules in the order of international commerce, except for the possibility of uniform interpretation under some international conventions. Even when applying international conventions incorporated in their own legal systems, national courts usually tend to interpret and supplement them on the basis of principles and rules of the law of the forum despite the requirement of uniform interpretation contained in those conventions.²⁴⁴

The national legal systems are more in favor of reducing legal uncertainty for their internal orders through the harmony of decisions, than treating an individual case on its own merits. Therefore, the control of legal uncertainty remains with the national legal systems: in practice, this control is exercised by legislators or supreme courts, and not entrusted to the specialization of the individual judge, who will eventually be bound by certain verifiability thresholds established by the national legal system.²⁴⁵ The individual judge's ability to render

²⁴¹ Vischer, Frank, *General Course on Private International Law*, Recueil des Cours, 232 (1992), at 137

²⁴² Vischer, Frank, *The Antagonism between Legal Security and the Search for Justice in the Field of Contracts.*, Recueil des Cours, 142 (1974), at 13

²⁴³ Drobniq, Ulrich, *General Report: The Use of Comparative Law by Courts*, in Ulrich Drobniq & Sjef Van Erp (eds.), *The Use of Comparative Law by Courts: XIVth International Congress of Comparative Law*, Kluwer Law International, 1999, at 3-21

²⁴⁴ Bonell, Michael Joachim, *The UNIDROIT Principles and CISG – Sources of Inspiration for English Courts?*, *Pace International Law Review*, 19 (Spring 2007/1), at 9

²⁴⁵ For example, Hesselink's view on the judge's rule creating power reflects the confidence in a legal system, rather than that of an individual judge. "We should merely recognize that we have confidence in the subjective judgment of our judges - in particular those in our Supreme Courts - with regard to the interpretation, supplementation and correction of the law, and in the way our judicial system is organized (e.g. the selection and

such judgments that maintain or restore the order of international commerce in the presence of legal uncertainty is generally irrelevant since the ultimate control of legal uncertainty belongs to the authorities in national legal systems.²⁴⁶ In the context of a national court, contracting parties, state institutions and individual decision makers are expected to have confidence in the relevant national legal system, which contains a general framework of organizations that will provide responsible direction and control of the actions of individual judges in the presence of legal uncertainty.

The modern *lex mercatoria* doctrine tends to show that *lex mercatoria* is able to achieve an *ex ante* effect by functioning like a national legal system in practice either as a method of decision making or a legal system in the control of legal uncertainty. The proponents of modern *lex mercatoria* doctrine argued in favor of formal consolidations, whereby the expectations of international merchants are stabilized and the norms of *lex mercatoria* are determined, by means of arbitral case law, autonomous formulations of trade usages and practices by international organizations or “creeping codification” of *lex mercatoria* through international restatements of contract principles. They have tried to find in *lex mercatoria* variants of the structures of a legal system, such as legislation and precedent, as being used by a legal system in dealing with legal uncertainty. Similar to the approach of national legal systems, modern *lex mercatoria* doctrine does not sufficiently consider specialized consolidations on the basis of the abstract reasoning of the decision maker in dealing with legal uncertainty in view of possible arbitrariness and excessive power of discretion.

In this approach, *lex mercatoria* is expected to have certain institutions enabling it to provide confidence for contractual parties, states and decision makers in the control of legal uncertainty. For example, Schmitthoff argued in favor of the establishment of a supreme arbitral tribunal.²⁴⁷ Many others argued in favor of publication of arbitral awards and the creation of an arbitral case law. The codification of modern *lex mercatoria* is promoted and assigned to certain international organizations. However, what is observed in practice is that the emergence of an arbitral case law is limited due to the confidentiality of arbitral proceedings, the codification efforts with regard to trade usages only occurs fragmentally, and international restatements of contract principles have a questionable normative force. These features show that *lex mercatoria per se* cannot provide confidence in the control of legal uncertainty due to its incomplete, fragmentary and incoherent nature, whereas national legal systems can almost exhaustively define the obligations of the parties and provide a method for their judicial enforcement.²⁴⁸

In the absence of an organization, which could acquire enough of the dispersed knowledge in the order of international commerce to provide legal structures establishing formal

training, the career system, the plurality of judges, the duty to provide the grounds for the decision in question, and the appeal system).” Hesselink, Martijn W., *The Concept of Good Faith*, in A.S. Hartkamp, E.H. Hondius, M.W. Hesselink, C.E. du Perron & M. Veldman, (eds.), *Towards A European Civil Code*, Kluwer Law International, 2004, at 488

²⁴⁶ Teubner, Gunther, *Self-subversive Justice: Contingency or Transcendence Formula of Law?*, *Modern Law Review*, 72-1 (January 2009), at 17

²⁴⁷ Schmitthoff, Clive M., *The Unification or Harmonization of Law By Means of Standard Contracts and General Conditions*, in Chia-Jui Cheng (ed.), *Clive M. Schmitthoff's Select Essays on International Trade Law*, Graham & Trotman, 1988, at 202

²⁴⁸ Nygh, Peter E., *The Reasonable Expectations of the Parties as a Guide to the Choice of Law in Contract and in Tort*, *Recueil des Cours*, 251 (1995), at 307

consolidations, the specialized consolidations on the basis of the abstract reasoning of decision makers become integral to the control of legal uncertainty. Before the individual act, *lex mercatoria* is in the form of a few basic principles, which constitutes the basis of the going order of international commerce. It does not manifest itself in already articulated forms, but it has to be discovered and articulated by the *ex post* decision maker through specialized consolidations that reconstruct the tacit aspect of knowledge of circumstances of time and place possessed by the parties to a particular dispute in accordance with those basic principles. The constant necessity of articulating rules *ex post* in order to ascertain and give effect to the reasonable expectations of the parties to a particular dispute requires of the decision maker a capacity for abstract reasoning to discover the established rules, rarely acquired by a national judge who operates with a supposedly complete catalogue of applicable rules before him. When the generalizations from the formal consolidations are not supplied ready-made, a capacity for formulating abstractions is apparently kept alive, which the mechanical use of verbal formulae tends to kill.²⁴⁹

Since much of the knowledge that is actually utilized is not in this ready-made form, most of it consists in a technique of thought, which materializes with new constellations of circumstances. In this context, the elements of various kinds, such as states, transnational organizations and merchants, in the order of international commerce, are confronted with the abstract nature of *lex mercatoria*, and the capacity of the *ex post* decision maker for applying *lex mercatoria* in the sense of exercising the abstract reasoning in the specialized consolidations that are required for the maintenance and restoration of this order, which was disturbed by a particular dispute. Thus, when *lex mercatoria* is applicable, those elements can only have confidence in the specialization of the individual decision makers in the control of legal uncertainty in international commerce in line with the common interest of those elements in the maintenance and development of the ongoing order of international commerce according to the basic principles. This is the reason why *lex mercatoria* has always been associated with and considered to be the law of a special jurisdiction throughout its history, from mercantile courts of the Middle Ages to the international arbitral tribunals of the modern era.

Absent an ulterior guiding authority that provides confidence for the elements of the order of international commerce through formal consolidations, the question for the decision maker applying *lex mercatoria* can never be whether his actions are appropriate from some higher point of view, or served a particular result desired by an authority. The confidence must be expressed by the various elements of the order of international commerce in the specialization of the decision maker in abstract reasoning for the control of legal uncertainty. The decision maker applying *lex mercatoria* is only concerned about whether the conduct under dispute conformed to the established rules in a particular case. The only public good with which he can be concerned is the observance of those rules that the individuals could reasonably count on for the successful pursuit of their purposes. His reasoning should not involve any ulterior purpose which somebody may have intended the rules to serve. What must guide his decision is not any knowledge of what the whole of society requires at the particular moment, but solely what is demanded by the basic principles on which the going order of international commerce is based. If a need arises to call in a specialized decision maker to apply *lex mercatoria*, it will be because such a person will be expected to decide the case as one of a

²⁴⁹ Hayek, Friedrich A. von, *Law, Legislation and Liberty: A New Statement of the Liberal Principles of Justice and Political Economy*, Vol. 1: Rules and Order, London: Routledge, 1998, at 87

kind which might occur anywhere and at any time, and therefore in a manner which will satisfy the expectations of any person placed in a similar position.

As an alternative in the control of legal uncertainty in the order of international commerce, the applicability of *lex mercatoria* depends on the choice of individual merchants. The main means of merchants to convey their choices are their contracts. If these contractual preferences are against leaving the control of legal uncertainty to a legal system, then *lex mercatoria* will be applicable as the alternative. For those contracts, there is no longer a dichotomy between national laws and *lex mercatoria* with regard to the governing law of the substance of the dispute, but the distinction can be made between a legal system and *lex mercatoria* in the control of legal uncertainty. It should be determined under what conditions, it can be said that, the parties to a particular contract have expressed their confidence in a legal system thereby assigning the control of legal uncertainty to that legal system, which turns that uncertainty into a risk, or the parties have delegated the task of controlling legal uncertainty to the specialization of the decision maker, who will decide for them through *lex mercatoria* and provide fair and just results in the sense of restoration of the spontaneous order of actions in the context of international commerce that has been disturbed by the contractual dispute. If the choices of the parties indicate that they have placed their confidence in the specialization and ability of a decision maker to render correct judgments, in the sense that he will settle the dispute that upsets an existing order on its own merits by means of specialized consolidations on the basis of the abstract reasoning, it can be said that they prefer *lex mercatoria* in the control of legal uncertainty, which preserves the peaceful development of international commerce and assures that the flow of efforts of the individuals will continue undisturbed.

Only a decision maker, whose capacity for abstractions is not constrained by verifiability thresholds of national legal systems, which are established through formal consolidations, is able to assume the task of control of legal uncertainty. On the basis of specialized consolidation of legal materials that indicate reasonable expectations of the parties through his abstract reasoning according to the basic principles of *lex mercatoria*, such a decision maker will discover the established rules for a particular case thereby giving effect to reasonable expectations of mercantile parties and utilizing their knowledge of the particular circumstances of time and place. Thus, *lex mercatoria* emerges from a judicial process whereby the ex post decision maker exercises his abstract reasoning in his specialized consolidations to discover the established rules for a particular transaction. These rules will be the tacit knowledge of the parties to a particular dispute that determines their expectations. However, the parties' knowledge will be subject to revision in the light of better insight into its interaction with other rules established for the purpose of restoring or improving the existing order, such as the contents of public policy. Thus, which expectations should be protected must depend on how to maximize the fulfillment of expectations as a whole, given that the common interest of all the elements of the spontaneous order of international commerce is the ability to make feasible plans for individual purposes without impeding the very order, which provides this ability. In a society in which many of the facts are unavoidably uncertain, it is possible to achieve some degree of stability of the overall result of the activities of all elements only if those elements have confidence in the specialization of ex post decision maker, who is allowed to adapt his decision to what he learns in a manner which must be unforeseeable and unknown to others.

The decision maker applying *lex mercatoria* serves to maintain and improve a going order that is not the deliberate design of anybody, that has formed itself without the knowledge and

often against the will of authority, that extends beyond the range of deliberate organization on the part of anybody, and that is not based on the elements doing anybody's will, but on their expectations becoming mutually adjusted and corresponding. Lex mercatoria serves to enhance the stability of expectations not by determining a particular concrete state of things, but on the basis of an abstract order, which enables its members to derive from the particulars known to them expectations that have a good chance of being reasonable. This is what can be achieved in the world of international commerce where some of the facts change in an unpredictable manner and where order is achieved by the individuals adjusting themselves to new facts whenever they become aware of them. In such an overall order which continually adapts itself to changes, only a system of abstract relationships can remain constant. The efforts of the decision makers applying lex mercatoria are part of the process of adaptation of the order of international commerce to circumstances. As the central problem is which expectations must be assured in order to maximize the possibility of expectations in general being fulfilled, the decision maker will make a distinction between such expectations which lex mercatoria must protect and others which it must allow to be disappointed on the basis of his specialization. He makes this distinction by upholding the established rules which make it more likely that expectations will match and not conflict.²⁵⁰ The values, which those rules serve, will be abstract features of an existing factual order which the elements of that order will wish to enhance because they have found them to be conditions of the effective pursuit of a multiplicity of various, divergent, and unpredictable purposes.²⁵¹ The expectations arising from those rules will be considered as "reasonable" and constitute a genuine source of lex mercatoria.

In determining reasonable expectations of the parties by means of specialized consolidations on the basis of his abstract reasoning, the decision maker applying lex mercatoria should not limit his investigation to a comparative analysis of national legal systems, which has been promoted by the most of the second generation of the proponents of modern lex mercatoria. The comparative analysis of national laws is one instance of the application of main technique of thought that reveals the source of lex mercatoria in the form of established rules enabling the correspondence of expectations. The decision maker applying lex mercatoria should take into account any material in his search for corresponding expectations in a particular case, such as trade usages and contracting practices, general principles of law or even a specific national law, as a result of the application of this technique of thought at the conflict of laws stage or as part of the public policy contents in a particular case, without making a distinction between legal sources on the basis of its national or non-national character or being bound by the hierarchy or classifications of a legal system as to their normative value.

The decision maker will consolidate those materials on the basis of his abstract reasoning in the context of a particular dispute in order to discover the established rules, which have or should have permeated into the tacit knowledge of the parties to that dispute, and determine the expectations that deserve legal protection. Thus, even if the decision maker is required to apply a national legal rule according to the reasonable expectations of the parties, the application of such a rule will no longer be treated as an activity of the relevant legal system because he is not required to apply that rule by the legal system and his decision does not necessarily constitute a part of the self referential structure of the relevant legal system. The main concern of the decision maker applying lex mercatoria is to decide the case as one of a kind which might occur anywhere and at any time and, at the same time, in a manner which

²⁵⁰ Ibid., at 119

²⁵¹ Ibid., at 105

will correspond to what the reasonable people of the same kind as the actual parties would have expected in the same circumstances. In this task, the decision maker's consolidation of different kinds of materials will not be guided by a legal system, but by his specialization in exercising his capacity for abstract reasoning and utilizing the knowledge of particular circumstances of time and place.

v. Legal Character of Lex Mercatoria

Except for its basic principles, lex mercatoria emerges from an ex post judicial process, in the form of a case specific body of legal norms, which is appropriate for a particular bargain under an international commercial contract. Its basic principles work as a set of legal standards, yet in the absence of legal structures of self-reference, such as legislation and precedent, which stabilize expectations. As it is already noted in the doctrine, lex mercatoria does not “exist” as do national legal systems; it exists in the way a contract exists, i.e. on an individual basis, and, thus, it does not qualify as a recognized set of social norms that can be referred to as such.²⁵² This means that lex mercatoria requires an approach from the perspective of an individual contract. It also implies that the concept of lex mercatoria has very little to do with the harmonization or unification of national laws.²⁵³

However, if the established rules applied by the decision maker as lex mercatoria in the control of legal uncertainty have legal character, from where do they draw their normative force even if lex mercatoria is not a legal system?²⁵⁴ The legal character of the norms of lex mercatoria will depend on what all law has in common. This common feature has nothing to do with the content. The content of the law varies greatly across time and place, which rules out any possibility of defining law by reference to natural law or to universal law. A few principles may seem universal in the relevant sense, but a concept of law based on substantive overlaps among different legal systems would explain only a small fraction of law.²⁵⁵

Kelsen argues that what all legal systems have in common is the property of being a normative system backed by a credible threat of using physical force against a violator.²⁵⁶ Therefore, self enforcement mechanisms, such as reputation, the prospect of repeated transactions and fairness, are normative systems, but differ in not relying on physical force to secure compliance. They lack credibility or effectiveness, “if the coercive order regarded as the legal order is more effective than the coercive order constituting” such enforcement mechanisms.²⁵⁷ As long as self enforcement mechanisms do not pose a credible threat for the violator, namely when the reputation, the prospect of repeat dealings or fairness do not or cannot restrain the incentive of the individual to violate those norms, due to the moral ambiguity in some situations, heterogeneous structure of the community or end game situations in on-going relationships between parties, legal enforcement through states will be relevant for lex mercatoria as a body of legal norms. Therefore, the legal character of lex mercatoria should ultimately be questioned on the basis of its legal enforcement through the national legal systems.

²⁵² Fassberg, Celia Wasserstein, *The Empirical and Theoretical Underpinnings of the Law Merchant: Lex Mercatoria--Hoist with Its Own Petard?*, *Chicago Journal of International Law*, 5 (2004), at 79

²⁵³ This is also argued by Lord Mustill, although, he based this argument on the claim of non-nationality under the modern lex mercatoria doctrine, which renders the laws of individual states irrelevant, save as a quarry from which to draw the raw materials for generalized rules. Mustill, Michael, *The New Lex Mercatoria: The First Twenty-five Years*, *Arbitration International*, (1988), at 89

²⁵⁴ *Ibid.*, at 97

²⁵⁵ Posner, Richard A, *Law, Pragmatism and Democracy*, Harvard University Press, 2003, at 254

²⁵⁶ *Ibid.*, at 254

²⁵⁷ Kelsen, Hans, *Pure Theory of Law*, Translated from the Second (Revised and Enlarged) German Edition by Max Knight, University of California Press, 1967, the Lawbook Exchange Edition, 2009, at 48

According to Kelsen, the identification of a norm as being a legal norm in view of its legal enforcement depends on its derivation from another norm that has been determined to be valid, and not just from whether it is backed by force. Kelsen argues that application of law is not mechanical but often involves “the creation of a lower norm on the basis of a higher norm”.²⁵⁸ In these cases, “a legal norm is not valid because it has a certain content, that is, because its content is logically deducible from a presupposed basic norm, but because it is created in a certain way—ultimately in a way determined by a presupposed basic norm.”²⁵⁹ Kelsen points out that the contract law is a delegation to private persons of authority to create a body of norms backed by a credible threat of legal enforcement.²⁶⁰ In modern contract law, the presupposed basic norm is the principle of freedom of contract. Thus, a contract is valid not because it has a certain content under a liberal legal system, but because its normative force results from a chain of delegated powers whereby the parties create legal norms appropriate for a particular bargain by exercising their freedom of contract that has been determined to be valid in that legal system providing enforcement, and the resulting contract does not violate certain limitations, which are imposed by the legal system.

It is argued that “the force of the obligation in a contract comes from the force of the legal system that creates the obligation.”²⁶¹ This argument is made against the concept “*contrat sans loi*”, and highlights the necessity to look beyond the will of the parties to the legal framework within which that will may be expressed and possess content. However, the creation of the obligation in a contract can be delegated by the legal system to private persons and the obligations created by the will of the private parties obtain the status of law by means of enforcement provided by the legal system. In the context of international contracts, the legal framework where the will of the private parties embraces its meaning and content may not be provided by a single legal system in its entirety. The national legal systems may choose to treat differently domestic and international contracts and, in the latter cases, may rely on the spontaneously ordering forces of international commerce.

Essentially, while each legal system reserves the ability to determine the scope of delegation of law making to the contracting parties on the basis of the purposes and policies aimed at preserving or improving its internal order, it cannot maintain such ability with regard to the international commerce without impeding the forces producing its spontaneous order. Any intervention from national legal systems in the law making capacity of contracting parties in the order of international commerce should be in the form of the established rules rather than isolated commands of a legal system, which attempts at extending its internal ability to limit the freedom of contract to the international contracts.

In order to be able to rely on the spontaneously ordering forces of international commerce, the authorities in legal systems, as the elements of the order of international commerce, should enable the contracting parties to exercise their freedom of contract in order to dispense with the control of legal uncertainty by a legal system and to delegate that task to the *ex post* decision maker by expressing their confidence in the specialization of that decision maker in the control of legal uncertainty. The authorities in legal systems should also express their confidence in the specialization of the decision maker, who is more knowledgeable about

²⁵⁸ *Ibid.*, at 235

²⁵⁹ *Ibid.*, at 198

²⁶⁰ *Ibid.*, at 147–148

²⁶¹ Hight, Keith, *The Enigma of the Lex Mercatoria*, *Tulane Law Review*, 63 (1989), at 614

particulars of a dispute and, thus, about its potential to disturb the order of international commerce. To express their confidence, the authorities in legal systems should respect the finality of the decision of the specialist and only sanction his decision, by refusing its enforcement, if they consider the outcome of that decision will disturb their internal order, but they should not indulge in an examination as to the appropriateness of the content of the decision, the determination of which is the task of a specialized decision maker.

The refusal of enforcement by a legal system does not mean that the rules of *lex mercatoria* as applied in such a particular case are invalid and devoid of normative force. The authorities in legal systems, which understand the abstract features of the spontaneous order of international commerce, may prevent another legal system from depriving *lex mercatoria* of its legal character through its sole efforts and isolated commands. Such a legal system that functions in contravention to the abstract features of the order of international commerce may eventually find itself isolated from that order. As long as an actual decision, in which *lex mercatoria* is applied, finds legal enforcement by a legal system, as the element of the order of international commerce, and this enforcement is effective against the failed party, such as by means of attachment of its assets located within the jurisdiction of that legal system, *lex mercatoria* will have legal character. However, no individual decision maker should render a decision – and no legal system should allow its enforcement – which leads to the violation of certain established rules with public policy content or disturbs the internal order of a legal system so seriously as to disrupt the abstract relations existing between the elements of the order of international commerce.

Accordingly, there are three requirements of the freedom of contract as the presupposed basic norm, from which the established rules of *lex mercatoria* obtain their legal character. Firstly, the legal character of *lex mercatoria* depends on whether the national legal systems, as elements of the spontaneous order of international commerce, which potentially provide legal enforcement for the application of rules of *lex mercatoria* to a particular case, recognize that the capacity of contracting parties for creating legal rules on the basis of the principle of freedom of contract in the order of international commerce can be greater than that of parties contracting within their internal orders. The abstract order of international commerce requires this recognition since the certain actions of individuals, which are deemed as disturbances of the internal order as a result of the formal consolidations established by the structures of a legal system, might not lead to the same detrimental result, such as when the actual contract has little or no connection at all with the jurisdiction of that legal system. Moreover, most of these formal consolidations may have been established without the knowledge of particular circumstances of time and place possessed by the parties to an international commercial contract. In order for those formal consolidations to permeate such dispersed knowledge and become a source of *lex mercatoria*, they should be discovered by the decision maker as the established rules of policy, rather than isolated commands, from the perspective of a particular contract; this means that other legal systems relevant to the dispute should also have the same public policy value, which should be so fundamental to the internal order of the legal system that their violation cannot be tolerated in the context of peaceful development of international commerce, provided that the particular transaction has sufficient connection with the jurisdiction of that legal system.

Secondly, the legal character of *lex mercatoria* depends on the recognition by those legal systems of such a freedom of contract whereby the contracting parties' may choose to delegate the task of controlling legal uncertainty to the specialized decision maker applying *lex mercatoria*, instead of a legal system providing rules for an internal order on the basis of

formal consolidations. The consolidations provided by a legal system for the control of legal uncertainty may arise from such legal structures that are supervised and directed by an authority, which follow some peculiar purposes and policies to turn its domain into an organization so that the materials that are consolidated by such legal structures may be completely irrelevant to the circumstances of a particular international commercial contract. The applicability of the national rules arising from such consolidations should depend on whether they have become the established rules in the particular case, or whether they are explicitly chosen by the parties thereby becoming the part of the bargain contemplated under the contract.

Thirdly, for the achievement of the freedom of contract as the basis for legality of *lex mercatoria*, the legal systems should refrain from examining the substantive conclusions of the decision maker. This is required by the necessity to protect the spontaneous order of international commerce from disturbances, which may occur when the legal systems meddle with the conclusions of the specialized decision maker thereby substituting their knowledge of the internal order, for the knowledge of particular circumstances of time and place possessed by the parties to an international commercial contract and only available to the specialized decision maker. The national legal system should limit their control to the examination of whether the established rules of policy will be violated by the enforcement of his decision, and whether he has followed certain procedural safeguards in reaching those conclusions, such as the contractual parties' rights to a reasonable opportunity to be heard, to present its case and to equal treatment, and the decision maker's compliance with the scope of delegation by the parties. Such safeguards ensure the meaningful utilization of knowledge and the integrity of judicial process where *lex mercatoria* is applied.

In the presence of these requirements for the principle of freedom of contract, which constitutes the basis of the legality of *lex mercatoria*, what the decision maker exercises with the delegated capacity for controlling legal uncertainty may not actually be called as creating law, but discovering the established rules through specialized consolidations on the basis of the abstract reasoning, such as by means of comparative analysis of legal systems as well as by observing trade usages or other practices in the relevant field. Only when these established rules cannot prevent the conflict between the parties and resulting disturbance of the order, i.e. when the decision maker is confronted with conflicting expectations held by the parties in equally good faith and equally sanctioned by the established rules and he has to make a decision as to which one of the expectations arising from those rules should be disappointed, his actions will resemble an exercise of creating law, but essentially, he will only act on the view that what has been established beforehand will often be only an imperfect understanding of the basic principles in the context of the ongoing order with regard to a particular case, so the decision maker will fill in such a gap by appeal to basic principles of that order on the basis of abstractions for resolving that particular dispute. This is an exercise of equity *praeter legem*, i.e. equity in addition to the law, where the decision maker will make use of equity to fill such a gap in the law that it is no longer possible to refer to equity *infra legem*, i.e. equity within the law.

Each legal system may have a different purpose in becoming an element of the spontaneous order of international commerce and giving *lex mercatoria* a legal character by extending its power of coercive enforcement to the international contracts governed by *lex mercatoria*. This purpose need not be known to the specialized decision maker and should not be influential on the reasoning in the application of *lex mercatoria*. *Lex mercatoria* serves the common interest of the elements of the order of international commerce in their effective pursuit of a

multiplicity of various, divergent, and unpredictable purposes thereby maximizing the fulfillment of their expectations as a whole without impeding that order, which enables them to make feasible plans for such purposes.

c. Concluding Remarks

The historical evolution of the concept of *lex mercatoria* highlights the significance of flexibility and adaptability in the adjudication of contractual disputes in the spontaneous order of cross-border commerce, and the specialization of the decision maker in making use of knowledge of the particular circumstances of time and place. In this context, the issue of legal uncertainty is constantly inherent in the concept of *lex mercatoria*. Unlike the modern *lex mercatoria* doctrine which tries to provide tools to convert legal uncertainty into legal risk, the theory of *lex mercatoria* in this dissertation embraces legal uncertainty and conceives it as a means for achieving fair and just outcomes in the disputes arising from international contracts. In this context, the fairness and justice, which are notoriously amorphous concepts, denote more precise meaning: the restoration of the order of international commerce, which has been disturbed by a particular dispute, by resolving that dispute in a manner that maximizes the expectations of the elements of that order, which enables them to make feasible plans for the achievement of their individual purposes.

In this understanding, *lex mercatoria* is the alternative method for the control of legal uncertainty arising from international contracts in accordance with the liberal and spontaneous order of international commerce. It requires the confidence of the elements of the order in the specialization of the individual decision maker in exercising abstract reasoning to control legal uncertainty in a particular case, but *lex mercatoria* does not directly provide such confidence itself. Instead of providing formal consolidations, such as precedents, legislation and other legal structures that stabilize the expectations of the individuals *ex ante*, *lex mercatoria* requires the specialized decision maker to consolidate, on the basis of his abstract reasoning, such materials that allow him to mentally reconstruct the expectations that a reasonable person of the same kind as the parties would have had from the established rules in the same circumstances.

Lex mercatoria is the law of adjudication of the disputes arising from international contracts, on the basis of a few basic principles, which apply to the procedure of the decision making, the choice of law analyses and the substance of the dispute, and leads to the application of a body of more specific rules appropriate for a particular bargain. These rules are derived from the tacit knowledge of the parties by means of specialized consolidations on the basis of the abstract reasoning of the decision maker, and they indicate the reasonable expectations of the parties to a particular contract. The legality of those rules depends on the recognition of the freedom of contract as the presupposed basic norm of the spontaneous order of international commerce by the national legal systems providing legal enforcement, whereby the authorities will only be concerned about the outcome and procedural aspects, but not the content of decision, which arises from *lex mercatoria* as a technique of thought that requires specialization.

3. SPHERE OF APPLICATION OF LEX MERCATORIA

Uncertainty arises from imperfect knowledge. If the parties to an international contract had perfect knowledge about their dealing and, thus, could think about, plan for, and write down provisions for all future events in such an enforceable format that overcomes the legislative and interpretative fragmentation of the national legal systems relevant to their dispute, they would have comprehensive contracts, which specify precisely what each of their rights and obligations is in every conceivable state of the world. Such a comprehensive contract would eliminate any form of uncertainties for the parties in the order of international commerce. However, there are costs for increasing the degree of knowledge on the part of parties.²⁶² These costs are transaction costs, which are associated with acquiring and processing the relevant knowledge. They are incurred during negotiating and writing contingent contracts and enforcing the contractual promises.²⁶³ Even if the parties can increase their degree of knowledge, they may never attain perfect knowledge in the order of international commerce, and cannot completely eliminate legal uncertainty as long as the human foresight is limited, the laws are incomplete and, particularly, workings of decision makers are not mechanized. Therefore, the parties to international contracts may prefer not to reduce the deficit in their knowledge and look for other solutions, which would reduce the transaction costs by limiting the amount of contractual promises.

One of those solutions would be to establish a firm and to create a hierarchical relationship between the contracting parties. As Coase argues, the contractual promises are not eliminated when there is a firm but their amount is greatly reduced.²⁶⁴ In this situation, there is one contract whereby the party A, for certain remuneration, agrees to obey the orders of the party B within certain limits. Thus, through integration, i.e. establishing a single firm, the party B may have the authority over the party A, and give A orders within certain limits, instead of persuading A to do what he wants by use of other contracts. Thus, Coase argues that a firm consists of the system of relationships, and comes into existence when the authority of directing resources belongs to a single party in a contractual setting.²⁶⁵

On the basis of Coase's ideas, the incomplete contract theory tries to explain how the firms can be thought of as arising from the incompleteness of contracts.²⁶⁶ The theory suggests that it is frequently not possible to write and enforce detailed and complete contracts to manage economic exchanges due to transactions costs. As a result, the contract will specify some actions the parties must take but not others, and it will mention some contingencies but not others. In addition, the parties may disagree about what the contract really means.²⁶⁷ Accordingly, contractual rights will be either specific or residual. Residual rights are claims to

²⁶² Malmgren, H. B., Information, Expectations and the Theory of the Firm, *Quarterly Journal of Economics*, 75-3 (Aug., 1961), at 401

²⁶³ Joskow, Paul J., Vertical Integration and Long-term Contracts: the Case of Coal-Burning Electric Generating Plants, *Journal of Law, Economics and Organization*, 1-1 (1985), at 36

²⁶⁴ Coase, Ronald Harry, *The Nature of the Firm* (1937), in Oliver E. Williamson & Sidney G. Winter (eds.), *The Nature of the Firm: origins, evolution, and development*, Oxford University Press, 1991, at 21

²⁶⁵ *Ibid.*, at 22

²⁶⁶ Hart, Oliver D., *Incomplete Contracts and the Theory of the Firm*, in Oliver E. Williamson & Sidney G. Winter (eds.), *The Nature of the Firm: origins, evolution, and development*, Oxford University Press, 1991, at 138

²⁶⁷ *Ibid.*, at 141

whatever is not specifically mentioned in a contract. To the extent that the contracts are incomplete, there will be residual rights, namely, the rights to exercise control over the contractual relationship in the absence of specific contractual provisions. It is argued that possessing such residual rights is what it means to own the firm.²⁶⁸ Thus, according to incomplete contract theory, a firm emerges as an institutional framework where the contractual rights to make specific decisions in an exchange are assigned to different parties to that exchange, and the key decision rights are residual rights of control.

As another theory that is based on Coase's insights, the transaction cost economics observes that the choice between integration as a firm and entering into transactions in the market is a matter of degree. The firm and market are alternative modes for organizing the same transactions.²⁶⁹ The theory's argument is that where the transaction costs prevent parties from writing complete contracts in the context of a market, such contractual incompleteness creates ex post performance problems.²⁷⁰ The transactions cost theory focuses on ex post adaptation and the role of governance in solving those problems.²⁷¹ It argues that, although it has been instructive to view the firm as a nexus of contracts, the distinguishing feature of internal organization is hierarchical governance, in which ex post adaptation is effected through fiat.²⁷²

Hierarchical governance addresses the issue of opportunism that may arise from the incompleteness of the contract by bringing a problematic exchange within the boundaries of a firm, where a manager can control the behavior of all parties to that exchange through the exercise of fiat. Fiat arises from the implicit contract law of internal organization. Whereas courts routinely grant standing to firms, when there are certain disputes about the performance of a contract, they will refuse to hear disputes between one internal division of a firm and another over identical issues. Since the access to the courts is denied, the parties must resolve their differences internally. Accordingly, hierarchy becomes its own court of ultimate appeal.²⁷³ In this regard, the reference is made to the "business judgment rule", an American case law-derived concept in corporation law, which applies to the relation between shareholders and directors. The "business judgment rule" can be understood as a doctrine of abstention pursuant to which courts refrain from reviewing board decisions unless exacting preconditions for review are satisfied.²⁷⁴ As stated by the Appellate Court of Illinois in the case of *Shlensky v. Wrigley*, "the authority of the directors in the conduct of the business of the corporation must be regarded as absolute when they act within the law, and the court is without authority to substitute its judgment for that of the directors."²⁷⁵ Therefore, "absent bad faith or some

²⁶⁸ Langlois, Richard N. & Metin M. Cosgel, Frank Knight on Risk, Uncertainty, And the Firm: A New Interpretation, *Economic Inquiry*, 31 (July 1993), at 462

²⁶⁹ Williamson, Oliver E., Transaction Cost Economics, in Claude Menard and Mary M. Shirley (eds.), *Handbook of New Institutional Economics*, Dordrecht: Springer, 2005, at 46

²⁷⁰ Joskow, Paul J., Vertical Integration and Long-term Contracts: the Case of Coal-Burning Electric Generating Plants, *Journal of Law, Economics and Organization*, 1-1 (1985), at 37

²⁷¹ Williamson, Oliver E., Transaction Cost Economics, in Claude Menard and Mary M. Shirley (eds.), *Handbook of New Institutional Economics*, Dordrecht: Springer, 2005, at 48

²⁷² Williamson, Oliver E., Comparative Economic Organization: The Analysis of Discrete Structural Alternatives, *Administrative Science Quarterly*, 36-2 (Jun., 1991), at 274

²⁷³ *Ibid.*, at 274

²⁷⁴ Bainbridge, Stephen M., The Business Judgment Rule as Abstention Doctrine, *Vanderbilt Law Review*, 57-1 (2004), at 87

²⁷⁵ 237 N.E.2d 776 (Ill. App. Ct. 1968) (applying Delaware law).

other corrupt motive, directors are normally not liable to the corporation for mistakes of judgment, whether those mistakes are classified as mistakes of fact or mistakes of law”.²⁷⁶ Under the theory of transaction cost economics, this rule is interpreted as a particular manifestation of fiat, which applies to the management of the firm more generally.²⁷⁷ It is argued that markets do not have access to fiat since the attempts to award decision rights to autonomous agents by contract are commonly unenforceable.²⁷⁸

Similar to those understandings as to the nature of the firm, *lex mercatoria* is a solution against the problem of transactions costs of reducing the deficit in knowledge. The parties will articulate in their contract the knowledge of particular circumstances of time and place to the extent that they are willing to incur transaction costs, and such articulation will often result in specific contractual rights and obligations as well as specific allocations of risks relating to the contractual relationship between the parties. To the extent that *ex post* adaptation to a number of unknown facts is required, there will also be residual contractual rights and obligations and residual allocation of the relevant risks arising from the tacit knowledge of the parties, who have failed to articulate properly that knowledge in their contract. Accordingly, the parties may reduce the amount of contractual promises by relying on *lex mercatoria*, which will be applied by the specialized decision maker through *ex post* judicial process in order to give effect to the reasonable expectations of the parties. The decision maker will discover from the tacit knowledge of the parties the established rules for the particular case and articulate them in his decision, after the relevant knowledge have become available to the parties and resulted in a dispute between them.

Lex mercatoria can be regarded as an *ex post* governance mechanism not only dealing with the incompleteness of contracts, but, in general, the incompleteness of the articulated rules, which create contractual rights and obligations and allocate risks. The articulated rules in a particular case will consist of the contractual clauses and the default rules chosen by the parties to govern their contract. The default rules chosen by the parties as the articulated rules should be identifiable to the decision maker, such as the UNIDROIT Principles, the CISG, other sets of rules prepared by international organizations, or national legislative instruments in order to create specific contractual rights, obligations and risk allocations. Both such default rules and contractual clauses as the articulated rules should have clear meaning and should be understood both by the parties and by the *ex post* decision maker in the same manner in the same circumstances. The residual contractual rights, obligations and risk allocations emerge where the contractual clauses and the default rules chosen by the parties are more in the form of standards that contain vague references or they do not cover the particular issue at hand due to their exactness.

This form of incompleteness is the first condition for the applicability of *lex mercatoria* to a contractual dispute. *Lex mercatoria* as the law of principled adjudication mainly applies when there are questions of the residual contractual rights, obligations and risk allocations arising from the incompleteness of the contractual clauses and the chosen default rules in the context of an international contract. In order for the residual questions to emerge in this setting, there

²⁷⁶ Gilson, Ronald, *The Law and Finance of Corporate Acquisitions*, Mineola, NY: Foundation Press, 1986, at 741

²⁷⁷ Williamson, Oliver E., *Comparative Economic Organization: The Analysis of Discrete Structural Alternatives*, *Administrative Science Quarterly*, 36-2 (Jun., 1991), at 274

²⁷⁸ Williamson, Oliver E., *Transaction Cost Economics*, in Claude Menard and Mary M. Shirley (eds.), *Handbook of New Institutional Economics*, Dordrecht: Springer, 2005, at 48 fn 7

must be contingencies that are not specifically covered by the contractual provisions and the default rules adopted by the parties. *Lex mercatoria* will be relevant to the contracts where a hierarchical governance structure is not adopted in dealing with the legal uncertainty arising from incompletely articulated rules, yet the transaction costs that are incurred during the preparation of contract are attempted by the parties to be reduced through reducing the amount of specific contractual rights, obligations and risk allocations. Some characteristics of transactions indicate the parties' preferences for the method of allocation of the residual contractual rights, obligations and risks, i.e. the method of dealing with legal uncertainty; in this regard, the preference for specialization over formal consolidations will enable the application of *lex mercatoria*.

Second condition for the applicability of *lex mercatoria* is the *ex post* decision maker's capacity for exercising abstract reasoning in specialized consolidations to control uncertainty and determine the residual contractual rights, obligations and risks allocations. For the applicability of *lex mercatoria*, the decision maker should have a form of "business judgment rule", in the sense of the ability to make a final and binding decision, the content of which will not be reviewed by any other authority except for its examination with regard to the procedural process, which should ensure the meaningful utilization of the knowledge of the particular circumstances of time and place, and the review for a possible violation of the established rules of policy by its enforcement for the protection of the order of international commerce from disturbance. The fulfillment of the second condition will depend on the institutional choice made by the parties between arbitration and litigation with regard to the adjudication of their dispute.

a. Contractual Characteristics

Absent hierarchical governance, the international contracts can be roughly divided into two categories from the perspective of applicability of *lex mercatoria*: transactions governed through legal risk and transactions governed through legal uncertainty. The first category comprises discrete and short term contracts, where the interests of parties are antagonistic and covered by the specific contractual rights, obligations and risk allocations. These contracts are well suited to be submitted to formal consolidations provided for an internal order of an organization as they do not necessarily require tailor-made solutions. The second category essentially covers “relational contracts”, which involve not merely an exchange but also a relationship between the contracting parties.²⁷⁹ They typically have longer duration, involve more complexity or innovation, or contain clauses in the form of standards. This category of contracts requires context-specific approach to the residual contractual rights, obligations and risk allocations, by taking into account the knowledge of particular circumstances of time and place.

²⁷⁹ Eisenberg, Melvin A., *Relational Contracts*, in Jack Beatson and Daniel Friedmann (ed.) *Good Faith and Fault in Contract Law*, Oxford University Press, 1995, at 296

i. Transactions Governed Through Legal Risk

The issues of residual contractual rights, obligations and risk allocations can be minimal under certain transactions, and *lex mercatoria* may hardly become applicable to such transactions. These transactions are governed through the conditions of legal risk by using specific contract clauses and by adopting pre-defined default rules, which deal with almost all possible contingencies. It is possible to observe some common characteristics of international contracts, which indicate that the parties intend their transaction to be governed through legal risk. These contracts will usually be characterized by their discrete and short term nature, where unforeseen contingencies are truly exceptional, such as commodity sale agreements.²⁸⁰ They are the ideal transactions in law and economics with their basic characteristic as “sharp in by clear agreement; sharp out by clear performance.”²⁸¹ In these contracts, the interests of parties are antagonistic and lie in the routine enforceability of legal entitlements exactly as stated in the terms of the contract or by default rules.²⁸²

The most important feature of the appropriate rules for these transactions is that they have been provided *ex ante* by an organization with a view to be used to satisfy the needs of multitude in contractual relationships. This is the main approach adopted by national legal systems and trade associations. In this approach, the rules are provided for the internal order of the society of an organization, not upon specific needs of an individual. In the context of the transactions governed through legal risk, the individuals need not know which norms are the most appropriate for their future transactions and which aspects of their transactions should be or not be covered by those norms. They leave it to certain organizations to make rules and hold them ready for adoption when the time comes for entering into a contract thereby reducing the transaction costs and the deficit in their knowledge. Both national legal systems and trade associations agree on the primacy of formal consolidation in order to solve the uncertainty as to the individual needs.

The approach is based on the idea that an outsider can foresee the needs of a multitude with more ease and accuracy than an individual can attain with respect to his own.²⁸³ The outsider in the case of national legal systems is the legislator and supreme courts while, in the case of trade associations, it is an international organization and its arbitral organs. This phenomenon is primarily a case of reduction of uncertainty by formal consolidations. In this approach, there is little specialization of uncertainty, and, when there is, it is on a basis of the outsider’s position and purpose in relation to the problem, not the professional skills of an *ex post* decision maker, whose capacity is mostly limited to the mechanical use of verbal formulae provided by the parties or the outsider. In the transactions governed through legal risk, by choosing default rules provided for the internal order of an organization and by virtue of the typicality of needs and expectations, the parties become able to foresee the applicability and possible outcomes of the application of such rules, and they can make legal risk assessments.

In the order of international commerce, the transactions governed through legal risk can often be observed in the contracts between the members of a trade association. These contracts are

²⁸⁰ Williams, Chris, *The Search for Bases of Decision in Commercial Law: Llewellyn Redux*, Harvard Law Review, 97 (1984), at 1507

²⁸¹ Macneil, Ian R., *The Many Futures of Contracts*, Southern California Law Review, 47 (1974), at 738

²⁸² Collins, Hugh, *Regulating Contracts*, Oxford University Press, 1999, at 197

²⁸³ Knight, Frank H., *Risk, uncertainty and profit*, University of Chicago Press, (1971), Reprint of the 1921 ed., at 240

usually related to the sale and purchase of certain commodities between the members. The types of events that can disrupt a transaction are, except in highly unusual circumstances, known by parties at the time of contracting. Most of these contingencies are dealt with through either a codified trade rule or an explicit provision in a standard-form contract provided by the trade association. These contracts are well-specified, and, as a consequence, confronted with fewer gaps and interpretive disputes.²⁸⁴ Due to this nature of such transactions, there is hardly a question of residual contractual rights obligations, and risk allocations, i.e. legal uncertainty. Simply the contractual clauses or chosen default rules resolve the dispute. Moreover, some trade associations provide the possibilities of self-regulation through formal consolidations in the form of precedents under their own arbitration mechanisms. Finally, for the unlikely case of contingencies that are not dealt with by such norms, there is usually a chosen national law in the standard form contracts that reflect the preference of the trade association.

For example, the Federation of Oils, Seeds and Fats Associations (FOSFA) and the Grain and Feed Trade Association (GAFTA) have their own standard form contracts, which include their trade rules. Both FOSFA and GAFTA have their own arbitration rules, procedures, and appeal mechanisms for arbitral awards, which provide formal consolidations in the interpretation and supplementation of the pre-defined rules to some extent.²⁸⁵ Their arbitration rules even deny to the parties the right to have lawyers participate in the hearing or even to be present in the hearing room.²⁸⁶ The standard form contracts provided by these associations are strict in the selection of English law as the law governing the contract by creating the legal fiction that the contract was concluded in England. It is observed that there are many examples of contracts entered into by parties, neither of which is English.²⁸⁷ Moreover, many forms of standard contracts provided by FOSFA and GAFTA exclude the United Nations Convention on Contracts for the International Sale of Goods of 1980.²⁸⁸ Therefore, in these transactions, uncertainty is reduced into risk by the nature of transactions, trade rules that are

²⁸⁴ Bernstein, Lisa E., *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, *University of Pennsylvania Law Review*, 144-5 (1996), at 1816

²⁸⁵ GAFTA, *Arbitration Rules*, GAFTA Publication No. 125; FOSFA, *Guide to Arbitrations and Appeals*; Schmitthoff, Clive M., *The Unification or Harmonization of Law By Means of Standard Contracts and General Conditions*, in Chia-Jui Cheng (ed.), *Clive M. Schmitthoff's Select Essays on International Trade Law*, Graham & Trotman, 1988, at 202

²⁸⁶ FOSFA *Arbitration Rules*, Article 4(g): "Each party has the right to attend the arbitration hearing provided the arbitrators or umpire has been notified of the intention to do so. Either party has the right either to present their own case or to be represented at the hearing, but may not have present or be represented by any member of the legal profession wholly or principally engaged in legal practice". GAFTA, *Arbitration Rules*, GAFTA Publication No. 125, Article 4:8: "Where the tribunal considers that an oral hearing is necessary, the date, time and place will be arranged by GAFTA. In which event the parties may be represented by one of their employees, or by a GAFTA Qualified Arbitrator or other representative, but they may not be represented by a solicitor or barrister, or other legally qualified advocate, wholly or principally engaged in private practice, unless legal representation is expressly agreed." Article 16:2 "Where there is no [express agreement that they may engage legal representatives] between the parties they are nevertheless free to engage legal representatives to represent them in the written proceedings but not to appear on their behalf at oral hearings."

²⁸⁷ Bridge, Michael, *The International Sale of Goods: Law and Practice*, Oxford University Press, 2nd ed. 2007, at 26

²⁸⁸ See; GAFTA *Arbitration Rules* No. 125, Article 22; GAFTA No.100 *Contract for shipment of feeding stuffs in bulk tale quale - CIF terms*, Article 26, 27 and 28; GAFTA No. 119 *General Contract for feeding stuffs in bags or bulk FOB terms* No. 119, Article 25, 26 and 27; FOSFA No. 53 *Contract For Vegetable and Marine Oil in Bulk FOB terms*, Articles 27, 28 and 29; FOSFA No. 24 *Contract for Canadian/USA Soyabeans CIF Terms*, Articles 26, 27 and 28

codified in the standard form contracts, special arbitral mechanism and the choice of national law, which leads to strict application of English law in the absence of codified trade rules.

The transactions governed through legal risk are suitable for formal consolidations by an organization as the contractual expectations are simple and typical. In these transactions, the parties do not intend their disputes to be resolved by the decision maker through specialized consolidations on the basis of his abstract reasoning for discovering their tacit knowledge in order to maintain and restore the order of international commerce, but to be treated as one instance of a multitude of similar cases, which have been and will be subject to formal consolidations by a certain organization providing default rules for the internal order of its society. Such parties are prepared for the ex ante effect and legal risks arising from those formal consolidations, which, essentially, their case forms a part of. They accept that chosen default rules will apply, when they have failed to contract out those rules, namely when the legal risk materializes, unless there is an exceptional discrepancy between the rule and the situation, which requires the decision maker to transcend the articulated rules. Only in the unlikely case of the latter, *lex mercatoria* will be relevant to such transactions, provided that the parties have not expressed their confidence in the system of the organization providing default rules for the resolution of such discrepancy and the control of resulting legal uncertainty.

ii. Transactions Governed Through Legal Uncertainty

There are also international contracts in which some contingencies are not dealt with by contractual clauses, and the decision maker cannot find any immanently applicable default rules, which have been provided for the internal order of the society of an organization. These contracts face legal uncertainty and may be subject to the application of *lex mercatoria*. There are some characteristics which indicate that certain aspects of international contracts are governed through legal uncertainty. These contracts will usually have a longer duration, for the longer the contractual duration is, the more uncertainty will naturally be involved and the more questions of residual contractual rights, obligations, and risk allocations will appear. Their structure or purpose will usually be more complex or innovative. While the simple and common needs of individuals are the most stable and predictable for an outsider, as complexity or innovation increases, the greater becomes the uncertainty connected with foreseeing needs and satisfying them. This complexity or innovation may likely be required by the circumstances surrounding the transactions, such as when many legal systems are involved in the scope of transaction, by the status of the parties, such as when there is a contract between a private individual and a state or state enterprise, or by the atypical form of the transaction. Examples of this kind of transactions can be found in such contractual relationship as the international supply contracts outside the context of a trade association, construction contracts, concession contracts, joint-venture agreements, share purchase agreements or distribution contracts.

The number of atypical transactions has been increased particularly after the change in the theory and practice of business organization and the recent move towards externalized business relationships. Initially, business theory and practice favored the vertically integrated firm and hierarchical governance, where most relationships of production and distribution are internalized. More recently business theory and practice have tended towards a view of the firms as a bundle of capital and intelligence, seeking profit by whatever arrangements will yield profit. The new firm proactively seeks every sort of joint venture, minority or majority participation, lead- or sub-contractor, licensing franchising, leasing, concession, management, pooling, spin-off, subsidiary, partnership, or other arrangement that may be most feasible for meeting a particular purpose.²⁸⁹ Thus, many essential business relationships are externalized by such transactions. It should also be noted that vertical integration in the international markets is still common. Many corporations active in international markets consist of a parent company that controls foreign subsidiaries through equity shares or other means safeguarded by national property law and company law since, among other reasons, vertical integration generate the necessary conditions for the conduct of cross-border transactions internally in the absence of sufficient protection of market exchanges by means of the effective legal

²⁸⁹ Shapiro, Martin, Globalization of the Freedom of Contract, in Harry N. Scheiber (ed.), *The State and Freedom of Contract (Making of Modern Freedom)*, Stanford University Press, 1998, at 291

enforcement of contractual undertakings.²⁹⁰ Thus, the cross-border mergers or acquisitions account for a significant part of the global foreign direct investments.²⁹¹

The externalized business relationships and cross-border mergers and acquisitions have led to the rise of unconventional and atypical forms of contracts. Because of the inherent complexity, innovation or extended duration of these transactions and regulatory lacunae within the framework of national legal systems, the contracting parties have needed detailed contractual mechanisms in order to override the patchwork of varying national laws and to curtail opportunistic behaviors. The distinct style of American contracting among large business enterprises has been able to satisfy the needs of such international business relationships. American contracts tend to be long, detailed and designed to anticipate the possible contingencies of future business relationships under the contract.²⁹²

The long and detailed contracts can be related to the American style of litigation. The connection between contracts and litigation implies a connection between contracts and law firms. Big law firms have the resources to write long, detailed contracts and to litigate issues that arise under them if necessary.²⁹³ It can be said that American-style adversarial legal litigation has ultimately led to the emergence of contracting practices, in which each potential defense in a future litigation is attempted to be covered in the contract and the contracts are suited to fact oriented litigation style of American courts. Therefore, it is observed that, in American contracting practice, the parties include not only transaction-specific foresight clauses in an effort to handle all contingencies in the contract, but also contractual clauses incorporating default rules, such as well-settled principles of law and canons of interpretation, in an attempt to ascertain the applicable rules of law within the framework of party-initiated and fact-based litigation of disputed issues.²⁹⁴ In this practice, the drafters of contract tend to articulate every bit of knowledge the parties may have and to gather all the articulated rules into a single document. In contrast, the civil law approach to contract drafting favors rather short and easy to understand contracts, without reiterating and qualifying default rules derived from the civil codes in detailed and specific contractual clauses.²⁹⁵

²⁹⁰ Calliess Galf-Peter & Jens Mertens, *Transnational Corporations, Global Competition Policy, and the Shortcomings of Private International Law*, *Indiana Journal of Global Legal Studies*, 18-2 (Summer 2011), at 846, 850; The World Trade Organization stated in its annual report of 2008: “Another important factor in determining whether to integrate or outsource and where to offshore is the quality of the institutional framework The quality of institutions matters because the contract between the final good producer and the supplier of the intermediate good in the arm’s-length relationship needs to be enforceable. If not, the risk of outsourcing may be too high.” World Trade Organization, *World Trade Report 2008: Trade in a Globalizing World*, (2008), at 108, available at http://www.wto.org/english/res_e/booksp_e/anrep_e/world_trade_report08_e.pdf

²⁹¹ The global foreign direct investments rose from about \$200 billion in 1989 to a record high of \$1,833 billion in 2007. Continued consolidation through cross-border mergers and acquisitions contributed substantially to the global surge in the foreign direct investment. In 2007, the value of such transactions amounted to \$1,637 billion, 21% higher than the previous record in 2000. U.N. Conference on Trade & Development (UNCTAD), *World Investment Report 2008: Transnational Corporations and the Infrastructure Challenge*, at 3-4, U.N. Sales No. E.08.II.D.23 (2008), available at http://www.unctad.org/en/docs/wir2008_en.pdf

²⁹² Shapiro, Martin, *Globalization of the Freedom of Contract*, in Harry N. Scheiber (ed.), *The State and Freedom of Contract (Making of Modern Freedom)*, Stanford University Press, 1998, at 284

²⁹³ *Ibid.*, at 284

²⁹⁴ Langbein, John, *Comparative Civil Procedure and the Style of Complex Contracts*, 35 *American Journal of Comparative Law*, (1987), at 384

²⁹⁵ Frilet, Marc, *Terms and Conditions of Contract: the Civil Law Approach and the European Contract Law*, *International Business Law Journal*, (2007), at 60

American style of contracting has been favored in the context of international transactions as it enables the parties to carry their articulated rules around various jurisdictions of legal systems. This style has also spread to the rest of the world, as American companies doing business abroad insisted on contracting that business in the style to which they had become accustomed.²⁹⁶ It is further strengthened by the dominant position and influence of American and English multi-jurisdictional law firms in the international transactions.²⁹⁷ Moreover, since 1990s, there have been mergers of law firms in continental Europe, and these law firms have adopted the American style of law firm structure, with senior and junior partners, associates and young lawyers as trainees, with a view to providing comparable services with regard to contract drafting for international businessmen.²⁹⁸ Thus, international contracting practices mostly reflect American contracting style, irrespective of whether the legal relationship that the contracts regulate is governed by a law belonging to a common law system or not.²⁹⁹

This may seem paradoxical to the concept of *lex mercatoria* as the preferences of international merchants in favor of American form of long and detailed contracts can be interpreted as a certain disfavor towards the idea of transactions governed through legal uncertainty in the context of long-term, complex or innovative business relationships. American form of contracting is based on the principles of certainty and predictability and the assessment of legal risks. The parties and their lawyers assess the risks connected with the transaction and attempt to provide for appropriate regulation of the relationship and allocation of risk. The contract is aimed to be sufficient to regulate the transaction between the parties.³⁰⁰

However, in most cases, the parties will have no choice other than incorporating vague standards into the text of the contract in addition to precise terms. Scott and Triantis offer a theory of contract design that anticipates the enforcement of contracts by adversarial litigation, where courts do not verify facts by direct investigation, but rather rely on the self-interested evidence presented by the parties.³⁰¹ They argue that the choice between precise terms and standards can be reduced to the question of who chooses the relevant evidentiary means: the parties at the time of contracting or the decision maker at enforcement stage.³⁰² By specifying the facts relevant to evidentiary means *ex ante*, the parties delegate to the court the relatively simple task of choosing between the evidentiary bits before deciding on the issue. When the contract includes instead a vague standard, such as reasonable care, the litigation process should determine which evidentiary means are relevant and the weight to be assigned to each. In the latter case, transaction costs are incurred only with respect to the contingency

²⁹⁶ Shapiro, Martin, *Globalization of the Freedom of Contract*, in Harry N. Scheiber (ed.), *The State and Freedom of Contract (Making of Modern Freedom)*, Stanford University Press, 1998, at 285

²⁹⁷ Gessner, Volkmar, *Globalization and Legal Certainty*, in Volkmar Gessner & Ali Cem Budak (eds.), *Emerging Legal Certainty: Empirical Studies on the Globalization of Law*, Ashgate, 1998, at 438

²⁹⁸ Wiegand, Wolfgang, *Americanization of Law – Reception or Convergence*, in Lawrence M. Friedmann & Harry N. Scheiber, *Legal Culture and the Legal Profession*, Boulder: Westview Press, 1996, at 139

²⁹⁹ Moss, Giuditta Cordero, *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*, *Global Jurist*, 7-1 (2007), Available at: <http://www.bepress.com/gj/vol7/iss1/art3>, at 1

³⁰⁰ *Ibid.*

³⁰¹ Scott, Robert E. & George G. Triantis, *Anticipating Litigation in Contract Design*, *Yale Law Journal*, 115 (2006), at 818

³⁰² *Ibid.*

that actually materializes, and it might be avoided entirely if the parties settle or renegotiate.³⁰³

Thus, long-term, complex or innovative business transactions, despite involving long and detailed documents, usually confront unspecified contingencies and include contractual clauses in the form of standards, such as good faith or best efforts clauses, which require the decision maker to give them content *ex post* by taking into account the knowledge of particular circumstances of time and place.³⁰⁴ These standards will indicate the questions of residual contractual rights, obligations and risk allocations, other than those specifically set out in the contract documents. With more standards, those transactions will become closer to Llewellyn's concept of contract, which is "a framework highly adjustable, a framework which almost never accurately indicates real working relations, but which affords a rough indication around which such relations vary, an occasional guide in cases of doubt, and a norm of ultimate appeal when the relations cease in fact to work."³⁰⁵

Any transaction that is governed through the conditions of legal uncertainty will be so only in its certain aspects. Naturally, the contracting parties will make some effort to describe their obligations clearly *ex ante* and to create specific contractual rights, obligations and risk allocations. However, it may be prohibitively costly to draft a contract that faces no legal uncertainty, when the underlying business relationships are complex, innovative or long-term. Under a transaction governed through legal uncertainty, there will be some contingencies that have been specified by the contract, or referred to the application of chosen default rules that have been provided for the internal order of the society of an organization. The disputes arising from the control of unspecified contingencies, i.e. residual contractual rights, obligations and risk allocations, will be suitable for the resolution by means of specialized consolidations on the basis of the abstract reasoning of the decision maker, who is to discover the established rules from the parties' knowledge of the particular circumstances of time and place.

When compared with transactions governed through risk and transactions under hierarchical governance, the transactions governed through uncertainty are located in between. The nature of appropriate default rules differs from those of transactions governed through risk and transactions under hierarchical governance. It requires more flexibility than the former but more legalism than the latter.³⁰⁶ *Lex mercatoria*, as the law of principled adjudication, provides the appropriate default rules for the transactions governed through legal uncertainty

³⁰³ *Ibid.*, at 819, 836; Scott and Triantis give the example of a contractual stipulation that when X occurs, the promisor must pay a certain amount. They argue that the parties might define X at any of three levels. First, X might be the production of a specific bit of evidence, such as a signed document or testimony by a specific witness. Second, X may be a relatively specific event, such as the delivery of a good with a specified size. In this category, the parties delegate to the court the determination of which bits of evidence are sufficient to satisfy X. Third, X may be a vague term, such as the delivery of a good in excellent or merchantable condition. In this category, the court must determine not only what evidence is sufficient to establish the occurrence of X, but also the degree to which facts are relevant in the determination of whether the standard has been met.

³⁰⁴ *Ibid.*, at 817

³⁰⁵ Llewellyn, Karl N., What price contract? An essay in perspective, *Yale Law Journal*, 40 (1931), at 737. This concept is originally cited by Williamson in order to describe the hybrid transactions that are situated between the firm and the market. Williamson, Oliver E., *Transaction Cost Economics*, in Claude Menard and Mary M. Shirley (eds.), *Handbook of New Institutional Economics*, Dordrecht: Springer, 2005, at 51

³⁰⁶ This is based on the distinction made by Williamson, Oliver E., *Comparative Economic Organization: The Analysis of Discrete Structural Alternatives*, *Administrative Science Quarterly*, 36-2 (Jun., 1991), at 280

by enabling the parties to utilize the judicial process as an ex post governance mechanism for the allocation of residual rights, obligations and risks, where specialization of the decision maker prevails over the formal consolidations of an organization. The approach of *lex mercatoria* enables more than a mere transformation of legal uncertainty into legal risk. It enables the parties to transactions governed through legal uncertainty to leave the allocation and enforcement of residual rights, obligations and risks to ex post processes to produce some gain in the form of fair and just results for a particular case thereby preserving or restoring the existing order of international commerce that increases the effectiveness of individual actions. In this approach, the word “risk” can be seen as any sort of uncertainty viewed from the standpoint of the unfavorable contingency, namely a loss, and the term “uncertainty” with reference to the favorable outcome, namely a gain in the sense of maximizing the expectations of the elements of the order of international commerce as a whole.

The difference between the approach of *lex mercatoria* and the approach of an organization providing default rules for the internal order of the society it represents is the addition of specialization to the consolidation for the purpose of solving the same problem, the control of uncertainty. In the approach of *lex mercatoria*, the solution of this problem is taken out of the hands of the outsiders providing ex ante norms and structures for their internal orders and placed in charge of a specialized decision maker at the enforcement stage. The former norm providers cease to exercise responsible direction over the control of legal uncertainty. They take up the subsidiary roles of furnishing materials, such as private codifications and practices of international organizations, and national legal instruments, that can be used in specialized consolidations of the ex post decision maker exercising an abstract reasoning to discover the established rules in a particular case. These rules will be applied by the decision maker for a specific case on the basis of the reasonable expectations of parties with no formal consolidation and binding application to other cases which might be surrounded by different circumstances; nevertheless they can be used by other specialized decision makers as the relevant materials for discovering the established rules in other cases, thereby diffusing the specialized knowledge into the elements of the order of international commerce.

Lex mercatoria is mainly applicable to the international contracts governed through legal uncertainty in their certain aspects. The uncertain aspects of contractual relationship, i.e. the residual rights, obligations and risk allocations, can possibly be separated from the stable and predictable aspects of contract and the chosen default rules, and the control can be taken over by a specialized decision maker. The gain from dealing with such transactions through *lex mercatoria* arises largely from the decision maker’s exercise of his abstract reasoning in specialized consolidations, without being constrained by verifiability thresholds arising from the legal structures and formal consolidations of an organization focusing on the internal order of its society, not upon specific needs of an individual.

b. Institutional Choice

Lex mercatoria applies when the specific contractual rights, obligations and risk allocations that are articulated in the contract and in the default rules chosen by the parties do not prevent the conflict between the parties to an international contract, since the specific entitlements contemplated by those do not cover the issues at dispute. The application of lex mercatoria depends on the questions of residual contractual rights, obligations and risk allocations, which characterize the transactions governed through the conditions of legal uncertainty. Those questions are likely to arise in the context of complex, innovative or long-term contractual relationships because of the higher degree of uncertainty involved in them.

While the disputes over residual contractual rights, obligations and risk allocations indicate that the transaction is to be governed through the conditions of legal uncertainty and they constitute the preliminary requirement for the applicability of lex mercatoria, its application, however, ultimately depends on the ability of the parties to delegate the control of legal uncertainty to the specialized decision maker and the capacity of the decision maker to assume such a delegation. Moreover, when there is such a delegation, lex mercatoria is applicable, regardless of the characteristics of the transactions, in the determination of the limits of the parties' freedom of contract, through public policy considerations for the preservation and restoration of the order of international commerce. The delegation exists when the parties express their confidence in the specialization of the decision maker in exercising abstract reasoning in ex post consolidations for revealing the tacit knowledge of the parties that meets the deficit in their articulated knowledge by discovering the established rules, on which the reasonable expectations of the parties rests. Whether the parties have expressed their confidence in the specialization of the decision maker will be determined on the basis of the institutional choice of the parties for the ex post judicial process and the capacity of the chosen decision maker for the abstractions. There are two types of judicial process from which the parties to international contracts are to choose, and their choice indicates their preference between specialization and formal consolidations in meeting legal uncertainty. Those are litigation by national courts, which indicates the preference for formal consolidations, and arbitration by international tribunals, which indicates the preference for specialization.

In determining the capacity of decision makers for abstract reasoning to apply lex mercatoria, the relevant rules for the determination and ascertainment of the applicable law to the merits of the dispute, the relevance of trade usages and the role of general principles of law in the resolution of disputes is examined in the context of the national courts and international arbitration. Subsequently, the focus is directed to the factors that are influential on the judicial behavior of the national courts and international arbitral tribunals. Finally, the applicability of lex mercatoria in the context of litigation and arbitration to the resolution of contractual disputes is discussed.

In this regard, the examination of the role of international restatements of contract principles in contractual dispute resolution is particularly instructive. The UNIDROIT Principles and the PECL are neither model clauses nor standard contract forms. They are not in the form of an international convention or uniform law. They are not provided by an authority who wishes to turn its domain into an organization and to create an order in a specific society. They are intended to cover the whole area of contract law without being conceived in terms of specific types of transactions or trade sectors and prepared by distinguished groups of specialists in the field of international and comparative law. During their preparation, those specialists have

represented the major legal systems of the order of international commerce, but not the isolated positions of the authorities in those legal systems of the countries of which they are nationals. The restatements are primarily a product of the consolidations of those specialists exercising an abstract reasoning. In this sense, they represent an attempt at formulating the established rules from the abstract relations between the elements of international commerce with a view to maximizing the expectations of international merchants primarily by means of the comparative analysis of major national legal systems and an inspiration from the CISG as an international convention enjoying wide recognition in the field of the international sales of goods. They are able to assist the ex post decision maker applying *lex mercatoria* in utilizing the tacit knowledge of the parties to a particular dispute and in his endeavor to maintain the overall order of international commerce.

Most of the provisions of international restatements of contract principles contain standards, which enable the individual decision maker to find solutions when he is confronted with new constellations of circumstances. In those restatements, there are also more specific formulations of the established rules, and some reflect the position of their drafters as to the established rules in the commercial practices, when the irreconcilable differences between the understandings of national legal systems do not avail reproducing the common underlying principles.³⁰⁷ The drafters of the restatements also took into account the actual contracting practices on the basis of their considerable practical experience as counsel, consultants or arbitrators. Particularly, the UNIDROIT Secretariat provided a substantial collection of standard contracts used in international trade when the Working Group first began its task.³⁰⁸ What all of the provisions of international restatements of contract principles have in common is that they have a highly general character in the sense that they will be directed towards a very wide class of actions, which may differ a great deal among themselves in their detail.

Thus, international restatements of contract principles can be seen as a material product of *lex mercatoria* not because they represent a non-national source of law, but because they follow the same technique of thought that is expected from an ex post decision maker applying *lex mercatoria* as the law of principled adjudication. However, although the articulation of the established commercial practices or general principles as black letter rules in those restatements aims at obtaining consent about their existence, their individual provisions may not achieve more than an inadequate and partial expression of what was well known in practice. Since particular circumstances in which the articulated rules of those restatements

³⁰⁷ With regard to the UNIDROIT Principles see: Hyland, R., On Setting Forth the Law of Contract: A Foreword, *American Journal of Comparative Law*, 40 (1992), at 542: "... the working group has happily seen fit in at least one case, namely the rules relating to hardship, to disregard the dominant view in domestic law. In the end, the Principles might best be described as an attempt to formulate the current consensus concerning the contract rules that are most appropriate for international trade."; Farnsworth, E. A., Closing Remarks, *American Journal of Comparative Law*, 40 (1992), at 701; "...on some matters, such as hardship,..., we have adopted solutions not generally found in any domestic or international legal system but inspired instead by commercial practice."

³⁰⁸ Thus, the UNIDROIT Principles contain several provisions that are missing in the CISG and dealing with clauses common in contracts, such as writings in confirmation (Article 2.12), merger clauses (Article 2.17), written modification clauses (Article 2.18), exemption clauses (Article 7.1.6) and liquidated damages clauses (Article 7.4.13). The aim of those provisions is not to provide model clauses, but to provide for guidance in their application by the decision maker and remedies in the event of their abuse by a party. Fontaine, Marcel, *The UNIDROIT Principles: An Expression of Current Contract Practice?*, Special Supplement, ICC International Court of Arbitration Bulletin: UNIDROIT Principles of International Commercial Contracts: Reflections on their Use in International Arbitration, 2002, at 97

are not adequate will constantly arise, the task of the decision maker applying *lex mercatoria* is necessarily a never-ending one, requiring also the formulation of his own consolidations through abstract reasoning for the preservation of the order of international commerce.

The legal character of international restatements of contract principles, as trade usages or general principles, depends on their persuasive value to the decision maker applying *lex mercatoria*, resolving the particular dispute and restoring the order of international commerce, which has been disturbed by that dispute. The demonstration of in which manner the national courts and international arbitral tribunals refer to the international restatements of contract principles provides some kind of empirical basis for their actual capacity for the application of *lex mercatoria*.

i. Determination and Ascertainment of the Applicable Law

1. National Courts

In dealing with international contracts, the national courts are required to apply the conflict of laws rules of their forum, from which they derive their jurisdictional powers, in order to determine the applicable law. The party autonomy principle with regard to international contracts is widely adopted by the national conflict of law rules and, thus, the parties are able to articulate the applicable rules in the form of contractual clauses and default rules of a chosen national law. However, in applying the conflict of laws of the forum, the national courts have to ensure that the case before them is governed by a national legal system.

In various decisions of the national courts in different jurisdictions, there are statements that the validity of international contracts requires an unqualified submission to a legal system.³⁰⁹ The contracting parties may not exclude the application of any national law through a “negative choice of law”.³¹⁰ In the same vein, the parties’ choice of non-national rules as the governing law will at most amount to the incorporation of such rules into their contracts, provided that such rules are clearly identifiable.³¹¹ For example, the reference to the

³⁰⁹ Berger, Klaus Peter, *The Creeping Codification of the Lex Mercatoria*, Kluwer Law International, The Hague, 1999, at 43: citing French Cour de Cassation of June 21 1950, *Messageries Maritimes*, Rec.crit.dr.int.priv. 1950, at 609 (“... tout contrat est nécessairement soumis à la loi d’un Etat”); English House of Lords in *Amin Rashed Shipping Corporation v. Kuwait Insurance Co.* (1983) WLR 241, 249, (“Contracts are incapable of existing in a legal vacuum. They are mere pieces of paper devoid of all legal effects unless made by reference to some system of private law”); Permanent Court of International Justice, *Case concerning various Serbian loans issued in France*, 1929, PCIJ, Ser. A, No. 20, at 41 (“any contract which is not a contract between States in their capacity as subjects of international law is based on the municipal law of some country”)

³¹⁰ Berger, Klaus Peter, *The Creeping Codification of the Lex Mercatoria*, Kluwer Law International, The Hague, 1999, at 79

³¹¹ The decision of Switzerland Bundesgericht dated 20 December 2005: Plaintiff, a Swiss company, entered into a contract with Defendant, a Greek company, for the transfer of a football player managed by Plaintiff. The contract contained a forum selection clause in favor of the Swiss court and a choice of law clause stating that “this agreement is governed by FIFA Rules and Swiss law”. Concerning the question as to whether in disputes before domestic courts parties are entitled to choose a national or supranational rules as the law governing their contract, the Supreme Court stated that opinions were divided and that, at least with respect to sets of general principles and rules prepared by independent academics and comparable to domestic legal systems as to intrinsic equilibrium, comprehensiveness and general recognition such as the UNIDROIT Principles, the affirmative view prevailed. However the Supreme Court overruled the decision of the Court of first instance according to which the FIFA Rules could be chosen by the parties as the law governing the contract. The Supreme Court held that, like other sets of rules prepared by international sport associations such as the Rules of the International Ski Federation, the FIFA Rules have been prepared by a private organisation and therefore cannot be considered rules of law applicable instead of a particular domestic law. Consequently, in the case at hand the parties’ choice of the FIFA Rules as the law governing their contract amounted to a contractual incorporation of these Rules which would bind the parties only to the extent that they are not contrary to the mandatory provisions of the applicable domestic law. Abstract and full text available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1124&step=Abstract> The decision of Tribunale Padova - Sez. Este, Italy dated 11 January 2005: Plaintiff, a Slovene rabbit breeder, entered into a contract with Defendant, an Italian company, for the supply on a regular basis of rabbits. The contract contained a clause stating that “[t]his contract shall be governed by the laws and regulations of the International Chamber of Commerce of Paris, France”. The Court stated that according to Italian conflict of law rules parties are free to choose the applicable law but in so doing they must choose a particular domestic law. In the Court’s view, a reference by the parties to non-state rules of supranational or transnational character such as the *lex mercatoria*, the UNIDROIT Principles or CISG in cases where the Convention as such is not applicable cannot be considered a veritable choice of law by the parties but amounts to an incorporation of such rules into the contract with the consequence that they will bind the parties only to the extent that they do not conflict with the mandatory rules

UNIDROIT Principles in an international contract will be construed by a national court as if those rules are incorporated into the contract and any mandatory rule of the applicable national legal system will prevail over the UNIDROIT Principles without making a distinction between isolated or established rules of policy. This is foreseen by the revised Official Comment to Article 1.4 of the UNIDROIT Principles 2010, which states that “Where, as is the traditional and still prevailing approach adopted by domestic courts with respect to soft law instruments, the parties’ reference to the Principles is considered to be merely an agreement to incorporate them in the contract ..., the Principles and the individual contracts concluded in accordance with the Principles will first of all encounter the limit of the principles and rules of the domestic law that govern the contract from which parties may not contractually derogate (so-called “ordinary” or “domestically mandatory” rules). Moreover, the mandatory rules of the forum State, and possibly of other countries, may also apply if the mandatory rules claim application irrespective of what the law governing the contract is, and, in the case of the mandatory rules of other countries, there is a sufficiently close connection between those countries and the contract in question (so-called “overriding” or “internationally mandatory” rules)”.³¹²

Thus, when the set of non-national rules incorporated into the contract contains standards that require the national court to give them content *ex post* or it does not cover a contingency that has become the disputed issue, the national court will attempt to ensure that the residual rights, obligations and risks arising from such gaps and issues of interpretation will be allocated by the guidance, direction or formal consolidations of a national legal system. In such cases, the national court will apply the conflict of law rules of the forum relating to the determination of applicable law in the absence of contractual choice of law. Those rules will be immanently applicable to cases where the contractual choice of law solely contains references to such concepts as “*lex mercatoria*”, “general principles of law” or “international commercial law” because they will often be treated as an absence of choice of law.³¹³

of the applicable domestic law. The Court held that, in the case, even such incorporation into the contract must be excluded since the reference to “laws and regulations of the International Chamber of Commerce of Paris, France” was too vague as to permit a precise identification of the kind of rules the parties had in mind. Abstract and full text available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1004&step=Abstract>

³¹² Official Comment 3 to Article 1.4 of the UNIDROIT Principles

³¹³ Article 3(1) of the European Community Regulation No 593/2008 of 17 June 2008 on the law applicable to contractual obligations (Rome I) provides that “The choice shall be made expressly or clearly demonstrated by the terms of the contract or the circumstances of the case.” During the preparation of the Rome I Regulation, EC Commission presented the Proposal for a Regulation on the law applicable to contractual obligations, Rome I, COM (2005) 650 final which, in Article 3 (2), provided that “The parties may also choose as the applicable law the principles and rules of the substantive law of contract recognized internationally or in the Community. However, questions relating to matters governed by such principles or rules which are not expressly settled by them shall be governed by the general principles underlying them or, failing such principles, in accordance with the law applicable in the absence of a choice under this Regulation. ...” The Proposal’s approach expressly authorized the parties to choose instruments such as the UNIDROIT Principles and PECL, as the governing law. However, during the negotiations, the Commission’s proposal was completely deleted. The opponents’ main argument was that the internationally recognized principles of contract law lack a democratic basis since they have been drafted and agreed by working groups not established by legislatures. Lando, Ole & Peter Arnt Nielsen, *The Rome I Regulation*, *Common Market Law Review*, 45 (2008), at 1697; On the other hand, some of the recitals in Rome I Regulation refer to the Proposal’s approach. Recital 13 states that “this Regulation does not preclude parties from incorporating by reference into their contract a non-State body of law or an international convention.” Furthermore, Recital 14 states that “Should the Community adopt, in an appropriate legal instrument, rules of substantive contract law, including standard terms and conditions, such instrument may provide that the parties may choose to apply those rules.”

In the absence of choice of law by the parties, the national court will apply rules and standards of the national conflict of laws that require the court to identify one or more significant contacts or connecting factors, which serve to link the dispute to a given national legal system. The earlier tendency of conflict of laws was to provide a specific rule requiring the court to determine a single connecting factor and to resolve a dispute on that rule alone. For example, the place where a contract was entered or made (*lex loci contractus*), or the place of performance of the contract (*lex loci solutionis*) were seen as the key connecting factors, and the law of that place was applied as the governing law almost mechanically. The modern tendency in many jurisdictions seems to favor the employment of a standard, such as “center of gravity” or “most significant relationship” with respect to the territory of a national legal system. The courts give content to such standards *ex post* on the basis of the circumstances of the case by exercising an aggregate-contacts test in which several important factors are to compete, and the courts seek out the most relevant to a particular dispute.³¹⁴ However, in the application of such standards, the court is bound by the structures of the national legal system, which provide formal consolidations of similar cases, such as precedents or other specific rules that prevail over the standard, unless there is a truly atypical case.³¹⁵

The national courts cannot engage in a search for the established rules of conflict of laws; in other words, they cannot apply *lex mercatoria* at the stage of conflict of laws whereby the decision maker determines the applicable rule of conflict by means of specialized consolidations on the basis of his abstract reasoning, such as the comparative analysis of the national conflict of laws relevant to the dispute or the general principles of private international law. They have to apply the conflict rules of the forum in all cases, without exception. Only when the rule of conflict of laws required to be applied by the national court contains a standard, the court will have some kind of flexibility which, however, may be restricted by the formal consolidations provided by its national legal system.

With regard to the national court’s application of the national law that is chosen by the parties or determined pursuant to the conflict of laws rules, almost all legal systems adopt the principle that foreign law should be applied in the same manner as in its country of origin.³¹⁶

³¹⁴ Lookofsky, J. & K. Hertz, *Transnational Litigation and Commercial Arbitration: An Analysis of American, European, and International Law*, DJØF Pub., 2nd ed., 2004, at 392

³¹⁵ For example, the standard of the Rome I Regulation in the determination of the applicable law in the absence of an agreed choice is that a contract shall be governed by the law of the country with which it is most closely connected. The scope of the standard is severely limited by more specific rules, which reflect formal consolidations of similar cases. Article 4 (1) provides specific choice of law rules for certain types of contracts by means of a list of different types of contracts and the decisive connecting factor for each type of contract in points (a) to (h). Pursuant to Article 4 (2), where the contract is not covered by paragraph 1 or where the elements of the contract would be covered by more than one of points (a) to (h) of paragraph 1, the contract shall be governed by the law of the country where the party required to effect the characteristic performance of the contract has his habitual residence. In this context, the standard of Article 4 applies only where it is clear from all the circumstances of the case that the contract is manifestly more closely connected with a country other than that indicated in paragraphs 1 or 2, or where the law applicable cannot be determined pursuant to paragraphs 1 or 2. The same standard was also adopted by the predecessor of the Rome I Regulation, the Convention on the law applicable to contractual obligations (Rome Convention). The standard of the Rome Convention was complemented by some presumptions to guide the courts in the exercise of their discretion. However, the unclear relationship between the presumptions and the standard was seen as a cause of significant uncertainty so that the Rome I Regulation converted the presumptions of Rome Convention into specific rules by means of formal consolidations of similar cases in order to mitigate legal uncertainty.

³¹⁶ Jänterä-Jareborg, Maarit, *Foreign Law in National Courts: A Comparative Perspective*, *Recueil des Cours*, 304 (2003), at 230

The court applying a foreign law must take into account not only the legislation but also case law and other legal structures considered relevant in the country of origin to the reduction of legal uncertainty.³¹⁷ Common law countries constitute an important exception to this principle due to their different approach to the ascertainment of foreign law, which relies on the initiative of the parties to plead and prove foreign law as if it were a factual matter.³¹⁸ There are considerable differences between national legal systems as to the methods to be used to ascertain the content of the applicable law and the distribution of the responsibilities about the ascertainment between the court and the parties.³¹⁹ Nevertheless, in the case of failure to ascertain the contents of the applicable foreign law, from which residual questions emerge, most of the national legal systems require the national courts to apply the law of the forum as a last resort through either the presumption of similarity of foreign law with the law of the forum or the direct application of the law of forum as the subsidiary law.³²⁰

The national courts obviously do not contribute to the development of a foreign legal system, and if the content of a foreign law cannot be established, it is always possible for the national courts to fall back on their legal systems, which become competent in its place, to settle the dispute.³²¹ The considerations of general principles of law, in the sense of abstract reasoning for discovering the established rules and the application of *lex mercatoria*, might be exceptionally relevant for the national court applying a foreign law, when the court fails to ascertain the content of applicable foreign law and decides not to apply *lex fori* for a fair and just solution.³²² However, this approach is criticized due to the possible arbitrariness and uncertainty in decision making.³²³

³¹⁷ In a case before an Italian court, the contract for the license and distribution of a motion picture, which referred to English law as the applicable law, provided that in the event of termination by the licensor pursuant to the agreement, the licensee shall pay to the licensor the balance of all outstanding sums payable to the licensor under the agreement. The claimant, the Dutch licensor, terminated the contract for breach by the defendant, the Italian licensee, and claimed payment of the outstanding balance in accordance with the contract clause. The defendant objected that the clause in question represented a penalty clause the amount of which was, under the circumstances, clearly excessive and, despite the fact that the contract was governed by English law, requested the court to reduce the amount in accordance with Article 1384 of the Italian Civil Code which in its opinion was an internationally mandatory provision. The court rejected the defendant's argument concerning the applicability in the case at hand of Article 1384 of the Italian Civil Code, and asked for an expert opinion as to the nature and validity of the clause in question under English law. Since according to the expert the clause was to be considered a liquidated damages clause the amount of which according to English law could not be reduced by a court, it decided that the defendant had to pay the full amount. In so doing, the court also disregarded the defendant's further argument that the court's power to reduce the amount of a liquidated damages or penalty clause if manifestly excessive could be justified, if not under English law, on the basis of international principles such as Article 7.4.13 of the UNIDRPOIT Principles. Tribunale Rovereto, 1052/04, 15 March 2007, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1188&step=Abstract>

³¹⁸ Zajtay, Imre, *The Application of Foreign Law*, International Encyclopedia of Comparative Law, Vol. 3, Ch. 14, Tübingen: Mohr, 1972, at 12

³¹⁹ Jänterä-Jareborg, Maarit, *Foreign Law in National Courts: A Comparative Perspective*, *Recueil des Cours*, 304 (2003), at 313

³²⁰ Geeroms, Sofie, *Foreign law in Civil Litigation: A Comparative and Functional Analysis*, Oxford University Press, 2004, at 194

³²¹ Derains, Yves, *State Courts and Arbitrators*, in *Special Supplement, ICC International Court of Arbitration Bulletin: Arbitration in the Next Decade: Proceedings of the International Court of Arbitration's 75th Anniversary Conference*, ICC Publication No. 612, May 1999, at 30

³²² One example of this approach can be found in the decision of 11 July 1991 of the Commercial Court of Nantes in France. The case was about a contract between a Saudi Arabian principal, and a French agent. In resolving the dispute, the court invoked the *pacta sunt servanda* principle and the *lex mercatoria*. Under the Rome Convention the law applicable to the contract would probably have been the law of Saudi Arabia. It may

The approach of national conflict of laws is based on a presumption that all transactions whose disputes are adjudicated by a national court are governed through legal risk regardless of their characteristics unless the court is required to transcend the law in atypical cases. In atypical cases, the national court's exercise of abstract reasoning in its own consolidations for discovering the established rules in the order of international commerce will depend on willingness of the higher authorities in a legal system to improve its internal order in accordance with the order of international commerce, and on the convergence of such exercises by the individual judge with the position of those higher authorities, which review the content of his decision. In such a context, the contracts referred to litigation will be treated as transactions governed through the conditions of legal risk to a great extent. The application of *lex mercatoria*, on the other hand, requires a capacity in the decision maker for exercising abstractions and discovering the established rules, from such materials as trade usages, general principles of law and comparative law considerations. Such a decision maker should be able to give precedence to the established rules derived from those materials over the national default rules on the basis of his specialization in order to give effect to the reasonable expectations of the parties to a particular dispute, regardless of the position of a higher authority in a legal system to the problem of legal uncertainty.

2. International Arbitral Tribunals

Under most of the modern arbitration laws, the parties are free to agree upon the rules of law to be applied by the arbitral tribunal to the merits of the dispute. The reference to “rules of law” instead of “the law” was first used by the 1981 French decree on international arbitration, which provided in Article 1496 of the New Code of Civil Procedure that the parties were to select the “rules of law” applicable to their dispute.³²⁴ This terminology is later

have been difficult for the parties and the court to obtain reliable knowledge on the Saudi Arabian law of agency. The court did not find it appropriate to apply French law either. To support its selection of the *lex mercatoria*, the court made reference to the article by Lord Mustill by stating that “the general principles of law, usages of international trade and the *lex mercatoria*, of which, as recalled by Lord Mustill, the principle of “*pacta sunt servanda*” constitutes the fundamental principle of the entire system.” Cited by Lando, Ole, Some Issues Relating to the Law Applicable to Contractual Obligations, *King's College Law Journal*, 7 (1996-1997), at 61 In another case, where the parties expressly chose German law as the law applicable to a contract of agency, the Spanish Supreme Court had to decide on the argument that the lower court had applied the principle of good faith under German law incorrectly. The appellant argued that Section 242 of the German Civil Code corresponded in substance to Article 1258 of the Spanish Civil Code and the lower court erred in its application. The Supreme Court rejected that argument on the ground that while Article 1258 of the Spanish Civil Code provides that the rights and duties arising from a contract are not only those expressly stated in the contract but also those following from the principle of good faith and is therefore directed at both parties, Section 242 of the German Civil Code is directed at only the debtor imposing on it the duty to perform its obligations in accordance with good faith and the applicable trade usages. The Supreme Court held that Section 242 of the German Civil Code essentially corresponded to Article 1.7 of the UNIDROIT Principles of International Commercial Contracts and Article 1:201 of the Principles of European Contract Law, and by means of such references, the Court considered that the obligation contained under Section 242 of the German Civil Code was similar to the provisions of Article 7.1 of the Spanish Civil Code and Article 57 of the Spanish Commercial Code but not Article 1258 of the Spanish Civil Code. Consequently, the Supreme Court rejected this ground of appeal. Tribunal Supremo (Sala de lo Civil), RJ2006/6080, 4 July 2006, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1158&step=Abstract>

³²³ Zajtay, Imre, *The Application of Foreign Law*, International Encyclopedia of Comparative Law, Vol. 3, Ch. 14, Tübingen: Mohr, 1972, at 26

³²⁴ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 802, French Code of Civil Procedure (1981) Art. 1496 (1): the

codified by various arbitration codes³²⁵, UNCITRAL Model Law on Arbitration³²⁶ and rules of arbitration institutions³²⁷. It is generally agreed that the use of words “rules of law” as opposed to “the law” or “laws”, when describing the rules in which the parties are free to choose pursuant to the principle of party autonomy, indicates that the parties may choose various rules from different national or non-national legal sources, or the international restatements of contract principles, as the law governing the contract. The Official Comment to the UNIDROIT Principles provides that “Where, as may be the case if the dispute is brought before an arbitral tribunal, the Principles are applied as the law governing the contract ..., they no longer encounter the limit of the ordinary mandatory rules of any domestic law. As far as the overriding mandatory rules of the forum State or of other countries are concerned, their application basically depends on the circumstances of the case.”³²⁸ Similarly, the Official Comment to the PECL states that “Where the parties have submitted their dispute to arbitration, it is widely held that they may also agree to let the Principles govern their dispute. This means that no national legal system will be applicable to the contract and that national mandatory provisions which are not directly applicable rules or rules of public policy ... will not apply.”³²⁹

In the absence of contractual choice of law, no conflict of laws rules are immediately applicable in the context of international arbitration. According to a traditional and outdated theory, the arbitral conflict of laws should be the conflict of laws of the arbitration seat, i.e. *lex arbitri* or *lex loci arbitri*.³³⁰ This theory attempts to assure that the conflict of laws used in arbitration is the same as conflict of laws applied by national courts, which will have jurisdiction to intervene and supervise the arbitral award through setting aside proceedings.³³¹ Its main argument is that the law of the arbitration tribunal’s seat initially governs the whole of the tribunal’s life and work and in particular the validity of submission, the creation and composition of the tribunal, the rules of conflict of laws to be followed by it, its procedure,

arbitrator shall decide the dispute in accordance with the rules of law chosen by the parties or, in the absence of such choice, in accordance with the rules of law he considers appropriate.

³²⁵ Swiss Private International Law Act (1987) Article 187 (1); Dutch Code of Civil Procedure (1986) Article 1054 (1) & (2); Italian Code of Civil Procedure Article 822. United States Federal Arbitration Act and the Arbitration Act of Sweden are silent on whether the arbitrator must act in accordance with the rules of law, and if so, what law should be applied. Arbitration rules generally address the issue. As a different approach to the applicability of *lex mercatoria* see English Arbitration Act 1996 Art. 46: (1) The arbitral tribunal shall decide the dispute (a) in accordance with the law chosen by the parties as applicable to the substance of the dispute, or (b) if the parties so agree, in accordance with such other considerations as are agreed by them or determined by the tribunal....

³²⁶ UNCITRAL Model Law on Arbitration (1985) Article 28 (1).

³²⁷ ICC Arbitration Rules (1998), Article 17(1); AAA, International Arbitration Rules (2008), Article 28 (1); LCIA, Arbitration Rules (1998), Article 22.3; Arbitration Institute of the SCC, Arbitration Rules (2007), Article 22 (1). As a different approach, see China International Economic and Trade Arbitration Commission (CIETAC), Arbitration Rules (2005), Article 43 (1): The arbitral tribunal shall independently and impartially make its arbitral award on the basis of the facts, in accordance with the law and the terms of the contracts, with reference to international practices and in compliance with the principle of fairness and reasonableness.

³²⁸ Official Comment 3 to Article 1.4 of the UNIDROIT Principles

³²⁹ Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law*, Parts I and II, Kluwer Law International, 2000, at 100

³³⁰ ICC Award in Case No. 1455, 1967, *Yearbook Commercial Arbitration*, 3 (1978), at 215; ICC Award in Case No. 1598, 1971, *Yearbook Commercial Arbitration*, 3 (1978), at 216

³³¹ De Ly Filip, *International business law and lex mercatoria*, T.M.C. Asser Instituut, 1992, at 93

and the making of its award.³³² However this theory is criticized on the ground that it does not reflect reasonable expectations of the parties since the choice of the place of arbitration often has little or nothing to do with the parties or with the contract under which the dispute arises.³³³ While recognizing that there is no justification for applying the conflict of laws rules of the seat of arbitration, many national legal systems adopted, in their laws relating to international arbitration, different conflict of laws rules specifically intended to be applied by the arbitrators and allowing a greater degree of flexibility in the determination of the applicable law.

Article VII of the European Convention on International Commercial Arbitration of 1961 provided that “failing any indication by the parties as to the applicable law, the arbitrators shall apply the proper law under the rule of conflict that the arbitrators deem applicable”. This solution was adopted by Article 13(3) of the ICC Arbitration Rules of 1975 and by the UNCITRAL Model Law on Arbitration of 1985. The 1996 English Arbitration Act adopts a similar approach.³³⁴ Alternatively, Article 187 (1) of the Swiss Private International Law Act (1987) provides that in the absence of a choice of law by the parties, the arbitral tribunal shall decide the case according to the rules of law with which the case has the closest connection. This rule apparently denies the arbitrators sitting in Switzerland, in their determination of the applicable law, the option of applying other choice of law rules or of exercising greater discretion in their choice of the governing law. However, it has been argued that the choice of law rule under Article 187 is so flexible that in practice it barely restricts the arbitrator’s freedom to apply the law he deems appropriate.³³⁵

It has quickly become apparent that the obligation laid upon arbitrators to apply a conflict of laws rule was not the same thing as a national courts’ obligation to apply the conflict of laws of the forum. As pointed out in ICC Case No 1512, “the international arbitrator has no *lex fori*, to which he can borrow rules of conflict of laws.”³³⁶ In ICC Case No 2930, the arbitral tribunal determining the law applicable to the substance of the dispute stated that “the most authoritative present-day doctrine and international commercial arbitration jurisprudence admit that in determining the substantive law, the arbitrator may leave aside the application of the conflict rules of the forum.” The arbitral tribunal added that it enjoys “wide, and even discretionary powers, in the choice of the applicable law..., and if it is authorized to refer to the different systems of conflict of laws at its disposal, it is by no means obliged to give

³³² Mann, F. A., *Lex Facit Arbitrum*, in Pieter Sanders (ed.) *International arbitration, Liber amicorum for Martin Domke*, The Hague, Martinus Nijhoff, 1967, at 164

³³³ Redfern, Alan & Martin Hunter with Nigel Blackaby and Constantine Partasides, *Law and Practice of International Commercial Arbitration*, London: Sweet & Maxwell, 4th ed. Student version, 2004, at 145; The argument that a venue for arbitration is chosen for reasons of convenience and/or neutrality also finds empirical validation in a study conducted by the School of International Arbitration at the Centre for Commercial Law Studies, Queen Mary University of London, where the in-house lawyers of various corporations were the respondents. In the study, it appeared that corporations accept the minimum or basic role of local courts but they do hope that arbitrators can decide most if not all matters without having to resort to national courts, and there was no evidence that the parties expect that the law of the place of arbitration would necessarily apply, but when they know that it may apply they are prepared to take the risk. Mistelis, Loukas, *International arbitration, Corporate Attitudes and Practices, 12 Perceptions Tested: Myths, Data and Analysis Research Report*, *American Review of International Arbitration*, 15 (2004), at 570-571

³³⁴ See English Arbitration Act 1996 Art. 46 (3)

³³⁵ Gaillard, Emmanuel & John Savage (eds.), *Fouchard, Gaillard, Goldman on International Commercial Arbitration*, Kluwer Law International, 1999, at 870 and 866 fn. 7

³³⁶ ICC Award in Case No. 1512, 1971, *Yearbook Commercial Arbitration*, (1976), at 129

precedence to one of them, above another.”³³⁷ Thus, it is argued that the arbitrators freed themselves from national conflict of laws regimes by adopting original approaches based above all on the wish to give effect to the reasonable expectations of the parties.³³⁸

In such a context, the arbitrators reason differently and attempt to convince the parties that the law deemed to be applicable to the contract meets their reasonable expectations.³³⁹ Apart from some cases in which they decide to place themselves within the framework of a national regime of conflict of laws, arbitrators generally look for the established rules of conflict of laws through one of the following two methods: (1) cumulative application of the different systems of conflict of laws related to the dispute, and (2) recourse to general principles of private international law. Under the first method, the arbitrator considers the conflict of laws rules of each of the national legal systems connected with the dispute. If these rules converge towards one single national law, the arbitrator determines that law as the applicable law. Under the second method, the arbitrator refers to a rule of conflict of laws that is widely accepted in the order of international commerce. In addition to those two methods, some arbitrators resort to the direct choice method (*voie directe*). According to the direct method, the arbitrators decide that the contract must be subject to a particular set of rules, which can be either national or non-national, in view of the nature and characteristics of the contract without referring to a particular regime of conflict of laws. Their analysis of the contract resembles an extensive form of interpretation of the contractual intentions of the parties, and attempts to demonstrate to the parties that they could not reasonably expect the arbitrators to apply any law other than the one finally determined.³⁴⁰

By means of any of those methods, the arbitrators actually exercise their capacity for abstract reasoning in their specialized consolidations by addressing the issue of applicable law in terms of “what the parties' expectations or understanding were or would have been, had they addressed the issue”.³⁴¹ As stated by the arbitral tribunal in ICC Case No 7110, “the determination of the applicable law is an exercise which may not remain indifferent to the substantive outcome of the choice-of law process. If projected to the field of international commercial arbitration and the interpretation of the relevant part of Art. 13(3) of the ICC Arbitration Rules, the necessary conclusion is that the very distinction between *voie indirecte* and *voie directe* becomes blurred and on the verge of fading away, since both would pursue the same ends through essentially the same means, namely, the application of the “better law”, i.e. the substantive rules, laws and principles best adapted to a just and fair decision of the dispute on the basis of the circumstances of the case and the parties' expectations by directly taking into account, for so doing, the contents of the substantive rules and principles to be applied”.³⁴²

³³⁷ ICC Award in Case No. 2930, 1982, *Yearbook Commercial Arbitration*, (1984), at 105-106

³³⁸ Derains, Yves, *State Courts and Arbitrators*, in *Special Supplement, ICC International Court of Arbitration Bulletin: Arbitration in the Next Decade: Proceedings of the International Court of Arbitration's 75th Anniversary Conference*, ICC Publication No. 612, May 1999, at 28

³³⁹ Derains, Yves, *The Role of the UNIDROIT Principles in International Commercial Arbitration (1): A European Perspective*, in *Special Supplement, ICC International Court of Arbitration Bulletin: UNIDROIT Principles of International Commercial Contracts: Reflections on their Use in International Arbitration*, 2002, at 12

³⁴⁰ *Ibid.*, at 13

³⁴¹ Mehren, A. T. von, *To What Extent is International Commercial Arbitration Autonomous?* in *Le droit des relations économiques internationales. Etudes offertes à Berthold Goldman*, Paris: Litec, 1982, at 227

³⁴² ICC Award in Case No. 7110, *ICC International Court of Arbitration Bulletin*, 10-2 (1999), at 50

Some modern international arbitration laws no longer refer to arbitrators' being under any obligation to determine the applicable law by means of a conflict of laws rule in the absence of choice by the parties, by providing the direct choice method as the default option for the determination of the applicable law. Article 1496 (1) of the French Code of Civil Procedure allows the arbitrator to apply the rules of law he considers appropriate even when there is no choice of law by the parties. The Dutch Code of Civil Procedure adopts the same approach.³⁴³ Similarly, Article 34(2) of the new Spanish Arbitration Act stipulates that, “failing any designation by the parties, the arbitrators shall apply the rules of law that they consider appropriate.”³⁴⁴

This approach is adopted by the rules of all major arbitration institutions, including the ICC Arbitration Rules of 1998 and 2012.³⁴⁵ Consequently, the variety of approaches adopted by the arbitration laws with regard to the determination of the applicable law in the absence of choice by the parties do not matter in practice, due to default nature of those conflict of laws rules, and almost all arbitration laws allow the parties not to choose a legal system to govern their contract due to their reference to “rules of law”. Since in the great majority of cases, the parties will choose to apply institutional rules of arbitration, which commonly endorse the direct application of “rules of law” by the arbitrators, the arbitrator will have the latitude required for the abstract reasoning and the application of *lex mercatoria* even in the absence of contractual choice of law.³⁴⁶

The approach of the international arbitral tribunals to the resolution of disputes on the basis of the reasonable expectations of the parties has also effects on the ascertainment of the law or rules of law governing the substance of the dispute in this context. Unlike the situation in national courts where there is a distinction between national and foreign law, in arbitration it is only possible to speak of “applicable law”. By the same token, neither party is a “foreign” party in the context of international arbitration. While the national courts benefit from the particular rules of the legal system of the forum specifying how a court should ascertain the content of the foreign law, there is no equivalent set of rules for the ascertainment of the applicable law in the context of international arbitration and there is no legal system upon which arbitrators may fall back in the same way as a national court falls back on its own legal system.³⁴⁷ Arbitration laws of national legal systems generally do not specify how arbitrators should ascertain the applicable law’s contents.³⁴⁸ Similarly, the institutional arbitration rules

³⁴³ Dutch Code of Civil Procedure (1986) Article 1054

³⁴⁴ Spanish Arbitration Act, 2003, Law No. 60/2003, December 23, 2003, entered into force March 26, 2004

³⁴⁵ ICC Arbitration Rules (1998), Article 17(1); ICC Arbitration Rules (2012), Article 21(1); AAA, International Arbitration Rules (2008), Article 28 (1); LCIA, Arbitration Rules (1998), Article 22.3; SCC, Arbitration Rules (2007), Article 22 (1) China International Economic and Trade Arbitration Commission (CIETAC), Arbitration Rules (2005), Article 43 (1).

³⁴⁶ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 876: Since United States Federal Arbitration Act and the Arbitration Act of Sweden are silent on what law should be applied, arbitration rules will govern the issue.

³⁴⁷ Derains, Yves, State Courts and Arbitrators, in Special Supplement, ICC International Court of Arbitration Bulletin: Arbitration in the Next Decade: Proceedings of the International Court of Arbitration's 75th Anniversary Conference, ICC Publication No. 612, May 1999, at 30

³⁴⁸ There are also exceptions. Article 1044 of the Dutch Code of Civil Procedure provides that “Request for Information on Foreign Law 1. The arbitral tribunal may, through the intervention of the President of the District Court at The Hague, ask for information as mentioned in article 3 of the European Convention on Information on Foreign Law, concluded at London, 7 June 1968 (Dutch Treaty Series 1968, 142). The President shall, unless he

are usually silent on the matter.³⁴⁹ Thus, the arbitrators have considerable freedom to operate within broad standards based on fundamental principles, such as fairness to the parties, due process, limits on arbitral mandates and respect for public policy contents, which are reflected in international arbitration conventions such as the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards as well as in arbitration laws and rules. As long as the arbitrators ascertain the contents of the applicable law in accordance with those principles, their awards are unlikely to be annulled or denied enforcement on grounds relating to their ascertainment of the contents of the applicable law.³⁵⁰ Since the ascertainment of the contents of the applicable law is mainly a matter of procedure, in the absence of mandatory rules of the law of the seat, the arbitrators will have to deal with it as with any other procedural matter by having regard to the direct or indirect will of the parties, in the absence of which they will follow the rules or approach of their choice.³⁵¹

In this context, arbitral practice varies widely with regard to the determination and ascertainment of the applicable law. In cases where the parties agree on a national law to govern their contract, the arbitrators have the capacity to interpret the parties' choice of a particular national law as exclusive of those rules, which would frustrate their contractual intentions or would otherwise be contrary to their reasonable expectations at the time of contracting within the confines of the principle of freedom of contract that is specific to the order of international commerce. It is also argued that the arbitrators are reluctant to make decisions that may have significant economic consequences simply by referring to a national law or a national legal tradition that may take at least one of the parties by surprise. Instead, the arbitrators prefer to show that their solution, although based on a national law, is also recognized as the established rules in the order of international commerce.³⁵² The various methods, by means of which the arbitrators give effect to the reasonable expectations of the parties as to the applicability of a national law, apparently influence the way the national law

considers the request to be without merit, send the request without delay to the agency mentioned in article 2 of said Convention and notify the arbitral tribunal thereof. 2. The arbitral tribunal may suspend the proceedings until the day on which it has received the answer to its request for information." Section 27(2) of the Danish Arbitration Act provides that: "If the arbitral tribunal considers that a decision on a question of European Union law is necessary to enable it to make an award, the arbitral tribunal may request the courts to request the Court of Justice of the European Communities to give a ruling thereon." Article 34(1)(2)(g) of the English Arbitration Act 1996, without offering guidance on how arbitrators should perform their task of ascertaining the law, provides that "It shall be for the tribunal to decide all procedural and evidential matters, subject to the right of the parties to agree any matter. Procedural and evidential matters include ...whether and to what extent the tribunal should itself take the initiative in ascertaining the facts and the law."

³⁴⁹ One exception is Article 2.1(c) of the LCIA Rules which states: "Unless the parties at any time agree otherwise in writing, the Arbitral Tribunal shall have the power, on the application of any party or of its own motion, but in either case only after giving the parties a reasonable opportunity to state their views to conduct such enquiries as may appear to the Arbitral Tribunal to be necessary or expedient, including whether and to what extent the Arbitral Tribunal should itself take the initiative in identifying the issues and ascertaining the relevant facts and the law(s) or rules of law applicable to the arbitration, the merits of the parties' dispute and the Arbitration Agreement."

³⁵⁰ International Law Association, Committee on International Commercial Arbitration, Final Report on Ascertaining the Content of the Applicable Law in International Commercial Arbitration, 73rd Conference, Rio de Janeiro, Brazil (August 2008), at 5

³⁵¹ *Ibid.*, at 15

³⁵² Derains, Yves, The Role of the UNIDROIT Principles in International Commercial Arbitration (1): A European Perspective, in Special Supplement, ICC International Court of Arbitration Bulletin: UNIDROIT Principles of International Commercial Contracts: Reflections on their Use in International Arbitration, 2002, at 17

applied by an arbitral tribunal in that the arbitrators seem to consider themselves under no obligation to apply the law in exactly the same manner as a national court would do in the country of that law. It seems that the arbitrators are aware that they have neither mandate nor function in the development of any national legal system and their decisions will not become a part of the self-referential structure of any national legal system. Thus, even when an arbitrator applies a national law as a result of a contractual choice of law or the established rules of conflict in a particular case, he has the capacity to apply that law on the basis of the reasonable expectations of the parties to a particular dispute.

While the capacity of national courts for abstractions is severely limited by the presumption that all transactions which are referred to litigation are transactions primarily governed through legal risk and the national courts have to ensure that the case before them is governed by a national legal system, the arbitral tribunals have the full capacity for abstract reasoning in discovering the established rules from such materials as trade usages, general principles of law and comparative law considerations. As a result of such a capacity, the arbitral tribunals are able to interpret, supplement or correct both the contractual terms and the set of applicable default rules in accordance with the established rules derived from those materials on the basis of their specialization in order to give effect to the reasonable expectations of the parties to a particular dispute.

ii. Relevance of Trade Usages

1. National Courts

The approaches traditionally taken by the national legal systems with respect to the relevance of usages can broadly be divided into two different kinds.³⁵³ First, there is a subjective approach which results in a tendency to consider usages applicable only if there has been a corresponding express or implied intention of the parties.³⁵⁴ Second, there is an objective approach, which tries to explain the binding force of usages on objective grounds, such as their general validity in a certain community, or the national legal rules' reference to some usages which the parties established between themselves. However, even within the various national laws the differences between the subjective and the objective approaches are vague. Thus, in those legal systems in which the application of usages is in principle made dependent on a corresponding intention of the parties, such an intention is usually presumed when a particular usage is commonly observed in the trade sector in which both parties operate. On the other hand, the prevalence in different legal systems of the objective tendency does not prevent the courts from considering the application of a particular usage if a corresponding intention or the knowledge of the parties with regard to that usage proves to be sufficiently certain and justifies the expectation that it will be observed with respect to the transaction in question.³⁵⁵

The variety of approaches results from the controversy as to the normative force of usages in national legal systems. It can be said that subjective approach tries to validate the normative force of usage on the basis of the principle of freedom of contract, while objective approach is based on the concern for mitigating legal uncertainty and limiting the discretionary power of the national courts. Alternatively, both subjective and objective approaches to the relevance of trade usages can be based on an understanding of the established rules in a particular sector or industry, which give rise to the reasonable expectations of the parties in the sense that it would be reasonable for the parties to expect the application of a particular usage, if such usage is widely observed in a trade for a certain duration or if the parties expressly or impliedly have agreed on the applicability of a certain usage. Thus, the activities of national courts when applying a national law may be in the form of discovering the established rules and deriving applicable legal norms from trade usages by means of giving precedence to their *ex post* consolidations over the formal consolidations existing in the default rules of the national legal systems. Such activities can be particularly relevant to the allocation of the residual rights, obligations or risks under the transaction.

However, the national legal systems commonly set certain thresholds as to the verifiability of reasonable expectations of contractual parties arising from trade usages. Civil law countries generally adopt the procedural distinction between custom and usages. According to this distinction, national courts cannot know all usages and the parties must provide evidence as to their existence, whereas customs should not be proven and may be reviewed by supreme

³⁵³ Bonell, Michael Joachim, Article 9, in Bianca, C. Massimo & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 110

³⁵⁴ De Ly Filip, *International business law and lex mercatoria*, T.M.C. Asser Instituut, 1992, at 158

³⁵⁵ Bonell, Michael Joachim, Article 9, in Bianca, C. Massimo & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 110

courts as rules of law.³⁵⁶ Under those national laws, trade usages are not genuine sources of law. They function as tools of contractual interpretation and gap filling and, their applicability requires a national legal rule specifically referring to it.³⁵⁷ Such rules can often be found in the national codes regulating commercial contracts. For example, in German law, Section 242 of the Civil Code declares that, in order to determine what good faith requires, it is necessary to take common practice into consideration. Section 346 of the German Commercial Code provides that trade customs and usages must be observed among merchants, in respect of the meaning and effect of actions and omissions. Article 1135 of the French Civil Code provides that contracts create obligations not only in relation to what they expressly provide, but also to all the consequences which equity, custom or legislation give to them according to their nature. Pursuant to Article 1160 of the French Civil Code, terms which are customary shall be supplemented in the contract, even though they are not expressed there.

In civil law countries, the relevance of trade usages to the interpretation and supplementation of the contract is usually identified by at least two criteria: observance and duration. First, there must be general or at least widespread regular observance of a particular line of conduct amongst a specific group of persons. Second, the line of conduct has to be observed with certain regularity over a certain period of time.³⁵⁸ Custom, on the other hand, is subject to the test of *opinio iuris sive necessitatis*. Accordingly, *usus* must be conjoined with *opinio juris*, namely, the pattern of regular observance of a particular line of conduct is not enough for the emergence of a custom, since it also requires that the conduct be followed out of a belief that it is legally binding.³⁵⁹ The *opinio juris* requirement would make it impossible for a new commercial practice to develop normative force without ascribing to the business community a collective mental state which is rather unreal.³⁶⁰ Thus, the more modern approach of national contract laws focuses on the test of determining whether a commercial practice fits into a particular contract and binds parties on a contractual level.³⁶¹

Under German law, the existence of a common practice mainly depends on the evidence of an actual practice where, in a large number of cases, parties act in the same way.³⁶² Accordingly, a German court deciding on whether a practice has become legally binding usage will look for a rule that reflects a continuous, uniform and voluntary practice in the trades concerned over an appropriate period of time. Under French law, the existence and content of custom or usage is a matter for the “*juges du fond*”, but the courts will fill the gaps in the contract with trade practices only when both parties to the contract are members of the trade.³⁶³ According to a

³⁵⁶ De Ly Filip, *International business law and lex mercatoria*, T.M.C. Asser Instituut, 1992, at 221

³⁵⁷ Dalhuisen, J.H., *Custom and its Revival in Transnational Private Law*, *Duke Journal of Comparative and International Law*, 18 (2008), at 359

³⁵⁸ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 194

³⁵⁹ Goode, Roy, *Usage and its Reception in Transnational Commercial Law*, *International and Comparative Law Quarterly*, 46-1 (1997), at 8-9

³⁶⁰ Goode, Roy, *Rule, Practice and Pragmatism in Transnational Commercial Law*, *International and Comparative Law Quarterly*, 54-3 (2005), at 551

³⁶¹ UNIDROIT – Study L – Doc. 51, Rome, May 1992, at 61

³⁶² Kornet, Nicole, *Contract Interpretation and Gap Filling: Comparative and Theoretical Perspectives*, Intersentia, 2006, at 114

³⁶³ Bell, John, Sophie Boyron & Simon Whittaker, *Principles of French law*, Oxford University Press, 2nd ed., 2008, at 331

French court, a binding usage presupposes a collective practice, which can be observed from the repetition of the same acts, and the French case law emphasizes the requirement of generality.³⁶⁴

In common law countries, there is not a clear distinction between custom and usages, and they are all considered subjective and have to be proven.³⁶⁵ In English law, contractual terms can be implied into a contract from trade usages or customs unless the parties have expressly or impliedly excluded them.³⁶⁶ In *Hutton v Warren*, it was established that evidence of custom and usage is admissible to add implied terms to, but not to contradict the contract.³⁶⁷ This is based on the presumption that the parties did not intend to express the entire contract in writing, but intended to contract with reference to known usages. There are strict requirements that need to be fulfilled for a custom or usage to be implied into the contract.³⁶⁸ The custom or usage must be notorious; it must be “so well known in the market in which it alleged to exist that those who conduct business in that market contract with the usage as an implied term.”³⁶⁹ The custom or usage must be clearly established and identifiable in the sense that the course of conduct “consists of a continuity of acts, and those acts have to be established by persons familiar with them.”³⁷⁰ The custom or usage must be more than a mere trade practice that is followed in practice as a matter of grace or commercial convenience.³⁷¹ The custom or usage must be reasonable, in the sense that it must be “fair and proper and such as reasonable, honest and fair-minded men would adopt.”³⁷² However, where a large number of commercial people act upon a custom, it would be difficult for a court to hold that the practice is unreasonable due to the “tendency to support freedom of bargaining in commercial markets”.³⁷³ The custom or usage must not be contrary to mandatory law.³⁷⁴ Finally, the

³⁶⁴ Hyland, R., Note to ICC Case No. 5713 of 1989, in Albert H. Kritzer (ed.), *Guide to Practical Applications of the United Nations Convention on Contracts for the International Sale of Goods*, Kluwer 1994, Vol. 2, Suppl. 9, available at <http://www.cisg.law.pace.edu/cisg/biblio/hyland.html>

³⁶⁵ Dalhuisen, J.H., *Custom and its Revival in Transnational Private Law*, *Duke Journal of Comparative and International Law*, 18 (2008), at 358

³⁶⁶ Beatson, Jack, *Anson's Law of Contract*, Oxford University Press, 27th ed., 1998, at 148

³⁶⁷ (1836) 1 M & W 466, “It has long been settled, that, in commercial transactions, extrinsic evidence of custom and usage is admissible to annex incidents to written contracts, in matters with respect to which they are silent. The same rule has also been applied to contracts in other transactions of life, in which known usages have been established and prevailed; and this has been done upon the principle of presumption that, in such transactions, the parties did not mean to express in writing the whole of the contract by which they intended to be bound, but a contract with reference to those known usages.”

³⁶⁸ Dalhuisen, J.H., *Custom and its Revival in Transnational Private Law*, *Duke Journal of Comparative and International Law*, 18 (2008), at 358

³⁶⁹ *Cunliffe-Owen v Teather & Greenwood* [1967] 1 WLR 1421

³⁷⁰ *Cunliffe-Owen v Teather & Greenwood* [1967] 1 WLR 1421

³⁷¹ Beatson, Jack, *Anson's Law of Contract*, Oxford University Press, 27th ed., 1998, at 148, at 149

³⁷² *Produce Brokers Co. Ltd v Olympia Oil & Cake Co. Ltd* [1916] 2 KB 296

³⁷³ Beatson, Jack, *Anson's Law of Contract*, Oxford University Press, 27th ed., 1998, at 150; *Restatement (Second) of Contracts*, Section 222, Comment b.: “A usage of trade need not be “ancient” or “immemorial”, “universal”, or the like. Unless agreed to in fact, it must be reasonable, but commercial acceptance by regular observance makes out a prima facie case that a usage of trade is reasonable.”

³⁷⁴ Chitty, Joseph, & Hugh Beale, *Chitty on Contracts*, Vol. 1 *General Principles*, London: Sweet & Maxwell, 29th ed., 2004, at 784

custom or usage must be consistent with the express terms, with necessarily implied terms and with tenor of the contract.³⁷⁵

The requirements of a national legal system as to the normative force of trade usages and their relevance to the interpretation and supplementation of the contract prevents the national courts dealing with international contracts from having access to the entire contractual setting in the presence of unverifiable and tacit knowledge of the parties to a particular transaction. Therefore, the national courts may not be able to accurately determine the established rules for a particular international contract, which give rise to the reasonable expectations of the parties, when those can only be determined by means of abstractions on the basis of specialization of the decision maker. In the context of national courts, those requirements constitute the verifiability thresholds to the reasonable expectations of the parties arising from their tacit knowledge and mainly allow the applicability of trade usages, which have been widely adopted by the relevant community of international merchants for a certain period of time or which can be established on the basis of the intention of the parties. Those requirements will prevent the national courts from overcoming formal consolidations of the legal system developing default rules, with specialized consolidations in the form of abstractions from the relevant international contracting and business practices, which may not qualify as usage or custom in the relevant national legal system due to the difficulties in the verification of their normative force to a national court. Such a capacity for abstractions in the national courts is severely limited by the legal system for the purpose of mitigating legal uncertainty.³⁷⁶ Those thresholds will limit the national courts' capability of utilizing the tacit knowledge of the parties to a particular dispute, as far as the residual contractual rights, obligations and risks are concerned and, also of exercising abstract reasoning in ex post consolidations for discovering the established rules in a particular case.

In this context, the national courts refrain from referring to the international restatements of contract principles, as trade usages or customs. The national courts necessarily have a constant concern for the internal order of the relevant legal system. The applicability of those restatements in assisting the abstractions of national courts depends on the position of the higher authorities, namely supreme courts or legislative bodies in the relevant legal systems, to the idea of maintaining or improving their internal orders in line with the order of international commerce. The authorities in some legal systems seem to be aware that an effective framework for a functioning spontaneous order of international commerce will be achieved only by the consistent application of the same principles by the courts of various legal systems. Such an awareness of authorities enable the national courts dealing with international contracts to refer to those international restatements as general principles of law

³⁷⁵ *Palgrave, Brown & Son Ltd v SS Turid (Owners)* [1922] 1 AC 397; *Cunliffe-Owen v Teather & Greenwood* [1967] 1 WLR 1421

³⁷⁶ There are examples of court decisions which used international trade usages widely adopted in the relevant mercantile community thereby enabling homogenous consolidations, such as INCOTERMS, ICC Uniform Customs and Practice for Documentary Credit (UCP) and ICC Uniform Rules for Collection (URC). In England, URC were considered applicable, even if they are less well known, since they are subscribed to by all banks in England. *Harlow & Jones Ltd. v. Am. Express Ban Ltd.* (1990) 2 Lloyd's Rep. 343, 346-49 (Q.B.); Similarly, UCP were considered applicable due to the fact that "all, or practically all" banks in the world subscribe to them. *Power Curber Int'l Ltd. v. Nat'l Bank of Kuwait S.A.K.*, [1981] 2 Lloyd's Rep. 394, 398-99 (A.C.) In Germany, the Bundesgerichtshof on 18 June 1975 held that if parties agree that goods should be delivered FOB (free on board), the INCOTERMS interpretation of such a clause is applicable even if the parties did not expressly referred to the INCOTERMS and in a decision of French Cour de Cassation of 14 October 1981, UCP were given the status of suppletive law even if the parties did not expressly referred to UCP. Cited by Goldman, Berthold, *Lex mercatoria*, *Forum Internationale* No. 3, Deventer, November 1983, at 14

in the interpretation and supplementation of the national legal system, rather than trade usages or customs in the interpretation and supplementation of the contract. Thus, the applicability of those restatements in the context of a national court is not a result of the specialization exercised by the judge in a particular case, but depends on the position of the authority, whose power is directed towards the generality of actions in the internal order of the legal system. Consequently, the use of those restatements by the national courts is subject to the review of supreme courts as a matter of law.

2. International Arbitral Tribunals

In international arbitration, the understanding of trade usages suggests that, the arbitrators are entitled to supplement or correct the provisions of the law chosen by the parties on the basis of trade usages if the reasonable expectations of the parties so require. This is mainly due to the specific provisions of arbitration laws and rules relating to the consideration of trade usages by arbitral tribunals. For example Article 1496 of the New French Code of Civil Procedure instructs arbitrators to take into account international trade usages “in all cases,” that is, even where the parties have expressly chosen the law governing the dispute. The same is true for the 1961 European Convention³⁷⁷, the codes of civil procedure of the Netherlands³⁷⁸ and Germany³⁷⁹, and more generally, all arbitration laws inspired by the UNCITRAL Model Law.³⁸⁰ Moreover, various international arbitration institutions require, in their rules, arbitrators to consider usages of trade in deciding contractual disputes.³⁸¹ In the presence of such rules, the arbitrators are freed from the constraints arising from the requirements of national legal systems for considering the relevance of trade usages to the interpretation and supplementation of the contract. The arbitrators are even capable of overcoming the formal consolidations of the legal systems with their specialized consolidations in the form of abstractions from the relevant international contracting and business practices or international restatements of contract principles, which may not qualify as usage or custom in the relevant national legal system due to the difficulties in the verification of their normative force to a national court.

Therefore, in a number of arbitral awards, the arbitrators utilized this flexibility with regard to the relevance of trade usages and referred to the CISG or international restatements of contract principles as representing international trade usages, which is so far unprecedented in the context of national courts. In ICC Case No. 5713, the dispute arose from non-conformity of goods in a series of contracts for international sale of goods. As the contracts did not contain a choice of law clause, the arbitral tribunal held, pursuant to Article 13(3) of the 1975

³⁷⁷ Article VII of the 1961 European Convention on International Commercial Arbitration of 1961 done at Geneva: “The parties shall be free to determine, by agreement, the law to be applied by the arbitrators to the substance of the dispute. Failing any indication by the parties as to the applicable law, the arbitrators shall apply the proper law under the rule of conflict that the arbitrators deem applicable. In both cases the arbitrators shall take account of the terms of the contract and trade usages.”

³⁷⁸ Article 1054 (4) of the Netherlands Code of Civil Procedure

³⁷⁹ Article 1051 (4) of the German Code of Civil Procedure

³⁸⁰ Article 28 (4) of the UNCITRAL Model Law: “In all cases, the arbitral tribunal shall decide in accordance with the terms of the contract and shall take into account the usages of the trade applicable to the transaction.”

³⁸¹ For example, Article 17(2) of the ICC Rules of Arbitration of 1998 and Article 21(2) of the ICC Rules of Arbitration of 2012, Article 33 (3) of the UNCITRAL Rules and Article 28 (2) of the International Arbitration Rules of the AAA require the arbitrator to take into account usages. On the other hand, the LCIA and the SCC do not have rules requiring arbitrators to consider trade usages.

ICC arbitration rules, that the contract was governed by the law of the country where the seller had his place of business since “the general trend in conflicts of law is to apply the domestic law of the current residence of the debtor of the essential undertaking arising under the contract”.³⁸² The arbitral tribunal also stated that it would take into account the relevant trade usages in accordance with Article 13(5) of the ICC arbitration rules. In view of the tribunal, “there is no better source to determine the prevailing trade usages than the terms of the [CISG]... even though neither [the country of the Buyer] nor [the country of the Seller] are parties to that Convention.”³⁸³ Without discussing the requirements which the applicable national law sought for the relevance of trade usages, the arbitral tribunal maintained that “The Vienna Convention, which has been given effect to in 17 countries, may be fairly taken to reflect the generally recognized usages regarding the matter of non-conformity of goods in international sales.”³⁸⁴ The tribunal considered that the provisions of the applicable national law appeared as an exception to the generally accepted trade usages, as reflected in the CISG, since they imposed extremely short and specific time requirements in respect of the buyer giving notice to the seller in case of non-conformity of goods, and applied the relevant provisions of the CISG as a result of its abstract reasoning in its consolidation, instead of the formal consolidations of the applicable national legal system, to resolve the dispute.

In ICC Case No. 8502, where the contract did not contain a choice of law clause, the arbitral tribunal noting that “the application of the relevant trade usages is consistent with Article 13(5) of the ICC Rules and with the arbitral practice” decided to resolve the dispute by applying to the contract “trade usages and generally accepted principles of international trade.” In this regard, the arbitral tribunal stated that it “shall refer, when required by the circumstances, to the provisions of the [CISG] or to the [UNIDROIT Principles], as evidencing admitted practices under international trade law.”³⁸⁵

In an Ad hoc Arbitration in Buenos Aires, the dispute arose from a contract between shareholders of an Argentine company and a Chilean company for the sale of the shares of the Argentine company. The contract did not contain a choice of law clause and the parties authorized the tribunal to act as amiable compositeurs. The tribunal decided to apply the UNIDROIT Principles on the grounds that they constituted “usages of international trade reflecting the solutions of different legal systems and of international contract practice” and that as such, according to Article 28(4) of the UNCITRAL Model Law, they should prevail over any domestic law.³⁸⁶

In ICC Case No. 9479, the arbitral tribunal, recalling Article 13 of the ICC Rules, decided to “first apply the provisions of the contract, in the light of and, in case of need, supplemented by the usages of international trade, provided the validity of such provisions is not questioned by the parties or [such provisions] do not appear to the tribunal to be incompatible with international public policy in the sense of truly or transnational public policy.”³⁸⁷ The tribunal added that “In case the arbitral tribunal does not find in the contract or in the usages of

³⁸² ICC Award in Case No 5713, 1989, Yearbook Commercial Arbitration (1990), at 71

³⁸³ Ibid., at 72

³⁸⁴ Ibid., at 72

³⁸⁵ ICC Award in Case No. 8502, ICC International Court of Arbitration Bulletin, 10-2 (Fall 1999), at 72-73

³⁸⁶ Ad hoc Arbitration, Buenos Aires, 10 December 1997, Abstract published in English and French: Uniform Law Review, (1998), at 178-179

³⁸⁷ ICC Award in Case No. 9479, ICC International Court of Arbitration Bulletin, 12-2 (Fall 2001), at 67

international trade a solution to the problems raised by the parties' claims, it must revert to the law applicable to the contract." The arbitral tribunal noted that the contract expressly indicated the law of the State of New York as the law governing the validity of the agreement and concluded that the silence with respect to all other matters was to be understood as an indication of the parties' intention not to have these matters governed by a particular domestic law, but to consider the intervention of a national law as necessary for problems of validity only. The arbitral tribunal stated that "In the context of an ICC arbitration concerning a contract which was supposed to be performed in the whole world that implied intention of the parties is quite reasonable and in perfect conformity with the interpretation of articles 13(3) and 13(5) of the ICC Rules". Thus, the arbitral tribunal held that any question other than the validity of the agreement had to be decided according to the provisions of the agreement in the light of, and, in case of need, supplemented by the usages of international trade, having regard whenever necessary to "international public policy", and referred to the UNIDROIT Principles which it considered an "accurate representation, although incomplete, of the usages of international trade".³⁸⁸

In ICC Case No. 10021, the arbitrators, as authorized by Article 17 of the 1998 ICC Rules, decided to refer to the relevant trade usages in order to establish whether the purported termination might have been valid, given that the general provisions of the applicable Lithuanian law, as chosen by the parties, dealing with termination of contractual obligations did not offer any solution to the question at dispute. In this respect, the arbitrators referred to the UNIDROIT Principles "as codified trade usages", while stating that such a reference "is rather of persuasive than binding nature, and is in support of the Tribunal's view that the purported termination of the Shareholders' Agreement is invalid and without effect."³⁸⁹

Similarly, in ICC Case No 10022, although the parties agreed on Lithuanian law as the governing law of the contract, the claimant argued that it was legitimate to refer to the UNIDROIT Principles and the PECL as a source of usage, customs and practice and that they were to be relied on when interpretation of the law was necessary in order to determine the parties' rights and obligations. Referring to Article 17 of the 1998 ICC Rules, the arbitral tribunal stated that "Both sets of principles represent the latest codification of international commercial trade usages," but also noted that "unless expressly incorporated by agreement between the parties, which they are not, they are not of mandatory but only of persuasive nature". The tribunal concluded that "when necessary the Tribunal refers in this Award to "the relevant trade usages" and such reference includes, but is not limited to, the Unidroit Principles and Principles of European Contract Law'."³⁹⁰

In ICC Case No 8264, the contract contained a choice of law clause in favor of Algerian law and authorized the arbitral tribunal to consider the general principles of law and the usages of trade. The arbitral tribunal held that the claimant's failure to provide the defendant with certain information caused the loss of an opportunity for the defendant to develop and adapt its industrial production to the demands of the market. The arbitral tribunal stated that the UNIDROIT Principles consecrate rules "broadly recognized throughout the world and the practice of international contracts", and referred to Article 7.4.3(2) of the UNIDROIT

³⁸⁸ ICC Award in Case No. 9479, ICC International Court of Arbitration Bulletin, 12-2 (Fall 2001), at 69

³⁸⁹ ICC Award in Case No 10021, excerpts available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=832&step=FullText>

³⁹⁰ ICC Award in Case No. 10022, ICC International Court of Arbitration Bulletin, 12-2 (Fall 2001), at 100

Principles, according to which “compensation may be due for the loss of a chance in proportion to the probability of its occurrence”, in support of its holding.³⁹¹

In some cases, the arbitral tribunals excluded the applicability of international restatements of contract principles or international contracting practices as trade usages by exercising their capacity for abstract reasoning, but not because they do not fulfill the requirements established by a legal system for the relevance of trade usages to the resolution of contractual disputes. In ICC Case No. 8873, concerning a dispute arising from an agreement between a Spanish and a French company with regard to the construction of a road in Algeria, the parties included a provision in their agreement, which stated that “This contract shall be entirely governed by Spanish law, excluding any other legal system”.³⁹² The claimant contractor requested the renegotiation of the contract due to a number of unforeseen difficulties, which substantially increased the cost of the construction. According to the claimant, the dispute should be decided not only on the basis of the provisions of Spanish law, but taking into account the international trade usages and the general principles of law and, in particular, practices existing in the field of international civil engineering contracts. On the basis of this argument, the claimant invoked the hardship provisions of the UNIDROIT Principles and the relevant clauses contained both in FIDIC and in ENAA (Engineering Advancement Association of Japan) forms of construction contract. The defendant contended that, according to the applicable Spanish law, particularly under the Spanish Civil Code, trade usages are only applicable in the absence of statutory regulation. The arbitral tribunal emphasized the particular role of trade usages in the context of international arbitration under the rules regulating arbitration. Referring to Article 13 of the ICC Rules and Article VII of the 1961 European Convention, which both Spain and France had ratified, the arbitral tribunal observed that it was not bound to follow strict rules of national law in determining whether and to what extent the trade usages may apply, possibly in place of provisions of the applicable national law. According to the tribunal, particularly Article VII of the European Convention has established an internationally uniform principle, which applies instead of national rules on the matter, and recognizes to arbitrators a broad margin of discretion to determine the role which usages shall be given. The tribunal stated that, in the international field, the arbitrators are enabled to place trade usages in a very important position, being only limited by the need to respect the mandatory rules of the applicable law. According to the tribunal, in this understanding, trade usages were applicable when they are widely known and regularly observed in a given trade, and this assessment should be subject to the reasonable expectations of the parties.³⁹³

The tribunal stated that, as the parties chose exclusively Spanish law as the governing law of the contract, the claimant was required to prove that the hardship provisions of the UNIDROIT Principles reflect a generally established international practice, where those involved in international trade consider themselves bound without the need for an express stipulation to that effect. The arbitral tribunal considered that, although there is a tendency to stipulate hardship clauses in certain sectors of international trade in a repetitive way and it is possible to consider the provisions of UNIDROIT Principles on hardship as commercially reasonable, the hardship clauses in business practice deal with a principle of exceptional matters and, thus, determine, in detail, the circumstances justifying the hardship and its

³⁹¹ ICC Award in Case No. 8264, ICC International Court of Arbitration Bulletin, 10-2, (Fall 1999), at 62-65

³⁹² ICC Award in Case No. 8873, July 1997, ICC International Court of Arbitration Bulletin, 10- 2, (Fall 1999), at 78

³⁹³ *Ibid.*, at 79

consequences. In the tribunal's view, since the contents of the hardship clauses in international practice vary greatly in different contractual settings, the hardship provisions of the UNIDROIT Principles cannot be considered as trade usages, in the absence of explicit reference by the parties.³⁹⁴

According to the tribunal, FIDIC and ENAA forms of contract, as standard contracts, would have been applicable only if the parties had expressly or implicitly made reference to them. Even so, the tribunal held that principles contained in standard contracts, typical of certain economic sectors of trade, can become usages provided that (1) the rule of the standard contract is established in practice of business with a sufficient degree of uniformity in order to be applied directly without need to negotiate further elements and (2) the same rule is applied by the enterprises in the sector in question even in the absence of an express clause in the contract. As to the first requirement, the tribunal observed that the procedures and the covered risks under the relevant clauses of FIDIC and ENAA forms of contract did not correspond exactly and, those differences reflected a rule of an exceptional nature which, in its opinion, did not seem yet sufficiently "ripe" to be transformed into uniform and autonomous rule on the issue of hardship. Thus, the tribunal concluded that the relevant rules of those forms of contracts represented mere "contractual formulas," and had no legal value beyond the context of the standard contract containing them. Regarding the second requirement, the arbitral tribunal stated that there was no evidence to prove that, in the presence of a classical force majeure clause, such as the one contained in the contract in dispute, which is limited to provide an exemption from liability of the debtor who fail to perform his obligations, the enterprises in the construction industry consider themselves bound, in the absence of any contractual provision to that effect, by a usage, as provided by those forms of contracts, that would require the employer to pay the additional costs incurred by contractor as a result of force majeure.³⁹⁵

In ICC Case No 9029, where the contract in question contained a choice of law clause in favor of Italian law as the applicable law, the defendant claimed that the contract was invalid or inapplicable, and based its claims on the UNIDROIT Principles, particularly the provisions on hardship, gross disparity, and the principle of good faith, as "as an authoritative source of knowledge of international trade usages".³⁹⁶ The arbitral tribunal held that the abnormal hardship complained of by defendant did not exist, and that it could not therefore accept the connected claim aimed at obtaining from the arbitral tribunal the finding that the contract was invalid or void. The arbitral tribunal based its rejection not on the position of the legal system that was relevant to the contract, but an exercise of its specialization through abstract reasoning. According to the tribunal, the appeal to the UNIDROIT Principles in this regard was invalid because "the Unidroit Principles are only partly declaratory, being innovatory in many respects." The tribunal stated that "although the Unidroit Principles constitute a set of rules theoretically appropriate to prefigure the future *lex mercatoria* should international commercial practice adapt to the Principles, at present there is no necessary connection between the individual Principles and the rules of the *lex mercatoria*, so that recourse to the Principles is not purely and simply the same as recourse to an actually existing international commercial usage."³⁹⁷ Nevertheless, the tribunal noted that even if *lex mercatoria* and the

³⁹⁴ Ibid., at 80

³⁹⁵ Ibid., at 81

³⁹⁶ ICC Award in Case No. 9029, March 1998, ICC International Court of Arbitration Bulletin, 10-2 (Fall 1999), at 88

³⁹⁷ Ibid., at 90

UNIDROIT Principles were applicable, the defendant's claim aimed at obtaining from the arbitral tribunal the finding that the contract is invalid or void, could not be sustained, either with regard to the supposed gross disparity, or with regard to the supposed hardship, and went on to show that, had they applied UNIDROIT Principles, substantially the same solution would have been reached as by applying the chosen Italian law.

iii. Role of General Principles of Law

1. National Courts

In the context of national courts, the general principles of law are usually not applied directly to the contractual dispute, but used as a means to interpret, supplement or correct the rules of the legal system. In the civil law systems, the use of general principles of law stems from the claim that law cannot be laid down entirely *ex ante*, and it cannot reside exclusively in the articulated rules.³⁹⁸ The general principles are established by legislation, and legal rules must be interpreted and, if necessary, shaped on the basis of the general principles which underlie their specific provisions.³⁹⁹ Although the common law systems seem to lack a developed doctrine of general principles of law, it is argued that such general principles exist, particularly with regard to equity.⁴⁰⁰ The common law systems require the decision maker to look for the general principles in the precedents.⁴⁰¹ Statutory law is as not seen as a possible source of general principles. The principles expressed in the statute are not fully recognized by the courts until they have been applied, reformulated and developed by the decisions of the courts.⁴⁰²

In general, the national courts will use the general principles of law derived from the relevant national legal system. Nevertheless, as there is a growing awareness among the higher authorities in national legal systems that comparative materials may be a source for legal decisions in national courts, the international restatements of contract principles have sometimes become relevant to the interpretation and supplementation of a legal system in the context of national courts. In the legal doctrine, the use of international restatements and particular methods, such as “the internationally useful construction of national laws”, are promoted to spread among the authorities in national legal systems the awareness of the necessity of consistent application of the same principles by various legal systems, for the achievement of an effective framework for a functioning spontaneous order of international commerce.⁴⁰³ In the reality of globalization, many countries face identical legal problems and the courts may try to benefit from foreign experience.⁴⁰⁴ In practice, the international restatements of contract principles are used by the courts with a view to filling the existing

³⁹⁸ David, Rene & John E.C. Brierley, *Major Legal Systems in the World Today: An Introduction to the Comparative Study of Law*, London: Stevens, 3rd ed., 1985, at 154

³⁹⁹ Bonell, Michael Joachim, Article 7, in Bianca, C. Massimo & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 77

⁴⁰⁰ Brown, Neville, *General Principles of Law and the English Legal System*, in Mauro Cappeletti (ed.), *New Perspectives for a Common Law of Europe*, Leyden: Sijthoff, 1978, at 174-176

⁴⁰¹ Zweigert, Konrad & Hein Koetz, *An Introduction to Comparative Law*, translated by Tony Weir, Oxford University Press, 3rd rev. ed., 1998, at 269

⁴⁰² David, Rene & John E.C. Brierley, *Major Legal Systems in the World Today: An Introduction to the Comparative Study of Law*, London: Stevens, 3rd ed., 1985, at 392

⁴⁰³ Berger, Klaus Peter, *Harmonization of European Contract law the Influence of Comparative law*, *International & Comparative Law Quarterly*, 50-4 (2001), at 880

⁴⁰⁴ Smits, Jan M., *Comparative Law and its Influence on National Legal Systems*, in Mathias Reimann & Reinhard Zimmermann (eds.), *The Oxford Handbook Of Comparative Law*, Oxford, 2006, pp. 477-512, Available at SSRN: <http://ssrn.com/abstract=965389>, at 8

gaps or resolving ambiguities in national legal systems when the formal consolidations of similar cases are not very helpful for the reason that the problems are new and different.⁴⁰⁵

In national courts, the international restatements have been used in at least two different ways. First, the courts have relied on the restatements in the interpretation or supplementation of the legal system, in order to improve the internal order of the legal system in accordance with the order of international commerce. Since the 2004 revision, the UNIDROIT Principles explicitly provide, in the Preamble, that the Principles may be used to interpret and supplement national law, and explain, in the Official Comments, that the courts may resort to the Principles as a source of inspiration for the interpretation and supplementation of the national law in accordance with internationally accepted standards and/or the special needs of cross-border trade relationships, where the courts are faced with doubts as to the proper solution to be adopted under that law, either because different alternatives are available or because there seem to be no specific solutions at all.⁴⁰⁶ There are many examples of this kind in various jurisdictions. For instance, the Italian Courts, on some occasions, referred to the UNIDROIT Principles, the PECL and the CISG with regard to the principle that on termination a party is entitled to restitution of the performance it has rendered under the contract only if that party is in a position to make concurrently restitution of the performance it has received from the other party, given that under Italian law this was an open question.⁴⁰⁷

The Supreme Court of the Netherlands referred to the approach of the PECL and the UNIDROIT Principles, with regard to the surprising terms in a contract, which emphasizes their explicit acceptance by the parties, and is based on the assumption that a term is surprising if it is not in common usage in the relevant commercial sector. In the Court's view, this approach appeared preferable to the Dutch solution, which allows standard terms to be avoided on formal grounds, even if they are commonly used in a given sector and therefore should not be surprising to the other party.⁴⁰⁸

The Supreme Court of Poland issued a resolution with respect to the question as to whether, under Polish law, a contractually stipulated penalty must be paid even where the creditor has suffered no loss. In the resolution, the Court held that "If the contract provides for payment of a penalty in the case of non-performance or improper performance of an obligation, the debtor

⁴⁰⁵ Koopmans, T., *Comparative Law and the Courts*, *International and Comparative Law Quarterly*, 45-3 (July 1996), at 549

⁴⁰⁶ Official Comment 6 to Preamble of the UNIDROIT Principles

⁴⁰⁷ Tribunale Bergamo, 19 April 2006, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1508&step=Abstract>; The court rejected the claim for restitution due to the illegality of the contract for the use of the billboard alongside a highway outside Milan for two years on the ground that, since a party was not in a position to make restitution of the performance it had received under the contract from the other party, and since the user of the billboard undoubtedly had benefited from the performance; Tribunale Roma, 28 July 2004, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1509&step=Abstract>; The court held that since restitution in kind of the medical treatment a party received from another was by its very nature impossible, the recipient of medical treatment could not claim restitution of the fee paid; Tribunale di Catania, 6 February 2009, R.G. 8850/05, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1504&step=Abstract>; The court, having found that the plant's defects were such as to make it absolutely useless for the purpose for which it had been built, declared the relevant contract terminated. However, since restitution in kind of some parts of the plant was not possible or appropriate because the owner wanted to keep them, the Court granted the contractor an allowance in money corresponding to the value these parts had for the owner.

⁴⁰⁸ Hoge Raad der Nederlanden, 21 September 2007, C06/049HR, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1538&step=Abstract>

is not released from paying it even if it can prove that the creditor has not suffered any damage” and stated that “the view expressed in this resolution is supported by legal solutions found in regulations of international contract law pertaining to the institution of contractual penalties”, and in this context referred to the UNIDROIT Principles.⁴⁰⁹

The Spanish Supreme Court, in developing a case law with regard to the question of whether the debtor’s fault is required for the right of the creditor to terminate the contract, which was not expressly stated under the Spanish Civil Code, followed the approach of the CISG and international restatements, where the debtor’s fault is not an essential issue of the non-performance required for the termination of the contract.⁴¹⁰ In a number of decisions, the Spanish Supreme Court expressly referred to the CISG, the PECL and the UNIDROIT Principles in order to determine where non-performance is fundamental to justify termination of the contract, and this approach has been followed by the lower courts of Spain.⁴¹¹

⁴⁰⁹ Supreme Court of Poland, 6 November 2003, III CZP 61/03, available in abstract at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1054&step=Abstract>

⁴¹⁰ Trías, Encarnación Roca & Beatriz Fernández Gregoraci, *The Modern Law of Obligations in the Spanish High Court*, *European Review of Contract Law*, 5-1 (March 2009), at 48-49

⁴¹¹ Tribunal Supremo (Sala de lo Civil), 9 July 2007, 812, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1216&step=Abstract>: the Supreme Court stated that, in order for the aggrieved party to be entitled to terminate the contract and to claim damages, the defaulting party's non-performance did not have to be fundamental but it was sufficient that it "substantially deprives the aggrieved party of what it was entitled to expect under the contract" as stated in Art. 7.3.1 (2) (a) of the UNIDROIT Principles. The part of the decision of 9 July 2007, which referred to UNIDROIT Principles, has been quoted by the following Spanish courts in later cases: Audiencia Provincial de Madrid 12 November 2007, 949, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1361&step=Abstract>; Audiencia Provincial de Tarragona, 26 November 2007, 383, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1359&step=Abstract>; Audiencia Provincial de Madrid, 27 May 2008, 244, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1358&step=Abstract>; Audiencia Provincial de Cádiz (Sección 2ª), 19 January 2009, 25, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1469&step=Abstract> Tribunal Supremo (Sala de lo Civil), 5 April 2006, 364: the Supreme Court stated that: “This trend is in line with modern approaches of non-performance included in United Nations Convention on Contracts for International Sale of Goods, of 11 April 1980, joined by Spain in 1991, whose Article 25 considers that there is an essential non-performance of a contract ‘if it results in such detriment to the other party as substantially to deprive him of what he is entitled to expect under the contract’. That rule should serve to integrate Article 1124 of the Civil Code at the present time; in a similar way, the Article 8:103 (c) of the Principles of European contract law.” Tribunal Supremo (Sala de lo Civil), 23 July 2007, 849, the Supreme Court stated that “This is what happens according to the UNIDROIT Principles (Article 7.3.1. [2b]), when it ‘materially deprived’ the counterparty ‘of what he was entitled to expect under the contract’; in those cases the non performance is essential if it is not excusable. The latter happens, according to the Principles of European Law of Contracts, where the non performance was due to an impediment beyond its control and that it could not reasonably have been expected to take the impediment into account at the time of the conclusion of the contract, or to have avoided or overcome the impediment or its consequences (Article 8:108).” Translations of the quotations are from Trías, Encarnación Roca & Beatriz Fernández Gregoraci, *The Modern Law of Obligations in the Spanish High Court*, *European Review of Contract Law*, 5-1 (March 2009), at 50; Tribunal Supremo (sala de lo Civil, Sección 1ª), 3 December 2008, 1092, <http://www.unilex.info/case.cfm?pid=2&do=case&id=1467&step=Abstract>: the Supreme Court stated that only a fundamental breach by one of the parties entitled the other to terminate the contract, and since Article 1124 of the Spanish Civil Code referred generically to breach with no further qualification it was up to the Courts to define the notion of fundamental breach. Referring to Article 7.3.1 of the UNIDROIT Principles as well as to Articles 8:101 and 8:103 of the Principles of European Contract Law and to Article 49(1) CISG, the Court held that a fundamental breach of contract which gives rise to the right to termination is a breach which “deprives the aggrieved party of what it was entitled to expect under the contract”. Audiencia Provincial de Valencia, 6 March 2009, 126, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1468&step=Abstract>: The court quoted the reference to the UNIDROIT Principles in the Supreme Court decision of 3 December 2008. Tribunal Supremo, 17 February 2010, 35, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1524&step=Abstract>: The Supreme Court recalled its

The Federal Court of Australia have referred to the principle of good faith under the UNIDROIT Principles as an example that the principle of good faith has been “propounded as a fundamental principle to be honoured in international commercial contracts” in considering the duty of good faith and fair dealing as an implied duty in law and “a major (if not openly articulated) organising idea in Australian law”, although the judicial and scholarly opinions in Australia on this issue differ sharply.⁴¹²

previous rulings and mentioned their accordance with Article 7.3.1(2)(a) of the UNIDROIT Principles. Audiencia Provincial de Lleida (Cataluna), 13 September 2007, 289, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1215&step=Abstract> The court of appeal held that even if the non-performed obligation was to be considered impossible, this would not lead to the invalidity of the contract for original impossibility of its performance since according to recent legal writings the effects of an original impossibility are to be determined in the same way as those of supervening impossibility according to the rules on non-performance. In this respect the court pointed out that the best expression of this new tendency is to be found in Article 4:102 of the PECL and Article 3.3 of the UNIDROIT Principles.

⁴¹² Federal Court of Australia, 30 June 1997, 558, Hughes Aircraft Systems International v. Airservices Australia, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=634&step=FullText>: Finn J delivering the opinion of the court embraced the conclusion of Priestley JA in Renard Constructions (ME) Pty Ltd v Minister for Public Works that “people generally, including judges and other lawyers, from all strands of the community, have grown used to the courts applying standards of fairness to contract which are wholly consistent with the existence in all contracts of a duty upon the parties of good faith and fair dealing in its performance. In my view this is in these days the expected standard, and anything less is contrary to prevailing community expectations.” Finn J disagreed with Gummow J's characterization in Service Station Association Ltd v Berg Bennett & Associates Pty Ltd both of the methodology of Australian contract law while it remained subject to direct English control and of the role assumed by equity in regulating contract formation and performance. After considering North American jurisprudence's acceptance of an implied duty of good faith and fair dealing, Gummow J had observed that “Anglo-Australian contract law as to the implication of terms has heretofore developed differently, with greater emphasis upon specifics, rather than the identification of a genus expressed in wide terms.” Finn J I considered “a virtue of the implied duty to be that it expresses in a generalization of universal application, the standard of conduct to which all contracting parties are to be expected to adhere throughout the lives of their contracts.” Supreme Court of New South Wales, 16 July 1998, NSWSC 483 Alcatel Australia Ltd. v. Scarcella & Ors, <http://www.unilex.info/case.cfm?pid=2&do=case&id=648&step=FullText>: The court cited, among others, the decision in Hughes Aircraft Systems International v. Airservices Australia in concluding that, in New South Wales, a duty of good faith, both in performing obligations and exercising rights, may by implication be imposed upon parties as part of their contract, and there is no reason why such a duty should not be implied as part of the contract in question. Supreme Court of New South Wales, 1 October 1999, 996, Aiton v. Transfield, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=667&step=FullText>: In another case the Supreme Court of New South Wales, holding that an agreement to negotiate in good faith was enforceable, stated that “it appears to be common sense that as an obligation to act in 'good faith' may, in principle, be legally recognized as an implied or imputed obligation, there is no reason why it should be struck down as uncertain in cases where there is an express contractual term, as in the present case.” In support of its conclusion, the court referred to the Hughes Aircraft decision and noted that the expression “good faith and fair dealings” was chosen to underline the objective aspect of “good faith” in the European Principles and the UNIDROIT Principles, while Common lawyers tend to measure “good faith” on a subjective basis corresponding essentially to a given actor's state of mind. Supreme Court of Western Australia, 23.04.2002, Central Exchange Ltd v Anaconda Nickel Ltd, <http://www.unilex.info/case.cfm?pid=2&do=case&id=1134&step=FullText>: Steytler J observed that the courts have been inclined to the view that, if terms of good faith and reasonableness are to be implied, they are to be implied in law. However, the implication of such a term in law is not unrestricted, as Steytler observed that, many terms now implied in law reflect the courts' concern that, in the absence of those terms, the enjoyment of the contract would or could be rendered 'nugatory, worthless or ... seriously undermined'. Thus, the reference in the decisions to basing implication of terms is 'necessity'. He stated that he was prepared to assume that good faith should be implied into the contract in question without deciding the question. However, he also concluded that the content of 'good faith' in Australia remained to be worked out. Although sharing the view of Finn J in the decision of Hughes Aircraft Systems International v. Airservices Australia, Steytler J stated that the principles of good faith do not block the use of express terms. In the legal doctrine, this decision of Steytler was welcomed on the basis of the argument that since it is difficult to understand how a general over-arching duty of good faith can

be applied to all commercial contracts, the better approach is that an implied duty of good faith may attach to particular contractual obligations where this is necessary to achieve the aims of the contract or to ensure that one or both parties can have the benefit of the contract. See Baron, Paula, Robyn Carroll & Aviva Freilich, *Implied Terms: Central Exchange Ltd v. Anaconda Nickel Ltd.*, *University of Western Australia Law Review*, 31 (2003), p. 293; On the other hand, in 2003, the Federal Court of Australia confronted with a party's objection that, a duty of good faith, even if generally implied by law, could not be implied in the contract in the case at hand on account of the so-called "entire agreement" clause contained therein, in relation to which, the consideration for the payment of money or the rendering of some other counter performance is entire, indivisible and not severable. The objecting party relied on this provision in arguing that argued that the other party was not entitled to be paid as it had not complied with the requirements of payment under the contract. Finn J delivering the judgment of the Federal Court of Australia, while observing that there is not yet agreement in Australia as to the province of good faith in contract law, and that in Australian law there was no such mandatory rule of law imposing on the parties the duty of good faith and fair dealing, such as § 1-102(3) of the United States Uniform Commercial Code or Articles 1.7 of the UNIDROIT Principles and 1:201 of the PECL, concluded that the duty of good faith and fair dealing was to be considered an implied term of all contracts, by following the approach of his decision in *Hughes Aircraft Systems International v. Airservices Australia*, and held that the mere fact that the contract contained a "entire agreement" clause was not sufficient to constitute an "express exclusion" of an implied duty of good faith and fair dealing where that implication would otherwise have been made by law, also noting that the contract was a long term relational one in which cooperation and trust were to be expected. Federal Court of Australia 12 February 2003, NG733, *GEC Marconi Systems Pty Ltd. v BHP Information Technology Pty Ltd. and Others*, (2003) 128 FCR 1, para. 921-922. Supreme Court of New South Wales Court of Appeal, 3 July 2009, NSWCA 177, *United Group Rail Services v Rail Corporation Of New South Wales*, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1517&step=FullText>: Allsop J was confronted with the issue whether the agreement to negotiate in good faith is intended to be legally binding, and, if so whether it has a sufficiently certain content to be enforceable. First, Allsop J observed that "the task of the Court is to give effect to business contracts where there is a meaning capable of being ascribed to a word or phrase or term or contract, ambiguity not being vagueness." Subsequently, he argued that "good faith is not a concept foreign to the common law, the law merchant or businessmen and women" and "[i]t has been an underlying concept in the law merchant for centuries" citing some doctrinal writings on *lex mercatoria*. Allsop J also observed that the principle of good faith is recognised as part of the law of performance of contracts in numerous sophisticated commercial jurisdictions, and in this respect, he expressly referred, among others, to §§ 1-201 and 1-203 of the United States Uniform Commercial Code and to Article 1.7 of the UNIDROIT Principles. Although noting that the law in Australia is not settled as to the place of good faith in the law of contracts, Allsop J stated that "this Court should work from the position that it has said on at least three occasions (not including *Renard*) that good faith, in some degree or to some extent, is part of the law of performance of contracts." He also found unpersuasive the arguments of Lord Ackner, who considered an agreement to negotiate in good faith unenforceable, on which the decision of the English House of Lords in *Walford v Miles* [1992] is based. Allsop J held that "[a]n obligation to undertake discussions about a subject in an honest and genuine attempt to reach an identified result is not incomplete. It may be referable to a standard concerned with conduct assessed by subjective standards, but that does not make the standard or compliance with the standard impossible of assessment.... If what is required by the voluntarily assumed constraint is that a party negotiate honestly and genuinely with a view to resolution of a dispute ..., there is no inherent inconsistency with negotiation, so constrained. To say, as Lord Ackner did, that a party is entitled not to continue with, or withdraw from, negotiations at any time and for any reason, assumes that there is no relevant constraint on the negotiation or the manner of its conduct by the bargain that has been freely entered into. Here, the restraint is a requirement to meet and engage in genuine and good faith negotiations... These are not empty obligations; nor do they represent empty rhetoric... What the phrase "good faith" signifies in any particular context and contract will depend on that context and that contract.... the phrase "genuine and good faith" in this context needs little explication: it connotes an honest and genuine approach to the task. This task, rooted as it is in the existing bargain, carries with it an honest and genuine commitment to the bargain (fidelity to the bargain) and to the process of negotiation for the designated purpose.... a promise to negotiate (that is to treat and discuss) genuinely and in good faith with a view to resolving claims to entitlement by reference to a known body of rights and obligations, in a manner that respects the respective contractual rights of the parties, giving due allowance for honest and genuinely held views about those pre-existing rights is not vague, illusory or uncertain.... If business people are prepared in the exercise of their commercial judgement to constrain themselves by reference to express words that are broad and general, but which have sensible and ascribable meaning, the task of the Court is to give effect to, and not to impede, such solemn express contractual provisions."

Secondly, the national courts have referred to those restatements in order to justify a solution arrived at on the basis of their interpretation of national law.⁴¹³ For example, an Argentinean court, in deciding on the issue whether the contract between the parties had actually been concluded, expressly referred to the relevant provision of the UNIDROIT Principles, as an example of “modern law”, in order to justify their interpretation of Argentinean law.⁴¹⁴ In India, on some occasions, the High Court of Delhi, resolving issues of contract interpretation, determined the applicable rule of interpretation by referring to the UNIDROIT Principles, among a number of relevant Indian and English decisions.⁴¹⁵ Similarly, the Spanish Supreme Court referred among others to the UNIDROIT Principles with regard to the canon of interpretation that a contract shall be interpreted according to “the meaning commonly given to terms and expressions in the trade concerned”, although this was not expressly indicated in the Spanish Civil Code.⁴¹⁶ Moreover, the Spanish Supreme Court held with respect to damages for breach of contract that it was a basic principle that the aggrieved party was entitled to full compensation for the loss actually suffered, but that the amount of the loss, including future loss, had to be proved with a reasonable degree of certainty taking into account the loss of a chance the probability of the occurrence of the chance, and, in this regard, expressly referred to the UNIDROIT Principles because of its special significance in the commercial field.⁴¹⁷ In another case, the Spanish Supreme Court, in granting compensation also for the non-pecuniary harm, relied not only on the Spanish Civil Code, which over the years had been interpreted by the Spanish courts to the effect that a party in bad faith is liable for compensation for both pecuniary and non-pecuniary losses caused by its breach of contract, but also on the UNIDROIT Principles.⁴¹⁸

The reference to international restatements of contract principles is particularly relevant to the interpretation and supplementation of the CISG, which is a major source of inspiration for

⁴¹³ Koopmans, T., *Comparative Law and the Courts*, *International and Comparative Law Quarterly*, 45-3 (July 1996), at 550

⁴¹⁴ Cámara Nacional de Apelaciones en lo Comercial de la Capital Federal (CNCom Sala B), 10 June 2004, No. 80.808, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1180&step=Abstract>

⁴¹⁵ High Court of Delhi, 21 August 2006, CS (OS) No. 1599/1999, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1242&step=Abstract>; the Court held that in order to ascertain the meaning of its individual clauses the Agreement had to be read as a whole, and that the individual clauses had to be interpreted so as to give effect to all of them rather than to deprive some of them of effect. In support of this finding the Court referred to a number of Indian and English decisions and legal writings as well as to Articles 4.4 and 4.5 of the UNIDROIT Principles. High Court of Delhi, 20 August 2008, RFA (OS) No. 26/1986, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1454&step=FullText>: the Court held that “It is settled law that ... in construing a contract, the court must look primarily at the words used in the contract itself, unless they are such that one may suspect that they do not convey the intention correctly. If the words are clear, there is very little the court can do about it. This precludes the parties from giving direct evidence to show that their real intention was different from that reflected in the document. The UNIDROIT Principles provide the rules of interpretation of the contracts. The Principles provide that a contract shall be interpreted according to the common intention of the parties. It is only when the intention cannot be established, that the contract shall be interpreted according to the meaning that reasonable persons of the same kind as the parties would give it in the same circumstances.”

⁴¹⁶ Tribunal Supremo, 21 December 2007, 1320, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1360&step=Abstract>

⁴¹⁷ Tribunal Supremo (Sala de lo Civil), 16 May 2007, 506/2007, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1217&step=FullText>

⁴¹⁸ Tribunal Supremo, 15 June 2010, 366, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1548&step=Abstract>

those restatements. When the interpretation of the contractual terms, application of trade usages and default rules as provided by the CISG's provisions do not resolve the disputed issue, the national court will resort to Article 7 of the CISG. Pursuant to Article 7 (1), in the interpretation of the CISG, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade. The reference in Article 7 (1) to the "international character" of the CISG aims at avoiding the reliance on the rules and techniques traditionally followed in interpreting ordinary national legislation. The provision invites the national courts applying the CISG to refrain from adopting a narrow interpretation, and to take a liberal and flexible attitude by exercising abstractions, wherever appropriate, from the underlying purposes and policies of individual provisions as well as of the Convention as a whole before referring to a national law. It also implies the necessity of interpreting its terms and concepts autonomously, not by referring to the meaning which might traditionally be attached to them within a particular national law. Particularly, by its explicit reference to the principle of good faith with regard to the interpretation of the CISG, Article 7(1) makes it clear the principle of good faith may not be applied according to the standards ordinarily adopted within the different national legal systems, but must be construed in the light of the special conditions and requirements of international trade.⁴¹⁹ The reason for the autonomous interpretation of the CISG relates to the CISG's ultimate aim, which is to achieve uniformity in the law of international sale contracts.
420

Article 7 (2) provides that questions concerning matters governed by the Convention, which are not expressly settled in it, are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law. This provision provides that, in accordance with the criteria established in Article 7 (1) for the interpretation of the Convention in general, not only in the case of ambiguities in the text, but also in the case of gaps, the national courts should to the largest possible extent refrain from resorting to the different national laws and try to find a solution within the Convention itself. The recourse to general principles is provided only with respect to matters governed by, but not expressly settled in, the Convention.⁴²¹ When such a gap arises in a particular case, the national courts applying the CISG will try to find a solution whenever possible within the Convention itself, either by means of an analogical application of its specific provisions or on the basis of the general principles underlying the Convention as a whole.⁴²² The reference to a national law is only subsidiary while the initial reference must be made to the CISG's general principles.

⁴¹⁹ Bonell, Michael Joachim, Article 7, in Bianca, C. Massimo & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 86

⁴²⁰ *Ibid.*, at 72

⁴²¹ The scope of the Convention is generally defined by Article 4, which states that "This Convention governs only the formation of the contract of sale and the rights and obligations of the seller and the buyer arising from such contract" and excludes the matters (a) the validity of the contract or of any of its provisions or of any usage, and (b) the effect which the contract may have on the property in the goods sold. Article 5 further provides that the Convention does not apply to the liability of the seller for death or personal injury caused by the goods to any person.

⁴²² Bonell, Michael Joachim, Article 7, in Bianca, C. Massimo & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 78; Ferrari, Franco, *General Principles and International Uniform Commercial Law Conventions: A Study of the 1980 Vienna Sales Convention and the 1988 UNIDROIT Conventions*, *Uniform Law Review*, (1997), at 458-459

While some of these principles are expressly stated in the Convention⁴²³, most of the general principles of the CISG have not been expressly provided for and must be deduced from its provisions by way of an analysis. In this respect, it is argued that in specifying “general principles”, the courts should, in accordance with the basic criteria of Article 7(1), try to find the particular solution within the Convention itself.⁴²⁴ Where the national courts cannot deduce a general principle from the provisions of the CISG, some commentators argued in favor of a comparative analysis of law and deriving such principles that are generally accepted at a comparative level from outside the Convention. In this view, such principles can be derived from the comparative analysis in the context of autonomous interpretation, common national solutions or the general principles which stem from the corpus of the national legal systems.⁴²⁵ Other commentators do not share the opinion, according to which the comparative method could be useful in identifying the general principles of the CISG. They argue that it is impossible to choose objectively for the purpose of comparative analysis the relevant legal systems of the countries which were involved in preparing the Convention, and the wording of the Convention does not support the application of the comparative method, but refers to “the law applicable by virtue of the rules of private international law.”⁴²⁶

Following this latter line of reasoning, some commentators oppose to the idea of referring to international restatements of contract principles in the interpretation and supplementation of the CISG. It is argued that international restatements may only serve to corroborate a solution based on the Convention’s general principles or to interpret them, but they cannot be used as an independent source of gap-filling.⁴²⁷ Accordingly, in view of the wording of Article 7 of the CISG, the use of international restatements as a means of interpreting and supplementing

⁴²³ For example, one can find in the CISG the principle of good faith referred to in Article 7(1), the principle of the parties’ autonomy in Article 6, the principle of informality, i.e. the principle according to which “the agreement between the parties is not subject to any formal requirement under Articles 11 and 29 (1), the principle whereby widely known and largely observed trade usages must be taken into account in Article 9, the principle of foreseeability of damages that limits recoverable damages to those which were foreseen or could have been foreseen prior to or at the conclusion of the contract and the principle of full compensation under Article 74, and the principle that delay in payment creates an obligation to pay interest on the sum in arrears in Article 78.

⁴²⁴ Bonell, Michael Joachim, Article 7, in Bianca, C. Massimo & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 81

⁴²⁵ Gebauer, Martin, *Uniform Law, General Principles and Autonomous Interpretation*, *Uniform Law Review*, (2000), at 694

⁴²⁶ Enderlein, Fritz & Dietrich Maskow, *International Sales Law: United Nations Convention on Contracts for the International Sale of Goods: Convention on the Limitation Period in the International Sale of Goods: Commentary*, Oceana Publications, 1992, at 60; Ferrari, Franco, *General Principles and International Uniform Commercial Law Conventions: A Study of the 1980 Vienna Sales Convention and the 1988 UNIDROIT Conventions*, *Uniform Law Review*, (1997), at 463

⁴²⁷ Ferrari, Franco, *General Principles and International Uniform Commercial Law Conventions: A Study of the 1980 Vienna Sales Convention and the 1988 UNIDROIT Conventions*, *Uniform Law Review*, (1997), at 459: Noting that the CISG stipulates that the gaps are to be filled by resorting “to the general principles upon which this Convention is based”, Ferrari argues that “no recourse can be had to 'external' general principles, such as the 'Principles of International Commercial Contracts', drafted by UNIDROIT”. Ferrari maintains that the principles on which the CISG is based “may correspond to "external" general principles of international commerce (as, for example, the ... UNIDROIT Principles); but even in this instance, the principles to be applied to fill a gap are always, unless otherwise agreed by the parties, those upon which the Convention is based.” Veneziano, Anna, *UNIDROIT Principles and CISG: Change of Circumstances and Duty to Renegotiate according to the Belgian Supreme Court*, *Uniform Law Review*, (2010), at 142: “the Principles may be used to supplement CISG only as long as they help in clarifying or supporting already existing general principles underlying the Convention.”

the CISG depends on the condition that the relevant provisions of the international restatements are actually the expression of a general principle underlying the CISG.⁴²⁸

In contrast, it is argued that the national courts should resort to the UNIDROIT Principles in order to interpret ambiguous provisions and to fill the many gaps found in the CISG, since the CISG is not a self-contained body of rules, independent and distinct from trade usages and other international instruments related in one way or another to international commercial contracts, and the UNIDROIT Principles are meant to be applied to a much wider array of international commercial transactions than those regulated by the CISG.⁴²⁹ This is specifically mentioned in the Preamble of the UNIDROIT Principles, which provides that the Principles “may be used to interpret or supplement international uniform law instruments.” In essence, as the CISG has a great influence on the provisions of the international restatements of contract principles, many of their provisions can be understood as reflecting the approach of the CISG to the issues covered but not expressly dealt with in the CISG. Thus, some national courts have actually used the UNIDROIT Principles and the PECL for the purpose of interpreting and supplementing the CISG.⁴³⁰

⁴²⁸ Bonell, Michael Joachim, *The UNIDROIT Principles of International Commercial Contracts and CISG - Alternatives or Complementary Instruments?*, *Uniform Law Review* (1996), at 36

⁴²⁹ Garro, Alejandro M., *The Gap-Filling Role of the UNIDROIT Principles in International Sales Law: Some Comments on the Interplay Between the Principles and CISG*, *Tulane Law Review*, 69 (1995), at 1189

⁴³⁰ The Netherlands [District Appeal Court]: Hof 'S-Hertogenbosch 16.10.2002: A Dutch company purchased plants from a French company. A dispute arose as to whether seller's standard terms were not incorporated into the contract. The contract was governed by the CISG. The CISG does not have any special provisions concerning standard terms. This posed a problem of interpretation of the Convention, which needs to be solved according to Article 7. According to the Court of Appeal, this implied that special attention had to be paid to how the interpretative question is dealt with in the laws of the contracting states and what may be considered common principles of those legal systems. In this context the Court expressly referred, first of all, to the UNIDROIT Principles of International Commercial Contracts, which, it stated, expressly provide that they may assist in interpreting the Convention, and in particular to the Comments to Article 2.1.20. According to the Court these Comments address the question as to whether the adhering party must know the content of the standard terms, but do not address the other question as to whether the adhering party should have a reasonable opportunity of becoming acquainted with the content of the standard terms, and whether the principle of good faith requires that the other party take the necessary steps to make sure that the adhering party has such an opportunity, e.g. by sending it the text of the standard terms before or at the time of concluding the contract. Therefore, the court made reference to Article 2.104 of the Principles of European Contract Law. According to the Court, this rule not only largely coincides with Dutch and French law on standard terms and hence with the law of the two countries to which the parties belong, but also promotes the observance of good faith in international trade. The Court therefore decided to apply this rule also in interpreting the CISG. Abstract available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=959&step=Abstract>; Similarly, the Court of Appeal of Grenoble on 23 October 1996 used the UNIDROIT Principles as a means to supplementing the CISG. The case concerns a sales contract between a German and a French company. In order to determine its own jurisdiction in conformity with Article 5(1) of the 1968 Brussels Convention on Jurisdiction and the Enforcement of Judgments in Civil and Commercial Matters, the Court had to determine the place of performance of the seller's obligation to return part of the price unduly paid by the buyer. The CISG, which governed the contract, is silent on this point. The Court, while openly rejecting the opposite solution adopted by both French and German domestic laws, decided in favor of the buyer's place of business. In doing so, it based itself on the general principle that monetary obligations are to be performed at the obligee's place of business, which could be extracted not only from Article 57(1) CISG, but also from Article 6.1.6 of the UNIDROIT Principles. Cited by Bonell, Michael Joachim, *The UNIDROIT Principles in Practice: The Experience of the First Two Years*, *Uniform Law Review*, (1997), at 42; Another example is from Supreme Economic Court of the Republic of Belarus (*Holzimpex Inc. v. Republican Agricultural Unitary*, Number: 8-5/2003) A U.S. trading company entered into a sales contract with a state-owned enterprise of Belarus. The goods were delivered but the Belarus enterprise failed to pay the price, prompting the U.S. company to bring an action for payment. The contract contained a choice of law clause in favor of the law of Belarus and indicated the Supreme Economic Court of the Republic of Belarus as the competent forum for the settlement of any disputes. The Court held that the CISG was

Essentially, it is not a coincidence that the use of international restatements in the interpretation and supplementation of a national law has been observed in the courts of those countries that adopted the CISG. This is because the adoption of the CISG by a legal system implies the willingness of the authorities in that legal system to admit the possibility of improving its internal order in line with the order of international commerce and some degree of openness to the exercise of abstractions by the individual judges for discovering and applying the established rules in the spontaneous order of international commerce. In such a legal system, the national courts become more comfortable in referring to international restatements of contract principles as the traditional objection to the use of comparative law in national courts due to the lack of democratic legitimacy loses its weight. For example, the Spanish Supreme Court in its decision of 31 October 2006, openly stated that “The criterion in a provision of an international treaty (CISG) which forms part of our legal system and also reflected in a document setting out the legal principles that form the so-called *lex mercatoria* (Commercial Law) common to the various jurisdictions in terms intended to reflect and in order to develop uniform standards and the practice in trade relations that are beyond the state

applicable and decided that the U.S. company was entitled to the payment of the agreed price plus interest according to Article 78 of the CISG. With no further explanation the Court held that “the rate of such interest is determined pursuant to Article 7.4.9 of the UNIDROIT Principles and is the average bank short-term lending rate to prime borrowers prevailing for the currency of payment at the place for payment or where no such rate exists at that place, the same rate in the state of the currency of payment”. Abstract available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1007&step=Abstract>; The Belgian Supreme Court also made reference to the UNIDROIT Principles in a case governed by the CISG. In the case, the parties had concluded an agreement for the sale of steel tubes. After the conclusion of the contract and before delivery, the price of steel unexpectedly increased by 70%, but the agreement contained no price adjustment clause. The seller tried to renegotiate a higher contract price, but the buyer refused and insisted on delivery of the goods at the price agreed upon. The Court of First Instance rejected the request of renegotiation since the CISG was silent on the issue of hardship, a supervening change of circumstances rendering the performance more onerous, while covering force majeure cases leading to an exemption from performance. The Court considered that although the seller proved that there was an unforeseen price increase excluded the seller's right to renegotiate the price, the seller should have agreed a price adjustment clause with the buyer, had it wanted to adapt the contract to new circumstances. On the basis of this reasoning, the Court denied recourse to a national law in order to fill this gap in the Convention. The Court of Appeal ruled that the Court of First Instance incorrectly excluded the application of price adaptation in accordance with the so-called theory of *imprévision* based on the mere finding that this is not settled in the CISG and without examining which law was applicable under the rules of private international law and whether this applicable law excluded the adaptation of the price. The Court of Appeal referred to Article 7(2) of the CISG and decided to apply French law, as the law of the seller. According to the Court of Appeal, although French law does not provide for remedies in the case of hardship, in certain circumstances, such as in case of substantial imbalance of the contractual obligations, it imposes in accordance with the general principle of good faith the re-negotiation of the contract. The Supreme Court, in confirming the decision of the Court of Appeal, followed a different line of reasoning. The Supreme Court pointed out that while the CISG contained an express provision for force majeure as an exempting event in Article 79(1), this did not mean that it implicitly excluded the relevance of hardship and possibility of re-negotiation of the price. The Supreme Court, after pointing out that in order for gaps to be filled in a uniform manner, regard must be had to the general principles governing the law of international commerce, concluded that according to such principles as incorporated *inter alia* in the UNIDROIT Principles, a party invoking a change in circumstances fundamentally disrupting the contractual equilibrium, had the right to request re-negotiation of the contract. Accordingly, the Supreme Court confirmed the decision of the Court of Appeal granting the seller the right to request the re-negotiation of the price. Supreme Court of Belgium, 19 June 2009, *Scafom International BV v. Lorraine Tubes S.A.S.* an English translation is available at <http://cisgw3.law.pace.edu/cases/090619b1.html>; also see; Veneziano, Anna, UNIDROIT Principles and CISG: Change of Circumstances and Duty to Renegotiate according to the Belgian Supreme Court, *Uniform Law Review*, (2010), p. 137

level (PECL), should serve to integrate Article 1124 [of the Spanish Civil Code] by interpreting it in accordance with the social reality of the moment at which it applies.”⁴³¹

The national courts are bound by the position of the authorities in their legal systems, and that position determines the capacity of national courts for exercising abstract reasoning in their consolidations of national laws through a comparative research in order to discover the established rules in the order of international commerce. The isolated position of the authorities and their insistence on maintaining this position in view of a purpose they follow in relation to the internal order of the legal system may prevent the national courts, whose decision is not final with regard to the interpretation and supplementation of the national law, from exercising abstract reasoning and from bringing the internal order of the legal system closer to the order of international commerce. Examples of this kind can be found in the English legal system and other legal systems, on which the English authorities exercise some degree of control.

In New Zealand, the Court of Appeal had to deal with a case where, reliable extrinsic evidence of the pre-contractual negotiations was available and confirmed, in the Court’s view, that the plain meaning of a particular clause in the contract was not what the parties actually intended.⁴³² However, the Court was confronted with the difficult question of interpretation as to the admissibility of extrinsic evidence under common law. Thomas J delivering the principal judgment of the Court of Appeal was of the opinion that if reference was made to the extrinsic evidence of pre-contractual negotiations, there could not be any real doubt about the parties’ actual intention. Thomas J noted that, in common law, there has been a shift away from a black-letter approach to questions of interpretation and the purposive approach has prevailed, but he also observed that, under the English case law, the rule against the admission of the evidence that relates to prior negotiations as an aid to interpretation seems to be absolute and applied without qualification. Thomas J, noting that the Court of Appeal is not a final court since a right of appeal remains to the Privy Council sitting in London, discussed whether it would be open to seek to depart from the law as applied in England on the basis of New Zealand’s implementation of the CISG. In this context, Thomas J also referred to the UNIDROIT Principles which, in his view, “is in the nature of a restatement of the commercial contract law of the world, refines and expands the principles contained in the United Nations Convention.”⁴³³ Noting that both of those instruments allowed the admission of such extrinsic evidence in the interpretation of the contract, Thomas J stated that “it is desirable that the approach of the Courts in this country to the interpretation of statutes should be consistent with the best international practice.”⁴³⁴

However, Thomas J concluded that, while the Court of Appeal could seek to depart from the law as applied in England and bring the law in New Zealand into line with these international instruments, it would not be permitted to do so by the Privy Council, given that England has not yet adopted the CISG and has shown little readiness to allow the Courts in New Zealand any latitude in the interpretation of contracts, and the law of contract in New Zealand, other

⁴³¹ Translation of the quotation from Trias, Encarnación Roca & Beatriz Fernández Gregoraci, *The Modern Law of Obligations in the Spanish High Court*, *European Review of Contract Law*, 5-1 (March 2009), at 59

⁴³² Court of Appeal of New Zealand, 27 November 2000, (2000) NZCA 350, *Hideo Yoshimoto v Canterbury Golf International Limited*, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=802&step=FullText>

⁴³³ *Ibid.*, para. 89

⁴³⁴ *Ibid.*

than as specifically reshaped by statute, is likely to remain the law of England. Thus, Thomas J held that “For the moment, therefore, this Court must accept that, until the rule is reviewed by the Privy Council (or, possibly, the House of Lords) the extrinsic evidence relating to the draft agreement must be disregarded as part of the negotiations.”⁴³⁵ As he expected, upon appeal, the Privy Council stated that “In a separate section of his judgment, Thomas J said that the normal rule which excludes evidence of pre-contractual negotiations, authoritatively stated by Lord Wilberforce in *Prenn v Simmonds* [1971] 1 WLR 1381, should be relaxed or departed from. Their Lordships do not think that this is a suitable occasion for re-examining the law because they consider that in this case the evidence is, as Lord Wilberforce predicted, unhelpful.”⁴³⁶

Later, in the case of *Chartbrook Limited v. Persimmon Homes Limited*, the Court of Appeal in United Kingdom attempted to take a more flexible approach with respect to the question of the evidence of the parties’ negotiations for the purpose of contract interpretation. In his judgment, Lawrence Collins LJ, though admitting that the general rule was that extrinsic evidence was inadmissible, pointed out that the policy reasons for the exclusionary rule were by no means self-evident and compelling. In his view, if a semantic analysis of words in a commercial contract leads to a conclusion which flouts business common sense, it must be made to yield to business common sense, but this does not mean that the language can be rewritten in order to make the language conform to business common sense. In this respect, he recalled that the US Restatement Second on Contracts expressly admits negotiations as evidence to establish the meaning of the writing and referred also to both the UNIDROIT Principles and the CISG to demonstrate that the traditional exclusionary rule is not accepted in international instruments dealing with private law contracts. Lawrence Collins LJ further recalled a number of English decisions admitting that negotiations may be looked at to see whether the parties had negotiated on an agreed basis that the words used in their contract bore only one of two possible meanings and concluded that this basically amounted to admitting evidence of prior negotiations in construing a contract.⁴³⁷

However, the House of Lords overturned that decision of the Court of Appeal. Lord Hoffmann stated that “The rule that pre-contractual negotiations are inadmissible was clearly reaffirmed by this House... It is clear that the rule of inadmissibility has been established for a very long time. ... To allow evidence of pre-contractual negotiations to be used in aid of construction would therefore require the House to depart from a long and consistent line of authority, the binding force of which has frequently been acknowledged... The House is nevertheless invited to do so, on the ground that the rule is illogical... The general rule ... is that there are no conceptual limits to what can properly be regarded as background. Prima facie, therefore, the negotiations are potentially relevant background. They may be inadmissible simply because they are irrelevant to the question which the court has to decide, namely, what the parties would reasonably be taken to have meant by the language which they finally adopted to express their agreement.”⁴³⁸ Lord Hoffmann concluded that “there is no clearly established case for departing from the exclusionary rule. The rule may well mean ... that parties are sometimes held bound by a contract in terms which, upon a full

⁴³⁵ *Ibid.*, para. 95

⁴³⁶ Judgment of the Lords of the Judicial Committee of the Privy Council, Appeal No. 99 of 2001, *Canterbury Golf International Limited v. Hideo Yoshimoto*, Delivered on 15th July 2002, para. 25

⁴³⁷ Court of Appeal (Civil Division) *Chartbrook Limited v. Persimmon Homes Limited*, 2008 EWCA Civ 183

⁴³⁸ Lord Hoffmann in *Chartbrook Limited (Respondents) v Persimmon Homes Limited and others (Appellants) and another (Respondent)* [2009] UKHL 38

investigation of the course of negotiations, a reasonable observer would not have taken them to have intended. But a system which sometimes allows this to happen may be justified in the more general interest of economy and predictability in obtaining advice and adjudicating disputes. It is, after all, usually possible to avoid surprises by carefully reading the documents before signing them and there are the safety nets of rectification and estoppel by convention.”⁴³⁹

Lord Hoffmann also stated that international instruments, such as the CISG, the UNIDROIT Principles and the PECL, reflect “the French philosophy of contractual interpretation” which “regards the intentions of the parties as a pure question of subjective fact, their *volonté psychologique*, uninfluenced by any rules of law” so that “any evidence of what they said or did, whether to each other or to third parties, may be relevant to establishing what their intentions actually were.”⁴⁴⁰ He saw this approach as conflicting with the approach of English law to interpretation, which “mixes up the ascertainment of intention with the rules of law by depersonalizing the contracting parties and asking, not what their intentions actually were, but what a reasonable outside observer would have taken them to be.”⁴⁴¹

The exercise of abstract reasoning in the specialized consolidations for discovering the established rules in the order of international commerce and the use of international restatements of contract principles as an aid in such an exercise, which is essentially the application of *lex mercatoria*, in the context of a national court depend on the position of the higher authority in the relevant legal system. The isolated position of the authorities in a legal system may well prevent the national courts from engaging into such exercises that lead to the application of *lex mercatoria*. There are also occasional objections to the use of comparative law in national courts due to the lack of democratic legitimacy.⁴⁴² The gaps or unclear rules in a national law can always be, and in the past often were, resolved by means of general principles within the relevant national legal system rather than by reference to specialized consolidations of such materials as national laws or commercial practices through abstract reasoning. Thus, the influence of international restatements on the practices of national courts is mostly limited to finding inspiration in the process of weighing the arguments in favor of or against a particular solution in the face of a new problem, provided that the authorities in the relevant legal system indicated their willingness to improve the internal order of the legal system in line with the order of international commerce, for example, by adopting an international convention that aims at articulating the established rules in the order of international commerce. Even in such cases, the abstract reasoning of national courts in their consolidation of the national laws or commercial practices are used with a view to filling a gap or resolving an ambiguity in the relevant national legal system, but not applied directly to the contractual dispute for overriding the conflict of laws of the forum or the formal

⁴³⁹ Ibid.

⁴⁴⁰ Ibid.

⁴⁴¹ Ibid. Also see Supreme Court of New South Wales, *Franklins Pty Ltd v Metcash Trading Ltd*, 16 December 2009, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=1520&step=FullText> where Allsop P, citing the decision of the House of Lords, stated that “the approach to the construction and interpretation of contracts in the UNIDROIT Principles and the CISG reflects to a significant degree civil law principles”.

⁴⁴² For instance, the United States Supreme Court Justice Antonin Scalia argued in a scholarly article that “We judges of the American democracies are servants of our peoples, sworn to apply ... the laws that those peoples deem appropriate. We are not some international priesthood empowered to impose upon our free and independent citizens supra-national values that contradict their own.” Antonin Scalia, ‘Commentary’, *Saint Louis University Law Journal*, 40 (1996), at 1122

consolidations under the relevant national legal system, even if those implement some isolated purpose of the authority in the internal order of the legal system.

2. International Arbitral Tribunals

As a result of the flexibility provided by the arbitration laws and rules with regard to the determination and ascertainment of the applicable law, the arbitral tribunals' use of the general principles of law is not limited to the interpretation, supplementation or correction of a national law, but it can also be directly relevant to the resolution of the contractual dispute, particularly when the parties have not agreed on a governing law.

In ICC Case No 7110, the arbitral tribunal stated that "In international commercial arbitration, though it is imaginable that the term "justice" may be utilized only in the sense of procedural justice, i.e. due process and fair trial, it is commonly understood as referring to arbitral justice in a more comprehensive sense, including not only arbitral procedural fairness but also the type of solution regarding the merits - not necessarily the same that would be obtained from national courts - that should be expected by the parties by the very fact of having chosen international commercial arbitration for resolving their contractual disputes." In the tribunal's view, "often the parties resort to arbitration in order to have access to a "justice" other than that which would be obtained by applying a "national law", particularly when, on account of the discrete circumstances of the case, a national law would not be adapted to the solution of the dispute at stake." The tribunal argued that this understanding of justice in the context of international commercial arbitration is confirmed by the existence of choice of law provisions which are specific to international commercial arbitration, and differ from those that would have been otherwise obtained had the decision of the case been left to the national courts and their conflict of law regimes.⁴⁴³ The tribunal found "a clear correspondence between, on one hand, the mandate of international arbitrators of making a fair and just decision adapted to the particular controversy at stake without being tied to precedent or abstract concerns and, as it happens in this case, without the parties' contractual stipulations directing the arbitrators to apply any specific national rule or legal system, and, on the other hand, choice of law methodologies aimed at reaching fair and just results by applying the substantive legal rules and principles which are better adapted to the circumstances of the case."⁴⁴⁴ According to the tribunal, this choice of law justice is "premised on the idea that multistate cases are imperfectly governed by the laws of a single national jurisdiction, since by their very nature, they constitute a "social and economic unit" for which, in view of the fact that they overlap national frontiers, there is no equivalent comprehensive tailor made "legal unit", sufficiently adapted to the circumstances of the multistate case and the expectations of the parties, that would provide a fair and just substantive solution for it." In that context, the arbitral tribunal maintained that "Choice of law methodologies advancing the application of that type of multi-state substantive rules are then the best adapted to resolve international commercial cases on the basis of the substantive justice and fairness expectations of the parties and the circumstances of the case."⁴⁴⁵

In ICC Case No 7375, after having discussed whether the omission of a choice of law provision was an accident or specifically wanted by parties and found that none of the parties

⁴⁴³ ICC Award in Case No. 7110, ICC International Court of Arbitration Bulletin, 10-2 (1999), at 44-45

⁴⁴⁴ Ibid., at 45

⁴⁴⁵ Ibid., at 46

was willing to accept the law of the other parties to the contract, the arbitral tribunal held that “the absence of a choice of law clause must be understood as a so-called "implied negative choice" of the Parties [...] in the sense that none of the Parties' national laws should be imposed on any of the Parties.” The arbitral tribunal decided to apply general principles of international commercial law, which, in view of the tribunal, have “the advantage to protect both Parties against the application of a national law which might contain particular provisions which they had not expected, and which may not be suitable in a truly international context of the present nature.” The tribunal stated that “Freeing the Parties from the constraints of a national law thus would ascertain and warrant that the dispute shall be decided by having regard to those rules of law and notions which deserve to be qualified as being "generally accepted". Thus, a decision based on generally accepted principles has moreover the advantage to ascertain foreseeability of the outcome and certainty of law.” Although noting that “it is always a more difficult and more demanding task for a tribunal to decide a case by the only reference to, and guidance by, general principles of law, *lex mercatoria* etc., instead of simply having regard and applying the solution as provided for in a particular national law, its case law and doctrine”, the tribunal decided to apply truly international standards as reflected in, and forming part of, the so-called "general principles of law", which, in the opinion of the tribunal, was “the only solution which fully maintains the equilibrium between the Parties and responds to both Parties objectively fair and subjectively justified and reasonable expectations, discarding any *pro domo* arguments of the Parties in support of their respective cases.”⁴⁴⁶

When the applicable law is a national law as a result of parties' choice or the established rules of conflict, the arbitral tribunals are not under an obligation to strictly follow the general principles of the applicable national law in its interpretation, supplementation and correction. The tribunals may interpret, supplement or correct the applicable national law in accordance with the general principles that they discover by exercising an abstract reasoning in their specialized consolidations, particularly when the general principles of that national law reflect the isolated position of the higher authorities in the relevant legal system rather than the reasonable expectations of the parties. In ICC Case No 12193, the arbitral tribunal decided, by applying cumulatively the conflict of laws of the legal systems relevant to the case, in favor of the application of the law of Lebanon to a distribution contract between a German manufacturer, the defendant, and a Lebanese distributor, the claimant. The defendant requested the subsidiary application of the UNIDROIT Principles. The arbitral tribunal held that normally recourse to general principles of law or the *lex mercatoria* was justified only where the contract was closely connected to more than one country equally or where the applicable national law failed to provide a solution to the issues at stake, but the claimant had to carry out its activity only in one country, i.e. in Lebanon, and the Lebanese law made express provision for the right to damages in case of termination for breach of a distribution contract, which was the disputed issue. Nevertheless, the tribunal was of the opinion that *lex mercatoria* could be applied if Lebanese law provided no right to damages in the event of termination of the distribution, but this was not the case. The tribunal expressly referred to Article 7.4.1 of the UNIDROIT Principles, as a general principle of law granting the right to damages for breach of contract, in order to demonstrate that the Lebanese law was in accordance with the *lex mercatoria*.⁴⁴⁷

⁴⁴⁶ ICC Award in Case No. 7375, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=625&step=FullText>

⁴⁴⁷ ICC Final Award in Case No. 12193, ICC International Court of Arbitration Bulletin, 19-1 (2008), at 122

In ICC Case No. 11256, the arbitral tribunal stated that “when, as in this case, the parties have chosen the applicable law to the Agreement, the role of the UNIDROIT Principles can only be a limited one.” According to the tribunal, the UNIDROIT Principles have a non-binding character and it is only when a national law is ambiguous and therefore calls for interpretation that the UNIDROIT Principles, which are the result of a thorough comparative study, may be used to interpret this law and solve unexpected difficulties in applying it to an international contract. The tribunal was of the opinion that “the UNIDROIT Principles propose reasonable solutions to meet the needs of international trade in the light of the experience of some of the major legal systems but do not generally reflect the trade usages referred to in Article 17(2) of the ICC Rules of Arbitration” since, according to the tribunal, not all of the provisions of the UNIDROIT Principles meet the traditional test required for usages to be accepted as source of law. The tribunal decided to “apply Mexican law, with the possibility, in case Mexican law is ambiguous on specific matters, to resort to the UNIDROIT Principles as a tool for interpretation when no Mexican legal source of interpretation can be used to solve the problem met.”⁴⁴⁸

In ICC Case No 8769, the parties entered into two contracts, one for the manufacture of an electrical appliance and the other for the sale of the goods necessary for the production of such device. Both of the contracts provided that “the arbitrator will interpret the contract and settle the dispute in accordance with French law and suppletorily with the [CISG].” Noting that in French law international sales are principally, not just suppletorily, governed by the CISG, the sole arbitrator interpreted the clause to the effect that the international sales law aspects of their relationship should be governed by the CISG and other aspects, such as construction law or mandate, should be governed by general French law. However, the arbitrator stated that to the extent that French law is silent, the CISG would fill the gaps.⁴⁴⁹ In dealing with the merits of the case, the arbitrator applied the Article 74 of the CISG on the issue of lost profits as a component of recoverable damages in order to show that a party might claim both *damnum emergens* and *lucrum cessans*, and referred to the UNIDROIT Principles in awarding interest, given that Article 78 of the CISG does not specify a particular interest rate.

The arbitral tribunals also referred to the UNIDROIT Principles in order to fill a gap in international conventions. The arbitrator in ICC Case No 8817, having decided to apply the CISG to the substance of the dispute, was of the opinion that the general principles of the CISG are “presently elaborated in the UNIDROIT Principles.”⁴⁵⁰ In dealing with the substance of the case, the arbitrator referred to Article 1.8 of the UNIDROIT Principles to confirm the binding character of the parties’ established practices, which is expressed under Article 9 (1) of the CISG, and to Article 7.4.8 of the UNIDROIT Principles to confirm that a party suffering harm must take steps to mitigate the harm, which is regulated under Article 77 of the CISG.⁴⁵¹

In ICC Case No 8547, the agreement underlying the dispute provided that “The present Contract shall be governed by, constructed and interpreted in accordance with the Uniform

⁴⁴⁸ ICC Award in Case No 11256, cited by Jolivet, Emmanuel, *L'harmonisation du droit OHADA des contrats: l'influence des Principes d'UNIDROIT en matière de pratique contractuelle et d'arbitrage*, *Uniform Law Review*, (2008), at 144 fn 41

⁴⁴⁹ ICC Award in Case No. 8769, *ICC International Court of Arbitration Bulletin*, 11-2 (2000), at 69

⁴⁵⁰ ICC Award in Case No. 8817, 1997, *Yearbook Commercial Arbitration*, 25 (2000), at 359

⁴⁵¹ *Ibid.*, at 361 and 367

Law for the international sale of corporal movables (Hague convention 1/7/64).” The arbitral tribunal pointed out that such a choice of law includes the Convention relating to a Uniform Law on the International Sale of Goods (ULIS) and the Convention relating to a Uniform Law on the Formation of Contracts for the International Sale of Goods (ULF) and held that “In so far as the Conventions ULIS and ULF did not cover all questions and referring to Art. 17 of the ICC Arbitration Rules, the arbitral tribunal felt it appropriate to turn to the UNIDROIT Principles which provide [a] useful complement to fill the lacuna and allow to find proper solutions.”⁴⁵² When dealing with the question of formation of the contract, the tribunal stated that “When taking into consideration the internationality of the relations between the parties, the UNIDROIT Principles become relevant. Art. 4.5 UNIDROIT Principles states that contract terms should be interpreted as to give effect to as many of them as possible. Therefore, if the parties at one point agreed on certain provisions, this needs to be taken into account when trying to resolve a dispute.”⁴⁵³ The tribunal also referred to Article 7.1.3 of the UNIDROIT Principles, according to which, a party may withhold its performance until performance has been affected by the other party since the *exceptio non adimpleti contractus* was not expressly provided in ULIS, and followed from the general principles of law referred to in Article 17 of ULIS.⁴⁵⁴

In the absence of a *lex fori* for the international arbitration, the exercise of abstract reasoning by the arbitral tribunals is not bound by the position of any higher authority in a legal system to the idea of maintaining or improving the internal order of the legal system in line with the order of international commerce. In this context, the applicability of international restatements of contract principles in assisting the consolidations of the arbitral tribunals exercising an abstract reasoning for discovering the established rules may directly result from the specialization exercised by the decision maker in a particular case, as observed from the reasons given by them in their arbitral awards for the reference to those restatements.

In ICC Case No 7110, the arbitral tribunal stated that the general rules and principles regarding international contractual obligations and enjoying wide international consensus, which constitute the proper law of the contract in dispute, are primarily reflected by the UNIDROIT Principles.⁴⁵⁵ The tribunal considered the UNIDROIT Principles to be the central component of such rules, for the reasons that, among others, “(1) the Unidroit Principles are a restatement of international legal principles applicable to international commercial contracts made by a distinguished group of international experts coming from all prevailing legal systems of the world, without the intervention of states or governments, both circumstances redounding to the high quality and neutrality of the product and its ability to reflect the present stage of consensus on international legal rules and principles governing international contractual obligations in the world, primarily on the basis of their fairness and appropriateness for international commercial transactions falling within their purview; (2) at the same time, the Unidroit Principles are largely inspired [by] an international uniform-law

⁴⁵² ICC Award in Case No 8547, *Yearbook Commercial Arbitration*, 28 (2003), at 32

⁴⁵³ *Ibid.*, at 33

⁴⁵⁴ *Ibid.*, at 35

⁴⁵⁵ ICC Award in Case No. 7110, *ICC International Court of Arbitration Bulletin*, 10-2 (1999), at 49; The statements of the arbitral tribunal in ICC Case No 7110 as to the nature of the UNIDROIT Principles were cited in full by the arbitral tribunal in an ad hoc award of 2001 rendered in Costa Rica. *Ad hoc Award (San José, Costa Rica)*, April 30, 2001, Costa Rican company vs. French company, Cited by Vargas, V. Pérez & D. Pérez Umana, *The UNIDROIT Principles of International Commercial Contracts in Costa Rican Arbitral Practice*, *Uniform Law Review*, (2006), at 181-182

text already enjoying wide international recognition and generally considered as reflecting international trade usages and practices in the field of the international sales of goods, which has already been ratified by almost 40 countries, namely, the [CISG].”⁴⁵⁶

In ICC Case No 7375, the arbitral tribunal decided to apply those general principles and rules of law applicable to international contractual obligations, which qualify as rules of law and which have earned a wide acceptance and international consensus in the international business community, including notions which are said to form part of a *lex mercatoria*, also taking into account any relevant trade usages as well as the UNIDROIT Principles, as far as they can be considered to reflect generally accepted principles and rules. In the arbitral tribunal’s view the UNIDROIT Principles “contain in essence a restatement of those ‘principes directeurs’ that have enjoyed universal acceptance and, moreover, are at the heart of those most fundamental notions which have consistently been applied in arbitral practice.” However, the tribunal also pointed out that the UNIDROIT Principles have not as yet stood the test of detailed scrutiny in all their aspects so that some of their individual provisions might not reflect international consensus. Thus, the tribunal was prepared to apply the UNIDROIT Principles only to the extent that they actually reflect generally accepted principles and rules.⁴⁵⁷

In ICC Case No 13012, where the contract was silent as to the applicable law, the arbitral tribunal decided to apply the general principles of law as the governing law of the contract. The tribunal observed that “several ICC cases have considered that the UNIDROIT Principles of International Commercial Contracts (‘UNIDROIT Principles’) are the best approach to apprehend the general principles of law” and decided to have recourse to the UNIDROIT Principles “as a primary set of guidelines in determining international rules of law applicable to the parties’ contract.” The tribunal also stated that “when relying on the general principles of law as embodied in the UNIDROIT Principles, the Arbitral Tribunal shall duly consider the *Lex Mercatoria* in its two fundamental principles, i.e. the standards of good faith which the parties should observe when performing the contract and the rule of *pacta sunt servanda*.” The tribunal concluded that “the material law applicable to the case shall be the general principles of law resulting from the UNIDROIT principles (2004 edition) and from the aforesaid

⁴⁵⁶ ICC Award in Case No. 7110, ICC International Court of Arbitration Bulletin, 10-2 (1999), at 49; When dealing with the merits of the dispute, the tribunal applied general principles of law to the dispute and referred to the UNIDROIT Principles in relation to a number of issues. As to the question whether the claims pursued by the claimant in the proceedings were time-barred, the tribunal noted that there was no provision in any of the Contracts dealing with limitation periods, in trade usages in contracts for the sale and supply of goods or services, and in the UNIDROIT Principles. The tribunal had to determine whether there are general legal rules enjoying a wide international consensus on this question. According to the tribunal, “the solution to the question does not have to be derived from the domestic laws, and that a comparative approach such as the one suggested by Respondent does not reveal a generally accepted principle as to the length of an extinctive limitation period.” The tribunal concluded that “it was not unreasonable for Claimant, in all the circumstances, not to launch arbitration proceedings so long as there seemed to be a prospect of arriving at an agreement on the terms of a settlement.” As to the question whether an unpaid seller could refuse to deliver the goods until it had received payment, it decided that in accordance with the civil law concept of the *exceptio non adimpleti contractus*, as confirmed by Article 7.1.3 of the UNIDROIT Principles, the seller had a right to refuse to make delivery until payment in full was received in accordance with the contractual provisions. As to the question whether, failing payment by the buyer, the seller was entitled to terminate the contract and sell the goods to a third party, the tribunal affirmed the seller’s right to dispose of the goods on the basis of the general principle of mitigation of harm laid down in Article 7.4.8 of the UNIDROIT Principles. The tribunal also relied on Article 2.14 of the UNIDROIT Principles to affirm the validity of the modified contract notwithstanding the fact that some terms had been left open and had to be agreed upon by the parties in further negotiations. *Ibid.*, at 56-57

⁴⁵⁷ ICC Award in Case No. 7375, available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=625&step=FullText>

fundamental rules of the *Lex Mercatoria*, as well as from the commercial usages prevailing in the sector of activities to which the parties' agreement relates."⁴⁵⁸

In ICC Case No. 12111, the sole arbitrator considered that the terms "international law" used by the parties in relation to the applicable law referred to "lex mercatoria and general principles of law applicable to international contractual obligations such as the ones arising out of the Contract". According to the arbitrator, "Such general principles are reflected in the UNIDROIT Principles of International Commercial Contracts which will be applied for the determination of the parties' respective claims in this arbitration." However, the arbitrator rejected the claimant's claim for application of the PECL, on the ground that "they constitute an academic research, at this stage not largely well-known to the international business community and are a preliminary step to the drafting of a future European Code of Contracts, not enacted yet."⁴⁵⁹

In ICC Case No 9797, the arbitral tribunal, noting that it shall apply the rules of law it deems appropriate, pursuant to Article 17 of the 1998 ICC Rules, determined those rules of law as the general principles of law and the general principles of equity commonly accepted by the legal systems of most countries. The tribunal, referring to ICC Case No 7375, stated that "The UNIDROIT Principles of International Commercial Contracts are a reliable source of international commercial law in international arbitration for they "contain" in essence a restatement of those 'principes directeurs' that have enjoyed universal acceptance and, moreover, are at the heart of those most fundamental notions which have consistently been applied in arbitral practice."⁴⁶⁰

Some arbitral tribunals' rejection of the applicability of international restatements of contract principles for discovering the general principles of law may also directly result from the specialization exercised by the decision maker in a particular case. In ICC Case No 10385, when determining the substantive law applicable to the dispute, the arbitral tribunal examined the procedural law and legal literature and decided that neither the national law of the two parties nor other laws without any link to the dispute were applicable. The tribunal noted that this finding led to the question of the applicability of the *lex mercatoria*, and observed that, in similar cases, other arbitral tribunals applied *lex mercatoria* in general and the UNIDROIT Principles in particular. In view of the tribunal, the UNIDROIT Principles complement or even "compete with" *lex mercatoria* and appear to represent an attempt to unify certain general or specific principles of contract law. However, the tribunal maintained that the doctrine and jurisprudence were far from unanimous as to the definition and the precise scope of *lex mercatoria*. The tribunal observed that there was a gap which could not be filled with certainty by means of interpretation in the case, but the same uncertainty authorized the tribunal to apply the rules of law that it deems appropriate or advisable. Accordingly, the tribunal decided to resolve the dispute by interpreting the will of the parties on the sole basis

⁴⁵⁸ ICC Award in Case No 13012, cited by Jolivet, Emmanuel, *L'harmonisation du droit OHADA des contrats: l'influence des Principes d'UNIDROIT en matière de pratique contractuelle et d'arbitrage*, *Uniform Law Review*, (2008), at 137 fn 29

⁴⁵⁹ ICC Award in Case No 12111, 2003, *ICC International Court of Arbitration Bulletin*, 21-1 (2010), at 78

⁴⁶⁰ ICC Award in Case No. 9797, July 28, 2000, *Andersen Consulting Business Unit Member Firms vs. Arthur Andersen Business Unit Member Firms and Andersen Worldwide Societe Cooperative*, *World Trade and Arbitration Materials*, 12-5 (2000), at 121

of the terms of the contract and, to examine the question of the rules of law it deemed to be appropriate if it appeared necessary to deviate from rules of contract.⁴⁶¹

As a result of their capacity for abstractions, some arbitral tribunals identified the UNIDROIT Principles even as reflecting both general principles of law and trade usages in their awards, thereby disregarding the traditional conceptual distinctions between those two different legal sources made under the national legal systems with regard to their functions and normative forces. For example, in ICC Case No. 11265, the arbitral tribunal decided to apply the UNIDROIT Principles, mainly on the basis of two grounds: first, in the course of the arbitral proceedings, the parties themselves seemed to agree on the application of the UNIDROIT Principles, and second, according to the tribunal, the UNIDROIT Principles constituted “a codification of trade usages and an expression of the general principles of contract law”.⁴⁶² On the other hand, in ICC Case No. 10422, observing that in numerous arbitral awards the UNIDROIT Principles have been applied as an expression of the *lex mercatoria* or of international trade usages, the tribunal considered the UNIDROIT Principles neither as general principles of law nor as trade usages, but identified them, except for a few provisions, such as the one on hardship, as “a “restatement” of the rules that parties engaged in international trade consider to be consonant with their interests and expectations”. The tribunal defined *lex mercatoria* as the rules and principles generally recognized in international trade and decided to apply “the UNIDROIT Principles, to the extent that they represent rules recognised by international business people as being applicable to international contracts.”⁴⁶³

Thus, in the context of international arbitration, the applicability of general principles of law directly to the substance of the dispute or the choice between the general principles of a national legal system and the order of international commerce in the interpretation, supplementation or correction of the applicable rules of law depend on the abstract reasoning and specialization of the arbitrators, rather than the position of the authorities in a legal system to the issue of controlling legal uncertainty and improving the internal order of that legal system in line with the order of international commerce. Thus, the arbitrators have the capacity of determining the relevance of the international restatements of contract principles to the resolution of commercial dispute by exercising abstract reasoning in their specialized consolidations and by freely evaluating their persuasive authority as indications of trade usages or general principles of law, or both.

⁴⁶¹ ICC Award in Case No. 10385, March 2002, ICC International Court of Arbitration Bulletin, Special Supplement: UNIDROIT Principles: New Developments and Applications, 2005, at 80-83

⁴⁶² ICC Award in Case No 11265, October 2003, ICC International Court of Arbitration Bulletin, 21-1 (2010), at 68

⁴⁶³ ICC Award in Case No. 10422, 2001, Excerpts of the original French version of the award have been published in *Journal du droit international*, (2003), pp. 1142-1150 Available in English at <http://www.unilex.info/case.cfm?pid=2&do=case&id=957&step=FullText>

iv. Influential Factors in Judicial Behavior

1. National Courts

The national legal systems are in a constant effort to convert legal uncertainty into legal risk through formal consolidations thereby enabling the contracting parties to be in a position to ascertain the law and to maximize their freedom of contract. This is what defines a legal system, which emerges as a governance regime only when it is able to stabilize the normative expectations of individuals by establishing a self-referential structure. In order to remain as they are, the national legal systems constantly monitor the changes in the expectations of the elements of their internal orders and provide mechanisms that respond to the need of adaptation. The national courts, as the organ of a legal system, necessarily have a constant concern for the development and the internal order of the relevant legal system. This concern is the main influential factor on the judicial behavior of the national courts. Thus, the national courts refrain from relying on abstract reasoning in considering trade usages or customs thereby referring to the international restatements of contract principles for that purpose. When national courts exercise abstractions for discovering the established rules in the form of general principles of law derived from the order of international commerce, their decisions are subject to review by the higher authorities, and may eventually become a part of the self referential structures of the legal system.

The national legal systems may allow the courts to disregard their self referential structures that stabilize the normative expectations and to determine whether, in the light of the change in the expectations of individuals under new circumstances, the case needs to be decided differently. Some national legal systems provide various gap filling mechanisms, which employ contractual interpretation and default rules to differing extents. In general, the national legal systems require the decision makers to fill contractual gaps on the basis of the default rules provided by the system. Even so, some other mechanisms enable contractual gap filling on the basis of the presumed intentions of parties, where the activities of interpretation and gap filling of the contract are combined. These mechanisms provide a specific solution for the individual dispute on the basis of its circumstances, without a concern for the development of the legal system for future reference. They generally let the presumed intentions of the parties prevail over default rules of national law under certain circumstances in order to achieve justice in a particular case, such as when the parties clearly express their intention not to be bound by default rules in their contract or when the particular gap in their contract does not fall under the scope of default rules, which do not offer legal results that meet the particular requirements of the case at hand.

For example, under German law, the court may fill contractual gaps through constructive interpretation. The court, when using the method of constructive interpretation, must “discover and attend to what parties, instead of actually expressing, would have expressed in view of the purpose of the contract as a whole if they had indeed covered the point in their agreement and paid due attention to the requirements of good faith and good commercial practice.”⁴⁶⁴ Through constructive interpretation, the court will use a form of reasonableness test in order to determine and apply what the contracting parties, acting as reasonable contracting parties, would have agreed upon if they would have been considered the unsettled

⁴⁶⁴ Zweigert, Konrad & Hein Koetz, *An Introduction to Comparative Law*, translated by Tony Weir, Oxford University Press, 3rd rev. ed., 1998, at 405

issue in advance. The prevailing view in Germany holds that constructive interpretation is not aimed at the judicial development of contract law or at providing a solution for the type of contract, but concentrates on creating a solution for the specific contract.⁴⁶⁵ The gap filling activities of the German courts exercising constructive interpretation is based on the extensive interpretation of the intention of the parties. The intention of the parties for the purpose of constructive interpretation is not to be determined by reference to the subjective expectations of the parties to a contract, but is to be hypothetically established by balancing the parties' interests and taking into account such factors as the purpose of the transaction, the surrounding circumstances, the parties' relevant individual and joint interests, good faith and common practice.⁴⁶⁶

Under German law, constructive interpretation may only be used as a gap filling technique in certain situations. The constructive interpretation is concerned with situations in which a solution is lacking in the parties' agreement and default rules.⁴⁶⁷ The element of necessity of gap filling for the achievement of contractual purpose is relevant to determining whether constructive interpretation is justified.⁴⁶⁸ Moreover, a gap contained in a contract cannot be filled by using constructive interpretation if the parties regarded their agreement as conclusive and as an exhaustive reflection of the rights and duties contained in their contract.⁴⁶⁹ Similarly, the court may not use the constructive interpretation to the effect of extending the subject matter of the contract and producing a result at odds with the purpose of the contract as agreed by the parties.⁴⁷⁰

There are also other requirements for the use of constructive interpretation under German law. First, if the interests in a particular contractual relationship differ from those reflected in the legislative provision and indicate a different result, constructive interpretation prevails. Second, if the individual contract does not reflect a legislatively regulated type, constructive interpretation is to be preferred to the application of legislative default provisions. Third, constructive interpretation is applicable if legislation does not regulate the matter.⁴⁷¹ Thus, in general, the application of default rules of German law prevails over the judicial gap filling through constructive interpretation. The German Federal Court has held that constructive interpretation is excluded to the extent that a legislative provision with the same purpose is available.⁴⁷² In the German doctrine, the supremacy of default rules over the constructive

⁴⁶⁵ Kornet, Nicole, *Contract Interpretation and Gap Filling: Comparative and Theoretical Perspectives*, Intersentia, 2006, at 142

⁴⁶⁶ *Ibid.*, at 138

⁴⁶⁷ *Ibid.*, at 131

⁴⁶⁸ German Federal Court, BGHZ, 16, 71, 18 December 1954, translation in Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 750

⁴⁶⁹ Kornet, Nicole, *Contract Interpretation and Gap Filling: Comparative and Theoretical Perspectives*, Intersentia, 2006, at 134

⁴⁷⁰ German Federal Court, BGHZ, 77, 301, 25 June 1980, translation in Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 751-752

⁴⁷¹ Kornet, Nicole, *Contract Interpretation and Gap Filling: Comparative and Theoretical Perspectives*, Intersentia, 2006, at 153

⁴⁷² *Ibid.*, at 152; citing German Federal Court Decisions: BGHZ 40, 91, 103; BGHZ 77, 301, 304; BGHZ 90, 69; BGHZ 137, 153, 157.

interpretation has been maintained mainly on the basis of such arguments that it would be inefficient if the courts would have provide an individual solution by way of constructive interpretation every time contracting parties leave a matter unsettled in their contract, that if constructive interpretation were to prevail over default law in every case, default law would be rendered obsolete and functionless, that the creation of individual solutions each time an unsettled matter is presented to the courts would jeopardize legal certainty, and that parties rely on the legislature to provide for the situations they do not address in the express terms of the contract to save transaction costs related to negotiating contract terms.⁴⁷³ Consequently, the constructive interpretation has been sparingly used by the courts which apply it if there is a gap in the default rules or when the application of default rules would be inappropriate in a particular case.⁴⁷⁴

In English law, the implication of terms in the contract deals with the situations in which contracting parties have not expressly provided for a particular contingency in their contract and the court is required to fill the gap. Mainly, the terms will be implied in law into all contracts of a particular type because of the particular form of the contract, e.g. contracts for building work, contracts of sale, hire, etc., rather than the presumed intentions of the parties. They will apply to all contracts of the particular kind for which they have been developed, unless a contrary intention is expressed in the contract. Such implied terms have crystallized in statute or case law and they operate as default rules.⁴⁷⁵

In some cases, the English courts look for the implied terms of the contract in the individualized terms that are read into contract by considering the contextual scene of the particular contract. These terms are called “terms implied in fact” and their use is akin to the interpretation of a contract. The English law on implied terms can be traced back to the Court of Appeal decision in *Moorcock*⁴⁷⁶, where it was established that the basis for the implication of a term in a contract is the presumed intention of the parties and necessity.⁴⁷⁷ The English law has evolved practical and strict tests for the permissibility of such an implication in order to curtail legal uncertainty. The Privy Council attempted a consolidation of those tests in the case of *BP Refinery (Westernport) Pty Ltd v Hastings Shire Council*. Lord Simon, giving the

⁴⁷³ *Ibid.*, at 108-110

⁴⁷⁴ *Ibid.*, at 151

⁴⁷⁵ Steyn, Johan, *Contract Law: Fulfilling the Reasonable Expectations of Honest Men*, *Law Quarterly Review*, 113 (1997), at 441

⁴⁷⁶ [1889] LR 14 PD 64, The owners of the ship "Moorcock" contracted for space at a wharf owner's jetty in order to unload the Moorcock's cargo. While docked the tide went down and the ship grounded causing damage to the ship. The plaintiff argued that the wharf owners were responsible to ensure that his vessel would remain safe while docked. The wharf owners, in their defense, based their claim on the fact that there were no provisions in the contract as to the vessel's safety or the requisite depth of water. The issue before the Court of Appeal was whether there can be any implied warranty in the circumstances. The Court held for the ship owner, ruling that the wharf owners were responsible for the safety of the ship while docked. Bowen LJ held that any implied warranties must be based on the presumed intentions of the parties for reasons of "business efficacy" since, without it, the whole point and purpose of the contract would be defeated. He stated that "In business transactions such as this, what the law desires to effect by the implication is to give such business efficacy to the transaction as must have been intended at all events by both parties who are business men; not to impose on one side all perils of the transaction, or to emancipate one side from all the chances of failure, but to make each party promise in law as much, at all events as it must have been in the contemplation of both parties that he should be responsible for in respect to those perils or chances."

⁴⁷⁷ Whincup, Michael H., *Contract Law and Practice: the English System and Continental Comparisons*, Kluwer Law International, 4th rev. and enl. ed., 2001, at 128

opinion of the majority of the Privy Council, suggested that these tests should be regarded as cumulative, and “for a term to be implied, the following conditions (which may overlap) must be satisfied: (1) it must be reasonable and equitable; (2) it must be necessary to give business efficacy to the contract so that no term will be implied if the contract is effective without it; (3) it must be so obvious that “it goes without saying”; (4) it must be capable of clear expression; (5) it must not contradict any express term of the contract.”⁴⁷⁸ Furthermore, recently, the English courts have determined the terms implied in fact by asking whether the implied term is “necessary to give effect to the reasonable expectations of the parties.”⁴⁷⁹ However, the courts are generally not able to supplement a contract by an implication of fact unless it is perfectly obvious that it is necessary to give effect to the reasonable expectations of parties.⁴⁸⁰ While the implication must, in all the circumstances, be reasonable, as held by House of Lords in *Liverpool City Council v Irwin*, “the touchstone is always necessity and not merely reasonableness”.⁴⁸¹

The French courts in some cases have held that a term can be implied on the basis of what the court, exercising the *pouvoir souverain des juges de fond*, thinks has been the common intention of the parties.⁴⁸² This form of contractual gap filling under French law is mainly based on Articles 1135 and 1160 of the Civil Code, which refers to equity and usages in relation to the binding force of the contract. However, the relevance of equity as a source of contractual obligations is controversial and its scope is mostly limited to the implication of the two sets of obligations; obligations de sécurité (obligations as to the safety of the person or property of a contracting party) and obligations d’information (obligations to provide information to the other party). The French courts rarely expressly rely on equity as a ground for their decisions outside those established contexts of implied obligations.⁴⁸³ The implication of a term outside of those contexts is allowed if the parties must have intended such a term to apply but omitted it unintentionally and if it can be applied without the court having to stipulate factual matters, the choice and determination of which lay with the parties alone, and with regard to which the court may not substitute its own ideas of what the parties intended for those of the parties themselves.⁴⁸⁴

⁴⁷⁸ *BP Refinery (Westernport) Pty Ltd v Hastings Shire Council* (1977) 180 CLR 266; (1977) 45 LGRA 62; (1977) 16 ALR 363; (1977) 52 ALJR 20; However, in some later cases, the tests are considered to be separate, albeit overlapping. See, for example, *Gatehouse J in Ashmore v Corporation of Lloyd’s (no 2)* [1992] 2 Lloyds Rep 620 at 627).

⁴⁷⁹ Lord Steyn, giving the leading judgment for the House of Lords in *Equitable Life Assurance Society v Hyman* [2000] UKHL 39; [2000] 3 All ER 961; [2000] 3 WLR 529 (20th July, 2000); Court of Appeal, *Paragon Finance plc v Staunton* [2001] EWCA Civ 1466

⁴⁸⁰ Steyn, Johan, *Contract Law: Fulfilling the Reasonable Expectations of Honest Men*, *Law Quarterly Review*, 113 (1997), at 441, *Equitable Life Assurance v Hyman* [2002] 1 AC 408

⁴⁸¹ *Liverpool City Council v. Irwin* [1977] A.C. 239

⁴⁸² Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 753

⁴⁸³ Bell, John, Sophie Boyron & Simon Whittaker, *Principles of French law*, Oxford University Press, 2nd ed., 2008, at 331

⁴⁸⁴ *Cour d’appel de Rouen*, 29 November 1968, translation in Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 754

Lex mercatoria, as the law of principled adjudication, is not about the supplementation, interpretation or correction of a contract according to the normative expectations that are stabilized ex ante by a legal system. It relates to how a decision maker should approach to a particular dispute in order to resolve it by preserving the order of international commerce on the basis of his specialization expressed in a combination of his own consolidations and abstract reasoning. The gap filling activities of national courts when they are enabled by the legal system to set aside their concern for the development of the legal system and the relevant internal order and to search for an individualized solution for a particular case on the basis of extensive interpretation of the contract can be seen as an instance of the application of lex mercatoria in the sense of exercising abstractions for discovering the established rules in a particular case. However, the capacity of national courts for abstractions is severely limited by strict requirements for the terms to be implied on an individualized basis, which implement the supremacy of formal consolidations under the default rules of the legal system for the purpose of mitigating legal uncertainty and make those gap filling activities exceptional in practice.

The national court's concern for the development of the legal system loses its significance when the legal system leaves room for judicial discretion in order to achieve justice in a particular case. This is called "equity infra legem", which can be resorted by a national court in the application of law. In addition to the extensive interpretation of the contract, this form of equity can also be employed by the national legal systems in order to overcome the difficulty in pre-determining or pre-quantifying the relief that a party is entitled to, such as the amount of the compensation to be granted to the aggrieved party in tort cases or the damages arising from contractual relationships. In such cases, the national courts may exercise an abstract reasoning in assessment of damages for non-performance and the aggrieved party must only provide a basis upon which a court can reasonably estimate the extent of damages. Thus, if there is a rule of law entitling the aggrieved party to compensation for loss but it is impossible or extremely difficult to quantify the damages precisely, the national courts may make an equitable estimate of the compensation to which the aggrieved party is entitled since the legal system does not deprive the aggrieved party of compensation solely because damages cannot be calculated with absolute precision, and requires the court to make an equitable estimate of the compensation due.

For instance, under French law, the discretionary power of the judge governs the actual assessment of the amount of damages.⁴⁸⁵ Although the damage must be certain, it is sufficient that the damages are reasonably capable of being calculated. In such cases as the loss of chance, the French courts have to make an estimate of the probability of success.⁴⁸⁶ In some countries, such as Germany and Switzerland, the requirement of certainty is treated as a procedural requirement.⁴⁸⁷ In German law, the loss suffered by the plaintiff must be precisely

⁴⁸⁵ Bell, John, Sophie Boyron & Simon Whittaker, *Principles of French law*, Oxford University Press, 2nd ed., 2008, at 353-354

⁴⁸⁶ Nicholas, Barry, *The French law of contract*, Oxford University Press, 1992, at 228

⁴⁸⁷ Switzerland, District Court Sissach, 5 November 1998, available at <http://cisgw3.law.pace.edu/cases/981105s1.html> : The court stated that under Article 8 of the Swiss Civil Code, the burden of proof for a possible loss is borne by the aggrieved party and rejected the aggrieved party's claim for damages, which remained unproven. Handelsgericht des Kantons Aargau, Switzerland, 26 September 1997, available at <http://cisgw3.law.pace.edu/cases/970926s1.html>: The majority held that although further damages had been proven, the exact extent of such damages was not capable of exact proof. Accordingly, the majority, using the expert knowledge of the court, concluded that damages in the amount of ten percent of the sales price

quantified, but if the precise amount of damages cannot be determined given the available methods of proof, Section 287 of the German Code of Civil Procedure allows the court to determine the damages according to its free conviction in consideration of all the circumstances.⁴⁸⁸ In Italy, if damages cannot be proved in their exact amount, they may be equitably liquidated by the judge.⁴⁸⁹ Similarly, under Belgian law, if it is not possible to give mathematical calculation of the damage, the court may award a lump sum *ex aequo et bono*.⁴⁹⁰ Under English law, Vaughan Williams L.J. in *Chaplin v Hicks*, the seminal case on the doctrine of loss of a chance, stated that “The fact that damages cannot be assessed with certainty does not relieve the wrongdoer of the necessity of paying damages.”⁴⁹¹ In the United States, although the damages must be established with reasonable certainty, the requirement of certainty applies only to the existence of loss, not the extent of loss, and it is even relaxed or abandoned where the breach has been characterized as “willful”, despite the general tenet that the amount of contract damages does not depend on the character of the breach.⁴⁹²

would normally be suffered by any party in a similar situation. The minority of the court rejected the damages claims because insufficient proof had been put before the court to prove the damages.

⁴⁸⁸ Reimann, Mathias & Joachim Zekoll, *Introduction to German law*, Kluwer Law International, 2nd ed., 2005, at 222; District Court Hamburg, 26 September 1990, available at <http://cisgw3.law.pace.edu/cases/900926g1.html>: The court awarded interest in addition to statutory interest as damages by estimating the loss of interest payment incurred by the aggrieved party pursuant to Section 287 of the ZPO. Oberlandesgericht Celle, Germany, 2 September 1998, available at <http://cisgw3.law.pace.edu/cases/980902g1.html>: The counterclaim for damages was dismissed because it had failed to properly prove its damages. The court held that under Article 74 of the CISG, the plaintiff must exactly calculate its damages. Under the circumstances, the loss of profit relied on was not properly substantiated. The court did not consider the possibility under Section 287 of the ZPO.

⁴⁸⁹ Article 1226 of the Italian Civil Code

⁴⁹⁰ Court of Appeal, Antwerp 18 May 1999 (*Vandermaesen Viswaren v. Euromar Seafood*), translation available at <http://cisgw3.law.pace.edu/cases/990518b1.html>; The court of appeal agreed held that an amount *ex aequo et bono* should be awarded as there was no exact quantification of the damages. District Court Kortrijk 4 June 2004 (*Steinbock-Bjonustan EHF v. NV Duma*), translation available at <http://cisgw3.law.pace.edu/cases/040604b1.html>: Where the aggrieved buyer justly claims the loss of a profit for his missed/failed resale of the initial product, the Court framed the damages *ex aequo et bono* at a certain percentage of the purchase price.

⁴⁹¹ [1911] 2 K.B. 786: In the case, a woman was denied the opportunity to compete in a beauty contest with 50 other contestants for the chance to win one of 12 acting contracts. The organizer of the contest unsuccessfully argued that the woman’s loss of chance was incapable of assessment. Instead, the court held for the beauty contestant and denied that “the mere fact that it is impossible to assess the damages with precision and certainty relieves a wrongdoer from paying any damages in respect of the breach of a duty of which he has been guilty”. The court ruled that the beauty contestant’s chance of winning was something to which a monetary value could be assigned. The court reasoned that if the beauty contestant had tried to sell her position as one of the 50 beauty contestants in the running for 12 possible acting contracts, an individual could have bought it from her for a fixed price. With respect to damages, the court let stand the jury’s decision to award the beauty contestant 100 pounds. The beauty contestants were competing for twelve acting contracts — four contracts for three years in the amount of five pounds salary per week, four contracts for three years in the amount of four pounds salary per week, and four contracts for three years in the amount of three pounds salary per week. On average, a winner of the contest would have had a salary of UK£576. Twenty-five per cent of UK£576 equals roughly UK£125. Factoring in the fact that the plaintiff may never have won the contest, the court held that the jury’s original award of UK£100 in damages was fair.

⁴⁹² E. Allan Farnsworth, *Legal Remedies for Breach of Contract*, *Columbia Law Review*, Vol. 70, No. 7 (Nov., 1970), at 1214, Restatement (Second) of Contracts, Section 352, Comment a: “The requirement [of certainty] does not mean, however, that the injured party is barred from recovery unless he establishes the total amount of his loss. It merely excludes those elements of loss that cannot be proved with reasonable certainty... Doubts are generally resolved against the party in breach. A party who has, by his breach, forced the injured party to seek compensation in damages should not be allowed to profit from his breach where it is established that a significant loss has occurred. A court may take into account all the circumstances of the breach, including

However, in general, while some courts adopting the approach that they will make an estimate, even if damages are not proven with absolute precision, other courts conclude that where the burden of proof has not been sufficiently acquitted, then no damages will be awarded.⁴⁹³ In the context of the CISG, it is argued that this diversity may undermine the goal of the Convention to provide a uniform law on the sale of goods as the CISG does not cover the issue of certainty of damages explicitly and the existence of differing rules concerning the proof of damage could lead to the differential treatment of similarly situated parties.⁴⁹⁴ Above all, to the extent that a failure to meet the requirement of certainty does not preclude all recovery, but merely results in an amount of damages on the basis of the abstract reasoning of the national courts, the requirement of certainty does not impose the all or nothing approach that characterizes the formal consolidations of the legal systems, but allows for specific solutions that suit better the transactions governed by legal uncertainty.

The national legal systems may enable the national courts to improve the internal order of the legal system in line with the order of international commerce, or allow them to disregard the concern of the legal system for the generality of actions in its internal order and seek for specific solutions for a particular case. Those mechanisms may conceivably lead to a capacity in the national courts for abstract reasoning in the ex post consolidations. However, the national courts are bound by a higher authority's position in relation to the problem of meeting legal uncertainty ex post, which determines the conditions for the application of *lex mercatoria* by a national court interpreting, supplementing or correcting the default rules of the legal system in accordance with the principles of the order of international commerce, or searching specific solutions for particular cases through abstractions from the context of the contract instead of applying the default rules of the legal system.

The primacy of formal consolidations over the specialization of the ex post decision maker in meeting legal uncertainty in the national legal systems leads to the verifiability thresholds for the reasonable expectations of the contracting parties arising from the established rules in a particular case, when those rules can only be discovered by means of abstract reasoning of the ex post decision maker on the basis of his specialization. These thresholds, which are ultimately enforced by the higher authorities in a legal system, potentially affect the judges' judicial behavior. Only in exceptional cases, the judges are allowed to set aside a concern for the development of the legal system and the formal consolidations established under the legal structures of the legal system. Even in those exceptional cases, the judge's judicial behavior in exercising abstract reasoning in ex post consolidations will mostly be characterized by his specialization as to the internal order of the relevant legal system due to his concentration on domestic cases.

willfulness, in deciding whether to require a lesser degree of certainty, giving greater discretion to the trier of the facts. Damages need not be calculable with mathematical accuracy and are often at best approximate." Uniform Commercial Code, Section 1-106, Comment 1: "The third purpose ... is to reject any doctrine that damages must be calculable with mathematical accuracy. Compensatory damages are often at best approximate: they have to be proved with whatever definiteness and accuracy the facts permit, but no more."

⁴⁹³ For instance in the United States, there seems to be differing approaches, with some courts applying the requirement of reasonable certainty strictly, whereas others have more or less abandoned it. Eiselen, Sieg, Proving the Quantum of Damages, *Journal of Law and Commerce*, 25-1 (2005), at 381

⁴⁹⁴ CISG-AC Opinion No. 6, Calculation of Damages under CISG Article 74. Rapporteur: Professor John Y. Gotanda, Villanova University School of Law, Villanova, Pennsylvania, USA, 2006, at para. 2.3; Eiselen, Sieg, Proving the Quantum of Damages, *Journal of Law and Commerce*, 25-1 (2005), at 382

In such a context, the national court's judicial behavior is highly influenced by the view that its decisions may be subject to review of a higher authority that upholds the interests of an organization. Thus, the national court has to uphold those interests regardless of their compatibility with the interests of the elements of the order of international commerce, unless the higher authority in the relevant legal system is willing to improve the internal order in line with the overall order of international commerce, and to be conducive to achieving an effective framework for the functioning spontaneous order of international commerce. However, ultimately, the national court is an organ of the internal order of a national legal system, and even its decision that follows the guiding model of the overall order of international commerce is not final, but reviewed by a higher authority for the purpose of preserving or improving the internal order and the self-referential structure of the legal system.

2. International Arbitral Tribunals

The pressure exerted by the needs of international commerce after the Second World War has contributed to the emergence of arbitration as an acceptable alternative to the jurisdiction of national courts and to the process of progressive freedom from the rigid subjection to national laws and to national courts' control. The prior disfavor towards arbitration is progressively replaced by its acceptance as a valid alternative to the justice provided by national courts on condition that the limitations imposed by the national legal system for allowing the parties to adopt this method of dispute settlement are respected.⁴⁹⁵ The increasing confidence of the authorities of the national legal systems in the ability of the arbitrators exercising abstract reasoning in their specialized consolidations in a manner contributive to the peaceful development of the order of international commerce is confirmed by the increasing number of arbitrable matters and of states, which have become parties to international arbitration conventions recognizing the greater degree of finality of arbitral awards, as a principle prevailing at international level for the regulation of arbitration.

It is generally accepted that an international arbitral tribunal is not an organ of a legal system.⁴⁹⁶ An important consequence is that the tribunals lack a *lex fori*. This implies that the substantive content of the decision of the arbitral tribunals should be final and binding, due to the lack of an organized hierarchy of a legal system, which could provide an effective appeal mechanism focusing on and ensuring the full compliance of a decision with the decision maker's *lex fori*. Thus, under the modern regulation of international arbitration, when proceedings for the enforcement of arbitral awards are brought in the national courts, the national court may not re-litigate the case. The national court reviewing an international arbitral award may not be motivated by a desire of integrating the award into its own legal

⁴⁹⁵ Bernardini, Piero, *Arbitral Justice, Courts and Legislation*, in Special Supplement, ICC International Court of Arbitration Bulletin: Arbitration in the Next Decade: Proceedings of the International Court of Arbitration's 75th Anniversary Conference, ICC Publication No. 612, May 1999, at 15

⁴⁹⁶ See among others ICC Award in Case No. 6379, 1990, *Yearbook Commercial Arbitration*, 17 (1992) at 218: (The arbitral tribunal stated that "arbitral tribunal is not an instrumentality of any particular State."); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.* 473 U.S. 614 (1985), at 636 (U.S. Supreme Court stated that "[T]he international arbitral tribunal owes no prior allegiance to the legal norms of particular states.") *Putrabali v. Rena Holding*, *Yearbook Commercial Arbitration*, 32 (2007), at 302 (The Cour de cassation stated that "[a]n international award, which is not anchored in any national legal order, is a decision of international justice whose validity must be ascertained with regard to the rules applicable in the country where its recognition and enforcement is sought.")

system as if it was the tribunal's *lex fori*, even if the arbitral proceedings were held in that particular jurisdiction. The national courts may not focus on which law was applied and how it was applied to the merits of the case by the arbitral tribunal. The cause of the refusal of enforcement may not be the choice of one law rather than another or the manner of interpretation, supplementation or correction of the applicable law. The national court's review of arbitral awards should mainly focus on two issues: whether the procedural manner in which the arbitral award is rendered is in compliance with the parties' intentions and the procedural public policy, and whether the enforcement of the award creates a situation that is unacceptable for the substantive public policy in the relevant legal system.

On the one hand, the consensual nature of arbitration requires the arbitrators to respect certain procedural safeguards, such as the parties' rights to a reasonable opportunity to be heard and to equal treatment in both the constitution of the tribunal and the later proceedings, which are based on the principle of due process. These safeguards enable the proper utilization of the knowledge of the particular circumstances of time and place in the resolution of contractual disputes through a flexible adjudication process, given that such knowledge can only be obtained by the cooperation of the parties to the dispute. In the same vein, the arbitrators are bound by the mandate given by the parties as they owe only allegiance to the parties, and cannot deal with issues not submitted to them. The award must be within the confines of relief requested by the parties. The national courts should ensure that, in any arbitral proceedings, the tribunals have respected those safeguards that are needed for the proper application of *lex mercatoria*.

On the other hand, arbitration cannot and should not be seen as a means to circumvent the application of certain mandatory legislation and issues of substantive public policy. Although the authorities may have better knowledge about the internal order of the relevant legal system, the enforcement of a decision that violates some norms of mandatory nature under that legal system in international cases may not necessarily lead to a substantial impact on the internal order of that legal system, given that the freedom of contract in the order of international commerce do not always overlap with the freedom of contract as understood in a particular national legal system. Thus, the national courts' review of arbitral awards on public policy issues should be limited with external or international public policy of the *lex fori*. The same considerations should also be relevant to the national courts reviewing the award in setting aside proceedings considering that an award is always subject to court challenge under the national legal system of the country where it was rendered. In such a context, the arbitrator is required to render an award which can be expected to stand effectively both in setting aside procedures and in enforcement procedures before national courts.⁴⁹⁷

The principle of party autonomy in the international arbitration postulates that the award should be final and there should be no judicial review on its merits.⁴⁹⁸ Thus, the agreement of parties on arbitration is deemed by law as their agreement to abide by any award rendered by

⁴⁹⁷ Actions for setting aside must normally be filed with the court at the seat of arbitration. This is the position adopted in the UNCITRAL Model Law on International Commercial Arbitration and the majority of arbitration laws. Lew, Julian D. M., Loukas Mistelis L. A., & Stefan M. Kröll, *Comparative International Commercial Arbitration*, Kluwer Law International, 2003, at 667; ICC Rules of Arbitration Article 35: "In all matters not expressly provided for in these Rules, the Court and the Arbitral Tribunal shall act in the spirit of these Rules and shall make every effort to make sure that the Award is enforceable at law."

⁴⁹⁸ Schmitthoff, Clive M., *Finality of Arbitral Awards and Judicial Review*, in Julian D. M. Lew (ed.), *Contemporary Problems in International Arbitration*, London, 1986, at 230

arbitrators acting within their powers granted by the parties and states.⁴⁹⁹ The finality of awards constitutes an essential expectation of the parties. However, the violation of public policy which is universally considered as a ground for refusal of enforcement and for setting aside of an arbitral award is an acknowledgement of the essential expectations of states to protect the internal order of their legal systems. There is a tension between the nations not wishing to lend their authority in refusing enforcement of awards, which contravene domestic laws and values, and the desire to respect the finality of awards. This tension is generally resolved by arbitration laws in favor of finality of awards by means of prohibiting the review of the merits by national courts and limiting it with questions of fundamental notions of public policy.⁵⁰⁰ This solution is enshrined in the New York Convention, which does not include such requirements, that may only be determined with the review on merits or re-litigation of the dispute, into the exhaustive grounds for refusal of enforcement set out in its Article V.⁵⁰¹ In setting aside of arbitral awards, the prohibition of review of the merits is slightly less straightforward due to the relative variety of grounds for setting aside in national arbitration laws, but, in general, these grounds are often mirror the grounds listed in Article V of the New York Convention.⁵⁰²

The prohibition of review of the merits is widely accepted, and this provides the adequate environment for the application of *lex mercatoria* as an *ex post* governance mechanism in the context of international arbitration. Even so, in some national laws, there exists the possibility of appeal on points of law and manifest disregard of law, which leads to the review of an award on the merits by the national courts. It is generally accepted that in the enforcement proceedings, mistake as to the law or the facts by the tribunal will not constitute a ground for refusal, if unaccompanied by some serious procedural irregularity, as the Article V of the New York Convention does not include such a ground and exhaustively lists the grounds for refusal of recognition and enforcement. However, there have been cases, where one of the parties attempted to invoke manifest disregard of law, which is available as a ground for setting aside in a certain jurisdiction, as a ground for the refusal of enforcement in the same jurisdiction. In those cases, the courts have held that it is not a valid defense to an enforcement action under the New York Convention, and that the manifest disregard standard does not fall within the scope of Article V.⁵⁰³

⁴⁹⁹ Ball, M., *The Essential Judge: the Role of the Courts in a System of National and International Commercial Arbitration*, *Arbitration International*, 22-1 (2006), at 82

⁵⁰⁰ Sheppard, Audley, *Interim ILA Report on Public Policy as a Bar to Enforcement of International Arbitral Awards*, *Arbitration International*, 19-2 (2003), at 217

⁵⁰¹ Schmitthoff, Clive M., *Finality of Arbitral Awards and Judicial Review*, in Julian D. M. Lew (ed.), *Contemporary Problems in International Arbitration*, London, 1986, at 233

⁵⁰² Lew, Julian D. M., Loukas Mistelis L. A., & Stefan M. Kröll, *Comparative International Commercial Arbitration*, Kluwer Law International, 2003, at 673

⁵⁰³ For instance in United States, although the U.S. federal courts of appeals ("circuit courts") are divided on whether the Federal Arbitration Act or the New York Convention grounds apply in an action to vacate a nondomestic award made in the United States, the manifest disregard standard has never been applied to international arbitrations arbitrated in a foreign state. Chen, Annie, *The Doctrine of Manifest Disregard of the Law After Hall Street: Implications for Judicial Review of International Arbitrations in U. S. Courts*, *Fordham International Law Journal*, 32 (2009), at 1874 In the case of *Brandies Instel Ltd -v- Calabrian Chemicals Corp.* 656 F Supp. 160 (SDNY, 1987) at 165, the court, in response to the claim that "manifest disregard" of the law should be raised to the level of "public policy" within the context of Article V of the Convention, found that the manifest disregard doctrine is a creature of domestic arbitration cases in the United States, and stated that "manifest disregard" of law, whatever the phrase may mean, does not rise to the level of contravening "public policy," as that phrase is used in Article V of the Convention. Nor, unlike proceedings under chapter 1 of the Federal Arbitration Act, can manifest disregard of law be urged as an independent ground for vacating an award

As far as setting aside proceedings are concerned, the attitude towards manifest disregard of law as a ground for setting aside the award reflects a variety of approaches in national arbitration laws. The UNCITRAL Model Law on Arbitration does not contain any provision for any form of appeal from an arbitral award on the law or on the facts. Moreover, Article 5 of the UNCITRAL Model Law on Arbitration provides that “In matters governed by this Law, no court shall intervene except where so provided in this Law.” In France and Germany, the national courts have increasingly refused to allow the claim of mistake in law to be used as a means to review arbitral awards on the merits and to jeopardize the principle of finality.

504

In the United States, an award may be set aside if the arbitrator exhibits a “manifest disregard of the law”. When adopting the New York Convention, the United States accepted the application of the Convention not only to awards rendered abroad, but also to international awards rendered in the United States.⁵⁰⁵ However, in some cases, the courts have allowed manifest disregard challenges to international awards, while other courts have appeared to be

falling within the Convention.”; In the case of *International Standard Electric Corp. -v- Bidas Sociedad Anonima Petrolera, Industrial Y Commercial* 745 F Supp. 172 (SDNY, 1990) at 182, the court rejecting the manifest disregard complaint stated that “We cannot understand how the Convention, created to assure consistency in the enforcement of foreign arbitral awards, would not be gravely undermined, if judges sitting in each of the many jurisdictions where enforcement may be obtained, were authorized by the Convention to undertake a de novo inquiry into whether the law the arbitrators said they were using was or was not properly applied by them. The plain answer is that the Convention does not, and could not, contemplate such a chaos.”; In the case of *M&C Corp. -v- Erwin Behr GmbH & Co.* KG 87 F 3d 844 (6th Cir., 1996) at 12-13 the court held that “under the terms of the New York Convention itself, judicial review of [an international arbitral award] is extremely limited and extends only to procedural aspects of the determination.... Article V of the Convention lists the exclusive grounds justifying refusal to recognize an arbitral award. Those grounds, ..., do not include miscalculations of fact or manifest disregard of the law... This court is, therefore, without jurisdiction to engage in the type of review requested by [the Defendant-Appellant].” In England, in the case of *Omnium de Traitement et de Valorisation SA v. Hilmarton Ltd* [1999] 2 QB 222, also reported at *Yearbook Commercial Arbitration*, 24 (1999), p. 777, Timothy Walker J. held “I am not adjudicating upon the underlying contract. I am deciding whether or not an arbitration award should be enforced in England. In this context it seems to me that (absent a finding of fact of corrupt practices which would give rise to obvious public policy considerations) the fact that English law would or might have arrived at a different result is nothing to the point. Indeed, the reason for the different result is that Swiss law is different from English law, and the parties chose Swiss law and Swiss arbitration. If anything, this consideration dictates (as a matter of policy of the upholding of international arbitral awards) that the award should be enforced.”

⁵⁰⁴ In France, the courts have developed a consistent case law which refuses to reassess the arbitrators’ decision in the light of public policy or to set aside awards allegedly contrary to public policy, on the ground that the arbitrators’ reasoning is not subject to the control of the courts as long as the solution is not incompatible with public policy in itself. Mourre, Alexis &, Luca G. Radicati di Brozolo, *Towards Finality of Arbitral Awards: Two Steps Forward and One Step Back*, *Journal of International Arbitration*, 23-2 (2006), at 173. Therefore, in the context of an action to set aside an award or to obtain its enforcement, the French courts cannot review the merits of the dispute. Errors of judgment, whether of fact or of law, are clearly not in themselves grounds on which the award can be set aside or refused enforcement. Gaillard, Emmanuel, *Transnational Law: A Legal System or a Method of Decision-Making*, in Klaus Peter Berger, *The Practice of Transnational Law*, Kluwer Law International, 2001, at 923. German Federal Court of Justice stated that “in this context it is irrelevant if the arbitral tribunal wanted to circumvent German law or if it applied the law erroneously; this is because in so far [as the review under public policy is concerned] only the facts and the result matter.” *Bundesgerichtshof* 27.2.1964, *Fritz Lindenmaier and Phillip Möhring, Nachschlagewerk des BGH in Zivilsachen*, (C.H. Beck, München) § 1044 ZPO No. 4. (cited by Liebscher, Christoph, *European Public Policy, A Black Box?*, *Journal of International Arbitration* 17-3 (2000), at 84)

⁵⁰⁵ Park, William W., *The Specificity of International Arbitration: The Case for FAA Reform*, *Vanderbilt Journal of Transnational Law*, 36 (2003), at 1246

undecided on the issue.⁵⁰⁶ Essentially, the Federal Arbitration Act (FAA) applies to domestic arbitrations and international arbitrations for which the seat of arbitration is in the United States. The FAA encourages confirmation of arbitral awards by means of the presumption that awards will be enforced for certain exceptions. Pursuant to Section 9 of the FAA, a court must confirm an arbitral award unless it is “vacated, modified, or corrected as prescribed” in Sections 10 and 11. The grounds for vacating an arbitral award are set out in section 10 of the FAA, and the grounds for modifying an award are set out in section 11 of the FAA. The “manifest disregard of the law” is not mentioned in the FAA, but has been developed as a non-statutory standard for vacatur of arbitral awards.⁵⁰⁷ However, there is no uniform standard of the doctrine.⁵⁰⁸ Moreover, there has been considerable debate about the continued viability of “manifest disregard of the law” as a basis for challenging arbitration awards following the Supreme Court’s decision in *Hall Street Associates, L.L.C. v. Mattel Inc.* The Supreme Court held that the express grounds stated in Section 10 of the FAA for vacating arbitral awards cannot be contractually expanded by parties.⁵⁰⁹ This holding implicitly called into question the continued viability of manifest disregard, because manifest disregard is not a basis for vacatur expressly stated in the FAA. While the Supreme Court recognized that its ruling had implications for the manifest disregard doctrine, the Court did not endorse any specific view of the role that doctrine would continue to play after *Hall Street*.⁵¹⁰ The Supreme Court therefore left it to the lower courts to determine what that role should be, but those courts have not answered the question uniformly.⁵¹¹ Later, in *Stolt-Nielsen S.A. v.*

⁵⁰⁶ *Yusuf Ahmed Alghanim & Sons, WLL -v - Toys ‘R’ Us, Inc.*, 126 F. 3d 15 (2d Cir., 1997).(holding that the Federal Arbitration Act standards, including manifest disregard of the law, do apply to non-domestic awards rendered in the United States); *Jacada (Europe), Ltd. v. Int’l Mktg., Inc.*, 401 F.3d 701 (6th Cir. 2005) (permitting manifest disregard challenge to a New York Convention award); *Int’l Thunderbird Gaming Corp. v. United Mexican States*, 255 Fed. Appx. 531, 532-33 (D.C. Cir. 2007) (affirming district court decision considering manifest disregard challenge to NAFTA award issued under UNCITRAL Rules) *Indus. Risk Ins. v. M.A.N. Gutehoffnungshutte GmbH*, 141 F.3d 1434, 1443, 1446 (11th Cir. 1998) (rejecting manifest disregard challenges to international awards); *Karaha Bodas Co., L.L.C. v. Perusahaan Pertambangan Minyak Dan Gas Bumi Negara*, 364 F.3d 274 (5th Cir. 2004) (permitting a manifest disregard challenge to an award governed by the New York Convention),

⁵⁰⁷ *Wilko v. Swan*, 346 U.S. 427, 436-37, (1953); U.S. Supreme Court stated in that the “[p]ower to vacate an [arbitration] award is limited” and that “the interpretations of law by the arbitrators in contrast to manifest disregard are not subject, in the federal courts, to judicial review for error in interpretation.” The doctrine of manifest disregard of the law has developed out of this dictum, although *Wilko* has been since overruled on its principal ruling on other grounds by *Rodriguez de Quijas v. Shearson/AmExpress, Inc.*, 490 U.S. 477 (1989).

⁵⁰⁸ Chen, Annie, *The Doctrine of Manifest Disregard of the Law After Hall Street: Implications for Judicial Review of International Arbitrations in U. S. Courts*, *Fordham International Law Journal*, 32 (2009), at 1882

⁵⁰⁹ In the case, *Hall Street* argued that *Wilko v. Swan* had created a non-statutory ground for vacatur through manifest disregard, and that parties should be allowed to also contractually expand the grounds for review. The Court rejected this argument, finding that there is “nothing malleable about ‘must grant’ [in section 9 of the FAA,] which unequivocally tells courts to grant confirmation in all cases, except when one of the ‘prescribed’ exceptions applies.” *Hall Street Assocs. v. Mattel, Inc.*, 128 S. Ct. 1398, 1403 (2008), at 1404-1405

⁵¹⁰ The Court stated several possible justifications for the manifest disregard of law doctrine, including one that ties the doctrine back to the FAA: “Maybe the term ‘manifest disregard’ was meant to name a new ground for review, but maybe it merely referred to the §10 grounds collectively, rather than adding to them. Or, as some courts have thought, ‘manifest disregard’ may have been shorthand for §10(a) (3) or §10(a) (4), the subsections authorizing vacatur when the arbitrators were ‘guilty of misconduct’ or ‘exceeded their powers.’” *Hall Street Assocs. v. Mattel, Inc.*, 128 S. Ct. 1398, 1403 (2008), at 1404

⁵¹¹ The Fifth Circuit, which previously permitted manifest disregard challenges to international awards, had expressly concluded that the doctrine did not survive *Hall Street*. *Karaha Bodas Co., L.L.C. v. Perusahaan Pertambangan Minyak Dan Gas Bumi Negara*, 364 F.3d 274 (5th Cir. 2004) (The Fifth Circuit permitted a manifest disregard challenge to an award governed by the New York Convention), *Citigroup Global Markets Inc. v. Bacon*, No. 07-20670, 2009 U.S. App. LEXIS 4543, at *1-2 (5th Cir. March 5, 2009) (The Fifth Circuit

AnimalFeeds International Corp., the Supreme Court again declined to take a position. In a footnote, the majority of the Supreme Court expressly declined to determine whether manifest disregard survived Hall Street, although it assumed, *arguendo*, that the standard for manifest disregard of law identified by the respondent was satisfied in the case.⁵¹²

Regardless of the diversity in its application by the different courts and the uncertainty surrounding its viability after Hall Street, it can be said that the doctrine of manifest disregard of the law in the United States generally leads to the vacatur of an award, provided that a party demonstrates that the arbitrator was aware of some governing legal standard, but consciously chose to ignore it and, thus, a mere mistake in application or interpretation is generally insufficient to satisfy the manifest disregard ground.⁵¹³ In this regard, its actual application may seem akin to the implications of Article V(1)(c) of the New York Convention and other national laws that allow similar considerations in cases of excess of authority by the arbitrators thereby permitting an award to be set aside or refused recognition if the arbitrators failed to apply the substantive law chosen by the parties. As a matter of fact, some courts and commentators in the United States have considered manifest disregard of the law as an application of the excess of authority ground in Section 10(a)(4) of the FAA.⁵¹⁴

concluded that manifest disregard has not survived Hall Street by finding that “Hall Street unequivocally held that the statutory grounds are the exclusive means for vacatur under the FAA.” And held that “To the extent that our previous precedent holds that non-statutory grounds may support the vacatur of an arbitral award, it is hereby overruled.”) Other circuits, the Second, Sixth and Ninth, have ruled that Hall Street does not foreclose manifest disregard challenges. *Stolt-Nielsen SA v. Animal Feeds Int’l Corp.*, 548 F.3d 85, 94 (2d Cir. 2008) (the Second Circuit held that the manifest disregard standard continues to exist as a ground for reviewing an arbitral award but that it should be “reconceptualized as a judicial gloss on the specific grounds for vacatur enumerated in section 10 of the FAA ...”) *Coffee Beanery, Ltd., v. WW, L.L.C.*, 300 F. App’x 415, 419 (6th Cir. 2008) (The Sixth Circuit stated that “[i]n light of the Supreme Court’s hesitation to reject the manifest disregard doctrine in all circumstances, we believe it would be imprudent to cease employing such a universally recognized principle” and “this Court will follow its well established precedent and continue to employ the ‘manifest disregard’ standard.”) *Comedy Club, Inc. v. Improv West Assocs.*, 553 F.3d 1277, 1281 (9th Cir. 2009) (The Ninth Circuit found that the circuit’s view of the manifest disregard of the law ground for vacatur is still permitted under Hall Street and stated that “We determine that Hall Street Associates does not undermine our prior precedent”). The First Circuit stated in dicta in one opinion that Hall Street abolished manifest disregard as a ground for vacatur, but in subsequent opinions applied the doctrine of manifest disregard standard without discussing the impact of Hall Street. *Ramos-Santiago v. United Parcel Serv.*, 524 F.3d 120, 124 n.3 (1st Cir. 2008) (“We acknowledge the Supreme Court’s recent holding in Hall Street..., that manifest disregard of the law is not a valid ground for vacating or modifying an arbitral award in cases brought under the Federal Arbitration Act”); but see; *Kashner Davidson Sec. Corp. v. Mscisz*, 531 F.3d 68, 74 (1st Cir. 2008)

⁵¹² “We do not decide whether “ ‘manifest disregard’ ” survives our decision in Hall Street Associates, L. L. C. v. Mattel, Inc., 552 U. S. 576, 585 (2008), as an independent ground for review or as a judicial gloss on the enumerated grounds for vacatur set forth at 9 U. S. C. §10. [The respondent] characterizes that standard as requiring a showing that the arbitrators “knew of the relevant [legal] principle, appreciated that this principle controlled the outcome of the disputed issue, and nonetheless willfully flouted the governing law by refusing to apply it.” Brief for Respondent 25 (internal quotation marks omitted). Assuming, *arguendo*, that such a standard applies, we find it satisfied ...” *Stolt-Nielsen S.A. v. AnimalFeeds International Corp.*, 559 U.S. ___, 2010 WL 1655826, (2010), footnote 3

⁵¹³ Duffy, J.P., Hall Street One Year Later: The Manifest Disregard Debate Continues, *American Review of International Arbitration*, 19 (2008), at 195

⁵¹⁴ Drahozal, Christopher R., Codifying Manifest Disregard, *Nevada Law Journal*, 8 (2007), at 239 (stating that some commentators treat manifest disregard as an application of the excess authority ground in 10(a) (4) of the FAA). *Stolt-Nielsen SA v. Animal Feeds Int’l Corp.*, 548 F.3d 85, 94 (2d Cir. 2008) (the Second Circuit read manifest disregard of the law as an error in which the arbitrator exceeds his powers, within the meaning of section 10(a) (4) of the FAA, rather than as an independent ground for vacatur.) *Kyocera Corp. v. Prudential-Bache T Servs., Inc.*, 341 F.3d 987, 997 (9th Cir. 2003) (en banc) (The Ninth Circuit stated that “We have held that arbitrators ‘exceed their powers’ in this regard not when they merely interpret or apply the governing law

In England, the courts have certain powers to set aside awards made in England for errors of law, but the parties have the power to exclude by agreement the possibility of judicial review of questions of law pursuant to Section 69 of the English Arbitration Act 1996.⁵¹⁵ Although the parties' agreement to exclude is required to be in writing, the provision contained in the institutional rules of arbitration to the effect that the award shall be final and binding has been held to constitute a valid agreement to exclude mistakes of law from grounds for setting aside.⁵¹⁶ Moreover, in its decision of *B v A*, which concerned an arbitral award rendered under the ICC Rules by a tribunal whose seat was in London, the English High Court dismissed the challenge that the tribunal failed to decide in accordance with law chosen by the parties on the basis that the failure to apply the chosen law was not a serious irregularity. According to the Court, for the challenge to have succeeded, the appellant would have had to show that the tribunal made a "conscious disregard of the provisions of the chosen law." The dispute arose in the context of a share purchase agreement of shares in a Spanish company. The contract was governed by Spanish law. The award was made by two of the arbitrators, who constituted the majority and who were common lawyers. The third arbitrator was Spanish and argued that the majority arbitrators did not follow Spanish law and had decided the matter in an arbitrary fashion. The Court found the majority had based their decision on their understanding of Spanish law and that the dissenting arbitrator's contentions that they did so erroneously was irrelevant and not grounds to challenge.⁵¹⁷

Some national legal systems have even referred to a policy in favor of giving effect as far as possible to the finality of international arbitral awards and discouraging the re-litigation of issues already determined. For instance, Article 1717(4) of the Belgian Judicial Code, Article 192 of the Swiss Law on Private International Law, Section 51 of the 1999 Swedish Arbitration Act and Article 78(6) of the Tunisian Code of Arbitration allow certain awards to escape any setting aside actions at the place of the seat when no national or resident party was involved and no enforcement sought on its territory, provided that the parties have agreed

incorrectly, but when the award is 'completely irrational,' or exhibits a 'manifest disregard of law'") *Comedy Club, Inc. v. Improv West Assocs.*, 553 F.3d 1277, 1281 (9th Cir. 2009) (The Ninth Circuit reiterated that "in this circuit, an arbitrator's manifest disregard of the law remains a valid ground for vacatur of an arbitral award under § 10(a)(4) of the Federal Arbitration Act.").

⁵¹⁵ English Arbitration Act 1996 limits the scope of the New York Convention to awards made in the territory of a state "other than the United Kingdom." (Section 100 (1)) However, in the *Westacre* case, the Court indicated that "the great weight to be attached to the public policy of sustaining the finality of international arbitration" and advocated a balancing exercise between the policies of finality and preventing illegality: i.e., "between the finality that should prima facie exist particularly for those that agree to have their disputes arbitrated, against the public policy of ensuring that the executive power of the English court is not abused." The Court also held that the English courts "would be entitled to assume that arbitrators appointed were of undoubted competence and capability, well able to understand and determine the particular issue of illegality arising in this case." *Westacre Investments v. Jugoimport* [1999] 3 All E.R. 864 (Q.B.); [1999] 3 W.L.R. 811 (C.A.)

⁵¹⁶ Redfern, Alan & Martin Hunter with Nigel Blackaby and Constantine Partasides, *Law and Practice of International Commercial Arbitration*, London: Sweet & Maxwell, 4th ed. Student version, 2004, at 503; E.g. Article 28(6) of the ICC Rules of Arbitration provides: "Every award shall be binding on the parties. By submitting the dispute to arbitration under these Rules, the parties undertake to carry out any Award without delay and shall be deemed to have waived their right to any form of recourse Insofar as such waiver can validly be made": To the same effect is Article 26.9 of the LCIA Rules. By contrast, the AAA International Arbitration Rules and the UNCITRAL Arbitration Rules have no comparable provisions.

⁵¹⁷ *B v A*, [2010] EWHC 1862

so.⁵¹⁸ The French arbitration law, which has been revised by Decree No. 2011-48 of January 13, 2011 that came into force on May 1, 2011, also authorizes the parties to waive their right to seek annulment of an award rendered in France before French courts. Article 1522 of the French Code of Civil Procedure provides that the parties may, by specific agreement, waive at any time their right to challenge the award by way of annulment. The parties' waiver under Article 1522 does not affect their right to appeal any decision to enforce the award in France. The new French provision grants the right to exclude judicial review in annulment proceedings not only to foreign but also to French parties.⁵¹⁹

In fact, this variety of approaches adopted by the national arbitration laws with regard to the finality of arbitral awards provides the contractual parties with a means to refine the degree of their delegation of the task of controlling of legal uncertainty to the specialization of the decision maker, through the choice of arbitral seat from those options provided by the various jurisdictions.⁵²⁰ For example, the parties have three options in Switzerland. The first is to conduct the arbitration under Swiss Private International Law Act 1987, which reflects the approach of majority of national arbitration laws. Secondly, if none of the parties domiciled in Switzerland, they can agree to exclude all setting aside proceedings or to limit such proceedings to one or more of the grounds listed in the Act. The third option is to agree to the application of the Intercantonal Concordat on Arbitration of 1969, which is known as the "nostalgia" clause, although rarely adopted in practice. Under the Concordat, the grounds for setting aside an award are more extensive than under the Swiss Private International Act, as it includes a provision for setting aside an award on the basis that it is "arbitrary", which enables the court to review the merits of the award to a greater extent.⁵²¹

In general, the finality of arbitral awards and the "general pro-enforcement bias" under the New York Convention and modern arbitration laws indicate the confidence of the states in the ability of the arbitrator to render decisions, which are conducive to maintaining and improving the spontaneous order of international commerce, and, thus, enable the confidence

⁵¹⁸ Gaillard, Emmanuel, *The Enforcement of Awards Set Aside in the Country of Origin*, ICSID Review—Foreign Investment Law Journal, 14 (1999), at 40

⁵¹⁹ Castellane, Beatrice, *The New French Law on International Arbitration*, Journal of International Arbitration, 28-4 (2011), at 379

⁵²⁰ Article V (1) (e) of the New York Convention provides that recognition and enforcement may be refused if the award has been set aside at the place of arbitration. However, this rule can be neutralized by applying Article VII of the New York Convention, which aims to give precedence to more pro-enforcement national laws over the Convention and provides that the judge may not refuse to enforce unless the national law so authorizes. For instance, in France, the Paris Court of Appeal, in its decision of December 19, 1991, held that Article 1502 of the New Code of Civil Procedure does not include, as one of the grounds for refusal to enforce an award, the fact that it has been set aside in its country of origin. Gaillard, Emmanuel, *The Enforcement of Awards Set Aside in the Country of Origin*, ICSID Review—Foreign Investment Law Journal, 14 (1999), at 40. It must also be noted that, the effect of Article V (1) (e) of the New York Convention is limited with regard to the jurisdictions of the signatories of European Convention on International Commercial Arbitration of 1961 done at Geneva. Thus, pursuant to the European Convention, an award that has been set aside in the state of its origin is not an absolute ground for refusal of recognition, but may be enforced in another contracting state. Article IX of the European Convention enumerates the grounds for setting aside. When the award is set aside based on any of these grounds, such decision leads to the refusal of recognition or enforcement. The setting aside for other grounds, in particular for a violation of public policy of the country in which the award was made, is not indicated as a ground to refuse enforcement. Haugeneder, F., *The New Austrian Arbitration Act and the European Convention on International Commercial Arbitration*, Arbitration International, 23-4 (2007), at 660

⁵²¹ Redfern, Alan & Martin Hunter with Nigel Blackaby and Constantine Partasides, *Law and Practice of International Commercial Arbitration*, London: Sweet & Maxwell, 4th ed. Student version, 2004, at 504

of contracting parties in the arbitrator. More importantly, the national legal systems generally recognize that even if the arbitrator is required to apply a national legal rule, the application of such a rule may be according to the reasonable expectations of the parties to a particular case and it will not be considered as an activity of the relevant legal system since his decision do not constitute a part of the self referential structure of the relevant legal system.⁵²²

The absence of a legal system that provide responsible guidance for the decision making process in the context of international arbitration and finality of arbitral awards preclude the possibility of an emerging self-referential structure that can be influential on the judicial behavior of the arbitrators and direct them to resolve the disputes with a concern for the development of the order of international commerce. The resulting increase in the capacity of the arbitrators for abstract reasoning enables flexibility in adjudication and justice in a particular case, which have become some of the most important advantages of arbitration over litigation.⁵²³ However, the exercise of such increased powers by the arbitrators may render the institution of arbitration vulnerable against some undesired factors, which potentially become influential on the judicial behavior of the decision makers whose decisions are final and binding. Although the absence of self-referential legal structures in the order of international commerce is the main reason for the existence of *lex mercatoria*, it can be observed that the parties to arbitration proceedings sometimes have difficulties in predicting the substantive outcome of the dispute. It is argued that the arbitrators' judicial behavior has been characterized by a tendency to "split the difference" between the parties, as a result of the flexibility inherent in arbitration proceedings, rather than drawing from a legal system the full consequences of their decisions.⁵²⁴

⁵²² The Cour de cassation confirmed this approach in a decision dated March 23, 1994, ruling that the award in question, which was governed by Swiss law and set aside by the Swiss courts, was "an international award which was not integrated into the Swiss . . . legal order, such that its existence continued in spite of its being set aside and that its recognition in France was not contrary to international public policy." *Yearbook Commercial Arbitration*, 18 (1993), p. 663

⁵²³ A study by Richard Naimark and Stephanie Keer asked participants in AAA international arbitrations to rank a list of attributes in order of importance in that particular proceeding. They found that "an overwhelming majority of the parties ranked a fair and just result as the most important attribute, even above the receipt of a monetary award, speed of outcome, cost or arbitrator expertise." Naimark, Richard W. & Stephanie E. Keer, *International Private Commercial Arbitration: Expectations and Perceptions of Attorneys and Business People – A Forced-Rank Analysis*, *International Business Lawyer*, (May 2002), at 203-209; In a study conducted by the School of International Arbitration at the Centre for Commercial Law Studies, Queen Mary University of London, where the in-house lawyers, general counsel or heads of legal departments of various corporations in various industrial sectors and jurisdictions with cross-border economic activities were targeted to obtain empirical evidence of the attitudes of major corporate entities towards international arbitration and resolving cross-border disputes, the most of the interviewees admitted that the traditional grounds for opting for arbitration (arbitration being faster and more cost effective than litigation) are no longer true in most cases, and in the scoring system, flexible procedure was ranked as the most important reason as the most respondents considered it one of the top three reasons why corporations opt for arbitration as their preferred process for resolving their international commercial disputes. Mistelis, Loukas, *International arbitration, Corporate Attitudes and Practices, 12 Perceptions Tested: Myths, Data and Analysis Research Report*, *American Review of International Arbitration*, 15 (2004), at 543

⁵²⁴ The arbitral tribunals' tendency to split the difference is reminiscent of King Solomon's interim ruling between the proverbial Jerusalem mothers. In a Biblical dispute, one woman accused another of stealing her baby. King Solomon called for a sword so the child might be divided, half for each litigant. When one woman abandoned her claim in order to save the infant, King Solomon recognized the real mother and granted her custody. Thus, this tendency of modern arbitral tribunals is sometimes called as "splitting the baby" or "Solomonic approach." Park, William W., *Arbitrators and Accuracy*, *Journal of International Dispute Settlement*, 1-1 (2010), at 32 In the field of international banking and finance, there is a general disfavor against the use of arbitration in the resolution of contractual disputes, among others, as a result of the tendency of splitting the difference, and the international loan agreements typically provide that the borrower will submit to

Some studies put forward that, arbitrators, who wish to increase their chances of reappointment in future disputes, will tend to split the difference between the parties in order to satisfy both parties to the dispute.⁵²⁵ This argument is based on the observation that while

the jurisdiction of the courts of a creditor-friendly jurisdiction, such as New York or London or the courts of the creditors' home country. Park, William W., *Arbitration in Banking and Finance*, Annual Review of Banking Law, 17 (1998), at 213; Horn, Norbert, *The Development of Arbitration in International Financial Transactions*, *Arbitration International*, 16 (2000), at 284; The reasons for the preference in international loan agreements for the jurisdiction of national courts over arbitration can be summarized as follows: (1) the contractual and legal entitlements are clear, so only an executory title needs to be obtained which expresses those entitlements and which forces the debtor to perform without giving rise complicated legal questions; (2) as the legal situation is so clear, that the decision will be made strictly according to law without equitable considerations influencing the decision; (3) where the proceedings were conducted in public, the publicity pressure would force the contractor to fulfill his contractual obligations, while such publicity pressure is lacking in confidentially conducted arbitration proceedings; (4) in the context of national courts in many jurisdictions, the creditors have various possibilities to bring their claims summarily; and (5) the parties may agree that the jurisdiction of the selected forum shall be non-exclusive whereby the creditor holds the option to introduce his claims in other statute-based jurisdictions, while an arbitration agreement specifies an exclusive forum. Sandrock, Otto, *Is International Arbitration Inept to Solve Disputes Arising out of International Loan Agreements?*, *Journal of International Arbitration*, 11-3 (1994), at 33 et seq.; Boeglin, Marcus C., *The Use of Arbitration Clauses in the Field of Banking and Finance*, *Journal of International Arbitration*, 15-3 (1998), at 27

⁵²⁵ Cooter, Robert D., *The Objectives of Private and Public Judges*, *Public Choice*, 41 (1983), at 131, arguing that "Private judges who maximize demand for their services from disputants, each of whom has the power to veto choice of a judge, will make decisions which are pairwise Pareto efficient and split the cooperative surplus according to how hard the disputants bargain," but competition in the market for such services compels private judges to consider the effects of their decisions upon the actual litigants exclusively rather than considering third parties. Dammann, Jens & Henry Hansmann, *Globalizing Commercial Litigation*, *Cornell Law Review*, 94 (2008), at 34 arguing that "Broadly speaking, arbitration serves primarily as a means of ex post dispute resolution, seeking to offer an acceptable settlement of a conflict once it has arisen. Adjudication in public courts, in contrast, is more focused on holding parties to the contractual commitments they made ex ante, before a conflict arose. This view of arbitration is supported by survey data showing that participants find that courts have an advantage over arbitration in reaching predictable decisions. An important reason for this advantage is that arbitrators are commonly chosen (directly or indirectly) and paid by the parties, giving the arbitrators an interest in rendering decisions that will maximize the chances that they will be chosen again in future disputes. The result is an incentive to render compromised judgments that do not badly offend either party."; Posner, Richard. A., *Judicial Behavior and Performance: An Economic Approach*, *Florida State University Law Review*, 32 (2005), at 1260-1261, arguing that "Arbitrators are selected by, or with the consent of, the litigants. An arbitrator who gets a reputation for favoring one side or the other in a class of cases, such as cases of employment termination or disputes between investors and brokers or between management and unions, will be unacceptable to one of the parties in any such dispute, and so the demand for his services will wither. We can expect, therefore, a tendency for arbitrators to "split the difference" in their awards, that is, to try to give each side a partial victory (and therefore partial defeat). For this will make it difficult for the parties on either side of the class of suits in question to infer a pattern of favoritism. ... arbitrators, unlike courts, are not subsidized by the government; their fees and expenses must be defrayed by the disputants. The public subsidy of adjudication places them at a cost disadvantage vis-à-vis the courts. One way to overcome this disadvantage is to offer a distinctive service, and splitting-the-difference decisionmaking is such a service."; Shell, G. Richard, *Res Judicata and Collateral Estoppel Effects of Commercial Arbitration*, *UCLA Law Review*, 35 (1988), at 633-634 ("Arbitration ... differs from court litigation in that arbitrators are legally free to render compromise awards rather than "all or nothing" decisions. Research on this subject suggests that arbitrators do indeed "split the difference" between the conflicting demands of the parties, though it is impossible to say with what frequency this occurs... In commercial arbitration, compromise awards are made possible because arbitrators need not justify their decisions and because, ..., judicial review of awards is extremely limited. The arbitration system also sometimes creates positive incentives for arbitrators to split the difference between the parties. Arbitrators, unlike judges, often have an incentive to make disputants equally happy or unhappy because they are paid by the parties rather than by the state. Since risk averse parties are more likely to agree on an arbitrator who has a reputation for moderate decisions than one who consistently renders all or nothing awards, arbitrators who want to encourage repeat business will seek a reputation for moderation rather than extremism in their decisionmaking.")

judges are usually randomly assigned to hear cases, and receive a secure income regardless of these assignments and irrespective of the number of cases they hear, in arbitration, the parties usually select the arbitrators, and the arbitrators receive compensation from these parties only after their appointment. The arbitrators compete in the arbitration market like any other service provider and, for appointment, they rely on their backgrounds, which consist of their academic standing, scholarly publication, practical experience, training in alternative dispute resolution, connections to law firms, businesses, arbitral institutions and political power, language skills, and proficiency in technical aspects of arbitration practice.⁵²⁶ Thus, market information can affect their future reappointment to arbitration tribunals and potentially influence their judicial behavior.⁵²⁷ However, it is important to note that the majority of arbitration professionals is also practicing lawyers in this field and earns much more from their activity as lawyers than from their activity as arbitrators.⁵²⁸ Thus, in this understanding, it seems that the phenomenon of splitting the difference only makes sense as part of an effort to assume a place at the top of the legal profession, not merely to maximize income over the short term, but also to build up and keep up reputation in the arbitration world.⁵²⁹

Although it might be possible to theorize that the arbitrators are willing to satisfy both parties by choosing, strategically, to split the difference in order to increase their chances of reappointment, one could equally argue that the arbitrators wish to render an accurate decision according to the particular circumstances of the case in order to strengthen their reputation in the arbitration world. Thus, to the extent they are concerned with the impression they make, the arbitrators should care about the views of all participants in the process, not just those who

⁵²⁶ Dezalay, Yves & Bryant G. Garth, *Dealing in Virtue: International Commercial Arbitration and the Construction of a Transnational Legal Order*, University of Chicago Press, 1996, at 19, 21 providing an observation of a partner in a New York law firm that ““You’ve got to have a platform” such as an academic position or a partnership in a “significant law firm” or you can’t get into the game.”

⁵²⁷ According to the study conducted by the School of International Arbitration at the Centre for Commercial Law Studies, Queen Mary University of London, where the in-house lawyers of various corporations were the respondents, the reputation of the potential arbitrator within the international arbitration community was mentioned by all respondents as one of the most important factors they consider when choosing an arbitrator for appointment. This attribute was closely followed by expertise and common sense. The necessary information to assess the candidate is obtained from informal contacts, personal knowledge and recommendation of outside counsel. Mistelis, Loukas, *International arbitration, Corporate Attitudes and Practices, 12 Perceptions Tested: Myths, Data and Analysis Research Report*, *American Review of International Arbitration*, 15 (2004), at 574-575

⁵²⁸ Dezalay, Yves & Bryant G. Garth, *Dealing in Virtue: International Commercial Arbitration and the Construction of a Transnational Legal Order*, University of Chicago Press, 1996, at 50; In a survey conducted by Klaus Sachs, where he compared several ICC cases of which he had knowledge, the conclusion was that most of the money in arbitral proceedings is spent on counsels (about 85%), not on arbitrators, the costs of which represents the lower share, spanning from 5.6% to 20.6%, the average being 12.12%. He also noted that, according to a study undertaken by a well-known Swiss arbitrator, in ICC practice, the share of the tribunal’s cost of the total cost of the proceeding is nowadays in the range of 10 %, while 10 years ago such share was two times higher. i.e.. 20 %, which suggests that the growing costliness of arbitration is much more the result of lawyers’ fees becoming more and more expensive, than of the one of increasing arbitrators’ and institutional costs. Sachs, Klaus, *Time and Money*, in Loukas Mistelis & Julian D. M. Lew (eds.), *Pervasive Problems in International Arbitration*, Kluwer Law International, 2006, at 111-112

⁵²⁹ Paulsson, Jan, *Ethics, Elitism, Eligibility*, *Journal of International Arbitration*, 14-4 (1997), at 14: “Although arbitrators can expect to receive fees for their work, the prospect of financial rewards is doubtless a less motivating factor than non-specialists might imagine. ... The important attractions of the job are, therefore, perhaps less tangible. Lawyers like to judge, and believe they do it well. Undeniably, appointment as arbitrator satisfies the ego in more or less admirable ways; the fact that an arbitrator is gratified by a sense of peer recognition and accomplishment, or even “a resurgence of omnipotence fantasies,” is not inconsistent with excellent performance in the role.”

are directly responsible for their presence in a particular case, whereby their reputations grow by the slow accretion of evidence of independence and fair-mindedness.⁵³⁰ Accordingly, it is argued that an arbitrator's primary duty remains the delivery of an accurate award, resting on a reasonably ascertainable picture of reality.⁵³¹

The arbitrators' reputation may provide an incentive for them to get as near as reasonably possible to a correct picture, in examining the competing views of reality proposed by each side, while considering the importance of the efficient proceedings in terms of speed and economy of adjudication in order to provide a proper case management. Thus, the arbitrators may more plausibly understand their task in terms of increasing accuracy of their decisions by balancing the search of knowledge against sensitivity to speed and economy in arbitration rather than in terms of rendering compromise awards that satisfy both parties. It is argued that "Any account of international arbitration remains inadequate if it denigrates the aspiration to accuracy, or shifts an arbitrator's aim from a correct award to splitting the baby or dictating quick peace treaties."⁵³² Thus, the phenomenon of splitting the difference can be better explained as an outcome, from the perspective of a legal system, of the arbitrators' attempt to identify accurately the tacit knowledge of the parties, which directs the arbitrators to find a common ground between the positions of the parties, and their failure to state clearly their line of thought in the final award. The lack of clarification in this regard gives rise to speculations about the influential factors in the judicial behavior of the arbitrators mainly on the basis of their reputation in the market and the prospect of future reappointments.

There are also some empirical studies, which suggest that arbitrators, as a rule, make decisive awards and do not "split the difference" by looking at what percentage of the original amount claimed was awarded by the arbitral tribunals.⁵³³ In addition to being limited in their scope

⁵³⁰ Ibid., at 20-21

⁵³¹ Park, William W., Arbitrators and Accuracy, *Journal of International Dispute Settlement*, 1-1 (2010), at 25

⁵³² Ibid., at 33

⁵³³ Keer, Stephanie E. & Richard W. Naimark, Arbitrators Do Not "Split the Baby"--Empirical Evidence from International Business Arbitration, *Journal of International Arbitration*, 18 (2001), p. 573: The study shows that in a sample of 54 international arbitration proceedings administered by the AAA, 31% of claimants recovered nothing and 35% recovering 100% of the amount claimed, while the remaining 34% of claimants were awarded a widely distributed percentage of the amount claimed distributed, with awards from 10% to 90% of the amount claimed. A newer statistical study undertaken by the American Arbitration Association also concludes that arbitrators typically did not "split the baby" in either the claim or counterclaim categories according to the research done on 111 commercial arbitration cases administered by the International Centre for Dispute Resolution in 2005 that were awarded. The research show that that 21 cases (19%) were totally denied, 13 (12%) received up to 20% of their claim value, 15 (13.5%) received between 61 and 80% of their claims and 46 cases (41% of the sample) were awarded more than 80% of their claimed amount. Splitting the Baby: A New AAA Study, American Arbitration Association (Mar. 9, 2007), available at <http://www.adr.org/sp.asp?id=32004>.; Another study, which explores the decision pattern of arbitrators based only on the monetary awards granted, analyzes investment-arbitration awards rendered by repeatedly appointed arbitrators in arbitrations held under the auspices of the ICSID during a period of fifteen years, from the mid-1990's to 2009. On the tribunal level, the study finds that awards do not show a tendency to split the difference or to favor investors. The study examines 43 publicly available awards, which are concluded by an award on the merits by ICSID tribunals, which had at least one arbitrator, who had been served in ICSID Tribunals more than three times. Of those cases, 26 (60.5%) denied the claimant any recovery and 3 (7%) awarded the claimant 100% of the amount claimed, while the claimant received some monetary award in the remaining 14 awards. According to the study, only one award split the difference by awarding the claimant a sum ranging between 40% and 60% of the claimed amount. Moreover, since most awards dismissed all investors' claims and more than 80% of all decisions rendered an award of less than 40% of the amount claimed, the study concludes that investment-arbitration tribunals do not display a tendency to rule in favor of investors. Kapeliuk, Daphna, The Repeat Appointment Factor: Exploring Decision Patterns of Elite Investment Arbitrators, *Cornell Law Review*, 96 (2010), at 81

due to the scant reliable sources available in the field of international arbitration, such empirical studies can even be misleading, when exclusively focused on the difference between the original claim amount and the amount awarded. There are certainly differences between the approaches of a national court and an international arbitral tribunal to the resolution of contractual disputes as a result of the increased flexibility provided for the latter by the modern arbitration laws and rules. However, it is superficial to look at the outcome of the awards in monetary terms in the search for the existence of the phenomenon of splitting the difference.

A notion of proportionality necessarily lies at the heart of the desire for accuracy in arbitration, accommodating both the principle of due process and efficiency.⁵³⁴ In international disputes, the proportionality also implicates an accommodation among different legal cultures and backgrounds.⁵³⁵ The phenomenon of splitting the difference is ultimately the impression of an outside observer from a legal system, so it should not be perceived as an exercise of the arbitral tribunals to reduce the original claim amount by an equitable percentage just to find a compromise between the claims of the parties and to satisfy both of them, a perception which could harm the credibility of the institution of arbitration. This phenomenon should be seen as a result of the arbitrators' increased concern for the particularities of an individual transaction and their increased capacity for abstract reasoning, which is considerably freed from the rigidities of national legal systems. The national legal systems traditionally do not permit their courts such a degree of involvement with the particularities of an individual transaction, by building various verifiability thresholds and other obstacles to the interpretative mechanisms of contractual gap filling, such as constructive interpretation or implied terms in fact, or to the exercise of equity *infra legem*, due to their concern for the internal order and their purpose of stabilizing the normative expectations *ex ante* through formal consolidations. In the context of international arbitration, the abstract reasoning and the interpretation of the particular contract, by combining with tacit knowledge, the explicit knowledge, such as the articulated rules in the contract, the default rules chosen by the parties and other factual matters, potentially precede all other legal questions in the course of adjudication for the sake of accuracy of the final decision.

The concern for the accuracy of the decision and, thus, the impression of splitting the difference by arbitral tribunals sometimes can be found in the determination of governing law and its application to the merits of the case. Examples can be found in those cases where the arbitral tribunals interpreted the absence of choice of law clause in a contract to the effect that the parties did not want the contract to be governed by the laws of the countries of which they are nationals on the basis of the assumption that none of the parties would agree on the application of the law of the other party, and determined the applicable law as the law of a neutral country or general principles of law. By the same token, since the arbitrators are more concerned about the accuracy of their decisions in line with particularities of the dispute than the proper application of rules that have been provided for the internal order of an organization, they may not feel bound by the implications of those rules about who is right or who is wrong when applying such rules. As far as the transactions governed through legal uncertainty are concerned, it is highly difficult to identify a single party to blame for what has gone wrong in the presence of complex, innovative or long-term contractual relationships where both parties might have contributed to the problems that arose under the contract. This may lead to a mitigation of the claim or counterclaims, and the rigidities of the applicable

⁵³⁴ Park, William W., *Arbitrators and Accuracy*, *Journal of International Dispute Settlement*, 1-1 (2010), at 52

⁵³⁵ *Ibid.*, at 53

rules, which are indifferent to such nuances, may be disregarded by the arbitrators. Moreover, in such cases, the arbitrators more often than not have to resort to their discretion in the determination of the amount of recoverable damages due to the difficulties and inherent uncertainties in their precise calculation of lost profits, particularly in the absence of a sufficiently long record of profitable operations. This is neither exclusive to the arbitration nor unprecedented in the legal systems, which allow the courts to resort to equity *infra legem* where the exact calculation of the amount of damages is not possible thereby enabling also the courts to “split the difference” in such cases.

Although, sometimes the outcome of the arbitral proceedings seems to reflect a compromise between the positions of the parties, from the perspective of the national legal systems, in the absence of clear indications about the legal reasoning of arbitrators, such an outcome should not immediately be considered to the effect the arbitral tribunal aimed to satisfy both parties by straightforwardly awarding both of them something rather than nothing. Such considerations would even become contradictory in themselves, since a party, who believed that he had a strong case and expected to receive the full amount of his original claim, would surely not be satisfied if he got less than what he considered himself entitled to at the end of proceedings. The parties’ satisfaction with the outcome may also become hard to observe given the involvement of some large Anglo-American law firms, who consider arbitration as a kind of litigation and a means of pressure and, thus, combine judicial attacks and negotiation behind the scenes in order to lead to an optimal solution from the point of view of the interest of the client. It is argued that those law firms are ready to exploit any procedural tactics and appeals and willing to create difficulties for the arbitral tribunal in order to protect, by all legal means at their disposal, their clients’ interest.⁵³⁶ Such practices have already become a cause for concern in the arbitration community and, for instance, the new ICC Rules of Arbitration in force as from 1 January 2012 provides in Article 22.1 that the arbitral tribunal and the parties shall make every effort to conduct the arbitration in an expeditious and cost-effective manner, having regard to the complexity and value of the dispute, whereas the 1998 ICC Rules contained no express requirement for the tribunal or the parties to conduct the arbitration in such a manner. Similarly, the French arbitration law, as revised by Decree No. 2011-48 of January 13, 2011, explicitly provides both parties and arbitrators shall act diligently and in good faith in the conduct of the proceedings.⁵³⁷ It seems that it is extremely difficult to obtain the satisfactory empirical data for the impression of splitting the difference in arbitration, which mainly relates to such subjective aspects as the mentality of the arbitrator, so this phenomenon can only be hypothesized in the context of international arbitration on the basis of limited observations of certain factors.⁵³⁸

In the context of international arbitration, the most important factor that is relevant to the impression of a tendency of splitting the difference is that the quality of arbitration depends

⁵³⁶ Dezalay, Yves & Bryant G. Garth, *Dealing in Virtue: International Commercial Arbitration and the Construction of a Transnational Legal Order*, University of Chicago Press, 1996, at 56-57

⁵³⁷ Article 1464 of the French code of civil procedure (“Les parties et les arbitres agissent avec célérité et loyauté dans la conduite de la procédure”). Darwazeh, Nadia & Baptiste Rigaudeau, *Clues to Construing the New French Arbitration Law - An ICC Perspective on Procedural Efficiency, Good Faith, and Independence*, *Journal of International Arbitration*, 28-4 (2011), at 383

⁵³⁸ It is even argued that, “one will never be able to produce the (negative) evidence that there are no arbitral awards of international arbitral tribunals which, although based on strictly legal reasonings, were in reality motivated more or less by concealed equitable considerations.” Sandrock, Otto, *Is International Arbitration Inept to Solve Disputes Arising out of International Loan Agreements?*, *Journal of International Arbitration*, 11-3 (1994), at 52

on the quality of the arbitrators and the choices made by the parties with regard to the selection of arbitrators.⁵³⁹ The parties to arbitration place their confidence in the specialization of the decision maker by being able to select the arbitrator. This selection is usually made by the parties after the dispute has arisen, according to the potential arbitrators' backgrounds, the relevant word-of-mouth information, previous arbitration procedures, published awards and sometimes preliminary communications between a party and a prospective arbitrator.⁵⁴⁰ When a tribunal consists of a sole arbitrator, the parties or an arbitral institution typically appoints that arbitrator. For an outside observer, the sole arbitrator may appear to reflect a lower tendency to split the difference since he may not be able to singlehandedly provide the same accuracy of determinations with regard to the reasonable expectations of the parties in a particular case as an arbitral panel composed of three or more members. Thus, he may have a stricter approach similar to the national courts, where his own legal culture may turn into his *lex fori*.⁵⁴¹

In the common international arbitration scenario where an arbitral tribunal consists of a panel of three arbitrators, each party appoints one arbitrator, and the parties, the two appointed arbitrators, an arbitral institution or an appointing authority selects the presiding arbitrator. In such a context, the arbitrator's relationship with the parties and with his colleagues on the arbitration panel has a particular significance for the accuracy of decision making. With the freedom to choose an arbitrator comes the confidence, expressed by this choice, in a decision

⁵³⁹ Mehren, Robert B. von, Concluding Remarks, in Special Supplement, ICC International Court of Arbitration Bulletin: The Status of the Arbitrator, 1995, at 129 ("The process cannot rise above the quality of the arbitrator"). Redfern, Alan & Martin Hunter with Nigel Blackaby and Constantine Partasides, Law and Practice of International Commercial Arbitration, London: Sweet & Maxwell, 4th ed. Student version, 2004, at 234 ("The reputation and acceptability of the arbitral process depends on the quality of the arbitrators.")

⁵⁴⁰ El-Kosheri, Ahmed S. & Karim Y. Youssef, The Independence of International Arbitrators: An Arbitrator's Perspective, Special Supplement, ICC International Court of Arbitration Bulletin: Independence of Arbitrators, ICC International Court of Arbitration Bulletin, 2007, at 47; Lowenfeld, Andreas F., The Party-Appointed Arbitrator in International Controversies: Some Reflections, Texas International Law Journal, 30 (1995), at 62; drawing from his own experiences as an arbitrator, he maintains that since one of the principal functions of a party-appointed arbitrator is to give confidence in the process to the parties and their counsel, some basis for that confidence may be established through mutual acquaintances, published writings, lectures, committee work, or public office and sometimes through direct personal contact between the party and arbitrator, but some restraint should be shown by both sides since the party-appointed arbitrator is not supposed to be a member of the appointing party's legal team, and is supposed to communicate with counsel only within a very limited area.

⁵⁴¹ Lowenfeld, Andreas F., The Party-Appointed Arbitrator in International Controversies: Some Reflections, Texas International Law Journal, 30 (1995), at 67: Lowenfeld provides an example from his experience as a party-appointed arbitrator. In his case, the dispute arose out of an agreement to import into the United States certain machines manufactured by a state owned enterprise in an East European country. The agreement between the U.S. importer and the manufacturer was embodied in a principal contract, governed by the law of New York, and an annex setting out minimum annual import quotas and targets. At the end of year three, a market for the machines having been established, the manufacturer gave notice of termination. The importer immediately replied that there was no legal basis to terminate, and initiated the arbitration, which was conducted with an East European and an American party-appointed arbitrator and a west European chairman. The chairman prepared a draft concluding that it was not necessary to decide the question of whether the manufacturer had a right to terminate, since in any event the importer had failed to fill its quota in year four, thus giving the manufacturer an independent ground to terminate. Lowenfeld pointed out that under the doctrine of anticipatory breach, familiar in common law jurisprudence, once the manufacturer had given notice of termination and if it was wrongful, there was no continuing obligation on the importer to complete its side of the bargain, pending resolution of the dispute, although neither party had briefed the issue. The draft award was discarded, and the arbitrators proceeded to decide the dispute on the basis of interpretation of the contract in order to examine the validity of termination by the manufacturer. Lowenfeld believes that had the west European chairman been sole arbitrator, the case would have been wrongly decided.

maker, and the confidence placed in him may considerably change the arbitrator's judicial behavior.⁵⁴² It is a truism that a party will strive to select an arbitrator, who has some inclination or predisposition to favor that party's side of the case such as by sharing the appointing party's legal or cultural background or by holding doctrinal views that coincide with that party's case.⁵⁴³ Each party may evaluate the background of the candidates, and strategically appoint one of those who are expected to raise, in the internal deliberations of the arbitral panel, the issues that would be instrumental in bringing about the outcome that the appointing party desired. Thus, the confidence of a party in an arbitrator also denotes an expectation that the arbitrator is to ensure that the case of the appointing party will receive the appropriate attention and that other members of the tribunal will understand that party's case. In this way, the party-appointed arbitrators can help in reducing the possibility of major misunderstandings by the other arbitrators, and the risk of an inaccurate award that could be rendered by a sole arbitrator.⁵⁴⁴ As an arbitral tribunal is mainly a collegial enterprise, the presiding arbitrator may try to persuade the party-appointed arbitrators to render an award that reflects some common ground between their differing opinions thereby providing an accurate decision and also protecting their reputation as arbitrators. Thus, it may be possible to observe a greater impression of splitting the difference from such arbitral tribunals.

While the party-appointed arbitrator may understand that a party selected him with a desire that he would be instrumental in rendering a final decision favorable to that party's claim, the arbitrator ultimately acts under the duties of independence and impartiality. In essence, one must assume the parties share the basic expectation that arbitration will provide justice or, at least, avoid clear injustice. Although justice is a vague concept, it is obvious that the concept of justice substantially rests on the ultimate fairness of the procedure and a perception that the decision makers are impartial and independent.⁵⁴⁵ A questionnaire on the status of arbitrators prepared by ICC and addressed to 47 practitioners from 24 countries showed that total independence and complete impartiality is almost always perceived as essential for the arbitrator, whether he is acting alone or as one of a panel of arbitrators, whether he is chairman of the arbitral tribunal or a co-arbitrator, whether he has been appointed by the parties directly, by a permanent arbitration institution or by the relevant judicial authority, and finally whether the arbitration is ad hoc or institutional.⁵⁴⁶ However, while the replies to the questionnaire expressed a unanimous view that the absence of any link with the parties was essential, some correspondents considered that it is not necessary to concern oneself with any links between the arbitrator and the parties' counsel or the other arbitrators.⁵⁴⁷ Indeed, the changes in legal practice and organization, including the international expansion and merger of law firms, the creation of associations and networks of law firms, the linking of law firms and accounting firms, and the varied nature of the positions occupied by lawyers within law

⁵⁴² Bedjaoui, Mohammed, *The Arbitrator: One Man - Three Roles: Some Independent Comments on the Ethical and Legal Obligations of an Arbitrator*, *Journal of International Arbitration*, 5-1 (1988), at 14

⁵⁴³ Bishop, Doak & Lucy Reed, *Practical Guidelines for Interviewing, Selecting and Challenging Party-Appointed Arbitrators in International Commercial Arbitration*, *Arbitration International*, 14 (1998), at 395

⁵⁴⁴ Mosk, Richard, *The Role of Party-Appointed Arbitrators in International Arbitration: The Experience of the Iran-United States Claims Tribunal*, *The Transnational Lawyer*, 1 (1981), at 253

⁵⁴⁵ Bishop, Doak & Lucy Reed, *Practical Guidelines for Interviewing, Selecting and Challenging Party-Appointed Arbitrators in International Commercial Arbitration*, *Arbitration International*, 14 (1998), at 396

⁵⁴⁶ Fouchard, Philippe, Chairman, *Final Report on the Status of the Arbitrator*, *ICC International Court of Arbitration Bulletin*, 7-1, (1996), at 32

⁵⁴⁷ *Ibid.*

firms, have created many gray areas complicating the determination of the existence or absence of independence and impartiality of an arbitrator.⁵⁴⁸

Most rules for institutional international arbitrations and arbitration laws, including the UNCITRAL Model Law make no distinctions between party-appointed and non party-appointed arbitrators for purposes of their independence and impartiality, and adopt the criterion of justifiable doubts as to the absence of impartiality and independence.⁵⁴⁹ Article 12 of the UNCITRAL Model Law provides that an arbitrator may be challenged and removed by the competent national court only if circumstances give rise to justifiable doubts as to his impartiality or independence.

Article 180(1) (c) of the Swiss Private International Law Act 1987 provides for the challenge of an arbitrator if circumstances give rise to justifiable doubts as to his independence. The absence of a requirement of impartiality in the Swiss law is said to be a deliberate attempt to restrict the requirement to the more objective notion of independence, which can be verified to the competent national courts through financial or other connections between a party and an arbitrator. It is suggested that impartiality can be expected from the party-appointed arbitrator as a matter of integrity and this commitment to impartiality does not prevent the arbitrator from examining the arguments advanced by the party that appointed him with particular care, and ensuring that they are carefully examined and weighed within the framework of the deliberations.⁵⁵⁰ Moreover, under Swiss law, the irregular constitution of the arbitral tribunal, including a violation of the guarantee of an independent and impartial

⁵⁴⁸ Whitesell, Anne Marie, Independence in ICC Arbitration: ICC Court Practice concerning the Appointment, Confirmation, Challenge and Replacement of Arbitrators, Special Supplement, ICC International Court of Arbitration Bulletin: Independence of Arbitrators, 2007, at 7

⁵⁴⁹ Such a distinction has been particularly advocated in the United States, particularly in New York case law, although the sole remedy for bias is set forth in section 10(a)(2) of the Federal Arbitration Act, which provides that an award may be vacated “where there was evident partiality or corruption in the arbitrators, or either of them”. Bishop, Doak & Lucy Reed, Practical Guidelines for Interviewing, Selecting and Challenging Party-Appointed Arbitrators in International Commercial Arbitration, *Arbitration International*, 14 (1998), at 403. The distinction was abandoned in the 2004 Code of Ethics for Arbitrators in Commercial Disputes, prepared under the auspices of the AAA and of the American Bar Association and intended for use in domestic arbitrations in the United States. The 2004 Code establishes a presumption of neutrality for all arbitrators and replaces the presumption of non-neutrality of party-appointed arbitrators under the earlier 1977 Code, according to which the party-appointed arbitrators were to be considered “non-neutral unless both parties inform the arbitrators that all three arbitrators are to be neutral or unless the contract, the applicable arbitration rules, or any governing law requires that all three arbitrators be neutral”. According to the 2004 Code, notwithstanding the presumption of neutrality, the parties may still agree that the party-appointed arbitrators are to be non-neutral. Such an agreement may be either express or implied from the circumstances. The non-neutral arbitrators can be predisposed towards the party who appointed them, but in all other respects, they are obliged to act in good faith and with integrity and fairness. Sheppard, B. H., A New Era of Arbitrator Ethics for the United States: The 2004 Revision to the AAA/ABA Code of Ethics for Arbitrators in Commercial Disputes, *Arbitration International*, 21-1 (2005), at 92-93; The 2004 Code was recently treated as persuasive by the Ninth Circuit Court of Appeals in *New Regency Productions, Inc. a California Corporation v. Nippon Herald Films, Inc., a Japanese Corporation*. (No. 05-55224 D.C. no. CV-04-09951- AHM Opinion, September 2007): “Although these sources are not binding authority and do not have the force of law, when considered along with an attorney’s traditional duty to avoid conflicts of interest, they reinforce our holding in *Schmitz* that “a reasonable impression of partiality can form when an actual conflict of interest exists and the lawyer has constructive knowledge of it. That the lawyer forgot to run a conflict check . . . is not an excuse.” 20 F.3d at 1048 (citations omitted); see also *Commonwealth Coatings*, 393 U.S. at 149 (treating the AAA rules as persuasive authority).”

⁵⁵⁰ Blessing, Marc, The New International Arbitration Law in Switzerland, *Journal of International Arbitration*, 5-2 (1988), at 39

arbitral tribunal, constitutes a ground to set aside an international arbitration award.⁵⁵¹ However, the party requesting the court to set aside the award on this latter ground must either demonstrate that he had challenged the arbitrator based on the facts, which in his view cast doubt on the independence or impartiality of an arbitrator, already in the course of the arbitration proceedings or that he was unable to invoke these circumstances before the arbitral tribunal, in which case he will also have to show that he has duly satisfied his duty to investigate. On the basis of such facts, the requesting party needs to establish a violation of his constitutional guarantee of an independent and impartial arbitral tribunal, either by showing that his actual challenge was wrongly rejected, or, if no challenge was made, that the arbitral tribunal would have had to accept a challenge.⁵⁵² However, the awards are in fact extremely rarely set aside on the basis of this ground.⁵⁵³ It is argued that the Swiss courts attempt to avoid annulling an award for lack of independence and/or impartiality of an arbitrator, in order to prevent the re-opening and, possibly, the repetition of arbitration proceedings which may have lasted several years and generated significant costs.⁵⁵⁴

In England, it is the concept of independence which has been discarded in favor of that of impartiality because of the understanding that independence denotes a component of impartiality and not a separate concept.⁵⁵⁵ Under Section 24(1) (a) of the Arbitration Act 1996, a party may apply to the court to remove an arbitrator upon the ground that “circumstances exist that give rise to justifiable doubts as to his impartiality”. The test to be applied in determining impartiality is mainly an objective one, and stated as follows: “The question is whether the fair-minded and informed observer, having considered the facts, would conclude that there was a real possibility that the tribunal was biased.”⁵⁵⁶ Under this test, which requires the court to view matters from the perspective of a fair-minded and informed observer, an arbitrator may be removed for apparent bias, but the apparent bias may

⁵⁵¹ Article 190 para. 2 letter a of the Swiss Private International Law Act of 18 December 1987; Leemann, Matthias, Challenging International Arbitration Awards in Switzerland on the Ground of a Lack of Independence and Impartiality of an Arbitrator, ASA Bulletin, 29-1 (March 2011), at 10

⁵⁵² *Ibid.*, at 19-20

⁵⁵³ Dasser, Felix, International Arbitration and Setting Aside Proceedings in Switzerland – An Updated Statistical Analysis, ASA Bulletin, 28-1 (March 2010), at 88: The rate of success of appeals made between 1989 and 2009 based on Article 190 para. 2 letter a of the Swiss Private International Law Act stands at 3.1%, which is the second lowest rate after the famous ground of public policy under Article 190 para. 2 letter e, which scored no single case set aside during the period under research.

⁵⁵⁴ Beffa, Luca, Challenge of International Arbitration Awards in Switzerland for Lack of Independence and/or Impartiality of an Arbitrator – Is it Time to Change the Approach?, Considerations, thoughts and suggestions further to the article of Matthias Leemann, and the exchange of correspondence and views concerning Art. 190(2) PILS, ASA Bulletin, 29-3 (September 2011), at 602

⁵⁵⁵ Nicholas, Geoff & Constantine Partasides, LCIA Court Decisions on Challenges to Arbitrators: A Proposal to Publish, *Arbitration International*, 23-1 (2007), at 22

⁵⁵⁶ This is the test for bias approved in *Porter v. Magill* [2002] 2 A.C. 357 by the House of Lords. This test modified the common law test laid down by Lord Goff in *R v. Gough* [1993] A.C. 646 in order to align it with the standard that had emerged from jurisprudence under Article 6(1) of the European Convention for the Protection of Human Rights and Fundamental Freedoms. In *R v. Gough*, Lord Goff formulated the test as “whether, in all the circumstances of the case, there appeared to be a real danger of bias” and suggested that the same standard should be “applicable in all cases of apparent bias, whether concerned with justices or members of other inferior tribunals, or with jurors, or with arbitrators.” Steyn, Johan, England: the Independence and/or Impartiality of Arbitrators in International Commercial Arbitration, Special Supplement, ICC International Court of Arbitration Bulletin: Independence of Arbitrators, 2007, at 92

also be “unconscious”.⁵⁵⁷ This approach has been criticized as it may allow the court to speculate about the impartiality of the arbitrator in the presence of such factual matters as short and informal ex parte meetings between the arbitrator and a party.⁵⁵⁸

The practice of French courts is not uniform on the issues of impartiality and independence of the arbitrators, and it is not clear about subjecting arbitrators to the double requirement of independence and impartiality, or only to the former. In some cases, the French courts have referred to Article 341 of the French Code of Civil Procedure, which governs the challenging of judges, applied that provision by analogy to arbitrators. It is also suggested that, as international public policy requires that the parties’ basic defense rights be guaranteed, an arbitrator’s lack of impartiality would lead either to a denial of recognition or enforcement to a foreign or international arbitral award under Article 1502(5) of the French Code of Civil Procedure or to the annulment of an international arbitral award rendered in France under Article 1504 of the Code.⁵⁵⁹

Article 10 of the UNCITRAL Rules, Article 10 of the LCIA Rules, Article 7 of the ICDR Rules of AAA and Article 15 of the SCC Rules contain similar provisions to those of the UNCITRAL Model Law, requiring both independence and impartiality of the arbitrator. Article 11 of the 1998 ICC Rules, on the other hand, provide for the challenge of an arbitrator for lack of independence or otherwise, but does not mention impartiality in this regard. The reason for the omission of the requirement of impartiality is that the requirement of independence is considered to be susceptible to an objective test dealing exclusively with questions arising out of the relationship between an arbitrator and a party, whether financially or otherwise, while the requirement of impartiality is considered to be connected with a subjective test that involves primarily the state of mind of the arbitrator.⁵⁶⁰ In the revised

⁵⁵⁷ As Lord Steyn observed in *Lawal v. Northern Spirit Ltd.* [2003] I.C.R. 856, “Public perception of the possibility of unconscious bias is the key.” In *ASM Shipping Ltd of India v. TTMI Ltd of England*, [2006] 1 Lloyd’s Rep. 375, the court said: “The threshold is only a real possibility of unconscious bias.”

⁵⁵⁸ Epstein, Louis, *Arbitrator Independence and Bias: The View of a Corporate In-House Counsel*, Special Supplement, ICC International Court of Arbitration Bulletin: Independence of Arbitrators, 2007, at 56-57

⁵⁵⁹ Poudret, Jean-Francois & Sebastien Besson, *Comparative Law of International Arbitration*, London: Sweet & Maxwell, 2nd ed., 2007, para. 415

⁵⁶⁰ This is explained as follows: “While the main purpose of Art. 7 (1) is to secure the appointment of impartial arbitrators, the drafters of the ICC Rules have preferred to express the relevant requirement in terms of independence because independence is a more objective notion. Independence is generally a function of prior or existing relationships that can be catalogued and verified, while impartiality is a state of mind, which it may be possible for anyone but the arbitrator to check or to know when the arbitrator is being appointed. It is therefore easier for the Court to determine, when confirming or appointing an arbitrator, whether that person is independent rather than to assess the extent of his or her impartiality.” Derains, Yves & Eric A. Schwartz, *A Guide to the New ICC Rules of Arbitration*, Kluwer Law International, 1998, at 109. For example, the ICC Court accepted the challenge of the arbitrator, who had been nominated by the respondent, informing the parties after his nomination that he had just learned that his firm had undertaken an engagement on behalf of the respondent. Although, the transaction was being chiefly handled by one of the foreign offices of his firm of over 700 lawyers and was an isolated event completely unrelated to the arbitration, and the arbitrator’s firm stated that the strictest possible internal confidentiality restrictions (‘Chinese walls’) were in place to isolate the co-arbitrator from any contact with the engagement, the ICC Court decided to remove the arbitrator from proceedings. In another example, the ICC Court rejected the challenge of an arbitrator nominated by the respondent on the ground that he allegedly had ex parte communications with the respondent’s representatives at a seminar a few weeks before the arbitration hearing. The claimant alleged that the arbitrator was at the seminar to promote himself professionally, so his purported conversations with the respondent showed that he hoped to benefit from a future relationship with the respondent. The claimant stated that the arbitrator should have disclosed this interaction with the respondent and, by not doing so, had acted in a manner that called into question his independence. The ICC Court was apparently convinced by the response of the challenged arbitrator that he had no involvement at all in

version of ICC Rules of Arbitration, which updates the version in force since 1 January 1998 and comes into force on 1 January 2012, the arbitrators are required to be and remain impartial and independent from the parties, and not just independent, as was provided in the 1998 Rules.⁵⁶¹

In general, an “impartial” arbitrator is understood as one who is not biased in favor of, or prejudiced against, a particular party or its case, while an “independent” arbitrator is one who has no close relationship, whether financial, professional or personal, with a party or its counsel.⁵⁶² In such an understanding, the requirement of impartiality, except for its meaning in the sense of due process, which cannot be waived by the parties, is usually used to denote a state of mind of the arbitrator, neither to favor nor to be biased for or against any party in the proceeding, or as to any issue in dispute. Thus, it is not easily determined by an objective test, and the demonstration of impartiality or the lack of it is often considered to be established from the demonstration of independence, which as a factual matter can be more readily proven objectively.⁵⁶³ The principle of appearance or objective independence and impartiality seems to be the rule in comparative law.⁵⁶⁴

Essentially, it is not so much the personal, financial or business relationships between the arbitrator and a party, which lead to a problem with regard to the impartiality or independence, but rather the act of concealing them from the other party.⁵⁶⁵ Thus, the arbitrators are usually under a duty to disclose such relationships.⁵⁶⁶ If no objection is made

the organization or promotion of the conference in question and in particular in the choice of the invitees, that his contact with one of the respondent's employees was extremely limited and was not of a substantive nature, and that the claimant's allegations lacked foundation and were mere speculation. Whitesell, Anne Marie, Independence in ICC Arbitration: ICC Court Practice concerning the Appointment, Confirmation, Challenge and Replacement of Arbitrators, Special Supplement, ICC International Court of Arbitration Bulletin: Independence of Arbitrators, 2007, at 27-30

⁵⁶¹ Article 11 (1) of the ICC Rules of Arbitration, in force as from 1 January 2012

⁵⁶² Bishop, Doak & Lucy Reed, Practical Guidelines for Interviewing, Selecting and Challenging Party-Appointed Arbitrators in International Commercial Arbitration, *Arbitration International*, 14 (1998), at 398

⁵⁶³ Lawson, David A., Impartiality and Independence of International Arbitrators, *Commentary on the 2004 IBA Guidelines on Conflicts of Interest in International Arbitration*, *ASA Bulletin*, 23-1 (2005), at 39

⁵⁶⁴ El-Kosheri, Ahmed S. & Karim Y. Youssef, The Independence of International Arbitrators: An Arbitrator's Perspective, Special Supplement, *ICC International Court of Arbitration Bulletin: Independence of Arbitrators*, *ICC International Court of Arbitration Bulletin*, 2007, at 45

⁵⁶⁵ Bedjaoui, Mohammed, The Arbitrator: One Man - Three Roles: Some Independent Comments on the Ethical and Legal Obligations of an Arbitrator, *Journal of International Arbitration*, 5-1 (1988), at 16

⁵⁶⁶ Pursuant to Article 12 of the UNCITRAL Model Law, a prospective arbitrator is required to disclose all circumstances likely to give rise to justifiable doubts as to his impartiality or independence. As to the requirement of disclosure, although the Swiss Private International Law Act does not explicitly stipulate an obligation of the arbitrators to disclose any facts which may constitute a ground for challenge, the Swiss courts have made clear in its case law, however, that based on the principle of good faith an arbitrator is obliged vis-à-vis the parties to inform them and focus on whether the information that was not disclosed constitutes circumstances likely to give rise to justifiable doubts as to his independence. This disclosure obligation applies not only at the beginning of the proceedings, but during the whole course of the arbitration. Poudret, Jean-Francois & Sebastien Besson, *Comparative Law of International Arbitration*, London: Sweet & Maxwell, 2nd ed., 2007, para. 429; Leemann, Matthias, Challenging International Arbitration Awards in Switzerland on the Ground of a Lack of Independence and Impartiality of an Arbitrator, *ASA Bulletin*, 29-1 (March 2011), at 13. After the enactment of the Decree No. 2011-48 of January 13, 2011, Article 1456 of the French Code of Civil Procedure provides that before accepting a mandate, an arbitrator shall disclose any circumstance that may affect his or her independence or impartiality and disclose promptly any such circumstance that may arise after accepting the mandate. The new provision codifies the disclosure obligation imposed by the French courts. According to the French case law, the

after the disclosure, any subsequent challenge on those should be unsuccessful. Thus, the parties are free to agree or such an agreement is sometimes presumed, when the other party fails to object after a disclosure, that a specific disclosed relationship between an arbitrator and a party is not to be considered as sufficiently substantial as to disqualify the person concerned.

However, the requirement of disclosure may not be so clear for arbitrators from law firms with a network of offices, who have themselves no direct involvement with a party but have a colleague, in another office, or who may be working or have worked even on an unrelated matter. The repeated appointment of an arbitrator by a party can also raise issues, as arbitrators adopt different approaches to the question of how many appointments by the same party require disclosure. The practice of interviewing prospective arbitrators by parties has also led to queries about how much contact between parties and arbitrators can be regarded as acceptable and whether they should be disclosed by the arbitrator.⁵⁶⁷ Although, in all cases, the duty of impartiality in terms of treating the parties with equality and giving each party a full opportunity of presenting his case remains intact, the types of situations in which issues of independence and impartiality arise are extremely varied and leave room for the personal or professional factors to exert an influence on the arbitrator's judicial behavior.

Before appointment or confirmation, Article 7 (2) of the ICC Rules require the prospective arbitrator to "disclose in writing to the Secretariat any facts or circumstances which might be of such a nature as to call into question the arbitrator's independence in the eyes of the

arbitrator has a duty to disclose any circumstance affecting his judgment and that could in the eyes of the parties create a reasonable doubt as to the independence and impartiality of the arbitrator. The duty of disclosure is meant to enable the parties to exercise their right to challenge. Finally, the duty of disclosure is evaluated according to the notoriety of the situation at hand and its effect on the arbitrator's judgment. Slaoui, Fatima-Zahra, *The Rising Issue of "Repeat Arbitrators": A Call for Clarification*, *Arbitration International*, 25 (2009), at 113. In two 2010 decisions, the French Cour de cassation set aside an award, because of facts or circumstances that the arbitrator had failed to disclose. In the first case, the arbitrator had disclosed having been "regularly" appointed by a party, when he had in fact been previously appointed by that party no less than fifty-one times. In the second case, the arbitrator had disclosed having been appointed "repeatedly" by a party, when he had in fact been appointed thirty-four times. In another 2010 decision, the Paris Cour d'appel set aside an award because the arbitrator had failed to disclose that he had regularly acted as consultant to one of the party's counsel. The court considered in this case that "the lack of independence may result from the connection that the arbitrator has with a party but also with that party's counsel, provided there is relationship which is not just occasional." In a 2011 case, the Paris Cour d'appel set aside an award because the arbitrator had failed to reveal that he had been first of counsel and then consultant at the law firm, which represented one of the parties in the arbitration. Darwazeh, Nadia & Baptiste Rigaudeau, *Clues to Construing the New French Arbitration Law - An ICC Perspective on Procedural Efficiency, Good Faith, and Independence*, *Journal of International Arbitration*, 28-4 (2011), at 394. The English Arbitration Act contains no duty to disclose, and the courts have not imposed such a duty on arbitrators. However, when the potential grounds for the objection have not been disclosed by the arbitrators, awards may become vulnerable to being set aside under Section 68 for "serious irregularity affecting the tribunal, the proceedings or the award." Under Section 68(2) (a), "serious irregularity" may include failure by the tribunal to comply with its duty under Section 33 of the Act to "act fairly and impartially between the parties". Section 73(1) of the Act bars a party from raising an objection that there has been a irregularity affecting the tribunal or the proceedings, unless the objecting party is able to show that "at the time he took part or continued to take part in the proceedings, he did not know and could not with reasonable diligence have discovered the grounds for objection". Thus, the arbitrator may disclose certain issues that may affect his impartiality in order to prevent the award from being set aside for apparent bias under Section 68. Epstein, Louis, *Arbitrator Independence and Bias: The View of a Corporate In-House Counsel*, *Special Supplement, ICC International Court of Arbitration Bulletin: Independence of Arbitrators*, 2007, at 61-62

⁵⁶⁷ Whitesell, Anne Marie, *Independence in ICC Arbitration: ICC Court Practice concerning the Appointment, Confirmation, Challenge and Replacement of Arbitrators*, *Special Supplement, ICC International Court of Arbitration Bulletin: Independence of Arbitrators*, 2007, at 8

parties”.⁵⁶⁸ This is understood as a subjective test in the sense of independence from the perspective of the parties, while the ICC Court's decision on whether or not to appoint or confirm an arbitrator is based on an objective standard.⁵⁶⁹ For example, the ICC Court has decided to confirm the nominated arbitrator in spite of an objection by the other party where no disclosure was made by the nominee in such cases as, (1) the nominee had been contacted directly by the nominating party's representative before his confirmation to ascertain his availability to serve as an arbitrator and that there was no discussion of the merits of the case, (2) the arbitrator and the nominating party's counsel had co-authored a law treatise and had previously worked in the same law firm as partner and senior associate, but the relationship had ended long before the nomination, (3) the arbitrator and the nominating party's counsel had been members of the same parliament during a certain period of time in the past and members of the same political party, (4) the arbitrator had worked with the nominating party's counsel in various academic settings, bar activities or professional organizations, or (5) the nominated arbitrator was a member of the ICC Court or an ICC National Committee.⁵⁷⁰ The cases in which arbitrators have not been confirmed by the ICC Court suggest that non-confirmation does not result from a single circumstance but from an accumulation of factors that convince the Court that confirmation would not be the proper way to proceed.⁵⁷¹ Thus, such types of past relationships between a party or its counsel and the nominated arbitrator as having been a student, fellow student, professor, co-employee, or co-counsel were not, without more, considered by the ICC Court as disqualifying factors.⁵⁷²

Some guidance with regard to the duty of disclosure may also be obtained from the Guidelines on Conflicts of Interest in International Arbitration, which was prepared by a working group of nineteen prominent arbitration specialists from fourteen countries' under the auspices of the International Bar Association (IBA), to develop out of best international practices a standard code of principles and concrete guidance applicable to arbitrators.⁵⁷³ The Guidelines are structured in two parts. Part I contains “General Standards Regarding Impartiality, Independence and Disclosure” and Part II provides for “Practical Application of the General Standards”. The Guidelines constitute an attempt to balance two conflicting policy goals, namely the parties' autonomy in selecting the arbitrator of their choice, and the

⁵⁶⁸ In the ICC Rules of Arbitration, in force as from 1 January 2012, Article 11 provides that the arbitrators shall sign a declaration of impartiality and independence, and remain under a positive duty throughout the arbitration to inform the Secretariat of any matters affecting their independence or impartiality.

⁵⁶⁹ Whitesell, Anne Marie, Independence in ICC Arbitration: ICC Court Practice concerning the Appointment, Confirmation, Challenge and Replacement of Arbitrators, Special Supplement, ICC International Court of Arbitration Bulletin: Independence of Arbitrators, 2007, at 10

⁵⁷⁰ *Ibid.*, at 14-16

⁵⁷¹ *Ibid.*, at 19; Similarly, the ICC Court has accepted challenges against an arbitrator on the basis of the combined effect of the multiple grounds. Cited cases No 30 to 34 in Darwazeh, Nadia & Baptiste Rigaudeau, Clues to Construing the New French Arbitration Law - An ICC Perspective on Procedural Efficiency, Good Faith, and Independence, *Journal of International Arbitration*, 28-4 (2011), at 397

⁵⁷² Hascher, Dominique, ICC Practice in Relation to the Appointment, Confirmation, Challenge and Replacement of Arbitrators, *ICC International Court of Arbitration Bulletin*, 6-2 (1996), at 8

⁵⁷³ General Standard 5: “These Guidelines apply equally to tribunal chairs, sole arbitrators and party-appointed arbitrators. These Guidelines do not apply to nonneutral arbitrators, who do not have an obligation to be independent

and impartial, as may be permitted by some arbitration rules or national laws.” IBA Guidelines on Conflicts of Interest in International Arbitration, Approved on 22 May 2004 by the Council of the International Bar Association

protection of the parties' right to have a full and timely disclosure in order to make their own judgments as to whether particular facts or circumstances give rise to reasonable doubts as to proposed or appointed arbitrator's impartiality and independence.⁵⁷⁴

General Standard 2 of the Guidelines provides the test to determine whether the principle of impartiality and independence of arbitrators has been violated. The test has both subjective and objective aspects. The subjective aspect focuses on the point of view of the arbitrator and requires him to decline to accept an appointment or, to refuse to continue to act as an arbitrator if he has any doubts as to his or her ability to be impartial or independent. This aspect is considered by the working group to be so self-evident that many national laws do not explicitly say so, but the working group included it in the General Standards because explicit expression in these Guidelines helps to avoid confusion and to create confidence in procedures before arbitral tribunals.⁵⁷⁵ The objective aspect of the test adopts the perspective of "from a reasonable third person's point of view having knowledge of the relevant facts." The test in this case is one of "justifiable doubts" as to impartiality or independence. It is stated that doubts are justifiable if, from that perspective, "there was a likelihood that the arbitrator may be influenced by factors other than the merits of the case as presented by the parties." The working group believed that the test for disqualification should be an objective one, and used the wording 'impartiality or independence' derived from the broadly adopted Article 12 of the UNCITRAL Model Law, and the use of an appearance test to be applied objectively.⁵⁷⁶ The objective aspect also contains a specific rule on when justifiable doubts "necessarily exist." Three situations are envisaged in that rule: (i) if there is an identity between a party and the arbitrator, (ii) if the arbitrator is a legal representative of a legal entity that is a party in the arbitration, or (iii) if the arbitrator has a significant financial or personal interest in the matter at stake.⁵⁷⁷ These situations are declared as the instances of "Non-Waivable Red list" in Part II of the Guidelines, which illustrate the principle that no person should be a judge in his own case.⁵⁷⁸

The Non-Waivable Red list is one of the four non-exhaustive lists of "circumstances", which are intended to provide specific guidance to arbitrators, parties, institutions and courts as to what situations do or do not constitute conflicts of interest or should be disclosed. There is a "Waivable Red list", which contains examples of circumstances that, while potentially leading to disqualification, may be accepted by the express agreement of the parties as not a ground of challenge of the arbitrator, such as cases in which the arbitrator has previously advised the party as a client, has been involved in the case, holds a significant financial or other interest in a party, currently represents or advises a party or a counsel, or has a close relationship with a party or a counsel in the arbitration. The "Orange list" enumerates the circumstances which may give rise to justifiable doubts as to the arbitrator's impartiality or independence, such as repeat appointment of an arbitrator by the same international law firm in different proceedings.⁵⁷⁹ Once these situations properly disclosed, the parties will be deemed to have

⁵⁷⁴ Lawson, David A., *Impartiality and Independence of International Arbitrators*, Commentary on the 2004 IBA Guidelines on Conflicts of Interest in International Arbitration, ASA Bulletin, 23-1 (2005), at 32

⁵⁷⁵ Explanation to General Standard 2, (a), IBA Guidelines

⁵⁷⁶ Explanation to General Standard 2, (b), IBA Guidelines.

⁵⁷⁷ General Standard 2 (d), IBA Guidelines.

⁵⁷⁸ Part II: Practical Application of the General Standards, para. 2, IBA Guidelines.

⁵⁷⁹ The Guidelines provide that an arbitrator fulfils the criteria for inclusion on the Orange List if "The arbitrator has within the past three years been appointed as arbitrator on two or more occasions by one of the parties or an affiliate of one of the parties" (3.1.3); if "The arbitrator's law firm has within the past three years acted for one of

waived their rights to object after a certain length of time has elapsed.⁵⁸⁰ Finally, the “Green list” contains the circumstances, which do not give rise to a conflict of interests from an objective perspective and need not be disclosed by the arbitrator, such as previously expressed legal opinions by the arbitrator in a law review article or public lecture concerning an issue which also arises in the arbitration or an arbitrator’s initial contact with the appointing party or its counsel prior to appointment, if this contact is limited to the arbitrator’s availability and qualifications to serve or to the names of possible candidates for a chairperson and did not address the merits or procedural aspects of the dispute.⁵⁸¹ Although the Guidelines are not intended to be binding, the national courts reviewing the impartiality and independence of an arbitrator may draw inspiration from them given that arbitration laws and rules do not contain detailed regulations in this regard.⁵⁸² It is observed that the Guidelines “are now being

the parties or an affiliate of one of the parties in an unrelated matter without the involvement of the arbitrator” (3.1.4); or if “The arbitrator has within the past three years received more than three appointments by the same counsel or the same law firm” (3.3.7). However, the Guidelines indicate “It may be the practice in certain specific kinds of arbitration, such as maritime or commodities arbitration, to draw arbitrators from a small, specialized pool. If in such fields it is the custom and practice for parties frequently to appoint the same arbitrator in different cases, no disclosure of this fact is required where all parties in the arbitration should be familiar with such custom and practice.” IBA Guidelines, Rule 3.1.3, note 6.

⁵⁸⁰ General Standard 4, (a): If, within 30 days after the receipt of any disclosure by the arbitrator or after a party learns of facts or circumstances that could constitute a potential conflict of interest for an arbitrator, a party does not raise an express objection with regard to that arbitrator, subject to paragraphs (b) and (c) of this General Standard, the party is deemed to have waived any potential conflict of interest by the arbitrator based on such facts or circumstances and may not raise any objection to such facts or circumstances at a later stage.

⁵⁸¹ § 4.5.1, Part II: Practical Application of the General Standards, IBA Guidelines. Redfern and Hunter also envisage that it may be permissible to question potential arbitrators about experiences, qualifications for the case in hand and availability, but there should be no probing the prospective arbitrators’ views on the merits or testing their forthcoming submissions of fact and law. They provide personal guidelines of an arbitrator as eminently sensible guidelines that should avoid any real risk of impropriety, and advise prospective arbitrators would to adopt a similar system, or to adapt them in a way that seems appropriate to the circumstances of individual cases.” The guidelines are as follows: “First, other than in exceptional circumstances, the interviewers must travel to see him in his office (i.e., he will not respond to a ‘summons’ to the premises of the party concerned or their representatives). Secondly, the interviewing delegation must be led by an external lawyer retained by the party in question (i.e., he will not see the party’s employees on their own). Thirdly, the meeting should not be conducted over lunch or other event involving hospitality—regardless of who will pay the bill. Fourthly, the meeting should not last for more than half an hour. Fifthly, he will take a note of the discussion that he will regard as disclosable to interested parties if appropriate. Sixthly, if appointed, he will inform the arbitrator nominated by the other party of both the fact and the content of the discussion with his appointor.” Redfern, Alan & Martin Hunter with Nigel Blackaby and Constantine Partasides, *Law and Practice of International Commercial Arbitration*, London: Sweet & Maxwell, 4th ed. Student version, 2004, at 235

⁵⁸² Landolt, Philip, *The IBA Guidelines on Conflicts of Interest in International Arbitration: An Overview*, *Journal of International Arbitration*, (2005), at 409. In Sweden, in case *Korsnäs AB v. AB Fortum Värme*, the Svea Court of Appeal as first instance, and the Supreme Court upon appeal referred to some degree to the IBA Guidelines on Conflicts of Interest in International Arbitration. The claimant based its claim on the grounds that the arbitrator appointed by the defendant had been appointed as arbitrator on numerous other occasions by the law firm acting as counsel for the defendant and this diminished the confidence in the arbitrator’s impartiality, and the arbitrator failed to inform about these appointments before and during the arbitration proceedings. The claimant referred particularly to the Orange list of the IBA Guidelines, which mention the circumstance that “The arbitrator has within the past three years received more than three appointments by the same counsel or the same law firm”, as potentially giving rise to justifiable doubts as to the arbitrator’s impartiality or independence, and required to be disclosed by the arbitrator. However, General Standard 6 of the Guidelines on “Relationships” provides that relationships within international law firms or groups of companies should be reasonably considered in each individual case as opposed to automatically constituting a source of conflict of interest. The Court of Appeal stated that the IBA Guidelines have essentially the same meaning as the principles and provisions of the Swedish Arbitration Act, and the guidelines as well as other domestic and international arbitration rules, serve as important guidelines for counsel and arbitrators and have also some relevance as

referred to widely by parties challenging arbitrators, parties opposing the challenge to arbitrators and institutions that are deciding those challenges”.⁵⁸³

In this context, it is generally accepted that the links between the arbitrators and law firms are not automatically considered to be a ground for challenge of arbitrators for the absence of impartiality or independence. In the world of international arbitration, many, if not most, players are in some way acquainted with each other thereby leaving room for the reputation of arbitrators to exert an influence on their judicial behavior insofar as the challenges of arbitrators are unsuccessful where the questions of independence and impartiality are based on an intellectual process in evaluating opposing claims and in treating the parties and their contentions with equality. In particular, as far as future prospects of reappointment and reputations are concerned, a subjective element is involved. It is argued that “Whatever their motivation, arbitrators tend to want to be reappointed. In the case of an arbitrator who considers that his only chance lies with the party which has already named him once, this

background material when the Court of Appeal is trying the case and applying the provisions of the Arbitration Act. The Court held that appointment of the same person as arbitrator on numerous occasions by the same law firm can constitute a circumstance that may diminish confidence in the arbitrator’s impartiality as a result of the economic interest in acquiring future appointments from this law firm., but the court must also consider the extent to which the person has been appointed as arbitrator by other law firms. According to the Court, the evidence demonstrated that the arbitrator had a substantial amount of arbitration appointments and had seemingly not been economically dependent on receiving appointments as arbitrator by the parties which have been represented by counsel from the relevant law firm. The Court of Appeal found that, based on an overall assessment, there was objectively no circumstances that may have diminished the confidence in the arbitrator’s impartiality, and denied the action. Svea Court of Appeal, 10 December 2008, Case T 10321-06. Upon appeal, the Supreme Court also referred to the Swedish Arbitration Act and noted that an arbitrator must be impartial and disclose all circumstances which might be considered to prevent him from serving as arbitrator. The Court stated that the assessment of whether there are circumstances that can diminish the confidence in an arbitrator should be made on objective grounds and affirmed the findings of the Court of Appeal with regard to the impartiality requirement. With regard to the disclosure requirement, the Court held that it is not sanctioned with any consequences for the party failing to provide required information under the Sweden Arbitration Act, while also noting that the IBA Guidelines to which the claimant referred do not contain any such remedies. The Court stated that a breach of the disclosure obligation does not itself constitute an independent cause for challenge, but it may be conducive to reaching a decision on the issue of impartiality as a cause for challenge, particularly where it is difficult to assess. Thus, the Court found no reason to set aside the award and uphold the decision of the Court of Appeal. Swedish Supreme Court, 9 June 2010, Case No. T 156-09. Unofficial English translations of both decisions can be found at <http://www.sccinstitute.com/swedish-courts-on-iba-guidelines.aspx> ; The Swiss Federal Supreme Court has referred to the IBA Guidelines on various occasions and has considered them a valuable working tool. Leemann, Matthias, Challenging International Arbitration Awards in Switzerland on the Ground of a Lack of Independence and Impartiality of an Arbitrator, ASA Bulletin, 29-1 (March 2011), at 14

⁵⁸³ Nicholas, Geoff & Constantine Partasides, LCIA Court Decisions on Challenges to Arbitrators: A Proposal to Publish, *Arbitration International*, 23-1 (2007), at 3; However, it should be noted that, the ICC Court has repeatedly made it clear that it is not bound by the IBA Guidelines, and it is argued from the ICC’s perspective that there is a fundamental incompatibility between the ICC Rules and the IBA Guidelines. According to this argument, since Article 7(2) of the ICC Rules requires a subjective approach to disclosure, which requires the arbitrator to disclose in writing any facts or circumstances which might be of such a nature as to call into question his or her independence “in the eyes of the parties”, it is not possible in ICC arbitration to have a list of situations which are said to be objective and never to require disclosure as provided in the IBA Guidelines’ Green List. Moreover, although the Orange List may be helpful for prospective arbitrators and parties in considering what to disclose, it does not provide any guidance for institutions as to the impact of such disclosure for confirmations or challenges, and the utility of the IBA Guidelines, where most of the cases concern the Orange list in the ICC Practice is argued to be limited for the ICC. Whitesell, Anne Marie, Independence in ICC Arbitration: ICC Court Practice concerning the Appointment, Confirmation, Challenge and Replacement of Arbitrators, Special Supplement, ICC International Court of Arbitration Bulletin: Independence of Arbitrators, 2007, at 35

might result in more or less dissimulated, but nevertheless systematic, favouritism.”⁵⁸⁴ However, no party, arbitral institution or court can look into the mind of a potential arbitrator and determine whether he is, in fact, evaluating whether a decision favorable to the appointing party will affect future business.⁵⁸⁵ The ICC Court, for instance, has been “reluctant to presume that the independence of an arbitrator is necessarily eroded by such repeated appointments”.⁵⁸⁶ If a party-appointed arbitrator has been frequently appointed by the same party, has substantial knowledge of the party and has obtained substantial fees from the appointing party, then the prior appointments may be sufficient ground for a challenge on the basis of an objective test which focuses on the size of the fees, and the potential for dependency by the arbitrator upon the fees.⁵⁸⁷ In this sense, the repeated appointments and the failure of the arbitrator to disclose them are usually not treated as an independent cause for disqualification, but rather an aggravating factor in the evaluation of a challenge.⁵⁸⁸

In practice, it is observed that occasionally the party-appointed arbitrators reveal their sympathy with the party who nominated them at the hearings or in the private deliberations, but the aggrieved party’s formal challenge of the offending arbitrator is rarely successful, particularly when the ground of challenge is impartiality in the sense of a state of mind of the offending arbitrator, so the parties usually rely on the other members of the tribunal and particularly the presiding arbitrator to deal with the situation in a diplomatic manner.⁵⁸⁹ Moreover, it is generally thought that a balance should be sought between the ideal of independence and impartiality and the realities of the world of arbitration and, a distinction is usually made between positive bias and general sympathy towards the appointing party.⁵⁹⁰

However, a party appointed arbitrator, who is too zealous in defense of the party that appointed him, may lose credibility with the presiding arbitrator and disturb the collegiality among the tribunal’s members by issuing dissenting opinions.⁵⁹¹ The collegial decision making is still considered an important aspect of arbitration, although the Anglo-American practice of permitting dissenting opinions has increasingly prevailed in arbitration over

⁵⁸⁴ Paulsson, Jan, Ethics, Elitism, Eligibility, *Journal of International Arbitration*, 14-4 (1997), at 14

⁵⁸⁵ Bishop, Doak & Lucy Reed, Practical Guidelines for Interviewing, Selecting and Challenging Party-Appointed Arbitrators in International Commercial Arbitration, *Arbitration International*, 14 (1998), at 418

⁵⁸⁶ Derains, Yves & Eric A. Schwartz, *A Guide to the New ICC Rules of Arbitration*, Kluwer Law International, 2005, at 128

⁵⁸⁷ Bishop, Doak & Lucy Reed, Practical Guidelines for Interviewing, Selecting and Challenging Party-Appointed Arbitrators in International Commercial Arbitration, *Arbitration International*, 14 (1998), at 422

⁵⁸⁸ Slaoui, Fatima-Zahra, The Rising Issue of “Repeat Arbitrators”: A Call for Clarification, *Arbitration International*, 25 (2009), at 117

⁵⁸⁹ Redfern, Alan & Martin Hunter with Nigel Blackaby and Constantine Partasides, *Law and Practice of International Commercial Arbitration*, London: Sweet & Maxwell, 4th ed. Student version, 2004, at 240

⁵⁹⁰ El-Kosheri, Ahmed S. & Karim Y. Youssef, The Independence of International Arbitrators: An Arbitrator’s Perspective, Special Supplement, *ICC International Court of Arbitration Bulletin: Independence of Arbitrators*, *ICC International Court of Arbitration Bulletin*, 2007, at 48; Paulsson, Jan, Ethics, Elitism, Eligibility, *Journal of International Arbitration*, 14-4 (1997), at 15: “When a Swedish party names a fellow national to sit with a Malaysian co-arbitrator and a Singaporean presiding arbitrator, not only is it proper for the Swedish arbitrator to help the two others to bridge any cultural gap to understand the conduct and arguments of the party that named him, it might help to avoid misunderstandings and, thus, contribute to a more acceptable award.”

⁵⁹¹ Lowenfeld, Andreas F., The Party-Appointed Arbitrator in International Controversies: Some Reflections, *Texas International Law Journal*, 30 (1995), at 60; Craig, W. Laurence, William W. Park & Jan Paulsson, *International Chamber of Commerce Arbitration*, Oceana Publications, 3rd ed., 2000, at 196

collegiality as a civil law tradition of decision making.⁵⁹² Despite certain advantages of dissenting opinions, such as stressing the weaknesses in the plurality's decision and forcing the plurality to address them in their factual and legal analyses thereby increasing the accuracy of the final decision, the dissenting opinions may also become means for pleasing the party that appointed the dissenter and providing the basis for an attack upon the award in national courts. Such dissents that merely reflect the views and arguments advanced by the party that appointed the dissenting arbitrator may give rise to a reasonable doubt as to whether he has made appropriate efforts towards collegiality, which could increase the accuracy of the final decision.⁵⁹³

As a result of the gray areas with regard to the independence and impartiality and the disclosure requirements, the personal and professional links among the arbitrators may also be influential on their judicial behavior. It is observed that the circle of international arbitrators consists of a limited number of people from whom the parties commonly choose.⁵⁹⁴ It is even argued that "It might be a mistake to think that it would be a good thing for the international arbitral process if the greatest number of persons possible had the opportunity to act as arbitrators. Considering the high economic and political stakes often involved in international cases, it would perhaps be more appropriate to welcome the emergence of an elite corps, of arbitrators widely perceived as immune to favouritism."⁵⁹⁵ Arguably, this elite circle of arbitrators has common ethics and common notions of how business should be conducted.⁵⁹⁶ In this circle, the mutual recognition of its members would build the confidence of all participants in the process.⁵⁹⁷

It is commonly argued that the circle of arbitrators represents a closed club, which seems influential on the selection of arbitrators by the parties. This club arguably makes it more difficult for other newcomers to enter the market despite the boom in arbitration that has created a demand exceeding the capacity of the club.⁵⁹⁸ While the old generation of the

⁵⁹² Smit, Hans, *Dissenting Opinions in Arbitration*, ICC International Court of Arbitration Bulletin 15-1 (2004), at 37 noting that none of the arbitration rules of the leading arbitration institutions, such as the ICC International Court of Arbitration, the American Arbitration Association, the London Court of International Arbitration, and the Arbitration Institute of the Stockholm Chamber of Commerce, provide for the submission of dissenting opinions, all of them accept them and distribute them to the parties, but dissenting opinions are generally not published, even in the few instances in which the plurality opinions are.

⁵⁹³ *Ibid.*, at 40: "In some recent cases, dissenting arbitrators have accused their colleagues of failing to allow them to express their position in the arbitral tribunal's deliberations when, in fact, the dissenting arbitrators had been given an adequate opportunity to present their views."

⁵⁹⁴ Hacking, David, *Ethics, Elitism, Eligibility: A Response*, What happens if the Icelandic Arbitrator falls through the Ice?, *Journal of International Arbitration* 15-4 (1998), at 73: "The statistics are not readily available, but the impression is that there are probably no more than two to three dozen international arbitrators, coming from Switzerland, its neighbouring countries in the European Union, the United States and Canada, who preside over the majority of international arbitrations."

⁵⁹⁵ Paulsson, Jan, *Ethics, Elitism, Eligibility*, *Journal of International Arbitration*, 14-4 (1997), at 13

⁵⁹⁶ Lando, Ole, *The Lex Mercatoria in International Commercial Arbitration*, *International and Comparative Law Quarterly*, 34 (1985), at 753

⁵⁹⁷ Paulsson, Jan, *Ethics, Elitism, Eligibility*, *Journal of International Arbitration*, 14-4 (1997), at 19

⁵⁹⁸ Gessner, Volkmar, *Globalization and Legal Certainty*, in Volkmar Gessner & Ali Cem Budak (eds.), *Emerging Legal Certainty: Empirical Studies on the Globalization of Law*, Ashgate, 1998, at 437; Dezalay, Yves & Bryant G. Garth, *Dealing in Virtue: International Commercial Arbitration and the Construction of a Transnational Legal Order*, University of Chicago Press, 1996, at 50: quoting the statement of a leading arbitrator of the new generation: "This is a mafia. There are about, I suppose, forty to fifty people in Western Europe who could claim that they make their living doing this. It took me, oh, probably close to fifteen years to

members of this club, who were professors and judges at the top of their domestic professions, understood arbitration as a duty not a profession, and arguably the reasonable expectations of the parties in a particular case played an important role in their reasoning, the younger generation presents themselves as international arbitration professionals and as entrepreneurs selling their fairly legalistic services to business people.⁵⁹⁹ Thus, the old generation, who were the pioneers of the idea of transnational arbitration that was truly instrumental in establishing the flexibility of adjudication in the context of arbitration, have probably a greater concern for the accuracy of the determination of reasonable expectations according to the particularities of the case as relieved from the rigidities of national legal systems and apparently greater tendency to exercise an abstract reasoning, leading to the impression of splitting the difference, than the younger generation of arbitrators, as a matter of approach.

Even so, in this club, many of the leaders of the younger generation are closely connected to the most well known senior arbitrators.⁶⁰⁰ This may conceivably result in the younger generation's commitment to the accuracy of decisions and their attachment to the approaches of the old generation of arbitrators with regard to the abstractions for discovering the reasonable expectations of the parties and delivering accurate decisions. This may be relevant

get to the point that when I go as I do regularly to the Swiss Arbitration Association meeting twice a year, or I go to an ICC gathering, or an ICCA gathering that I will know and be recognized, and know and talk to a number, you know, the leading figures. And if you ... that's how you just get into it. Now why is it a mafia? It's a mafia because people appoint one another. You always appoint your friends—people you know;” also quoting a lawyer from Switzerland who was seeking to gain recognition as an arbitrator, but has not been successful: “They call the shots in Switzerland. And I am of course not one of them, not yet. But I would like to do more arbitration. I, but it's hard to get into these circles because they tend to use, you know to hand cases among themselves. So it's quite difficult to get into these very closed arbitration circles. [Yet] people at ICC always promise to give me bigger cases.” Paulsson contended that the "mafia" argument does not have a solid evidentiary basis or any probing reflection. This is because the arbitral institutions, on the one hand, and the parties and their lawyers, on the other, have a far greater say in who gets appointed than do arbitrators. Moreover, the fact that a person is well-known in the international arbitration community does not ensure that he is a successful arbitrator, and no person has a protected status in terms of appointments that he could count on irrespective of his merits. Accordingly, the community of international arbitration has shown its eagerness to welcome new outstanding arbitrators. Paulsson, Jan, *Ethics, Elitism, Eligibility*, *Journal of International Arbitration*, 14-4 (1997), at 19; In response, Hacking argued that, “whenever there are groupings of professional people there is always a tendency for that group to be kept small and exclusive; and, whether the members of the group wish it or not (many do not), the work tends to remain within that group rather than go outside it. Indeed this happens, in honourable circumstances, for precisely the reasons which Paulsson advances, namely the preserving of competence, honesty and experience upon which the users of the group's services can rely.” Hacking, David, *Ethics, Elitism, Eligibility: A Response*, *What happens if the Icelandic Arbitrator falls through the Ice?*, *Journal of International Arbitration* 15-4 (1998), at 74-75. In the study conducted by the School of International Arbitration at the Centre for Commercial Law Studies, Queen Mary University of London, where the in-house lawyers of various corporations were the respondents, none of the respondents was willing to offer aspiring arbitrators their first job, preferring to leave it to the institutions to sort out, although many of them generally expressed concerns over the quality and availability of arbitrators and the need to widen the pool of available arbitrators. They stated that they opt for the more secure choices, i.e. arbitrators with experience and certain reputation in the arbitration community. However, the “reputation” was not understood as visibility, in the sense that people who attend every single event appear to not be very busy and rather desperate to get appointments. It could be word of mouth, especially recommendation by people in the know, the legacy arbitrators create about the position they take, e.g. in relation to conduct of proceedings, case management etc. Mistelis, Loukas, *International arbitration, Corporate Attitudes and Practices, 12 Perceptions Tested: Myths, Data and Analysis Research Report*, *American Review of International Arbitration*, 15 (2004), at 576

⁵⁹⁹ Dezalay, Yves & Bryant G. Garth, *Dealing in Virtue: International Commercial Arbitration and the Construction of a Transnational Legal Order*, University of Chicago Press, 1996, at 35-36

⁶⁰⁰ *Ibid.*, at 40 fn 16

to the persistence of the impression of splitting the difference as a matter of common ethics and common notions in the circle of arbitrators. This common understanding, which should be demonstrated by the newcomers through their connections with the members of the club and major arbitration institutions, might be seen as a requirement for their membership of the club and their eventual appointment to arbitral tribunals. It may also need to be reflected more strongly by the presiding arbitrators in three member tribunals, where he was appointed by the other party-appointed arbitrators or by an arbitration institution.

These are some of the many factors, which may explain, depending on the perspective, the concern for accuracy of decisions or the impression of splitting the difference that characterize the perceived judicial behavior of the arbitrators, on the basis of the relationship between the arbitrators and the parties and among the arbitrators in a tribunal or in the circle of arbitrators, their reputation or prospect of reappointment as a member or president of arbitral tribunals. In light of these factors, the criticisms of the judicial behavior of arbitrators in terms of compromise awards and the unpredictability of outcomes in the arbitral proceedings seem only justified when the arbitral tribunals are not clear in their awards on the issue of what motivates their legal reasoning in the absence of an organized and effective appeal mechanism focusing on and ensuring the full compliance of their decisions with a legal system, and they cannot be clear on that issue if their reasoning is motivated by their self-interest, such as their reputation in the arbitration world or the prospect of future reappointment.

v. Lex mercatoria in the Context of Litigation and Arbitration

The existence of the characteristics of the transactions governed through the conditions of legal uncertainty is the preliminary requirement for the applicability of *lex mercatoria*. Its applicability, however, ultimately depends on the existence of a delegation by the parties the tasks of controlling legal uncertainty and allocating residual contractual rights, obligations and risks to the *ex post* decision maker, by expressing their confidence in the specialization of the decision maker, and the capacity of the decision maker to assume such delegation. Thus, the applicability of *lex mercatoria* is ultimately determined on the basis of the institutional choice of the parties for the *ex post* judicial process between litigation and arbitration.

The national courts, whose jurisdictional power is derived from a national legal system, have a limited capacity to assume the delegation from the parties of the task of controlling legal uncertainty through their specialization and discovering the established rules, on which the reasonable expectations of the parties rest in a particular case. They do not have the sufficient capacity for abstract reasoning in *ex post* consolidations that are required for the application of *lex mercatoria* thereby maximizing the expectations of the elements of the order of international commerce in line with their common interest in the ability to make feasible plans for the achievement of their individual purposes.

The national courts determine the law applicable to an international contract in accordance with the conflict of laws rules of the national legal system from which they derive their jurisdictional powers. Those conflict of laws rules direct the national courts to ensure that the transaction in dispute will be governed by a national legal system and treated as a transaction governed through legal risk, whereby the formal consolidations become the primary source of reasonable expectations. The cases, where the national courts use trade usages, general principles of law or comparative materials, do not reflect the element of abstract reasoning required by *lex mercatoria* whereby these materials are used in specialized consolidations of the decision makers in order to discover the established rules in a particular case and give effect to the reasonable expectations of the contractual parties. If an international contract is organized under the conditions of legal uncertainty, the decision maker must be capable and competent to obtain tacit knowledge from these materials and to use it, regardless of the formal consolidations provided by a legal system, for the resolution of the dispute in accordance with the reasonable expectations of the parties.

Due to the absence of finality of decisions of an individual judge, the national courts are not capable to conduct a process of mercantile adjudication as an *ex post* governance mechanism for the allocation of residual contractual rights, obligations and risks arising from transactions governed through uncertainty. Thus, if the parties prefer their contractual disputes to be adjudicated by a national court, the applicability of *lex mercatoria*, as the law of principled adjudication will be at minimum. The parties cannot expect the national court to resolve legal uncertainty by means of *lex mercatoria*, as an alternative to and outside the context of a national legal system, except for those limited cases where the national court is enabled by higher authorities to override the default rules through interpretative techniques or abstract reasoning or to interpret and supplement the national law in accordance with the established rules in the order of international commerce, but even then the court will seek guidance and direction from a national legal system as it lacks the necessary specialization for abstractions in order to apply *lex mercatoria*.

Lex mercatoria in the context of litigation depends on the position of the higher authorities in a national legal system to the issue of meeting legal uncertainty. It is applicable to the extent that those authorities acknowledge that the justice in a particular case may require the court to decide outside the self-referential structure of the legal system, or to the extent that they are receptive to the idea of developing the internal order of the legal system in line with the spontaneous order of international commerce, which is also conducive to the achievement of an effective framework for a functioning spontaneous order of international commerce by means of the consistent application of the same principles by the courts of various legal systems.

The international arbitrators, whose jurisdictional power is derived entirely from the parties' agreement, have the ability to fully assume the delegation from the parties of the task of controlling legal uncertainty through their specialization and discovering the established rules, on which the reasonable expectations of the parties rest in a particular case. They have the capacity for abstractions that are required for the application of lex mercatoria thereby maximizing the expectations of the elements of the order of international commerce in line with their common interest in the ability to make feasible plans for the achievement of their individual purposes.

As noted by Lord Thurlow in an English case from 1791, "the arbitrator has a greater latitude than the Court in order to do complete justice between the parties: for example he may grant relief from a right which bears hard upon one party but which, having been acquired legally and without fraud, could not be resisted in a Court of Justice."⁶⁰¹ Likewise, as stated in the report of International Law Association's Committee on International Commercial Arbitration on the applicability of transnational rules in international commercial arbitration, "the law, legal rules or principles applied to the merits by international commercial arbitration are the outcome of their special attitude vis-à-vis dispute resolution, consisting of (i) respect for the will and reasonable expectations of the parties having appointed them; (ii) application of notions generally accepted within the context of, and due consideration of the realities concerned by, the trade or commercial activity in which the parties are involved or within whose framework the dispute arises ...; (iii) the conviction (more or less conscious) that if the parties choose international commercial arbitration as a means of dispute resolution, rather than expecting to have parochial rules applied, they seek to have their controversies decided in the light of rules and principles better adapted to the international and commercial or economic nature of the transaction at stake."⁶⁰²

While the national court derives its jurisdiction from the fact that it is an organ of the national legal system and resolves contractual disputes in the name of that legal system, the arbitrators are entrusted with their jurisdictional powers by the parties. As arbitrators do not resolve contractual disputes in the name of a legal system, they do not adopt the same approach as national courts in dealing with the problems linked to the determination of the applicable law

⁶⁰¹ Knox and Co. v. Symmonds, (1791) 1 Ves, 369 cited by Rubino-Sammartano, Mauro, International Arbitration Law and Practice, Kluwer Law International, 2nd rev. ed., 2001, at 465

⁶⁰² International Law Association, Committee on International Commercial Arbitration, Report on the Applicability of Transnational Rules in International Commercial Arbitration, 64th Conference, Broadbeach, Queensland, Australia (August 1990), International Law Association Reports of Conferences, London, 1991, at 129

and the ascertainment of its content.⁶⁰³ Thus, in the context of international arbitration, the most important factor in the determination of the applicable law by an arbitrator is the reasonable expectations of the parties who have appointed him to resolve a particular dispute. If the parties have provided that the dispute will be settled according to specified rules of law, the arbitrator must apply them in order to give effect to their reasonable expectations.

In the context of international arbitration, the capacity for abstract reasoning is not dependent upon the position of any higher authority in a legal system to the problem of legal uncertainty. The arbitral tribunals are freed from the formal consolidations, which determine the nature, functions and applicability of trade usages, customs and general principles of law in the interpretation, supplementation and correction of the contract or its default rules. However, the fact that international arbitrators have the sufficient capacity to apply *lex mercatoria* does not mean that they will always utilize their capacity for abstract reasoning to apply *lex mercatoria* thereby maximizing the expectations of the elements of the order of international commerce. The concept of capacity does not rest on an ability to make every decision better than anyone else, but rests on being in a better position than anyone else to make knowledgeable decisions. *Lex mercatoria*, as the law of principled adjudication, is, of course, far too general to define *ex ante* the specific rules of law that are appropriate for a particular contract. Even so, *lex mercatoria*, at this extremely general level, is theoretically revealing in several ways. First, it allows us to identify the capacity of decision making as a means of capitalizing on knowledge that cannot be transmitted through a chain of command to authorities in organizations to define *ex ante* the appropriate rules for each international contract. Second, it directs us to seek such a capacity in decision makers, whose experiences with the order of international commerce become incorporated in the abstract schemata of thought that guides them and makes them specialists for determining, through *ex post* consolidations, the tacit component of the knowledge of particular circumstances of time and place in a particular contractual dispute. Finally, it leads to the suggestion that such a capacity must somehow be bounded by some basic principles, for the purpose of preserving, maintaining and improving of the spontaneous order of international commerce.

In the exercise of such an increased capacity for providing justice in a particular case, the reasoning of arbitral tribunals, which determines the distinction between specific and residual contractual rights, obligations and risks and their allocation in a particular dispute, may sometimes seem unprincipled in the practice of international arbitration. *Lex mercatoria*, which provides a principled approach to the resolution of contractual disputes, helps the arbitrators to understand and to articulate why the accurate determination of reasonable expectations of the parties to a particular dispute should be the purpose of arbitration and how those expectations should be given effect to. The answers to those questions should essentially be the point of concern for the arguably common understanding of the circle of arbitrators given the subtle influence of the transnational theory of arbitration on the generations of arbitrators. In this manner, *lex mercatoria* opens up the possibility of a more refined “splitting the difference” for the arbitrators and more predictable outcomes for the parties.

However, there is a conceivable tendency of arbitrators to refrain from referring to *lex mercatoria* explicitly due to the misconceptions about *lex mercatoria*, which are created by the

⁶⁰³ Derains, Yves, State Courts and Arbitrators, in Special Supplement, ICC International Court of Arbitration Bulletin: Arbitration in the Next Decade: Proceedings of the International Court of Arbitration's 75th Anniversary Conference, ICC Publication No. 612, May 1999, at 27

modern legal doctrine presenting it as a body of non-national legal rules, directly applying to the substance of a contractual dispute either in lieu of national laws or in a supplementary manner. The concept of *lex mercatoria* is not merely related to a question of applicable law to an international contract in the sense of a choice between a national law and transnational law as the governing law of the contract, although it has been traditionally understood as being so, but, in more general terms, how a dispute arising from an international contract should be resolved with a view to maintaining and improving the spontaneous order of international commerce by giving effect to the reasonable expectations of the parties to a particular dispute, regardless of the application of national or non-national legal sources.

It is possible that a particular national law may be determined as the source of the reasonable expectations of the parties in an arbitration case, just as is possible that general principles of law or trade usages may be relevant to what the parties to a particular contract reasonably expect. In this regard, *lex mercatoria* directs the decision maker to apply the legal sources of reasonable expectations of the parties without making conceptual distinctions between national and non-national rules. Such distinctions traditionally arising from national legal systems distort the image of *lex mercatoria* and limit its relevance to an option in the choice of law analyses. The cases where *lex mercatoria* is actually applied in the arbitral practice should not be limited doctrinally to those where arbitrators considered that no national rules were capable of meeting reasonable expectations of the parties. *Lex mercatoria* can be applied whenever the articulated rules in the contractual relationship, which may or may not include the default rules of a particular national legal system, does not provide a solution for the dispute, and the decision maker is capable of exercising its specialization in the form of abstract reasoning in *ex post* consolidations, rather than relying on formal consolidations of a particular legal system, in order to allocate the residual contractual rights, obligations and risks in accordance with an accurate determination of the reasonable expectations of the parties.

Due to the pervasiveness of the understanding of the modern doctrine with regard to the concept of *lex mercatoria*, it is even argued that *lex mercatoria* has been seen as a privilege of a few arbitrators from the older generation with incontestable authority, who have the right to invoke the concept, while others must restrain themselves and carefully explicate the legal reasoning that prevents their decision from being condemned as arbitrary.⁶⁰⁴ Despite the increased accessibility of the concept of *lex mercatoria*, as argued by the modern doctrine, due to the international restatements of contract principles, the applicability of those instruments under such an understanding of *lex mercatoria* apparently creates considerable confusion among arbitrators, as observable in those arbitral awards, which identified them as trade usages, general principles of law, or as both or none of those. This confusion is more obvious in some cases than others. In ICC Case No 13129, where the parties had made no choice as to the applicable law to their contract of sale, and the buyer's suggestion that English law should apply was expressly rejected by the seller, the sole arbitrator dismissed the buyer's submission that he should apply *lex mercatoria*, stating that he had "reservations as to the real existence of anything that can be described as *lex mercatoria*", although he was aware of debate on this topic. Even so, the arbitrator saw no logical reason to apply English law and decided to apply general principles of international commercial law. He even added that, "not unsurprisingly", those principles led to the same result he would have reached by applying "English law principles or those of the alleged *lex mercatoria* or, indeed, those of any other

⁶⁰⁴ Dezalay, Yves & Bryant G. Garth, *Dealing in Virtue: International Commercial Arbitration and the Construction of a Transnational Legal Order*, University of Chicago Press, 1996, at 39

system of law of which I am aware, or any principle of common sense”.⁶⁰⁵ Thus, although the arbitrator did not consider the issue of applicable law as an important one in the particular case, he still had somehow reservations as to the concept and doctrine of *lex mercatoria* and found it more appropriate to designate the applicable law as “general principles of international commercial law”, yet even the arbitrator himself apparently wondered how his conclusion would differ from the application of *lex mercatoria*. This confusion is particularly apparent where the parties agree on a national law as the applicable law, which is the case for the great majority of contracts in the order of international commerce.

⁶⁰⁵ ICC Award in Case No. 13129, *Yearbook Commercial Arbitration*, (2009), at 233

c. Concluding Remarks

There are two conditions for the applicability of *lex mercatoria* as the law of principled adjudication. First, *lex mercatoria* applies when there are residual questions of contractual rights, obligations and risk allocations arising from the incompleteness of the rules articulated by the parties to an international contract on the basis of their knowledge of particular circumstances of time and place. These articulated rules consist of the contractual clauses and the default rules chosen by the parties to govern their contract, and they give rise to the residual questions to the extent that they contain standards, or they do not cover the particular issues in dispute due to their exactness. Some characteristics of contracts indicate the parties' preferences for the method of allocation of the residual contractual rights, obligations and risks, i.e. the method of dealing with legal uncertainty; in this regard, the preference for specialization over formal consolidations enables the application of *lex mercatoria*. *Lex mercatoria* is mainly applicable to the resolution of disputes arising from such transactions that have longer duration, more complexity or innovation. The complexity or innovation may arise from the circumstances surrounding the transactions, such as when many legal systems are involved in the scope of transaction, from the status of the parties, such as when there is a contract between a private individual and a state or state enterprise, or from the atypical nature of the transaction. The appropriate rules for these transactions should enable more than a mere transformation of legal uncertainty into legal risk. Such rules should arise from *ex post* processes, where specialization of the decision maker prevails over the formal consolidations of an organization, to produce some gain in the form of fair and just results for a particular case.

The applicability of *lex mercatoria* ultimately depends on the fulfillment of the second condition, namely the parties' delegation of the control of legal uncertainty to the specialized decision maker and the capacity of the decision maker to assume such a delegation. This condition is fulfilled when the parties and other elements of the order of international commerce express their confidence in the specialization of the decision maker exercising an abstract reasoning in *ex post* consolidations for revealing the tacit knowledge of the parties that meets the deficit in their articulated knowledge. When this condition is fulfilled, *lex mercatoria* is applicable, regardless of the characteristics of the transactions, in the determination of the limits of the parties' freedom of contract, through public policy considerations for the preservation and restoration of the order of international commerce. As a condition for the applicability of *lex mercatoria*, whether the parties and the elements of the order of international commerce have expressed their confidence in the specialization of the decision maker can be determined on the basis of the institutional choice of the parties for the *ex post* judicial process between litigation before national courts, which indicates the preference for formal consolidations, and arbitration before international tribunals, which indicates the preference for specialization.

Lex mercatoria can be seen to a great extent as a privilege of international arbitration, which is granted by national legal systems through their policies favoring finality of arbitral awards and flexibility of procedures. The finality of arbitral awards and the "general pro-enforcement bias" under the New York Convention and modern arbitration laws indicate the confidence of the states in the specialization of the arbitrators to render decisions, which are conducive to maintaining and improving the spontaneous order of international commerce. The national legal systems enable the international arbitrators to approach to the issues of conflict of laws as a matter of giving effect to the reasonable expectations of the parties. This approach has also effects on the ascertainment of the law or rules of law governing the substance of the

dispute, whereby the arbitrators ascertain the content of the applicable law by having regard to the direct or indirect will of the parties, in the absence of which they follow the rules of their choice. The national legal systems generally recognize that the arbitrators have neither mandate nor function in the development of any national legal system, and their decisions will not become a part of the self-referential structure of any national legal system. Thus, even when the arbitrators apply a national law, they have the capacity to apply that law on the basis of the reasonable expectations of the parties to a particular dispute, and they are under no obligation to apply the law in exactly the same manner as a national court would do in the country of that law. Thus, the international arbitrators, whose jurisdictional power is derived entirely from the parties' agreement, have the ability to fully assume the delegation from the parties of the task of controlling legal uncertainty through their specialization.

It is generally accepted that an international arbitral tribunal is not an organ of a legal system and it does not have a *lex fori*. This implies the absence of an organized hierarchy of a legal system, which could provide an effective appeal mechanism focusing on and ensuring the full compliance of a decision with the decision maker's *lex fori*. Thus, in the context of international arbitration, when proceedings for the enforcement of arbitral awards are brought in the national courts, the national court may not re-litigate the case under the modern laws of arbitration. The national court reviewing an international arbitral award may not be motivated by a desire of integrating the award into its own legal system. Accordingly, the national courts increasingly refrain from focusing on which law was applied and how it was applied to the merits of the case by the arbitral tribunal. Their review of arbitral awards mainly focuses on two issues: whether the procedural manner in which the arbitral award is rendered is in compliance with the parties' intentions and the procedural public policy, and whether the enforcement of the award creates a situation that is unacceptable for the substantive public policy in the relevant legal system.

However, the fact that arbitrators have the sufficient capacity to apply *lex mercatoria* does not mean that they will always utilize their capacity for abstract reasoning to maximize the possibility of correspondence of the expectations of the elements in the order of international commerce. In the exercise of such an increased capacity for providing justice in a particular case, the reasoning of arbitral tribunals may seem unprincipled in the practice of international arbitration. This leads to speculations as to the factors, which potentially become influential on the judicial behavior of the arbitrators, such as their reputation in the arbitration market, the prospect of future reappointments, and the personal, financial or business relationships between the arbitrator and a party, its counsel, major law firms, circle of arbitrators, arbitral institutions or political powers.

Lex mercatoria, as an alternative to the national legal systems in meeting legal uncertainty in the adjudication of contractual disputes, requires the decision makers to allocate the residual contractual rights, obligations and risks, which arise from the incompleteness of both contractual terms and applicable default rules, in accordance with the reasonable expectations of the parties, which depend on their knowledge of the particular circumstances of time and place and on the correspondence of the expectations of the elements in the spontaneous order of international commerce. In this understanding of *lex mercatoria*, the reasonable expectations of the parties matter as a result of the importance of the knowledge of particular circumstances of time and place and the abstract relations among the elements of the spontaneous order of international commerce for its functioning. This understanding should motivate the reasoning of arbitral tribunals rather than their reputation, income or personal connections to the clubs, major law firms or arbitral institutions. The arbitrators should be

aware of the function of *lex mercatoria* in the preservation and restoration of the order of international commerce and, thus, follow its basic principles.

In essence, in many cases, the arbitral tribunals actually apply *lex mercatoria*, as the law of principled adjudication, even without a proper understanding of the concept, as a result of their concern for giving effect to the reasonable expectations of the parties to a particular contract by utilizing the finality of their decisions and the flexibility of decision making, provided by the arbitration laws and rules, with regard to the determination of the applicable law, the ascertainment of its content and the manner of its application to a particular dispute. Nevertheless, a proper understanding of the concept of *lex mercatoria* may still help the arbitrators to motivate their judicial behavior with the reason why the accurate determination and enforcement of reasonable expectations of the parties to a particular contractual dispute matters for the spontaneous order of international commerce, and guide them in achieving such accuracy through a more principled decision making.

4. BASIC PRINCIPLES OF LEX MERCATORIA

The basic principles of *lex mercatoria* constitute the abstract schemata of thought that guides the decision maker resolving disputes arising from international contracts. They are the *ex ante* form of *lex mercatoria*, which will bring about a case specific body of legal norms through an *ex post* judicial process, which focuses on ascertaining the articulated rules and discovering the established rules in a particular case. Those rules are appropriate for a certain bargain under an international contract and give rise to the reasonable expectations of parties arising from their knowledge of the particular circumstances of time and place. On the basis of its basic principles, *lex mercatoria*, as the law of principled adjudication, enables the accurate determination and enforcement of reasonable expectations of the parties to a particular contractual dispute.

a. Freedom of Contract

The modern *lex mercatoria* doctrine emerged for the restoration of the liberal and spontaneous order of international commerce, which was disturbed by the political debates about whether the society should be framed along the lines of market economy or state economy. This political debate gradually died down during the last decades of the twentieth century. Today there seems to be a widespread consensus among the national legal systems about the freedom of contract and belief that the freedom of contract will encourage entrepreneurial spirit, that it will increase production, that it is one of the causes of wealth, and that it was the lack of this freedom which among other things caused the poverty of socialist states.⁶⁰⁶ Moreover, in the context of international arbitration, there is an increasing awareness among the national legal systems that the freedom of contract in the order of international commerce do not always overlap with the freedom of contract as understood in a particular national legal system, and that the national courts' review of arbitral awards on public policy issues should be limited with external or international public policy of the *lex fori*.

Freedom of contract also governs the CISG.⁶⁰⁷ The CISG does not interfere with the freedom of sellers and buyers to shape the terms of their transactions.⁶⁰⁸ The parties may contract out of the CISG in its entirety, or any rule of the CISG can be altered or rejected by the parties, as long as the requirements for their validity in the applicable domestic law are fulfilled.⁶⁰⁹ The freedom of contract is one of the most fundamental ideas underlying the UNIDROIT Principles.⁶¹⁰ The desire was expressed in the Working Group that it should be stated very clearly right at the outset that the principle is that parties are free to enter into a contract and to determine its content, despite its political character.⁶¹¹ Article 1.1 of the UNIDROIT Principles provides that "The parties are free to enter into a contract and to determine its contents."⁶¹² Although the article is not intended to take a position on questions, such as market economy versus planned economy, the principle of freedom of contract is considered as a prerequisite for international trade, and therefore, it is stated as a rule that anything contrary to is an exception.⁶¹³ It is even argued that the freedom of contract constitutes the "Grundnorm" from which all other rules derive so as to constitute the system of UNIDROIT Principles.⁶¹⁴

⁶⁰⁶ Lando Ole, *The Role of Party Autonomy and the Relevance of Usages*, in Michael Joachim Bonell & Franco Bonelli (eds.), *Contratti commerciali internazionali e Principi UNIDROIT*, Giuffr , Milano 1997, at 109

⁶⁰⁷ Article 6 of the CISG provides that "The parties may exclude the application of this Convention or, subject to article 12, derogate from or vary the effect of any of its provisions."

⁶⁰⁸ Honnold, John O., *Uniform Law for International Sales under the 1980 United Nations Convention*, Kluwer Law International, 3rd ed., 1999, at 3

⁶⁰⁹ Article 4 of the CISG states that "[t]his Convention ... is not concerned with ... the validity of the contract or of any of its provisions". Schlechtriem, Peter, *Uniform Sales Law: The UN-Convention on Contracts for the International Sale of Goods*, Manz, Vienna, 1986, at 35

⁶¹⁰ Bonell, Michael Joachim, *An International Restatement of Contract Law: the UNIDROIT Principles of International Commercial Contracts*, Transnational Publishers, 3rd ed., 2005, at 88

⁶¹¹ UNIDROIT 1992 – P.C. – Misc. 18, Rome, May 1992 at 37

⁶¹² Similarly, Article 1:102 (1) of the PECL provides that, "parties are free to enter into a contract and to determine its contents, subject to the requirements of good faith and fair dealing, and the mandatory rules established by these Principles."

⁶¹³ UNIDROIT 1992 – P.C. – Misc. 18, Rome, May 1992 at 40

⁶¹⁴ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 118

The freedom of contract is thus welcomed in the UNIDROIT Principles as a “cornerstone of an open, market-oriented and competitive international economic order”.⁶¹⁵ This cornerstone is not laid by the UNIDROIT Principles, but they merely rely on it. The UNIDROIT Principles recognize their dependence on the coercive power of states that provide legal enforcement. Indeed, various forms of abuse of the freedom of contract lead to state interference for the avoidance of contractual injustice. The national legal systems contain rules extending to the international contracts with a view to nursing the entrepreneurial spirit.⁶¹⁶ Moreover, as a prerequisite to the exercise of freedom of contract, the consent of the parties must not be flawed by fraud, coercion or abuse of an unequal bargaining power. The freedom of contract means that a party must have a substantive autonomy and his free will must not be corrupted.⁶¹⁷

Under Article 1.1 of the UNIDROIT Principles, there are two aspects of the freedom of contract. The first aspect is the possibility of concluding contracts with any other person, irrespective of their legal status and their nationality, but this aspect falls outside the scope of the UNIDROIT Principles.⁶¹⁸ The Official Comment explains that “As concerns the freedom to conclude contracts with any other person, there are economic sectors which States may decide in the public interest to exclude from open competition. In such cases the goods or services in question can only be requested from the one available supplier, which will usually be a public body, and which may or may not be under a duty to conclude a contract with whoever makes a request, within the limits of the availability of the goods or services.”⁶¹⁹

The second aspect of the freedom of contract is that the parties are free to determine the content of their contract. In the UNIDROIT Principles, this aspect is confirmed by Article 1.5, which provides that the parties may exclude the application of the Principles or derogate from or vary the effect of any of their provisions, except as otherwise provided in the Principles. Thus, the parties may in each individual case either exclude the application of the UNIDROIT Principles in whole or in part or modify their content so as to adapt them to the specific needs of the kind of the transaction involved.⁶²⁰ This aspect is, however, subject to limitations in the framework of the UNIDROIT Principles. First of all, the parties encounter the limits set by the application of mandatory rules, whether of national, international or supranational origin, which are applicable in accordance with the relevant rules of private international law, as provided in Article 1.4 of the Principles.⁶²¹ Apart from these external limitations, the freedom

⁶¹⁵ Official Comment 1 to Article 1.1 of the UNIDROIT Principles

⁶¹⁶ Lando Ole, *The Role of Party Autonomy and the Relevance of Usages*, in Michael Joachim Bonell & Franco Bonelli (eds.), *Contratti commerciali internazionali e Principi UNIDROIT*, Giuffrè, Milano 1997, at 110

⁶¹⁷ Lando, Ole, *CISG and Its Followers: A Proposal to Adopt Some International Principles of Contract Law*, in: *American Journal of Comparative Law*, 53 (2005), at 388

⁶¹⁸ Bonell, Michael Joachim, *An International Restatement of Contract Law: the UNIDROIT Principles of International Commercial Contracts*, Transnational Publishers, 3rd ed., 2005, at 88-89

⁶¹⁹ Official Comment 2 to Article 1.1 of the UNIDROIT Principles

⁶²⁰ Bonell, Michael Joachim, *An International Restatement of Contract Law: the UNIDROIT Principles of International Commercial Contracts*, Transnational Publishers, 3rd ed., 2005, at 90

⁶²¹ Official Comment 3 to Article 1.1 of the UNIDROIT Principles: “there are mandatory rules, whether of national, international or supra-national origin, which, if applicable in accordance with the relevant rules of private international law, prevail over the provisions contained in the Principles and from which the parties cannot derogate (see Article 1.4).”

of contract is also limited internally by the mandatory rules of the UNIDORIT Principles.⁶²² The Official Comments explain that although, given the particular nature of the Principles, the non-observance of the internal limitations to the freedom of contract may have no consequences, the relevant provisions reflect principles and standards of behavior which are of a mandatory character also under most domestic laws.⁶²³

The freedom of contract allows the parties to structure their transactions to follow their individual purposes on the basis of their knowledge of the particular circumstances of time and place. The freedom of contract as a basic principle of *lex mercatoria* will prevail only if it is accepted as a general principle whose application to particular instances requires no justification. This principle can only be subject to qualifications by the other principles that provide guidance to the elements of the order of international commerce in understanding what is and what is not permissible for the restoration of a disturbed equilibrium or balance in the order of international commerce. In this context, the freedom of contract mainly has two functions: freedom to contract and freedom from contract.

On the one hand, the freedom to contract enables the parties to allocate contractual rights, obligations and risks on the basis of their knowledge of the particular circumstances of time and place. The parties to a contract may make such allocations through contractual clauses and by choosing an identifiable set of default rules, which can be in the form of a national law, international restatements of contract principles or codified trade usages, and which constitute the part of the bargain that is contemplated under a particular contract by the parties. In the case of a discrepancy between the contractual clauses and the chosen set of default rules, the contractual clauses will prevail as a result of the primacy of the knowledge of particular circumstances of time and place in the context of the spontaneous order of international commerce, over the knowledge that has been accumulated and articulated by the outsiders in the form of default rules.

On the other hand, the freedom from contract protects the expectations of contracting parties, permitting them to put their knowledge into effect over a period of time free from the interference of others. Thus, the *ex post* decision maker should respect and enforce the articulated rules comprising both the contractual clauses and the chosen default rules and refrain from imposing a different contract on the parties and substituting his own ideas of what the parties intended for the specific allocations of contractual rights, obligations and risks, as determined explicitly by the parties themselves.

In cases where *lex mercatoria* is applicable, the parties exercise their freedom of contract to dispense with the control of legal uncertainty by a legal system and enter into transactions governed through legal uncertainty, from which the questions of residual contractual rights, obligations, and risks arise, while expressing their confidence in the specialization of the decision maker in the control of legal uncertainty. The freedom of contract as the basic principle of *lex mercatoria* implies the ability of the parties to delegate the task of controlling

⁶²² Official Comment 3 to Article 1.5 of the UNIDROIT Principles: “Those provisions of the Principles which are mandatory are normally expressly indicated as such. This is the case with Article 1.7 on good faith and fair dealing, with the provisions of Chapter 3 on substantive validity, except in so far as they relate or apply to mistake and to initial impossibility (see Article 3.1.4), with Article 5.1.7(2) on price determination, with Article 7.4.13(2) on agreed payment for non-performance and Article 10.3(2) on limitation periods. Exceptionally, the mandatory character of a provision is only implicit and follows from the content and purpose of the provision itself (see, e.g., Articles 1.8 and 7.1.6).”

⁶²³ Official Comment 3 to Article 1.5 of the UNIDROIT Principles

the legal uncertainty to the ex post decision maker, and the decision maker applying *lex mercatoria* should observe the terms of that delegation, for the validity of his decisions.

In the context of international arbitration, the compliance of the arbitrators with the terms of the delegation is assured by the principle that arbitrators owe only allegiance to the parties of the relevant contracts, and cannot deal with issues not submitted to them. Their award must be within the confines of relief requested by the parties. The violation of the terms or scope of the submission to arbitration constitutes a ground of setting aside the award or refusal of its enforcement. The contractual clauses and the default rules chosen by the parties are relevant to the scope of submission. Article 1502(3) of the French Code of Civil Procedure provide for the setting aside of the award when the arbitrator has not complied with his mission, which defines the arbitrator's duties and powers.⁶²⁴ Swiss law does not have any equivalent provision, but Article 190(2)(c) of the Swiss Code on Private International Law provides that where the arbitral tribunal's decision went beyond the claims submitted to it or when it failed to decide on one of the claims, the award can be set aside. Article 34 (2) (iii) of the UNCITRAL Model Law allows the court to set aside an award which deals with a dispute not contemplated by or not falling within the terms of the submission to arbitration, or contains decisions on matters beyond the scope of the submission to arbitration. This provision is almost identical to Article V (1) (c) New York Convention, which states the excess of arbitrator's mandate as a ground for the refusal of recognition or enforcement. Thus, if an arbitral tribunal totally disregards the contractual clauses or default rules chosen by the parties, in ascertaining the specific contractual rights, obligations and risks, or in exercising abstract reasoning on the basis of his specialization to resolve the disputes over the allocation of residual rights, obligations and risks, the resulting decision may not be legally enforceable by the national courts.

The decision maker applying *lex mercatoria* will control legal uncertainty arising from the issues, which are not covered by the rules that have been articulated by the parties in their contract or the default rules they have chosen, and that require ex post interpretation, supplementation or correction of those rules. The decision maker will take into account the articulated rules and the surrounding circumstances of the case as well as other basic principles of *lex mercatoria* in order to find some guidance in the exercise of his abstract reasoning in the specialized consolidations that are needed to discover the established rules in the particular case. He will also keep in mind that the limits of the freedom of contract as a basic principle of *lex mercatoria* are not determined solely on the basis of the imperative language used by the national legal systems, but through a balancing exercise between the interests of the contracting parties and states relevant to the dispute and by taking into account whether those states' interests are consistent with established rules of policy, including policies favoring international arbitration, and other generally accepted legal principles in the international community of states.

In the end, the freedom of contract is, first and foremost, an authorization or acknowledgement of a realm of private law-making in which by mutual agreement parties create their own law to govern some mutual undertaking.⁶²⁵ The decision maker applying *lex*

⁶²⁴ Poudret, Jean-Francois & Sebastien Besson, *Comparative Law of International Arbitration*, London: Sweet & Maxwell, 2nd ed., 2007, para. 804

⁶²⁵ Shapiro, Martin, *Globalization of the Freedom of Contract*, in Harry N. Scheiber (ed.), *The State and Freedom of Contract (Making of Modern Freedom)*, Stanford University Press, 1998, at 273 In the LIAMCO Arbitration, it was held: "The right to conclude contracts is one of the primordial civil rights acknowledged since olden times. It was the essence of "commercium" or "jus commercii" of the Roman "jus civile" whose scope was

mercatoria can only deal with issues that require interpretation or supplementation of the contents of the contract, and intervene into this realm of law-making when the enforcement of the contract potentially leads to a disturbance in the order of international commerce, such as the parties' violation of the established rules of policy. In this manner, the principle of freedom of contract will be qualified by the principle of good faith and fair dealing, which require the decision maker to take into account the interdependence of orders.

enlarged and extended by "jus gentium". Then it was always and constantly considered as security for economic transactions, and was even extended to the field of international relations." *Libyan American Oil Company v. The Government of the Libyan Arab Republic*, *Yearbook Commercial Arbitration*, 6 (1981), at 101

b. Sanctity of Contracts

The parties' freedom to enter into an agreement and to determine its content is linked to another basic principle that the parties become bound by the content they agreed in the contract, i.e., their self-made rules of inter-partes law.⁶²⁶ Since *lex mercatoria*, as the law of principled adjudication, is an alternative means in the control of uncertainty, which recognizes the significance of the individual contract, one of its basic principles is the sanctity of contracts, which forms the basis of every contractual relationship. The principle of sanctity of contracts is generally admitted into every national legal system partly due to the antiquity and moral tone of the principle *pacta sunt servanda* ("contracts are to be enforced").⁶²⁷

The draftsmen of the CISG considered the principle to be so obvious that it was not stated in a special rule.⁶²⁸ It is, however, implied in several articles, such as Article 29 (1), which states that "A contract may be modified or terminated by the mere agreement of the parties" and Article 79, which provides that the binding effect of the contract cannot be avoided in cases such as a simple change of circumstances, but only if the requirements listed in its provisions are present. Similarly, it is also implied in Article 6:111(1) of the PECL on change of circumstances, which provides that a party is bound to fulfill its obligations even if performance becomes more onerous.

The UNIDROIT Principles explicitly provides in Article 1.3 that, a contract validly entered into is binding upon the parties and it can only be modified or terminated in accordance with its terms or by agreement or as otherwise provided in the Principles. It makes explicit that a contract as such is binding upon the parties on the condition that it is validly concluded.⁶²⁹ There was some opposition in the Working Group to the inclusion of this principle into the UNIDROIT Principles at the early stages of drafting. Its necessity was questioned as it was indicated that with a general principle of *pacta sunt servanda*, the drafters were entering in the realm of the philosophy of law.⁶³⁰ Even so, the principle took its place in the general

⁶²⁶ Lookofsky, Joseph, *The Limits of Commercial Contract Freedom: Under the UNIDROIT "Restatement" and Danish Law*, *American Journal of Comparative Law*, 46 (1998) at 492

⁶²⁷ This principle can even be found in religious sources. For instance, the principle *pacta sunt servanda* is inherent in the conception of a contract and is recognized by all Muslim jurist-theologians. The Qur'an urges the Muslims "not to break oaths after making them" [Qur'an XVI:93], and if the other party does not break them, then to fulfill their agreement to the end of their term [Qur'an IX:4]. Majeed, Nudrat, *Good Faith and Due Process: Lessons from the Shari'ah*, *Arbitration International* 20-1 (2004), at 111. Christianity also exercised a great influence on the sanctity of contracts. Its basic idea demanded that one's word be kept, as is clearly expressed in the Gospel according to St. Matthew, in particular, where it is said, at Chapter 5, Verses 33 to 37, at the end: "But let your communication be, Yea, yea; Nay, nay: for whatsoever is more than these cometh of evil." Later, the Fathers of the Church set forth in detail the notion of the sanctity of contracts. Thus St. Augustine (354-430), for example, taught that one must keep one's word even with one's enemies. Wehberg, Hans, *Pacta Sunt Servanda*, *American Journal of International Law*, 53 (1959), at 775

⁶²⁸ Lando, Ole, *CISG and Its Followers: A Proposal to Adopt Some International Principles of Contract Law*, in: *American Journal of Comparative Law*, 53 (2005), at 388

⁶²⁹ Official Comment 1 to Article 1.3 of the UNIDROIT Principles: "The binding character of a contractual agreement obviously presupposes that an agreement has actually been concluded by the parties and that the agreement reached is not affected by any ground of invalidity. The rules governing the conclusion of contractual agreements are laid down in Chapter 2 Section 1 of the Principles, while the grounds of invalidity are dealt with in Chapter 3, as well as in individual provisions in other Chapters (see, e.g., Articles 7.1.6 and 7.4.13(2)). Additional requirements for the valid conclusion of contracts may be found in the applicable national or international mandatory rules."

⁶³⁰ UNIDROIT 1993 – P.C. – Misc. 17, Rome, February 1993 at 150

provisions of UNIDROIT Principles due to its importance in the basic philosophy of any regulation of contract.

The earlier version of this principle in the UNIDROIT Principles was drafted along the lines of Article 1134 (1) of the French Civil Code by providing that a contract validly entered into constitutes the law unto the parties and is therefore binding as between them.⁶³¹ It was argued that, in the international sphere, problems could arise by the use of the expression “the law unto parties”, because the law of the parties might give the impression that they were liberated from the restraints of national laws. Instead, it was suggested simply to provide that it was binding on the parties, and the final version of the provision did not contain the expression “the law unto parties”.⁶³² However, as it was pointed out in the Working Group, the French Civil Code did not actually say that the contract was the law unto the parties, but that it was just as binding for the parties as the law was binding for the citizens.⁶³³

Indeed, it is a logical implication, which can be drawn from the principle of sanctity of contracts, that the contract with its binding nature is the primary source of normative expectations of the parties. In this sense, for *lex mercatoria*, the contract is the law between the parties, as it is stated in Article 1134 (1) of the French Civil Code. Furthermore, as a conceptual matter, it is not possible to speak of residual contractual rights, obligations or risk allocations without some prior ascertainment that a contractual consent exists, and *pacta sunt servanda*, in the sense of a consent to be legally bound by the articulated rules, which consist of the contractual clauses and the chosen default rules, is the necessary element for all forms of contractual rights, obligations and risk allocations in the order of international commerce. The *pacta sunt servanda* requires the decision maker to ascertain the meaning of the articulated rules through interpretation in order to reveal and enforce the specific contractual rights, obligations and risk allocations. Moreover, the understanding that the ascertainable meaning of the articulated rules is the law between the parties can be seen as the point of departure for the proponents of transnational theory of arbitration. The theory was based on the basic foundations of the contract and relied on the contract as the law between parties.

In the state party disputes, there have been many references to *pacta sunt servanda* in the sense that the contract is the law between the parties, particularly prior to the popularity of Bilateral Investment Treaties (BITs) in the early 1990s.⁶³⁴ While BITs undoubtedly support the enforcement of state promises to investors by providing investors with guaranteed access to international arbitration and to particular causes of action in the event of a breach of promise, they are not indispensable to render state promises enforceable.⁶³⁵ Regardless of BITs, the principle of *pacta sunt servanda* has been invoked by the arbitrators against the claims of some countries that foreign investment contracts could be breached as a matter of sovereign right.

⁶³¹ The earlier draft of this provision drafted by Crepeau read as follows: “Art. 3A.1: A contract validly entered into constitutes the law unto the parties and is therefore binding as between them. It cannot be modified or terminated except by agreement or as otherwise provided under the Principles” in UNIDROIT 1993 – P.C. – Misc. 17, Rome, February 1993 at 143

⁶³² *Ibid.*, at 151

⁶³³ *Ibid.*, at 152

⁶³⁴ Yackee, Jason W., *Pacta Sunt Servanda and State Promises to Foreign Investors Before Bilateral Investment Treaties: Myth and Reality*, *Fordham International Law Journal*, 32-5 (2008), at 1550

⁶³⁵ *Ibid.*, at 1552

In Aramco Award from 1958, the issue was the interpretation of a long-term concession agreement about whether Saudi Arabia had granted Aramco the exclusive transportation rights that were later improperly given to a third party. During the proceedings Saudi Arabia raised the argument that because the contracts underlying the dispute, were “acts accomplished in the exercise of its sovereignty” the arbitral tribunal had no authority to decide the legality of the “consequences of such acts” and that it retained the sovereign power to regulate oil transportation as it saw fit. However, the tribunal held that “the Concession has the nature of a constitution which has the effect of conferring acquired rights on the contracting Parties. By reason of its very sovereignty within its territorial domain, the State possesses the legal power to grant rights which it forbids itself to withdraw before the end of the Concession....Nothing can prevent a State, in the exercise of its sovereignty, from binding itself irrevocably by the provisions of a concession and from granting to the concessionaire irrevocable rights [the breach of which will] engag[e] its responsibility.”⁶³⁶ This statement in support of the principle that the state contract is law between the parties and binding upon them generated echoes in later arbitral awards.⁶³⁷ George Ray, Aramco’s general counsel, considered the award’s implication as supporting the centuries old and “generally accepted principles” of “ad hoc contract and pacta sunt servanda”.⁶³⁸

The main argument is that “the principle of ‘pacta sunt servanda’ of international law applies not only to agreements between states, but also to contracts between states and private enterprises.”⁶³⁹ This argument can be found in the Preliminary Award in ICC Case No. 2321 of 1974. The arbitrator stated that “I must admit that I have found some difficulties to follow a line of reasoning that a State, just because of its supreme position and qualities, should be unable to give a binding promise. The principle of pacta sunt servanda is generally acknowledged in international law and it is difficult to see any reason why it should not apply here. A sovereign State must be sovereign enough to make a binding promise both under international law and municipal law. As to the latter aspect of the question I was informed by the Counsel of the First Defendant that according to both . . . and English law the capacity of the State to enter into arbitration clauses was not restricted as such and that also the State could be sued in its own courts. To require or assume then that a promise of a State to submit to arbitration, in order to be binding has to be confirmed in the face of the arbitrator, would probably impair the sovereignty of a State and its dignity more than the arbitrator's

⁶³⁶ Ad hoc Award, August 23, 1958, Saudi Arabia vs. Arabian American Oil Co. (ARAMCO), International Law Reports, 27 (1963) at 168

⁶³⁷ For example in an ad hoc award of January 14, 1982, the arbitrator stated that “A state which has itself entered into an international agreement or has permitted companies or institutions controlled by it to enter into such agreement regulated as *lex contractus* by recognized principles of international law, is not free to change that *lex contractus* by subsequent legislation. The agreement contains in Art. 44 a clause of intangibility and in the Preamble to the agreement the parties NIOC and ERAP (now ELF) express their intention to ‘carry out in a spirit of good faith and good will the provisions’ of the agreement.” The arbitrator noted that a State “is bound by its obligations under international agreements or concessions”, in accordance with the principal of *pacta sunt servanda*. The arbitrator referred to the awards of *Lena Goldfields Company (Ltd.) vs. Union of Socialist Soviet Republics* and to *Saudi Arabia vs. Aramco*. Ad hoc award, January 14, 1982, *Elf Aquitaine Iran vs. National Iranian Oil Company*, Yearbook Commercial Arbitration, (1986), at 101

⁶³⁸ Ray, Jr., George W., Some Reasons for the Binding Force of Development Contracts between States and Foreign Nationals, *The Business Lawyer*, 16 (1961), at 943

⁶³⁹ Böckstiegel, Karl-Heinz, Arbitration of Disputes between States and Private Enterprises in the International Chamber of Commerce, *American Journal of International Law*, 59 (1965), 586

performance of his task, conferred upon him in accordance with what the parties once have agreed upon.”⁶⁴⁰

In the Saphire Award from 1963, on the issue of whether state promises to investors should be recognized as binding, with breaches subject to a duty to compensate, the sole arbitrator held that “it has been duly established that the [state party] deliberately refused to carry out certain of its obligations and that this failure is a breach of contract. Moreover, it is a fundamental principle of law, which is constantly being proclaimed by international courts, that contractual undertakings must be respected. The rule *pacta sunt servanda* is the basis of every contractual relationship. Moreover, it is contained in the laws of both parties to the dispute, in Article 219 of the Iranian Civil Code as well as in Canadian law.”⁶⁴¹

The principle of sanctity of contracts has also been endorsed in the famous Libya arbitration trilogy. These arbitrations involved claims by the BP Exploration Company (Libya) Ltd. (the BP award),⁶⁴² the Texaco Overseas Petroleum Company (the TOPCO award)⁶⁴³ and the Libyan American Oil Company (the LIAMCO award),⁶⁴⁴ against the Libyan government for breaches of the companies’ concession contracts. The choice of law clause was same in the different concession agreements that came before the different arbitrators. It provided that “This concession shall be governed by and interpreted in accordance with the principles of law of Libya common to the principles of international law and, in the absence of such common principles, then by and in accordance with the general principles of law, including such of those principles as may have been applied by international tribunals.”⁶⁴⁵

The principle *pacta sunt servanda* was expressly invoked in the TOPCO and LIAMCO awards. In the TOPCO Award, considering that some contracts may be governed both by municipal law and by international law, the arbitrator held that the choice of law clause referred to the principles of Libyan law rather than to the rules of Libyan law. In this connection, the arbitrator held that “The application of the principles of Libyan law does not have the effect of ruling out the application of the principles of international law, but quite the contrary: it simply requires us to combine the two in verifying the conformity of the first with the second”. Through this consolidation, the arbitrator declared that he would refer on the one hand to the principle of the binding force of contracts recognized by Libyan law, and on the other to the principle of *pacta sunt servanda* which is a general principle of law constituting an essential foundation of international law. The arbitrator found that the principles of Libyan law were in conformity with international law and concluded that the Deeds of Concession in dispute had a binding force.⁶⁴⁶

⁶⁴⁰ ICC Award in Case No. 2321, 1974, *Yearbook Commercial Arbitration*, (1976), at 135

⁶⁴¹ *Saphire International Petroleum Ltd. v. National Iranian Oil Co.*, ad hoc award of 15 March 1963, *International Legal Report*, 35 (1967), at 181

⁶⁴² Ad hoc Award, October 10, 1973, *British Petroleum (BP) Co Ltd vs. The Government of Libyan Arabic Republic*, *Yearbook Commercial Arbitration*, 5 (1980), at 158

⁶⁴³ Ad hoc award, January 19, 1977, *Texaco vs. Libya*, *Yearbook Commercial Arbitration*, 4 (1979), at 177

⁶⁴⁴ Ad hoc Award, April 12, 1977, *Liamco v. Libya*, *Yearbook Commercial Arbitration*, 6 (1981), at 89

⁶⁴⁵ Redfern, Alan & Martin Hunter with Nigel Blackaby and Constantine Partasides, *Law and Practice of International Commercial Arbitration*, London: Sweet & Maxwell, 4th ed. Student version, 2004, at 122

⁶⁴⁶ Ad hoc award, January 19, 1977, *Texaco vs. Libya*, *Yearbook Commercial Arbitration*, 4 (1979), at 182

In the LIAMCO Award, the sole arbitrator, consolidating various materials including European civil codes, Common Law, Islamic Jurisprudence, Libyan Civil Code, United Nations Resolutions in relation to the subject matter and Convention of Vienna on the Law of Treaties, held that: “The right to conclude contracts ... is protected and characterized by two important propositions couched respectively in the expression that "the contract is the law of the parties", and in the Latin maxim that "Pacta sunt servanda" (pacts are to be observed). The first proposition means that the contracting parties are free to arrange their contractual relationship as they mutually intend. The second means that a freely and validly concluded contract is binding upon the parties in their mutual relationship. In fact, the principle of the sanctity of contracts, in its two characteristic propositions, has always constituted an integral part of most legal systems... Consequently, one of the parties cannot unilaterally cancel or modify the contents of the agreement, unless it is so authorized by the law, by a special provision of the agreement, or by its nature which implies such presumed intention of the parties.”⁶⁴⁷

In the ICC Case No. 3896 between foreign investors and the Atomic Energy Organization of Iran, where Iran had repudiated a natural resources agreement and sought to avoid arbitration and liability for the repudiation by claiming that its repudiation was an act of sovereignty over natural resource, it was held that “The arguments put to the Arbitral Tribunal ... restrict themselves to emphasizing the right of [Iran] to change course and to abandon the policy previously adopted which led to the conclusion of the inter-State agreements and of the Contract in dispute. However, this right, although undisputable, clearly does not imply that non-performance of the disputed Contract must have no consequence, for example, of a financial nature or, which is more or less the same thing, that the consequences would exclusively depend on the unilateral and sovereign appreciation of the [Iran] Government, and would thus escape arbitration. Such a theory would be incompatible with the fundamental principle of the binding force of undertakings freely concluded (pacta sunt servanda), which applies both to the Contract in dispute and to the inter-State agreement concluded by [Iran].”⁶⁴⁸

In the ICSID Amco I Award, the principle pacta sunt servanda was admitted as a principle of international law on the grounds that “i) First, it is so because of it being a general principle of law in the meaning of article 38 of the Statutes of the International Court of Justice, since it is common to all legal systems in which the institution of contract is known...Contract as a principle of ordering rests on the proposition that individuals and legal entities make, for their own accounts and on their own responsibility significant decisions respecting resource utilization and allocation. The form of order which a society seeks to achieve by accepting the institution of contract thus depends upon the recognition that, in principle, pacta sunt servanda. It follows that the binding force of contractual duties for parties to a contract or agreement is recognized in every legal order that utilizes the institution of contract. Thus, for instance, the principle is embodied in civil law systems... The principle is no less vigorous at common law. ... pacta sunt servanda is also a principle of traditional Islamic law ... ii) The principle of pacta sunt servanda was stated again in article 26 of the Vienna Convention on the law of treaties ... To be sure, the transposition of this principle to agreements between States and private enterprises is debated in contemporary doctrine. However, the Tribunal is bound to note that it was applied in leading international awards ... the basic concept which

⁶⁴⁷ Ad hoc Award Liamco v Libya, April 12, 1977, Yearbook Commercial Arbitration, 6 (1981), at 101

⁶⁴⁸ Framatome and others v The Atomic Energy Organization of Iran, Award of 30 April 1982, ICC Award in Case No. 3896 published in English under pseudonym in Yearbook Commercial Arbitration, 8 (1983), at 114

underlies *pacta sunt servanda* leads necessarily to the application, in the instant case, of the very contents of the same: the party who has undertaken obligations is bound to perform them, except for cases established by law, and this fundamental rule applies to States as well as to private entities or persons.”⁶⁴⁹

More recently, in ICC Case No 9753, relating to an agreement between a British company and a Czech state entity, the arbitrator referred to the principle of *pacta sunt servanda* as a general principle of business practice. Applying Czech law, the arbitrator took into consideration that “under paragraph (1), section 264 of the Czech Commercial Code in determining the rights and duties arising from a relationship of obligations, account is also taken of the business practice (trade usage) prevalent in a particular field of business, unless these are contrary to the contents of the contract or to the law. There are no special usages in the particular field of business but general principles of business practice have importance, too. Such general principles are *pacta sunt servanda* and to cooperate in good faith (articles 1.3 and 1.7 of the Unidroit Principles of International Commercial Contracts...).”⁶⁵⁰

These arbitral awards, relating to disputes between states and private persons has become influential on the arbitrators’ approach to the disputes between private parties and, thus, the arbitrators usually refer to the principle of *pacta sunt servanda* as a distinct rule from national laws and as a requirement for international commerce, which dictates that violation of the articulated rules will have consequences unless it is excused under certain circumstances. As early as 1955, in ICC Case No. 927, the arbitrator enforced the contract between (Federal) German and American parties for the sale of magnesium of a certain quality, on the basis of the principle of *pacta sunt servanda* as a distinct rule from national laws. The arbitrator held that “by receiving raw magnesium of a quality inferior to the one ordered [the buyer] has suffered a loss for which [the seller] must be liable. It is the obligation of a seller to deliver the goods exactly as contracted for and failing to do so, to indemnify the buyer for any loss caused thereby. This obligation is well established in the legal systems of all civilized nations and is of particular importance in international trade. It needs no further explanation to point out the impossibility of promoting international trade if a buyer should be left to the mercy of the seller’s fulfillment of contractual obligations agreed to.”⁶⁵¹

In ICC Case No. 3540, where the dispute arose from a contract between a French company and a Yugoslav subcontractor, the arbitrators were to decide as *amiable compositeurs*, and stated that “the arbitral tribunal, holding it appropriate not to avoid all references to a national law, will examine whether the solution contained in its award based on the *lex mercatoria* and the application of the maxim *pacta sunt servanda* – leaving aside the international public policy – would be fundamentally different from that resulting from national law... or rather, from the two national laws invoked by the parties: Swiss law by Claimant and French law by Defendant.”⁶⁵²

In ICC Case No 5485 concerning a "Basic Agreement", for the formation of a joint venture, concluded between a Bermudian Company and a Spanish Company, the arbitral tribunal

⁶⁴⁹ Award on the Merits, November 21, 1984, *Amco Asia Corporation et al. vs. Indonesia*, *International Legal Materials*, 24 (1985), at 1033-1035

⁶⁵⁰ ICC Award in Case No. 9753, 1999, *ICC International Court of Arbitration Bulletin*, 12-2 (Fall 2001), at 83

⁶⁵¹ ICC Award in Case No. 927, October 12, 1955, Doc. No. 410/364, cited by Lew, Julian D. M., *Applicable Law in International Commercial Arbitration: A Study in Commercial Arbitration Awards*, Oceana, 1978, at 497

⁶⁵² ICC Award in Case No. 3540, 1980, *Yearbook Commercial Arbitration*, 7 (1982), at 129

referred to the principle of *pacta sunt servanda* as a general principle of law, which was also reflected by the applicable national law. According to the arbitrators, the Basic Agreement was clear and had to be applied literally. They stated that “Whereas the rule *pacta sunt servanda* implies that the contract is the law of the parties, agreed to by them for the regulation of their legal relationship, and generates not only the obligation of each party to a contract to fulfill its promises, but also the obligation to perform them in good faith, to compensate for the damage caused to the other party by their non-fulfillment and to not terminate the contract unilaterally except as provided for in the contract. These principles are also part of Spanish law....”⁶⁵³

Thus, the sanctity of contracts, as a basic principle of *lex mercatoria*, is understood as the standard that the contractual obligations have to be performed unless there is a valid excuse for non-performance under the articulated rules or on the basis of the basic principle of good faith and fair dealing. Frequently, the arbitral tribunals simply apply the contract terms to the dispute and thus impliedly recognize the binding force of the contract.⁶⁵⁴ Thus, it is argued that *pacta sunt servanda* is not really a rule on its own, but is merely a reflection of the nature of a contractual obligation.⁶⁵⁵ On the other hand, it is also argued that, although there are differences as to the strength, and consequently as to effects of the principle of sanctity of contract in national legal systems, when the arbitrators refer to this principle, very frequently, they do not refer to a particular national law, but they see the principle as a general one in the order of international commerce, and therefore, that the actual consequences are not necessarily to be taken from any national law.⁶⁵⁶

Under *lex mercatoria*, the principle of sanctity of contract is essentially a presumption leaning against the existence of any right of unilateral termination or modification of the contract by the parties, but, like all presumptions, it may in some cases be successfully rebutted.⁶⁵⁷ In principle, modification or termination of the contract should be allowed by the mutual subsequent agreement of the parties to that effect. Such an agreement can be explicit or tacit depending on the circumstances of the case. Modification or termination without subsequent agreement can be admitted only when it is in conformity with the articulated rules, or on the basis of the qualifying function of the basic principle of good faith and fair dealing.

⁶⁵³ ICC Award in Case No. 5485, 1987, *Yearbook Commercial Arbitration*, (1989), at 168

⁶⁵⁴ Van Houtte, Hans, *Changed Circumstances and Pacta Sund Servanda*, in Emmanuel Gaillard (ed.), *Transnational Rules in International Commercial Arbitration*, ICC Publication No. 480/4, Paris, 1993, at 110

⁶⁵⁵ Mustill, Michael, *The New Lex Mercatoria: The First Twenty-five Years*, *Arbitration International*, (1988), at 110-111

⁶⁵⁶ Goldman, Berthold, *The Applicable Law: General Principles of Law - the Lex Mercatoria*, in Julian D. M. Lew (ed.), *Contemporary Problems in International Arbitration*, London, 1986, at 125

⁶⁵⁷ Jennings, R. Y., *State Contracts in International Law*, *British Yearbook of International Law*, 37 (1961), at 177

c. Good faith and Fair Dealing

The parties' consent to be legally bound that characterizes the principles of freedom of contract and sanctity of contracts also relates to a consent to the jurisdiction of some adjudicative and enforcement mechanism in the order of international commerce. Thus, whatever reasons of principle or policy support one default rule over another, or a mandatory rule over a default rule, there is always an additional reason that partly explains and justifies the enforcement of whatever background rules that are applicable: the parties have manifested their consent to be legally bound. The decision makers are justified in interpreting, supplementing and correcting the articulated rules comprising both the contractual clauses and the chosen default rules, only if parties have manifested their intent to create contractual relations.⁶⁵⁸ The principle of good faith and fair dealing under *lex mercatoria* denotes a contextual approach, on the basis of the established rules in a particular case, to the interpretation, supplementation and correction of the articulated rules. By invoking the legal enforcement under *lex mercatoria*, the parties implicitly accept they are bound by both articulated and established rules in the particular case. Thus, not only the articulated rules, but also the established rules are the law between the parties entering into the contract in the order of international commerce.

Essentially, this understanding also reflects the function of principle of good faith within some national legal systems. Through the principle of good faith, those national legal systems allow the decision makers to take into account the nature and purpose of the contract and relevant trade usages and customs and to balance the societal and private interests in exercising an abstract reasoning thereby determining the conduct that is required by the established rules. Such an understanding is most apparent in the civil law systems. Section 242 of the German Civil Code provides that the debtor must perform in a manner consistent with good faith taking into account accepted practice, and Section 157 provides that contracts are to be interpreted having regard to good faith and taking account of accepted practice. Both provisions refer to "Treu und Glauben", which is understood in the sense of objective good faith that constitutes a standard of conduct to which the behavior of a party has to conform and by which it may be judged.⁶⁵⁹ Under German law, the principle of good faith requires reasonable and loyal behavior within a private law relationship and the protection of reliance. Accordingly, a contract is not only to be performed in accordance with the letter of the contract, but also in accordance with its nature and purpose, and in light of what the other party, in view of the circumstances, could expect, and in accordance with the usage of reasonable business dealings.⁶⁶⁰

Moreover, the principle of good faith under German law is a standard, which takes shape only by the way in which it is applied. There is a developing "inner system" of good faith, based upon the existing case law and guiding the courts in deciding future cases. This system provides many formal consolidations, which are based on the principle of good faith and start to lead an independent life as legal rules. These rules developed under the cover of good faith

⁶⁵⁸ Barnett, Randy E., *The Sound of Silence: Default Rules and Contractual Consent*, *Virginia Law Review*, 78-4 (May, 1992), at 862-865

⁶⁵⁹ Whittaker, Simon & Reinhard Zimmermann, *Good faith in European Contract Law: Surveying the Legal Landscape*, in Reinhard Zimmermann and Simon Whittaker (eds.), *Good faith in European Contract Law*, Cambridge University Press, 2000, at 30

⁶⁶⁰ Kornet, Nicole, *Contract Interpretation and Gap Filling: Comparative and Theoretical Perspectives*, Intersentia, 2006, at 112-113

are relegated to that part of the law of contract to which they systematically belong, and which they restrict, supplement, change or otherwise modify.⁶⁶¹ Thus, the principle of good faith under German law provides the courts with the necessary discretion to specify, supplement and modify the law, thereby developing the law in accordance with the perceived needs of the time.⁶⁶²

Article 1134 (3) of the French Civil Code provides that contracts shall be performed in good faith. This provision was initially applied to the effect that the parties must keep to their agreements and that the agreement should be interpreted according to the parties' true intentions rather than the words which they used in accordance with the idea of autonomy of the parties in the French law of contract. By the end of nineteenth century and the beginning of the twentieth century, a trend to give the principle a wider scope of application, whereby the principle has become able to qualify the contract and the law, has been noticed with the advance of the theory of abuse of rights and accessory obligations of security and information.⁶⁶³ The contextual approach that is required for the application of the principle of good faith is also apparent in Article 1135 of the French Civil Code, which requires the courts to supplement the parties' agreements with legal, customary and equitable obligations, according to their nature.

The reference to the principle of good faith also appears at an international level. Under Article 7 (1) of the CISG, it is provided that consideration must be given to the international character of the convention and to need to promote uniformity in its application and the observance of good faith in international trade. At the Vienna Conference in 1980, a proposal was put forward to include a rule in the CISG providing that, in the formation, interpretation, and performance, the parties shall observe the principles of good faith and international cooperation. However, the majority of the delegates expressed concerns that such a rule would lead national courts to be influenced by their own legal and social traditions when interpreting such a vague concept as good faith, and the proposal was not adopted.⁶⁶⁴ There has been uncertainty as to whether the principle of good faith concerns only the interpretation of the Convention and not the conduct of the parties in the formation and performance of the contract, or the interpretation of their intentions. It is argued that the function of such a general clause can probably be fulfilled by the rule that the parties must conduct themselves according to the standard of the "reasonable person", which is expressly described in a number of provisions and, therefore, must be regarded as a general principle of the Convention.⁶⁶⁵ Moreover, the reference to the observance "of good faith in international trade" indicates one of the general principles that must be regarded in interpreting and extending the uniform law by giving effect to the reasonable expectations of the parties.⁶⁶⁶

⁶⁶¹ Whittaker, Simon & Reinhard Zimmermann, *Good faith in European Contract Law: Surveying the Legal Landscape*, in Reinhard Zimmermann and Simon Whittaker (eds.), *Good faith in European Contract Law*, Cambridge University Press, 2000, at 31

⁶⁶² *Ibid.*, at 32

⁶⁶³ *Ibid.*, at 32-39

⁶⁶⁴ Bonell, Michael Joachim, Article 7, in Bianca, C. Massimo & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 68, 84

⁶⁶⁵ Honnold, John O., *Uniform Law for International Sales under the 1980 United Nations Convention*, Kluwer Law International, 3rd ed., 1999, at 101

⁶⁶⁶ Schlechtriem, Peter, *Uniform Sales Law: The UN-Convention on Contracts for the International Sale of Goods*, Manz, Vienna, 1986, at 38

The international restatements of contract principles explicitly attach great importance to the principle of good faith and fair dealing. It is included into both the UNIDROIT Principles and the PECL as an over-arching general clause. The principle of good faith and fair dealing in the UNIDROIT Principles was initially drafted in the context of the provisions on the interpretation of contracts during the early stages of the preparation of the Principles.⁶⁶⁷ At this stage, the concept of good faith was used in connection with the concept of fair dealing, thereby highlighting the association between the principle of good faith and the contextual interpretation. The combination of the concepts of good faith and fair dealing was introduced on the basis of the argument that “it is not sufficient to base oneself on the confidence which the parties might have established between themselves; due consideration must also be given to the expectation which the generality of the operators has of fair dealing in the respective trade sector”.⁶⁶⁸ Thus, the Working Group, from the beginning of drafting process, attempted to devise a provision that was clearly intended to provide guidance to the decision maker in discovering the established rules to be observed by the parties in a particular case.

Later, it was suggested that an article of a more general character should be placed at the beginning of the UNIDROIT Principles.⁶⁶⁹ The draft provision was devised with a view to imposing the duty of good faith and fair dealing on the “formation, interpretation and performance of a contract”.⁶⁷⁰ It was then suggested to insert the words “and enforcement” after “performance”, so that the formula would be more similar to the wording used in the US Uniform Commercial Code (UCC).⁶⁷¹ That way, it would be clear for American lawyers that the standard was also meant to apply to parties having resort to remedies in the event of a breach of contract.⁶⁷² After extensive discussion, the drafters decided that all the phases of a contractual relationship should be covered, but that any attempt to enumerate them should be abandoned.⁶⁷³ The final version of Article 1.7 of the UNIDROIT Principles provides that each party must act in accordance with good faith and fair dealing in international trade, and the parties may not exclude or limit this duty.

In the Official Comments, it is stated that good faith and fair dealing in international trade may be considered to be one of the fundamental ideas underlying the UNIDROIT Principles, and, even in the absence of special provisions in the Principles, the parties’ behavior throughout the life of the contract, including the negotiation process, must conform to good faith and fair dealing.⁶⁷⁴ The reference to “good faith and fair dealing in international trade” is included in order to avoid national standards from being taken into account unless they are

⁶⁶⁷ UNIDROIT 1973 – Etudes L – Droit des obligations – Doc. 5, Rome, December 1973 in the un-paginated Appendix, with references to 2-103 of the pre-2001 version of the UCC (USA) and Art 23(1) of the 1963 Czechoslovakian International Trade Code which demanded on interpretation of contracts with respect to loyal commercial relationships’ See also draft Article 1 in UNIDROIT 1977 – Study L – Doc. 12, Rome, May 1977, at 3; UNIDROIT 1979 – Study L – Doc. 15, Rome, January 1979, at 23

⁶⁶⁸ UNIDROIT 1977 – Study L – Doc. 12, Rome, May 1977, at 3

⁶⁶⁹ UNIDROIT 1979 – Study L – Doc. 16, Rome, November 1979, at 3

⁶⁷⁰ UNIDROIT 1983 – Study L – Doc. 25, Rome, March 1983, at 1

⁶⁷¹ UNIDROIT 1992 – P.C. – Misc. 18, Rome, May 1992, at 66, 73

⁶⁷² Section 1-203 of the pre-2001 version of the UCC; UNIDROIT 1983 – P.C. – Misc. 4, Rome, June 1983, at 1

⁶⁷³ UNIDROIT 1983 – P.C. – Misc. 4, Rome, June 1983, at 1-2; UNIDROIT 1987 – Study L – Doc. 38, Rome, January 1987, at 3, draft Article 3; UNIDROIT 1992 – P.C. – Misc. 18, Rome, May 1992, at 70,72

⁶⁷⁴ Official Comment 1 to Article 1.7 of the UNIDROIT Principles

shown to be generally accepted among the various national legal systems.⁶⁷⁵ The reference also implies a contextual approach under which good faith and fair dealing must be specified in a particular case in the light of standards of business practice in international trade. There is no definition in the Official Comment and no such definition was suggested during the process of drafting the Principles. Instead, it was variously stated that the criterion of good faith is universally recognized and therefore too well known to need any further explanation⁶⁷⁶ or that it was impossible to give a precise definition.⁶⁷⁷

Similarly, Article 1:201(1) of the PECL provides: “Each party must act in accordance with good faith and fair dealing.” In the Official Comments to Article 1:201, it is stated that good faith and fair dealing are required in the formation, performance and enforcement of the parties’ duties under a contract, and equally in the exercise of a party’s rights under the contract. It is also explained that the concept is broader than any of its specific applications, and should be applied generally as a companion to Article 1:104 on Usages. It is stated that its purpose is to enforce community standards of decency, fairness and reasonableness in commercial transactions. Moreover, according to the Official Comments, it supplements other provisions of the PECL, and it may take precedence over other provisions when a strict adherence to them would lead to a manifestly unjust result.⁶⁷⁸

The principle of good faith is widely referred to in arbitral cases and applied in the interpretation⁶⁷⁹, performance⁶⁸⁰ or termination of contracts.⁶⁸¹ It has also become an integral part of the transnational theory of arbitration and modern *lex mercatoria* doctrine.⁶⁸² The

⁶⁷⁵ Official Comment 3 to Article 1.7 of the UNIDROIT Principles

⁶⁷⁶ UNIDROIT 1977 – Study L – Doc. 12, Rome, May 1977, at 3; UNIDROIT 1978 – Study L – Doc. 14, Rome, June 1978, at 6; UNIDROIT 1979 – Study L – Doc. 15, Rome, January 1979, at 23

⁶⁷⁷ UNIDROIT 1992 – P.C. – Misc. 18, Rome, May 1992, at 66, 67

⁶⁷⁸ Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law, Parts I and II*, Kluwer Law International, 2000, at 113

⁶⁷⁹ Ad hoc Award of 1954, *The Alsing Trading Company, Ltd., and the Swedish Match Company vs. The Greek State*, in Schwebel, Stephen M., *The Alsing Case*, *International and Comparative Law Quarterly*, 8 (1959), at 333-334; Zurich Chamber of Commerce, Preliminary Award, November 25, 1994, *Yearbook Commercial Arbitration*, 22 (1997) at 218 (applying Swiss law)

⁶⁸⁰ ICC Final Award in Case No. 6283 of 1990, *Yearbook Commercial Arbitration*, 17 (1992), at 181 (applying Belgian Law); Cairo Regional Centre for International Commercial Arbitration Final Award of 21 Dec. 1995, *Yearbook Commercial Arbitration*, 22 (1997), at 17-18 (applying Egyptian law); Arbitral Award, March 15, 1963, *Sapphire International Petroleum Ltd. vs. National Iranian Oil Company*, *International Law Reports*, (1967), at 183; Ad Hoc UNCITRAL Award of 17 November 1994, *Banque Arabe et Internationale d’Investissements et al v Inter-Arab Investment Guarantee Corporation*, *Yearbook Commercial Arbitration*, 21 (1996) at 34; ICC Partial Award in Case No. 3267, *Yearbook Commercial Arbitration*, 7 (1982), at 100 (deciding as “*amiable compositeurs*”); *Société Européenne d’Études et d’Entreprise v. Yugoslavia*, *International Law Reports* (1957), at 765-66; ICC Award in Case No. 1784, 1975, *Yearbook Commercial Arbitration*, 2 (1977), at 150 (applying French law); ICC Award on the Merits in Case No. 2114, *Yearbook Commercial Arbitration*, 5 (1980), at 190 (applying Swiss law)

⁶⁸¹ Hamburg Chamber of Commerce, Partial Award of 21 March 1996, *Yearbook Commercial Arbitration*, 22 (1997), at 42 (applying German law); ICC Final Award in Case No. 8362, 1995, *Yearbook Commercial Arbitration*, 22 (1997), at 168-169 (applying New York law); ICC Partial Award in Case No. 5073, 1986, *Yearbook Commercial Arbitration*, 13 (1988), at 65 (applying California Law)

⁶⁸² Schmitthoff, Clive M., *International Trade Usages*, *Institute of International Business Law and Practice Newsletter, Special Issue*, ICC Publication 440/4, Paris 1987, at 47; Lowenfeld, Andreas F., *Lex Mercatoria: An Arbitrator's View*, *Arbitration International*, (1990), at 148; Molineaux, Charles, *Moving Toward a Lex Mercatoria - A Lex Constructionis*, *Journal of International Arbitration*, 14-1 (1997), at 64; Mustill, Michael,

prevalence of good faith in the doctrine, international arbitration and international restatements of contract principles may appear in conflict with the general preferences in international contracting practices, which reflect an Anglo-American style of drafting as a product of fact-oriented adversarial method of litigation. It might be argued that when the contractual parties rely exclusively on detailed and specific contractual clauses to regulate their business relationship and forego vague standards in the contract, the decision maker should view the absence of such standards as indicating the parties' preference to prevent the decision maker from implying the standard of good faith and fair dealing into the contract, and to limit the task of the decision maker to the enforcement of precise terms of the contract on the basis of the self-interested evidence presented by the parties.⁶⁸³

However, the parties' consent to international arbitration as the dispute resolution mechanism can be considered as an indication of their willingness to have their dispute to be resolved in the light of rules and principles better adapted to the international and commercial or economic nature of the transaction at stake under a more informal, less adversarial mode of resolution. While Anglo-American lawyers and their style of contracting has influenced the international contracting practices, continental European lawyers and their transnational theory of arbitration and modern *lex mercatoria* doctrine have exerted persuasive authority on the practice of international arbitration, partly due to the limited United States and English involvement in international arbitration prior to World War II and for a considerable period subsequent to it.

Since the beginning of the twentieth century, the continental European theories and doctrines about transnational arbitration and *lex mercatoria* have sought to establish an intellectual discourse or legal tradition of international arbitration and a number of European centers for the conduct of an international arbitration practice. First, invoking the specific historical circumstances surrounding the concept of arbitration, they have succeeded in devising an autonomous juristic entity characterized by its flexibility of approach to application of the law by the arbitrators on the basis of the reasonable expectations of the parties having appointed them. This idea has been recognized by the arbitration laws of national legal systems of continental Europe, and the rules of ICC, whose headquarters are located in France. Secondly, these discourses have promoted the choice of specifying a continental European site of dispute resolution, such as Swiss cities, which have benefited from a tradition of business law practice, cosmopolitanism and neutrality.⁶⁸⁴ In those countries, the absence of monopoly of specialists in national and international commercial law, within the judiciary and the bars, was

The New *Lex Mercatoria*: The First Twenty-five Years, *Arbitration International*, (1988), at 111; Goldman, Berthold, *The Applicable Law: General Principles of Law - the Lex Mercatoria*, in Julian D. M. Lew (ed.), *Contemporary Problems in International Arbitration*, London, 1986, at 116; Berger, Klaus Peter, *The Creeping Codification of the Lex Mercatoria*, *Kluwer Law International*, The Hague, 1999, at 167; Steyn, Johan, *Contract Law: Fulfilling the Reasonable Expectations of Honest Men*, *Law Quarterly Review*, 113 (1997), at 438; Gaillard, Emmanuel & John Savage (eds.), *Fouchard, Gaillard, Goldman on International Commercial Arbitration*, *Kluwer Law International*, 1999, at 819; Craig, W. Laurence, William W. Park & Jan Paulsson, *International Chamber of Commerce Arbitration*, *Oceana Publications*, 3rd ed., 2000, at 639, Carbonneau Thomas E., *A Definition of and Perspective upon the Lex Mercatoria Debate*, in Thomas E. Carbonneau (ed.), *Lex mercatoria and arbitration: a discussion of the new law merchant*, *Kluwer Law International*, Rev. ed., 1998, at 17; Cremades, Bernardo M., *Practitioners' Notebook: The Impact of International Arbitration on the Development of Business Law*, *American Journal of Comparative Law*, 31 (1983), at 526

⁶⁸³ Scott, Robert E. & George G. Triantis, *Anticipating Litigation in Contract Design*, *Yale Law Journal*, 115 (2006), at 844

⁶⁸⁴ Shapiro, Martin, *Globalization of the Freedom of Contract*, in Harry N. Scheiber (ed.), *The State and Freedom of Contract (Making of Modern Freedom)*, *Stanford University Press*, 1998, at 294

conducive to the recognition of the existence of an arbitral justice, where it was accorded a relatively large degree of autonomy with respect to national courts, thereby leaving room for the idealist legal theories of professors, some judges and atypical practitioners to exert an influence on international arbitration.⁶⁸⁵ Thus, until recently, the laws of continental European sites of arbitration offered greater finality of awards than those of the United States or England, by limiting the extent of scope of review under a setting aside proceedings and preventing more effectively the courts from re-litigating the disputed issues.

On the other hand, in the United States, until 1970s, the cross-border disputes were not part of the practice of major law firms, and arbitration was associated with the relatively low status and perceived intellectual content of domestic arbitration in the sense of the less formal, compromise oriented arbitration largely practiced in labor and smaller commercial conflicts under the auspices of the AAA.⁶⁸⁶ The practice of the AAA was criticized by the practitioners for the “amateur” arbitrators’ invariable tendency to split the difference without reasoned opinions.⁶⁸⁷ Moreover, it was relatively easy to avoid an arbitration clause by means of an allegation that an issue of federal law was involved, which would be taken up by the federal courts.⁶⁸⁸ Consequently, the US arbitration practice generally did not attract major law firms, so the issues that arose from international arbitrations were not prevalent in the US legal scene. This situation continued until the arbitrations of oil disputes between American companies and other countries, which attract major law firms into the international arbitration, and probably contributed to the US ratification of the New York Convention in 1970.⁶⁸⁹ In 1985, the US Supreme Court in *Mitsubishi* case expressed its confidence in the ability of international arbitral tribunals to render correct judgments on the issues of federal law by referring to the policies favoring international commercial arbitration, which, in the Court’s view, was illustrated by the implementation of the New York Convention in the United States.⁶⁹⁰ In this context, the AAA gradually moved to a new set of rules for international

⁶⁸⁵ Dezalay, Yves & Bryant G. Garth, *Dealing in Virtue: International Commercial Arbitration and the Construction of a Transnational Legal Order*, University of Chicago Press, 1996, at 123, 303

⁶⁸⁶ *Ibid.*, at 52

⁶⁸⁷ *Ibid.*, at 153 fn 5

⁶⁸⁸ *Ibid.*, at 154

⁶⁸⁹ E.g. *Ad hoc Award*, June 1953, *Ruler of Qatar vs. International Marine Oil Company, Ltd.*, *International Law Reports*, (1953), p. 534; *Ad hoc Award*, August 23, 1958, *Saudi Arabia vs. Arabian American Oil Co. (ARAMCO)*, *International Law Reports*, 27 (1963), p. 117; Dezalay, Yves & Bryant G. Garth, *Dealing in Virtue: International Commercial Arbitration and the Construction of a Transnational Legal Order*, University of Chicago Press, 1996, at 75 arguing that “The petroleum disputes were founding acts. They made arbitration known and recognized.”

⁶⁹⁰ *Mitsubishi Motors v. Soler Chrysler-Plymouth*, 473 U.S. 614 (1985) at 626-627, 629, 631, 636-638: The Court noted that “we are well past the time when judicial suspicion of the desirability of arbitration and of the competence of arbitral tribunals inhibited the development of arbitration as an alternative means of dispute resolution.” The Court pointed out that: “concerns of international comity, respect for the capacities of foreign and transnational tribunals, and sensitivity to the need of the international commercial system for predictability in the resolution of disputes require that we enforce the parties’ agreement, even assuming that a contrary result would be forthcoming in a domestic context.” It is stated that “at least since this Nation’s accession in 1970 to the [New York] Convention,... and the implementation of the Convention in the same year by amendment of the Federal Arbitration Act, [the emphatic federal policy in favor of arbitral dispute resolution] applies with special force in the field of international commerce.” The Court also considered that “To be sure, the international arbitral tribunal owes no prior allegiance to the legal norms of particular states; hence, it has no direct obligation to vindicate their statutory dictates. The tribunal, however, is bound to effectuate the intentions of the parties. Where the parties have agreed that the arbitral body is to decide a defined set of claims which includes, as in these cases, those arising from the application of American antitrust law, the tribunal therefore

arbitrations, which brought the AAA rules in line with the standards of international commercial arbitration, which have been established under a continental European approach.⁶⁹¹

Although, England was actively involved in arbitration of international commercial disputes, dominated by shipping, commodities, insurance and construction, arbitration was deemed as an adjunct of the national court process, since both substantive and procedural English law governed international arbitration as a result of the historical development of English arbitration law. The tenor of English arbitration law was to strengthen and refine the links between arbitration and courts, in contrast to the transnational theory of arbitration that aimed at breaking those links.⁶⁹² Therefore, there was essentially English arbitration of international commercial disputes, as opposed to English participation in international commercial arbitration. The image of English arbitration of international commercial disputes was very legalistic and dominated by a small group of barristers and judges, who were expert in English commercial law and commercial practice. English participation in international commercial arbitration did not fully occur until the efforts of internationally minded figures in the legal scene of English arbitration culminated in England's ratification of New York Convention in 1975 and adoption of 1979 Arbitration Act, which weakened the judicial control of the courts, and the recreation of the London Court of International Arbitration as an arbitration center capable of competing with the ICC.⁶⁹³ Finally, in 1996, English Arbitration Act was adopted; an instrument that was strongly influenced by the UNCITRAL Model Law on International Commercial Arbitration although not incorporating it.⁶⁹⁴

should be bound to decide that dispute in accord with the national law giving rise to the claim." Thus, the Court concluded that "Having permitted the arbitration to go forward, the national courts of the United States will have the opportunity at the award-enforcement stage to ensure that the legitimate interest in the enforcement of the antitrust laws has been addressed... As international trade has expanded in recent decades, so too has the use of international arbitration to resolve disputes arising in the course of that trade. The controversies that international arbitral institutions are called upon to resolve have increased in diversity as well as in complexity. Yet the potential of these tribunals for efficient disposition of legal disagreements arising from commercial relations has not yet been tested. If they are to take a central place in the international legal order, national courts will need to "shake off the old judicial hostility to arbitration," ..., and also their customary and understandable unwillingness to cede jurisdiction of a claim arising under domestic law to a foreign or transnational tribunal. To this extent, at least, it will be necessary for national courts to subordinate domestic notions of arbitrability to the international policy favoring commercial arbitration."

⁶⁹¹ Dezalay, Yves & Bryant G. Garth, *Dealing in Virtue: International Commercial Arbitration and the Construction of a Transnational Legal Order*, University of Chicago Press, 1996, at 160

⁶⁹² Mustill, Michael, *Transnational Arbitration and English Law*, *Current Legal Problems*, (1984), at 135

⁶⁹³ Dezalay, Yves & Bryant G. Garth, *Dealing in Virtue: International Commercial Arbitration and the Construction of a Transnational Legal Order*, University of Chicago Press, 1996, at 137

⁶⁹⁴ Steyn, Johan, *England: the Independence and/or Impartiality of Arbitrators in International Commercial Arbitration*, *Special Supplement, ICC International Court of Arbitration Bulletin: Independence of Arbitrators*, 2007, at 90; In *Lesotho Highlands Development Authority v. Impreglio SpA and others* [2005] UKHL 43, the House of Lords cited the statement of Lord Wilberforce during the second reading of the 1996 Act in the House of Lords. Lord Wilberforce played a large role in the enactment of the Arbitration Act, and explained the essence of the new philosophy enshrined in the act as follows: "I would like to dwell for a moment on one point to which I personally attach some importance. That is the relation between arbitration and the courts. I have never taken the view that arbitration is a kind of annex, appendix or poor relation to court proceedings. I have always wished to see arbitration, as far as possible, and subject to statutory guidelines no doubt, regarded as a freestanding system, free to settle its own procedure and free to develop its own substantive law - yes, its substantive law. I have always hoped to see arbitration law moving in that direction. That is not the position generally which has been taken by English law, which adopts a broadly supervisory attitude, giving substantial powers to the court of correction and otherwise, and not really defining with any exactitude the relative positions of the arbitrators and the courts. Other countries adopted a different attitude and so does the UNCITRAL model law. The difference

It is observed that, with the later involvement of Anglo-American law firms, the international arbitration has become more judicial, formal and expensive, much like US litigation.⁶⁹⁵ It is suggested that the shift from the small group of European professors to the increasingly powerful transnational law firms dominated by the Anglo-American practitioners has led to a relative decline in the role of the modern *lex mercatoria* doctrine, which have already been criticized by the Anglo-American legal community for its lack of precision and the discretion it gives to the arbitrators.⁶⁹⁶ A key strength of Anglo-American practitioners has been in mustering the facts, while the continental European lawyers' primary focus has been the applicable law.⁶⁹⁷ In the current context, the arbitration may be seen as becoming more rational, routinized and manageable as part of business relations in most of the cases, as a result of the experience accumulated over the years by those law firms with regard to the contract drafting, which covers most of the contingencies that may arise in the course of the contractual relationship, and the effect of their usual arms of adversarial procedure, discovery and cross-examination.⁶⁹⁸

between our system and that of others has been and is, I believe, quite a substantial deterrent to people to sending arbitrations here. ... How then does this Bill stand in that respect? After reading the debates and the various drafts that have been moving from one point to another, I find that on the whole, although not going quite as far as I should personally like, it has moved very substantially in this direction. It has given to the court only those essential powers which I believe the court should have; that is, rendering assistance when the arbitrators cannot act in the way of enforcement or procedural steps, or, alternatively, in the direction of correcting very fundamental errors."

⁶⁹⁵ Dezalay, Yves & Bryant G. Garth, *Dealing in Virtue: International Commercial Arbitration and the Construction of a Transnational Legal Order*, University of Chicago Press, 1996, at 54-57

⁶⁹⁶ *Ibid.*, at 90

⁶⁹⁷ *Ibid.*, at 108

⁶⁹⁸ Essentially, party autonomy is the guiding principle in determining the procedure to be followed in an international commercial arbitration. This principle has been endorsed in national laws and by international arbitral institutions, such as Article 19(1) of the UNCITRAL Model Law, Article 15 (1) of the ICC Rules, Article 14 (1) of the LCIA Rules and Article 16 (1) of the AAA ICDR Rules. In this context, the rules of procedure that commonly apply in international arbitration reflect a mixture of common law and civil law approaches, but they also appear to be evolving more in common law direction that tends to favor adversarial process. Rubinstein, Javier H., *International Commercial Arbitration: Reflections at the Crossroads of the Common Law and Civil Law Traditions*, *Chicago Journal of International Law*, 5 (2004-2005), at 303. The 2010 IBA Rules on the Taking of Evidence in International Commercial Arbitration play an important role in shaping arbitration procedure. They restate and generalize practices that were already in use in international arbitration and address such issues as discovery, written witness statements and witness examinations, expert evidence, the admissibility of evidence, and privileges. They are drafted by a working party composed of arbitration specialists with civil-law or common-law backgrounds, who sought to achieve compromise solutions taking into account both common-law and civil-law approaches. Parties can agree on the application of the IBA Rules and, it is observed that, even in the absence of an agreement on their application, arbitral tribunals and counsel often look to the Rules for guidance. Kaufmann-Kohler, Gabrielle, *Globalization of Arbitral Procedure*, *Vanderbilt Journal of Transnational Law*, 36 (2003), at 1324. The IBA Rules exemplifies the method of discovery that has developed in arbitral practice, which aims to bridge the gap between different traditions, by embracing elements drawn from those and denying the broad U.S.-style discovery in international arbitration. Article 3 (3) of the IBA Rules specifically requires that any request for production of documents should contain (1) a statement of the document's identification with reasonable specificity or of a category of documents that are reasonably believed to exist demonstration of its existence, (2) a statement as to how the documents requested are relevant to the case and material to its outcome, and (3) a statement that the documents requested are not in the possession or control of the requesting party, and of the reasons why the requesting party assumes the documents requested are in the possession, custody or control of another party. It is also observed that the arbitrators usually take account of the expectations of the parties, and consider whether the parties come from jurisdictions with broad, limited, or no discovery at all, whether they expected discovery when they entered into the arbitration agreement, or whether they would be surprised to learn that, by agreeing to arbitrate, they had made all their

However, even if the concept of applicable law seems to become more and more secondary with the arrival of the Anglo-American practitioners and their expertise in fact-finding and gathering and adversarial lawyering, the continental European theories of *lex mercatoria* and transnational arbitration still preserve their importance with regard to the disputes over such contingencies that are not covered by the contract and that require the arbitrators to look beyond the four corners of the contract. In essence, the legal backgrounds of those Anglo-American practitioners are not completely foreign to the idea of giving effect to the reasonable expectations of the parties, and the necessity of a contextual approach for the allocation of residual contractual rights, obligations and risks arising from such unspecified contingencies, which constitute the gist of the principle of good faith and fair dealing under *lex mercatoria*.

The principle of good faith is formally recognized in US law. There has been an exponential rise in judicial references to good faith and fair dealing in US case law starting from 1960s, when the UCC was being introduced and adopted by the American state legislatures.⁶⁹⁹ There are some definitions of good faith in the UCC. Under the general definition in Section 1-201(19), “Good Faith means honesty in fact in the conduct or transaction concerned.” In the revised version of Article 1, Section 1-201 (20) defines “Good faith,” as “honesty in fact and the observance of reasonable commercial standards of fair dealing.” Under the special definition in Section 2-103 applicable to merchants in sales transactions, “Good Faith ... means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.”

These definitions have been subject to wide doctrinal writing in US law. The good-faith analysis elaborated by Farnsworth was one of the earliest, and has been greatly influential. Farnsworth criticized the definition of good faith in Article 1 of the UCC, before revision, as being too restrictive since it provided for the criterion of the honesty of the actor and did not include a requirement of reasonableness, as it was required by the special definition in Article 2.⁷⁰⁰ He argued that good faith requires “cooperation on the part of one party to the contract so that another party will not be deprived of his reasonable expectations.”⁷⁰¹ He observed that the primary use of the principle of good faith is as a “rationale” for a court to imply contract terms necessary to “secure the expected benefits of the contract”⁷⁰² to a party or to protect “reasonable expectations.”⁷⁰³

documents available to their adversary. Craig, W. Laurence, William W. Park & Jan Paulsson, *International Chamber of Commerce Arbitration*, Oceana Publications, 3rd ed., 2000, at 452. With respect to witness testimony, it is a wide-spread practice to resort to written witness statements, and the hearing is then limited to cross-examination and to questions posed by the tribunal. Article 8 (3) of the IBA Rules provides that the parties shall present the testimony of their witnesses, and, following direct testimony, any other party may question such witness, in an order to be determined by the arbitral tribunal, and the party who initially presented the witness shall subsequently have the opportunity to ask additional questions on the matters raised in the other parties’ questioning. The provision also allows the arbitral tribunal to ask questions to a witness at any time.

⁶⁹⁹ Summers, Robert S., *The Conceptualization of Good Faith in American Contract Law: A General Account*, in Reinhard Zimmermann & Simon Whittaker (eds.) *Good faith in European contract law*, Cambridge University Press, 2000, at 118-120

⁷⁰⁰ Farnsworth, E.A., *Good Faith Performance and Commercial Reasonableness under the Uniform Commercial Code*, *University of Chicago Law Review*, 30-4 (1963), at 671-672

⁷⁰¹ *Ibid.*, at 669

⁷⁰² *Ibid.*, at 672

⁷⁰³ *Ibid.*, at 669

Summers, another influential scholar on good faith principle in US law, argued that good faith should be conceptualized as an “excluder,” having no “general meaning . . . of its own, and [serving] to exclude a wide range of heterogeneous forms of bad faith.”⁷⁰⁴ According to Summers, good faith cannot be defined in the abstract because “any but the most vacuous general definition of good faith will . . . fail to cover all the many and varied specific meanings that it is possible to assign to the phrase in light of the many and varied forms of bad faith recognized in the cases.”⁷⁰⁵ He based his argument on the idea that the world of contract is an imperfect world inhabited by imperfect lawmakers and contracting parties who cannot foresee and provide in advance against all forms of contractual bad faith that may subsequently arise.⁷⁰⁶ In such a world, bad faith is not susceptible to statutory definition, but can only be identified as illuminated in judicial decisions.⁷⁰⁷

Although, the good faith principle under the UCC was applicable only to contracts covered by the Code, such as sale of goods contracts, letters of credit and security agreements, Restatement (Second) of Contracts acknowledged and extended a widespread general obligation of good faith in major types of contractual relations in US contract law in 1979 (with official promulgation in 1981).⁷⁰⁸ Summers’ excluder analysis clearly influenced the approach of Restatement Second to the principle good faith. Restatement Second does not attempt any definition of good faith in line with Summers’ view. While the language of Section 205 of Restatement Second follows that of the UCC, the official comment accompanying Section 205 makes it clear that the conceptualization of good faith endorsed by the Restatement is very different from that of the UCC in that the good faith may have different meanings depending on the particular context in which it applies.⁷⁰⁹ In the official comment, Restatement Second refers to types of conduct that Summers identifies as bad faith in performance and enforcement.⁷¹⁰

The principle of good faith under US law is supported by a very large body of cases.⁷¹¹ In those cases, one of the important functions of the standard of good faith has been the qualification of the contractual clauses and applicable default rules. This function is a result of the approach of the UCC and the Restatement Second, which emphasizes the context of an agreement, such as usage, course of dealing, course of performance, and other factors present

⁷⁰⁴ Summers, Robert S., “Good Faith” in General Contract Law and the Sales Provisions of the Uniform Commercial Code, *Virginia Law Review*, 54 (1968), at 201

⁷⁰⁵ *Ibid.*, at 206

⁷⁰⁶ Summers, Robert S., *The Conceptualization of Good Faith in American Contract Law: A General Account*, in Reinhard Zimmermann & Simon Whittaker (eds.) *Good faith in European contract law*, Cambridge University Press, 2000, at 135

⁷⁰⁷ Summers, Robert S., “Good Faith” in General Contract Law and the Sales Provisions of the Uniform Commercial Code, *Virginia Law Review*, 54 (1968), at 215

⁷⁰⁸ Section 205 of Restatement (Second) of Contracts: “Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement”.

⁷⁰⁹ Section 205 of Restatement (Second) of Contracts, comment (a): “The phrase good faith is used in a variety of contexts, and its meaning varies somewhat with the context.”

⁷¹⁰ Dubroff, Harold, *The Implied Covenant of Good Faith in Contract Interpretation and Gap-Filling: Reviling a Revered Relic*, *St. John’s Law Review*, 80 (Spring 2006), at 593

⁷¹¹ Braucher, Robert, *Interpretation and Legal Effect in the Second “Restatement of Contracts”*, *Columbia Law Review*, 81-1 (Jan., 1981), at 15

in the relationship that gave rise to an agreement. In line with this understanding, the Permanent Editorial Board for the Uniform Commercial Code adopted PEB Commentary No. 10 in 1994, which reflects the view that the sole purpose of the good faith obligation is to protect the reasonable expectations of the parties.⁷¹² The commentary added to the official comment to the former UCC Section 1-203 that, “This section does not support an independent cause of action for failure to perform or enforce in good faith. Rather, this section means that a failure to perform or enforce, in good faith, a specific duty or obligation under the contract, constitutes a breach of that contract or makes unavailable, under the particular circumstances, a remedial right or power. This distinction makes it clear that the doctrine of good faith merely directs a court towards interpreting contracts within the commercial context in which they are created, performed, and enforced, and does not create a separate duty of fairness and reasonableness which can be independently breached.”

However, this comment caused criticisms that there are well-accepted instances in which it would be difficult to find a basis for the cause of action aside from the duty of good faith performance, such as the duty of cooperation and the duty to give notice within a reasonable time.⁷¹³ Against these criticisms, a revised footnote added to the comment that a “breach of such duties gives rise to a cause of action for breach of the contract of which the implied term becomes a part,” and “although such a cause of action arguably has the same practical content as a cause of action based upon a purported breach of Section 1-203, there is an important methodological difference in that this commentary requires that the focus be upon the agreement of the parties and their reasonable expectations.” This is now part of the official comments to revised Article 1, Section 1-304.

Thus, the principle of good faith and fair dealing under US law aims to give effect to the reasonable expectations of the contracting parties. On the basis of reasonable expectations, the principle of good faith and fair dealing has a close connection with the contract of the parties and qualifies both the contractual clauses and relevant default rules, by creating exceptions to them, modifying their effects or strengthening their enforcement, depending on the circumstances of the case. Since the principle can be employed for varying purposes in a case-specific manner, as in addressing the questions of bad faith, it is inherently uncertain.

English law, on the other hand, does not have anything equivalent to the general concept of good faith found in the civil law or US law, since the predictability of the legal outcome of a case is considered more important than absolute justice.⁷¹⁴ English law starts from the premises of individualism, in which the parties are expected to look after their own interests and to bargain to obtain the best terms which they can for themselves. The traditional hostility towards the recognition of a doctrine of good faith can be seen in the decision of the House of Lords in *Walford v. Miles*, where Lord Ackner refused to imply a term that the parties would continue negotiate in good faith on the ground that “the concept of a duty to carry on

⁷¹² The Permanent Editorial Board (“PEB”) for the Uniform Commercial Code is a body under the joint control of the American Law Institute and the National Conference of Commissioners on Uniform State Laws. The PEB, from time to time, issues commentary on the U.C.C. which “seek to further the underlying policies of the UCC by affording guidance in interpreting and resolving issues raised by the UCC and/or the Official Comments.” Dubroff, Harold, *The Implied Covenant of Good Faith in Contract Interpretation and Gap-Filling: Reviling a Revered Relic*, *St. John's Law Review*, 80 (Spring 2006), at 611

⁷¹³ Farnsworth, E.A., *Good Faith in Contract Performance*, in Jack Beatson and Daniel Friedmann (ed.) *Good Faith and Fault in Contract Law*, Oxford University Press, 1995, at 165

⁷¹⁴ Goode, Roy, *The concept of "Good Faith" in English law*, *Centro di Studi e Ricerche di Diritto Comparato e Straniero, Saggi, conferenze e seminari 2*, Rome, 1992

negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations.” He argued that “Each party to the negotiations is entitled to pursue his (or her) own interest, so long as he avoids making misrepresentations.”⁷¹⁵ However, the commitment to individualism is not an absolute one and there are piecemeal exceptions, which aim to give effect to the reasonable expectations of the parties.

English law is reluctant to embrace broad general principles, and develops incrementally and by analogy to existing precedents.⁷¹⁶ An often quoted decision has expressed this reluctance clearly: “English law has, characteristically, committed itself to no such overriding principle [as the principle of good faith] but has developed piecemeal solutions in response to demonstrated problems of unfairness. Many examples could be given. Thus equity has intervened to strike down unconscionable bargains. Parliament has stepped in to regulate the imposition of exemption clauses and the form of certain hirepurchase agreements. The common law also has made its contribution, by holding that certain classes of contract require the utmost good faith, by treating as irrecoverable what purport to be agreed estimates of damage but are in truth a disguised penalty for breach, and in many other ways.”⁷¹⁷ English law tends to deal pragmatically with cases of perceived bad faith since the courts are more open in addressing the questions of bad faith. It has been argued that English law arrives indirectly at outcomes which would be achieved more directly if an overriding principle of good faith were recognized.⁷¹⁸

It should also be noted that some English judges and scholars question whether English law’s recourse to piecemeal solutions to achieve many of the results, which good faith is perceived to require, is satisfactory.⁷¹⁹ Brownsword argues that English contract law is moving in a direction that should enable it to extend its minimal protective function, by securing reasonable expectations of the parties, with commercial community’s own accepted standards of fair dealing as the background for those expectations.⁷²⁰ He observes that although a doctrine of good faith has not been explicitly adopted in English law, bad faith is regulated indirectly and there is a discernible movement to bring contract law and the practice and expectations of the contracting community more closely into alignment with one another.⁷²¹ He argues that the principle of good faith acts as a conduit through which community standards of fair dealing can be fed directly into the body of contract law, and its recognition is a precondition for a vision of contract as a co-operative venture rather than the traditional individualistic terms of the free market.⁷²²

⁷¹⁵ *Walford v. Miles* [1992] 2 AC 128

⁷¹⁶ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 267

⁷¹⁷ Judge Brimham LJ in *Interfoto Picture Library Ltd. v. Stiletto Visual Programmes Ltd.* [1988] 2 W.L.R. 615

⁷¹⁸ Brownsword, Roger, *Contract Law, Co-operation, and Good Faith: the Movement from Static to Dynamic Market Individualism*, in Simon Deakin and Jonathan Michie (eds.) *Contracts, Co-operation, and Competition: Studies in Economics, Management, and Law*, Oxford University Press, 1997, at 267

⁷¹⁹ Whittaker, Simon & Reinhard Zimmermann, *Good faith in European Contract Law: Surveying the Legal Landscape*, in Reinhard Zimmermann and Simon Whittaker (eds.), *Good faith in European Contract Law*, Cambridge University Press, 2000, at 47

⁷²⁰ Brownsword, Roger, *Contract Law, Co-operation, and Good Faith: the Movement from Static to Dynamic Market Individualism*, in Simon Deakin and Jonathan Michie (eds.) *Contracts, Co-operation, and Competition: Studies in Economics, Management, and Law*, Oxford University Press, 1997, at 255

⁷²¹ *Ibid.*, at 257

⁷²² *Ibid.*, at 272

Alternatively, McKendrick points out the peculiar position of English law, which stands out from the general approach in the order of international commerce, as can be seen in many other national laws, the CISG, the PECL and the UNIDROIT Principles with regard to the recognition of the principle of good faith. He argues that if English law is to embrace international conventions or to play role in the development of the Principles of European Contract Law, it must begin to get grips with the language of good faith. He maintains that it may not be possible for English contract law to resist the commercial and economic pressure in favor of an increasingly unified law of contract, which contains a significant role for the principle of good faith.⁷²³

Lord Steyn observes that in view of the needs of the international market place, and the primacy of European Union law, English law cannot avoid coming to terms with the concept of good faith. On the other hand, although not hostile to the notion, he believes that there is no need for English law to introduce a general duty of good faith as long as English courts respect the reasonable expectations of parties in accordance with English law's own pragmatic traditions. He argues that, the goal or purpose of English contract law, which is based on an objective theory, is the protection of reasonable expectations.⁷²⁴ In his view, there is not much difference between the objective requirement of good faith and the reasonable expectations of parties.⁷²⁵ He stated, as a judge, in the case *First Energy (UK) Ltd v. Hungarian International Bank Ltd.* that "A theme that runs through our law of contract is that the reasonable expectations of honest men must be protected. It is not a rule or principle of law. It is the objective which has been and still is the principal moulding force of our law of contract. It affords no license to a Judge to depart from binding precedent. On the other hand, if the prima facie solution to a problem runs counter to the reasonable expectations of honest men, this criterion sometimes requires a rigorous re-examination of the problem to ascertain whether the law does indeed compel demonstrable unfairness."⁷²⁶ Lord Steyn defines reasonable expectations as those expectations that are, in an objective sense, common to both parties and satisfy an objective criterion of reasonableness, which postulates community values in the form of usages and practices of dealings.⁷²⁷ He argues that the English law of contract draws its strength and vitality from a close adherence to the reasonable expectations of the contracting parties.⁷²⁸

It can be said that the appeal of the concept of reasonable expectations to common lawyers results from the equitable doctrines of estoppel.⁷²⁹ One of the main purposes of estoppel is to

⁷²³ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 269

⁷²⁴ "English law generally adopts an objective theory of contract formation. That means that in practice our law generally ignores the subjective expectations and the unexpressed mental reservations of the parties. Instead the governing criterion is the reasonable expectations of honest men." *G Percy Trentham Ltd v Archital Luxfer Ltd* [1993] 1 Lloyd's Rep 25 at 27 (Steyn LJ).

⁷²⁵ Steyn, Johan, *Contract Law: Fulfilling the Reasonable Expectations of Honest Men*, *Law Quarterly Review*, 113 (1997), at 439

⁷²⁶ *First Energy (UK) Ltd V Hungarian International Bank Ltd* (1993) 2 Lloyd's Rep 194 CA, at 196

⁷²⁷ Steyn, Johan, *Contract Law: Fulfilling the Reasonable Expectations of Honest Men*, *Law Quarterly Review*, 113 (1997), at 434

⁷²⁸ *Ibid.*, at 442

⁷²⁹ *Ibid.*, at 440: "Promissory estoppel is often used to soften the rigidity of classical contract law solutions in order to give effect to the reasonable expectations of parties."

protect reliance of a party, where he has acted upon the belief that the other party would do or abstain from doing a certain thing.⁷³⁰ Reliance in the concept of estoppel and reasonable expectations are similar concepts, provided that the reliance can be established for cases other than the conduct of a party, namely the expectations arising from both the internal and external context of the transaction. The flexibility of the concept of reasonable expectations enables common lawyers to infuse a greater dose of equity in contract law. Thus, it is possible to observe that reasonable expectations are protected in English law on a basis which is analogous to, or sometimes even explicitly based on, doctrines of estoppel.⁷³¹

Thus, it can be argued that, at a functional level in the order of international commerce, the difference between the approaches of common law and civil law to good faith may be less significant than frequently suggested.⁷³² However, in view of its effect on the contractual clauses and the default rules, the principle of good faith and fair dealing is an important source of legal uncertainty since neither its applicability nor the results of its application can be established *ex ante*.⁷³³ Thus, this principle may lead to arbitrary derogations from the principle of sanctity of contracts on the basis of the abstract reasoning of the decision maker. In the doctrine, this issue is generally approached as a question of which is the rule and which is the exception. This approach was also apparent in the meetings of Working Group for the preparation of UNIDROIT Principles. Considering that good faith principle is usually applied with a view to interfering with the binding force of what parties freely agreed to, it was suggested to include a direct reference to the principle of good faith in the comments to Article 1.3 as an exceptional case of modification or termination without agreement.⁷³⁴ This was rejected because of the general nature of the principle of good faith, which could be referred to almost in any rule of the Principles⁷³⁵ and, which could go too far, in contrary to the purpose of the Article 1.3 that, in some specific cases, there might have been derogations from the binding force of the contract.⁷³⁶

⁷³⁰ *McIlkenny v Chief Constable of the West Midlands* [1980] QB 283 at 316-317: “The word “estoppel” only means stopped. You will find it explained by Coke in his Commentaries on Littleton (19th ed, 1832), vol. II, s. 667, 352a. It was brought over by the Normans. They used the old French “estoupail.” That meant a bung or cork by which you stopped something from coming out. It was in common use in our courts when they carried on all their proceedings in Norman-French. Littleton writes in the law-French of his day (15th century) using the words “pur ceo que le baron est estoppe a dire,” meaning simply that the husband is stopped from saying something. From that simple origin there has been built up over the centuries in our law a big house with many rooms. It is the house called Estoppel. In Coke's time it was a small house with only three rooms, namely, estoppel by matter of record, by matter in writing, and by matter in pais. But by our time we have so many rooms that we are apt to get confused between them. Estoppel per rem judicatam, issue estoppel, estoppel by deed, estoppel by representation, estoppel by conduct, estoppel by acquiescence, estoppel by election or waiver, estoppel by negligence, promissory estoppel, proprietary estoppel, and goodness knows what else. These several rooms have this much in common: They are all under one roof. Someone is stopped from saying something or other, or doing something or other, or contesting something or other.”

⁷³¹ Cartwright, John, Protecting Legitimate Expectations and Estoppel in English Law, *Electronic Journal of Comparative Law*, 10.3 (December 2006), available at <http://www.ejcl.org/103/article103-6.pdf>, at 22

⁷³² Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 169

⁷³³ Hesselink, Martijn W., The Concept of Good Faith, in A.S. Hartkamp, E.H. Hondius, M.W. Hesselink, C.E. du Perron & M. Veldman, (eds.), *Towards A European Civil Code*, Kluwer Law International, 2004, at 474

⁷³⁴ UNIDROIT 1992 – P.C. – Misc. 18, Rome, May 1992 at 49 and UNIDROIT 1994 – P.C. – Misc. 19, Rome, January 1994, at 28

⁷³⁵ UNIDROIT 1992 – P.C. – Misc. 18, Rome, May 1992 at 50

⁷³⁶ UNIDROIT 1994 – P.C. – Misc. 19, Rome, January 1994, at 28-29

However, as observed in some arbitral awards, the relationship between those two principles is not limited to questions of which is the rule and which is the exception, but the arbitrators may simultaneously characterize the *pacta sunt servanda* and the principle of good faith as general principles of law reinforcing each other.⁷³⁷ This can be attributed to the influence of transnational theory of arbitration, which has utilized the well-established principle of good faith in treaty relations under public international law. Under international law, *pacta sunt servanda* is considered as an expression of the principle of good faith, which signifies the keeping of faith.⁷³⁸ This understanding was employed by the transnational theory of arbitration to provide a legal basis on the basis of general principles of law for state's liability for breaching its obligations towards foreign investors.

In the order of international commerce, as the consent to be legally bound is a necessary condition of the contractual rights and obligations, the principles of freedom of contract and sanctity of contracts denote the binding force of specific allocations of contractual rights, obligations and risks that have been made by the contracting parties through contractual clauses and the chosen set of default rules, whereas the principle of good faith and fair dealing implies the binding force of residual allocations of contractual rights, obligations and risks within the scope of the relevant contract, by the *ex post* decision maker, whose jurisdiction arises from the consent of the parties. Under *lex mercatoria*, the basic principle of good faith and fair dealing requires the contracting parties to take into account the knowledge and interests of the elements of the legal order in which they operate, in order avoid disturbances in the order when deciding whether to become bound by a contract. The disturbance in the order can only be avoided through the correspondence of the expectations of the contracting parties with those of other elements of the order, on which the parties' plans are based. This correspondence of the expectations that determine the actions of different elements is the form in which order manifests itself and enables the contracting parties to make feasible plans and to effectively follow their purpose.

By becoming part of the contracting parties' cost of enabling the correspondence of expectations in the order, the knowledge of the established rules is brought to bear on the allocational *ex post* decision with regard to the residual contractual rights, obligations and risks. The contracting parties are compelled to take that knowledge into account without requiring that they have direct access to the necessary knowledge provided that it is possible for the parties to be in a position to adapt their conduct to their ignorance of such knowledge

⁷³⁷ ICC Award in Case No. 5953, *Journal du Droit International*, (1990), at 1060: (referring to “*pacta sunt servanda bona fide*” as a principle of *lex mercatoria*); *Ad hoc Award*, April 12, 1977, *Liamco v. Libya*, *Yearbook Commercial Arbitration*, (1981), at 102: (referring to UNGA Resolution No. 1803 of 14 December 1962, which declares in Paragraph I, 8, that: “Agreements relative to foreign investments freely concluded by sovereign States or between such States shall be respected in good faith.”); *Ad hoc award*, January 19, 1977, *Texaco vs. Libya*, *Yearbook Commercial Arbitration*, (1979), at 184: (referring to the principle of good faith in support of *pacta sunt servanda*, on the basis of the consideration that it would be against the principle of good faith in contracts between a State and a foreign party when only the latter would be bound.); *Ad Hoc Award of April 30, 1982*, *Yearbook Commercial Arbitration*, (1983), at 116 (holding that the idea that, in questions relating to sovereignty, the opinion publicly declared by a State at a given time, has only an instantaneous value and that the State can never legally bind itself, either directly or indirectly, through a State organizations “contradicts both the general principle of good faith and the fundamental principle *pacta sunt servanda*, both principles forming the basis of all contractual relations, particularly in international affairs, and which are specifically enshrined in international commercial usages and international law”)

⁷³⁸ Cheng, Bin, *General Principles of Law as Applied by International Courts and Tribunals*, Cambridge: Grotius Publications, 1987, at 113

through abstractions. Thus, the principle of good faith and fair dealing requires the ex post decision maker to mentally reconstruct this tacit knowledge of the parties through a contextual approach and to tell them what ought to have guided their expectations, by revealing the established rules in the particular circumstances which they ought to have known and which become applicable as a result of the conclusion of their particular contract.

The principle of good faith and fair dealing under *lex mercatoria* is a substantive framework for the decision maker's determination of established rules in the particular case that give rise to those expectations which the parties in a transaction would have reasonably formed on the basis of their knowledge of the particular circumstances of time and place. Therefore, the basic principle of good faith and fair dealing is the central standard for *lex mercatoria* as the law of principled adjudication. It is the main means for the decision maker applying *lex mercatoria* to give effect to those expectations, which should be protected in order to maximize the fulfillment of expectations of the elements of the spontaneous order of international commerce as a whole, given that the common interest of all those elements is the ability to make feasible plans for individual purposes without impeding the very order, which provides this ability. Thus, the principle of good faith and fair dealing requires the decision maker to exercise abstract reasoning in specialized consolidations in order to decide in a manner which will correspond to what the reasonable people of the same kind as the actual parties would have expected in the same circumstances.

In this understanding, the principle of good faith and fair dealing is not a norm exclusively providing exceptions to the principles of freedom of contract and sanctity of contracts. As the substantive framework for principled adjudication, it brings more specific and fact-bound rules in particular cases.⁷³⁹ Those rules do not necessarily weaken the binding force of the contract, or impose solidarity and counterbalance the freedom of contract. The principle of good faith and fair dealing may be in favor of other basic principles of *lex mercatoria*, instead of establishing exceptions to them, depending on the circumstances of the case at an ex post stage. This is because the principle of good faith and fair dealing ultimately relates to the capacity of the contracting parties to adapt their conduct both to the particular facts which they know and to other facts they do not or cannot know explicitly, but only tacitly through abstract reasoning. The principle of good faith and fair dealing qualifies ex post other legal norms relevant to a particular contract. It is related to giving effect to reasonable expectations of the parties through a balancing exercise of various interests of elements of the order of international commerce involved in a particular case.

Due to its qualifying function, the principle of good faith is often seen as the highest norm of contract law, or of the law of obligations or even of all private law under some national legal systems.⁷⁴⁰ Many provisions in those national legal systems are said to be based on the principle of good faith, even in the absence of any explicit reference.⁷⁴¹ In a similar vein, it can be argued that, under those national legal systems, the principle of good faith is also understood as a substantive framework for principled adjudication and, thus, certain

⁷³⁹ Carbonneau Thomas E., A Definition of and Perspective upon the *Lex Mercatoria* Debate, in Thomas E. Carbonneau (ed.), *Lex mercatoria and arbitration: a discussion of the new law merchant*, Kluwer Law International, Rev. ed., 1998, at 18

⁷⁴⁰ For example French, German and Swiss laws. Robin, Guy, The Principle of Good Faith in International Contracts, *International Business Law Journal*, (2005), at 696

⁷⁴¹ Hesselink, Martijn W., The Concept of Good Faith, in A.S. Hartkamp, E.H. Hondius, M.W. Hesselink, C.E. du Perron & M. Veldman, (eds.), *Towards A European Civil Code*, Kluwer Law International, 2004, at 472

guidelines are developed by the legislation, legal doctrine or case law in order for the decision makers to utilize when applying the abstract standard of good faith. For example, in the Netherlands, the Civil Code provides in Article 3:12 what should be taken into account in determining what good faith requires in a particular case. The article provides that: “In determining what reasonableness and equity require, reference must be made to generally accepted principles of law, to current juridical views in the Netherlands, and to the particular societal and private interests involved”.⁷⁴² This article is criticized on the ground that those factors can hardly provide any guidance.⁷⁴³ Essentially, it reflects the attempt of the legislature to give some measure of objectivity to the determination of what good faith requires in a particular case in order to avoid a purely subjective decision on the part of the courts. It underlines the necessity for the court to justify its decisions and to provide sufficient insight into its abstract reasoning where the court’s discretion appears to be at its greatest.⁷⁴⁴ The article illustrates, in the application of the principle of good faith, those mentioned sources of abstract reasoning that the decision maker should explicitly add to and combine with the traditional sources of contextual approach in adjudication, such as the nature and purpose of contract and relevant trade usages.⁷⁴⁵

Similarly, the principle of good faith and fair dealing under *lex mercatoria* requires the decision maker to give effect to the reasonable expectations of the parties by explicitly referring to established rules in a particular case on the basis of a contextual approach that utilizes an abstract reasoning in the specialized consolidations of national laws, trade usages or contracting practices, and the balancing of public and private interests involved in the particular case. However, in their approach to international contracts, the national legal systems that admit the principle of good faith conceptually differentiate the sources of contextual approach under the principle of good faith from the rules promulgated by the legal systems, mainly as a result of their conflict of laws approaches. The traditional approach of conflict of laws requires each international contract to be governed by a particular national legal system that turns legal uncertainty into legal risk through formal consolidations. Subsequently, they establish thresholds for the verifiability of expectations as a result of a hierarchy between the sources of contextual approach and the national rules in the resolution of the contractual disputes. This approach limits the decision maker’s capacity for abstractions in the application of the principle of good faith in a particular case by excluding the national rules and comparative analysis from the traditional sources of good faith and fair dealing in the interpretation, supplementation and correction of the contract. Once it becomes possible to dispense with the conceptual distinctions among the national laws, the general principles of law and trade usages on the basis of their normative forces, as it has been possible in the context of international arbitration, the decision maker achieves such a capacity for abstractions in *ex post* consolidations in the application of the principle of good faith and fair dealing so as to take into account all of those materials at equal footing in order to accurately give effect to the reasonable expectations of the parties to a particular dispute.

⁷⁴² *Ibid.*, at 474

⁷⁴³ *Ibid.*, at 497 fn 153

⁷⁴⁴ Kornet, Nicole, *Contract Interpretation and Gap Filling: Comparative and Theoretical Perspectives*, Intersentia, 2006, at 53-54

⁷⁴⁵ ICC Award in Case No 8486, ICC International Court of Arbitration Bulletin, 10-2 (1999), at 70: The Sole Arbitrator applying Dutch law stated that: “The prime decisive factor here, according to Art. 3.12 of the [Dutch Civil Code] is the “legal conviction valid in the Netherlands”. In the case of application of the provision in an international context; this is replaced by the legal convictions valid in international contract law.... These legal convictions are also to be taken into consideration when applying national law to international matters.”

It is argued that good faith is not a norm at all, that there is no inner coherence between specific good faith rules, that any rule could be based on it and, thus, the only role of the principle of good faith is to cover the judge's power to create law by interpreting, supplementing or correcting the rules in a civil legal system.⁷⁴⁶ Essentially, the good faith principle, as a substantive framework for principled adjudication, refers to the decision maker's obligation of taking into account the expectations of the contracting parties and the elements of the relevant order through a contextual approach and discovering the established rules in a particular case rather than creating legal norms. These expectations may relate to each stage of the contractual relationship, such as its formation, performance or termination. In the context of an international contract, these expectations may emerge from trade usages, general principles of law and relevant national laws as materials to be taken into account in a comparative analysis, or as the governing law determined pursuant to the established rules of conflict of laws in a particular case.

The understanding of good faith and fair dealing on the basis of the reasonable expectations is mainly an objective one, as opposed to the subjective good faith, which denotes a state of mind, the knowledge or ignorance of a certain fact. Thus, the concept of good faith should be complemented by that of fair dealing within this basic principle.⁷⁴⁷ Even so, the principle of good faith and fair dealing under *lex mercatoria* has also a subjective aspect in the sense that the decision maker should take into account reasonable expectations of the parties that may arise from their contractual relationship by examining the purpose, nature and internal context of the contract. In this subjective sense, the principle mainly denotes honesty and fairness of mind in the particular circumstances of a contract and precludes a party from exercising a contractual right when he attempts to gain benefits not arising from the purpose and nature contemplated at the time of entering into contract. However, the subjective aspect of the contractual relationship, such as its purpose, nature, and internal context, should be considered in combination with and balanced against those objective considerations.

The decision maker applying *lex mercatoria* will resort to the principle of good faith and fair dealing in order to qualify the articulated rules, which comprise the contractual clauses and

⁷⁴⁶ Hesselink, Martijn W., *The Concept of Good Faith*, in A.S. Hartkamp, E.H. Hondius, M.W. Hesselink, C.E. du Perron & M. Veldman, (eds.), *Towards A European Civil Code*, Kluwer Law International, 2004, at 495

⁷⁴⁷ ICC Award in Case No. 3131, October 26, 1979, *Pabalk vs. Norsolor*, *Yearbook Commercial Arbitration*, 9 (1984), at 110-111: "One of the principles which inspires [international *lex mercatoria*] is that of good faith which must preside the formation and the performance of contracts. The emphasis placed on contractual good faith is moreover one of the dominant tendencies revealed by 'the convergence of national laws on the matter'. (...) Good faith expresses not only a state of mind, the knowledge or ignorance of a fact, but also 'reference to customs, to an ethical rule of conduct ...' (...). It thus expresses a required conduct which can be linked to the general principle of responsibility. In accordance with the principle of good faith which inspires the international *lex mercatoria*, the Tribunal sought to determine whether, in the present instance, the breach of the agency was attributable to the conduct of one of the parties and whether it had caused damage to the other which would thus be without justification and which equity would hence require to be remedied." ICC (Partial) Award in Case No. 5953, September 1, 1988, *Compania Valenciana de Cementos S.A. vs. Primary Coal Inc.*, *Journal du Droit International*, (1990), at 1060: "Parmi ces principes, le plus général est sans doute celui de la bonne foi. Cette exigence fondamentale de bonne foi... (se) trouve dans tous les systèmes de droit, qu'il s'agisse des droits nationaux ou du droit international " (Sentence AMCO du 25 septembre 1983 rendue dans le cadre du C.I.R.D.I. *Revue de l'arbitrage*, 1985, at 268). Elle " est bien de l'essence de la *lex mercatoria* " (B. Goldman, *La lex mercatoria dans les contrats et l'arbitrage internationaux : réalité et perspectives*, *Clunet* 1973, at 483). La bonne foi qui est toujours présumée, doit présider à la négociation des contrats et à leur interprétation comme à leur exécution. La doctrine est unanime et les sentences publiées qui sont la source de droit privilégiée des arbitres le confirment, sans exception."

the chosen set of default rules, on the basis of the established rules in a particular case, which give rise to reasonable expectations of the parties. This qualification will take place through a contextual approach in the interpretation, supplementation and correction of the articulated rules, and require the parties to perform their obligations in good faith and not merely in accordance with the letter of the articulated rules. The contractual parties wishing to limit the materials that are relevant to functioning of the principle of good faith and fair dealing under *lex mercatoria* should have explicit terms in their contracts. However, the principle of good faith is not entirely a default standard which can be opted out by the agreements of the parties. The contractual intentions aimed at limiting the principle of good faith may eventually be preempted by its mandatory character. Particularly, under the principle of good faith and fair dealing, the decision maker cannot tolerate the situations where the enforcement of the contract results in the violation of the public policy forming a part of parties' reasonable expectations through a balancing of relevant interests of the elements of the order of international commerce.

d. Procedural Principles

In the context of international arbitration, there are certain procedural principles of *lex mercatoria* that assure the accuracy in giving effect to the reasonable expectations of the parties by means of the established rules in a particular case. These principles are based on the premise that the utilization of the knowledge of particular circumstances of time and place is only possible if the decisions depending on such knowledge are made with the active cooperation of the holder of that knowledge. They ensure the meaningful utilization of knowledge and the integrity of judicial process where *lex mercatoria* is applied.

The procedural principles of *lex mercatoria* mainly arise from the procedural categories of public policy contents. It is possible to make a distinction between substantive and procedural categories of the public policy contents in the context of international arbitration.⁷⁴⁸ The substantive public policy relates to the recognition of rights and obligations by a tribunal or enforcement court in connection with the subject matter of the award. The procedural categories of public policy relate to the integrity of the process by which the dispute was adjudicated by the arbitral tribunals. Each of these categories performs different functions with regard to the concept of *lex mercatoria*. While the intervention of substantive public policy considerations into the articulated rules can be attributed to the functioning of the principle of good faith and fair dealing under *lex mercatoria* as the law of principled adjudication, the procedural categories provide the necessary safeguards for the proper utilization of the knowledge of particular circumstances of time and place in the control of legal uncertainty on the basis of the specialization of the decision maker.

The category of procedural public policy includes such mandatory rules that aim to prevent serious irregularities in arbitral process. Modern arbitration laws have reduced mandatory rules of law regarding the arbitral procedure to very few provisions.⁷⁴⁹ The right to a reasonable opportunity to be heard and the right to equal treatment in both the constitution of the tribunal and the later proceedings are fundamental procedural principles that may not be violated. The national and international legislations with regard to international arbitration explicitly provide these safeguards to ensure due process. Article V (1)(b) and (d) of the New York Convention requires that a party should be given proper notice of the appointment of the arbitrator or of the arbitration proceedings, that a party should be able to present his case, and that the arbitral procedure should be in accordance with the agreement of the parties, or in accordance with the law of the country where the arbitration took place. The UNCITRAL Model law provides the requirements of equality of treatment under Article 18 and of giving the parties a full opportunity to present their respective cases under Articles 18 and 34(2)(a)(ii).

⁷⁴⁸ Sheppard, Audley, Interim ILA Report on Public Policy as a Bar to Enforcement of International Arbitral Awards, *Arbitration International*, 19-2 (2003), at 228

⁷⁴⁹ Böckstiegel, Karl-Heinz, Major Criteria for International Arbitrators in Shaping an Efficient Procedure, in Special Supplement, *ICC International Court of Arbitration Bulletin: Arbitration in the Next Decade: Proceedings of the International Court of Arbitration's 75th Anniversary Conference*, ICC Publication No. 612, May 1999, at 50. See also Fortier, L. Yves, The Minimum Requirements of Due Process in Taking Measures Against Dilatory Tactics: Arbitral Discretion in International Commercial Arbitration: "A Few Plain Rules and a Few Strong Instincts", in Albert Jan van den Berg (ed.), *Improving the Efficiency of Arbitration Agreements and Awards: 40 Years of Application of the New York Convention*, ICCA Congress Series No. 9, Kluwer Law International, 1999, at 399: "mandatory rules of law of the forum governing the conduct of arbitral proceedings are ... usually limited to the basic requirement, broadly stated, that arbitration is conducted in a manner consistent with due process".

Similarly, Section 33 (1)(a) of the English Arbitration Act of 1996 provides that the tribunal shall act fairly and impartially as between the parties, giving each party a reasonable opportunity of putting his case and dealing with that of his opponent. Moreover, Section 68 (2) of the English Arbitration Act requires that there should not be any serious irregularity in the arbitral proceedings.⁷⁵⁰ Serious irregularity is defined as an irregularity which the court considers has caused or will cause substantial injustice to the aggrieved party. Section 68 lists exhaustively some instances which may constitute serious irregularity, including “the award or the way in which it was procured being contrary to public policy”.⁷⁵¹ Section 1042(1) of the German Civil Code of Procedure provides that the parties shall be treated with equality and each party shall be given a full opportunity of presenting his case. In France, the procedural guarantees are derived from the principle of adversarial proceedings under Article 1502 (4) of the French Code of Civil Procedure. Although French law treats the breach of this principle as a separate ground under this provision, on which an award can be set aside or refused enforcement, the courts have also treated due process as a matter of public policy. Moreover, since the principle of equality of the parties is not considered separately in French law, the courts have had to recognize its existence under the broader concept of international public policy.⁷⁵² It is generally considered that the concept of international public policy under Article 1502 (5) concerns both the procedure and the merits.⁷⁵³ Article 182 (3) of the Swiss Federal Code on Private International Law provides the minimum requirements to be observed irrespective of the procedure followed by the tribunal, namely the requirement of equal treatment of the parties and their right to be heard in adversarial proceedings, which is also stated as a ground for challenging the award under Article 190 (2)(d).

The arbitration rules, which are usually silent as to the duties of the arbitral tribunal, also provide these principles of due diligence. The UNCITRAL Rules requires the parties are treated with equality and that at any stage of the proceedings each party is given a full opportunity of presenting his case.⁷⁵⁴ Institutional arbitration rules, such as those of ICC, AAA, LCIA and SCC, contain similar provisions to the effect that each party must be accorded equality of treatment and given a fair opportunity to present its case.⁷⁵⁵

⁷⁵⁰ Section 68 (3) allows great flexibility in the choice of the remedy, which in principle leads to the case being remitted to the arbitrator to avoid as far as possible the setting aside of the award and a new arbitral procedure.

⁷⁵¹ Section 68 (2) provides a list of serious irregularities, which contains (a) failure by the tribunal to comply with section 33 (general duty of tribunal); (b) the tribunal exceeding its powers (otherwise than by exceeding its substantive jurisdiction); (c) failure by the tribunal to conduct the proceedings in accordance with the procedure agreed by the parties; (d) failure by the tribunal to deal with all the issues that were put to it; (e) any arbitral or other institution or person vested by the parties with powers in relation to the proceedings or the award exceeding its powers; (f) uncertainty or ambiguity as to the effect of the award; (g) the award being obtained by fraud or the award or the way in which it was procured being contrary to public policy; (h) failure to comply with the requirements as to the form of the award; or (i) any irregularity in the conduct of the proceedings or in the award which is admitted by the tribunal or by any arbitral or other institution or person vested by the parties with powers in relation to the proceedings or the award.

⁷⁵² Gaillard, Emmanuel & John Savage (eds.), *Fouchard, Gaillard, Goldman on International Commercial Arbitration*, Kluwer Law International, 1999, at 957

⁷⁵³ Poudret, Jean-Francois & Sebastien Besson, *Comparative Law of International Arbitration*, London: Sweet & Maxwell, 2nd ed., 2007, para. 816

⁷⁵⁴ UNCITRAL Rules 1976 Article 15.1; UNCITRAL Rules 2010 Article 17.1

⁷⁵⁵ ICC Article 15.2, SCC Article 19.2, AAA ICDR Article 16.1; LCIA Article 14.1(i). Although the ICC, LCIA and SCC rules do not expressly mention equality, but the phrases “fairly and impartially” or “in an impartial ... manner” encompass the rationale of the principle of equal treatment.

When the procedural safeguards are not explicitly provided in the applicable arbitration laws or rules, the aggrieved party may still be required to demonstrate that their violation affected the public policy of the country in which the enforcement of the award is sought or the award becomes subject to annulment proceedings.⁷⁵⁶ Thus, there has been a debate as to whether the procedural public policy is covered by the concept of public policy, which varies under national legal systems. For example, the German Federal Supreme Court once held that “From the viewpoint of German procedural public policy, the recognition of a foreign arbitral award can therefore only be denied if the arbitral procedure suffers from a grave defect that touches the foundation of the State and economic functions.”⁷⁵⁷ The Swiss court held that “a procedural defect in the course of the foreign arbitration does not lead necessarily to refusing enforcement even if the same defect would have resulted in the annulment of a Swiss award (with the obvious exception of the violation of fundamental principles of our legal system, which would contrast in an unbearable manner with our feeling of justice)”.⁷⁵⁸ The Netherlands Code of Civil Procedure expressly applies the reservation of public policy to the procedure followed by the arbitrator in that Article 1065(1)(e) allows the setting aside of an award not only when the award but also the way in which it was rendered are contrary to fundamental principles of public policy such as equal treatment of the parties, their right to be heard, impartiality, independence of the arbitrator. Similarly, Article 33(1) (2) of the Swedish Law on Arbitration provides for the invalidity of the award which was rendered in a manner incompatible with the fundamental principles of the Swedish legal system.⁷⁵⁹

The debate results from the lack of a universal concept of public policy and the difference between the common law concept of public policy and the civil law concept of *ordre public*. The latter concept is generally viewed as encompassing principles of procedural justice, while the former is not usually interpreted as broadly. Article V (2)(b) of the New York Convention provides that recognition and enforcement of an arbitral award may be refused if the competent authority in the country where recognition and enforcement is sought finds that the recognition or enforcement of the award would be contrary to the public policy of “that country”. Thus, the New York Convention does not attempt to harmonize the concept of public policy or to establish a common international standard. The UNCITRAL Model Law includes “public policy” as a ground for setting aside an award by the courts at the seat of the arbitration (Article 34) and as a ground for refusing recognition and enforcement of a foreign award (Article 36) but, following the approach of Article V (2) of the New York Convention, the Model Law does not define “public policy” and refers to the public policy of the state that adopted the Model Law.

The question of whether the concept of public policy also includes procedural public policy under the UNCITRAL Model Law was discussed during its preparation. The United Kingdom delegation expressed concern that “public policy”, as understood in common law jurisdictions, might not cover all cases of procedural injustice, such as fraud, corruption or

⁷⁵⁶ Kreindler, Richard H., *Standards of Procedural International Public Policy*, *Stockholm International Arbitration Review*, (2008:2), at 144

⁷⁵⁷ Bundesgerichtshof, 15 May 1986, *Charterer v. Shipowner*, *Yearbook Commercial Arbitration*, 12 (1987), at 489

⁷⁵⁸ *Camera di Esecuzione e Fallimenti, Canton Tessin*, 19 June 1990 (K.S. AG v. C.C. SA), *Yearbook Commercial Arbitration*, 20 (1995), at 764

⁷⁵⁹ Poudret, Jean-Francois & Sebastien Besson, *Comparative Law of International Arbitration*, London: Sweet & Maxwell, 2nd ed., 2007, para. 816

perjured evidence.⁷⁶⁰ It was eventually decided not to expand the list of the grounds for setting aside but that the position should be clarified in the Commission's Report. The Report stated: "It was understood that the term 'public policy', which was used in the 1958 New York Convention and many other treaties, covered fundamental principles of law and justice in substantive as well as procedural respects. Thus, instances such as corruption, bribery and fraud and similar serious cases would constitute a ground for setting aside. It was noted, in that connection, that the wording 'the award is in conflict with the public policy of the State' was not to be interpreted as excluding instances or events relating to the manner in which it was arrived at."⁷⁶¹ Similarly, Recommendation 1(c) of the Final Report on Public Policy of the International Law Association's Committee on International Arbitration provides that "The expression 'international public policy' is used in these Recommendations to designate the body of principles and rules recognised by a State, which, by their nature, may bar the recognition or enforcement of an arbitral award rendered in the context of international arbitration when recognition or enforcement of said award would entail their violation on account either of the procedure pursuant to which it was rendered (procedural international public policy) or of its contents (substantive international public policy)."⁷⁶²

In view of the recognition of and the desire to respect finality of arbitral awards despite its tension with the reservation of public policy of national legal systems, the concept of procedural public policy will be offended almost exclusively when the breach is manifest.⁷⁶³ While the mandatory provisions of laws of jurisdictions where the award is liable to be reviewed by the courts cannot be entirely ignored by the arbitrators, regardless of the law or the rules of law that govern the procedure, the parties' right to a reasonable opportunity to be heard and the right to equal treatment are apparently the only limits to the autonomy of the parties and the arbitral tribunal in the conduct of the arbitral proceedings.⁷⁶⁴ Under the right to equal treatment, the major safeguards include the right to an impartial arbitral tribunal, the right to equality in the appointment of the arbitral tribunal and the right to equal communications with the arbitral tribunal. The right to an equal opportunity for presentation of one's case is related to the right to an adversarial proceeding, and includes the right to

⁷⁶⁰ UN Document A/CN.9/263/Add.2, paras. 29-35 For example, US Federal Arbitration Act, Section 10 (a) (1) to (3) explicitly provides the following as the grounds for setting aside, or vacating, an arbitral award made in the US: "(1) where the award was procured by corruption, fraud, or undue means; (2) where there was evident partiality or corruption in the arbitrators, or either of them; or (3) where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced" Similarly, Section 68 (2) (g) of the English Arbitration Act of 1996 lists the event of "the award being obtained by fraud or the award or the way in which it was procured being contrary to public policy" as one of the instances of "serious irregularity" that empower a party to apply to the court challenging an award.

⁷⁶¹ UN Document A/40/17, para. 297. This clarification by the Commission also applies to Art. 36(1)(b)(ii), para. 303.

⁷⁶² Mayer, Pierre & Audley Sheppard, Final ILA Report on Public Policy as a Bar to Enforcement of International Arbitral Awards, *Arbitration International*, 19-2 (2003), at 253

⁷⁶³ Petrochilos, Georgios, *Procedural law in International Arbitration*, Oxford University Press, 2004, at 99; See e.g. *Generica Ltd v. Pharmaceutical Basics, Inc.*, 125 F.3d 1123 (7th Cir. 1997): the US Court of Appeals for the Seventh Circuit held that parties that have chosen to remedy their disputes through arbitration rather than litigation should not expect the same procedures they would find in the judicial arena. According to the court, an arbitrator must give each of the parties only an adequate opportunity to present its evidence and arguments, and exclusion of evidence will only constitute a deprivation of due process if the aggrieved party can show that such exclusion actually deprived it of a fair hearing.

⁷⁶⁴ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, *Kluwer Law International*, 1999, at 644-645

receive proper notice of the initiation of the proceeding, of the appointment process for the arbitral tribunal and of the pleadings, allegations, and evidence, the right to be given a reasonable time and opportunity to respond, and not be unreasonably deprived of an opportunity to present their case.⁷⁶⁵

The right to an equal opportunity for presentation of one's case also implies the arbitrators' duty to provide an equal opportunity for the parties to comment on the applicable substantive law, particularly given that the arbitrator's mistakes of law in most cases cannot be corrected by some appellate mechanism. In general, it is primarily for the parties to inform the tribunal about the contents of the applicable rules of law in arbitration. Even so, the arbitrators have also the capacity to ascertain such contents on their own initiative.⁷⁶⁶ This capacity, as a part of the jurisdictional power granted by the parties, may arise from the maxim *iura novit curia*, under which the court is assumed to know the law, which is accepted as applicable in arbitration mainly in civil law jurisdictions though under differing attenuations and conditions. In the arbitration laws or rules of common law origin where, in principle, foreign law must be pleaded and proved by the parties and the judge does not have the power to go beyond the material provided by the parties, there are some explicit provisions that grant to the arbitrators the capacity to ascertain the contents of the applicable law on their own initiative.⁷⁶⁷

As creatures of consent, arbitrators are law-finders rather than law-makers, and must show special respect to the parties' shared expectations as expressed in the contract. The capacity of arbitrators for engaging in direct study of legal authorities does not mean their award should contain surprises.⁷⁶⁸ The rule that parties must be given the opportunity to comment on the contents of the applicable law, which have been introduced by the arbitrators *ex officio*, is accepted by some national courts. For example, the Swiss Federal Tribunal accepts that the *iura novit curia* principle is applicable also in arbitration, yet recognizes that this capacity of the arbitrators is limited by the parties' right to be heard, since the application of legal provisions, where the parties could not foresee such application and it comes as a surprise, constitutes the violation of due process under Article 190(2)(d) of the Swiss Private International Law Act.⁷⁶⁹ The English courts consider that questions of law cannot be decided

⁷⁶⁵ Mantilla-Serrano, Fernando, *Towards a Transnational Procedural Public Policy*, *Arbitration International*, 20-4 (2004), at 342

⁷⁶⁶ Dimolitsa, Antonias, *The Equivocal Power of the Arbitrators to Introduce Ex Officio New Issues of Law*, *ASA Bulletin*, 27-3 (2009), at 427

⁷⁶⁷ See e.g. Section 34(2)(g) and Article 22(1)(c) of the LCIA Arbitration Rules. Originally, in common law, a principle of judicial unpreparedness applies to the court's approach to the applicable law, because, under the adversarial system, the court relies on counsel for the points of law on which the case will be decided. Mann, F.A., *Fusion of the Legal Profession*, *Law Quarterly Review*, 93 (1977), at 375. This approach was also relevant to the US law until a more balanced solution was provided by the Rule 44.1 of the Federal Rules of Civil Procedure: "A party who intends to raise an issue concerning the law of a foreign country shall give notice by pleadings or other reasonable written notice. The court, in determining foreign law, may consider any relevant material or source, including testimony, whether or not submitted by a party or admissible under the Federal Rules of Evidence. The court's determination shall be treated as a ruling on a question of law." It is argued that the contents of Rule 44.1 can provide helpful guidance for arbitration practice. Kaufmann-Kohler, Gabrielle, *The Arbitrator and the Law: Does He/She Know It? Apply It? How? And a Few More Questions*, *Arbitration International*, 21-4 (2005), at 634

⁷⁶⁸ Park, William W., *Arbitrators and Accuracy*, *Journal of International Dispute Settlement*, 1-1 (2010), at 44

⁷⁶⁹ Swiss Supreme Court (9 February 2009), *Urquijo Goitia v Da Silva Muniz* (No 4A_400/2008), *ASA Bulletin* (2009), at 495, 498-499: A fee claim by a soccer player's agent was rejected by the Federation International de Football Association (FIFA) in a decision upheld by the Court of Arbitration for Sport in Lausanne. The player

by an arbitral tribunal without prior debate with the parties.⁷⁷⁰ The application of this general concept can also be found in a case before the Finnish Courts.⁷⁷¹ Similarly, the Quebec

signed an agreement with a Portuguese soccer club apparently without the claimant's involvement despite the exclusive right for the representation of the agent in the European market. The CAS tribunal based its decision on the ground that the exclusive agreement between the agent and the player violated the mandatory provisions contained in the Swiss Federal Law on the Employment Exchange and the Hiring-out of Personnel, and, thus became null and void. The agent filed an action for annulment under Article 190 of the Swiss Private International Law Act with the Swiss Federal Supreme Court arguing that this Federal Law was not advanced by either party during the proceedings and constituted a violation of his right to be heard. The Supreme Court found that the application of the Federal Law came as a surprise and could not have been anticipated by the agent. The Court considered that the *jura novit curia* principle allows an arbitral tribunal to base its decision on legal provisions not introduced by the parties but, such reference to provisions not addressed by the parties should not come as a surprise. According to the Supreme Court, the relevant Federal law was manifestly inapplicable in the absence of any link of the case with Switzerland, and its application could not have been foreseen by the parties. Thus, the Court concluded that the CAS tribunal should at least have first submitted those legal provisions to the parties, thus allowing them to develop their arguments. The Court held that the CAS tribunal violated the right to be heard, which limits the *jura novit curia* principle and, consequently, annulled the award. Swiss Federal Supreme Court (9 June 2009), X v. Y, case no. 4A_108/2009, ASA Bulletin (2010), at 553 et seq.: The Swiss Federal Supreme Court decided that the right to be heard does not encompass a right of the parties to be specifically heard with regard to the legal qualification of the facts they had introduced into the proceedings. The dispute concerned an agreement between a Swiss company and a Hungarian company for the modernization of an electro steel plant of the latter. After various unsuccessful attempts to operate, the Hungarian company declared avoidance of the contract, asked for repayment of the paid installments and the removal of the charging system. The Swiss company instead initiated an ICC arbitration requesting payment of the full purchase price. The arbitral tribunal held that the Hungarian company was not entitled to avoid the contract according to the contractual terms. The Hungarian company asked the Swiss Federal Supreme Court to annul the award arguing that the tribunal based its decision on contractual terms and legal provisions that were not advanced by the parties and could not have otherwise been anticipated to become the basis for the tribunal's decision. The Court dismissed the action for annulment on the ground that the parties do not need to be specifically heard with regard to legal qualifications of the facts if the facts were introduced by the parties into the proceedings. According to the Court, only if the tribunal intends to base its decision on legal grounds which the parties have not invoked and which they could reasonably not anticipate as being relevant, the tribunal shall give the parties an opportunity to express their views in that respect. The Court found that the Swiss company had referred to the relevant provisions several times, albeit indirectly by referring to the consequences of their application without mentioning explicitly the contractual provisions themselves. Therefore, the Hungarian company would have had ample opportunity to respond to these arguments. In addition, the Court stated that the Hungarian company, represented by experienced business lawyers, should have anticipated the application of contractual terms addressing the contract termination.

⁷⁷⁰ In *Modern Engineering Ltd v C Miskin Ltd*, (1981) 1 LL 135, the Court of Appeal held that a new arbitrator should be appointed when the original one was found to have failed to deal properly with the question of law having come to a conclusion without giving the plaintiffs a proper hearing. In *Pacol Ltd v Joint Stock Company Rossakhar* [2000] 1 Lloyd's Rep 109, the Court set aside an award in which the tribunal re-opened the question of liability when the only remaining matter was quantum and held that the respondent was not liable, even though the respondent had in fact admitted liability. The tribunal had given no indication that it was considering a finding of non liability and the parties were not given any opportunity to put forward their respective cases on liability. The Court held that there had been a serious irregularity. In *Sanghi v The International Investor (KCFC)* [2000] 1 Lloyd's Rep. 480, the parties adopted the 1988 ICC Rules of Arbitration and agreed that the place of arbitration was to be London and that the dispute should be governed by the laws of England, except to the extent that these conflicted with Islamic Shari'a law, which would prevail. Under the contract The International Investor was to arrange finance to enable Sanghi to produce and export polyester yarn. The International Investor agreed to advance the finance for an 18-month period, with an agreed 'profit rate' of 9% per annum, thereby replacing any provision for interest so that the transaction complied with the requirements of Islamic Shari'a law. The ICC appointed an expert on Islamic Shari'a law as sole arbitrator. The arbitrator awarded The International Investor the outstanding principal and profit and ordered SPL to pay costs. SPL challenged the award, among other reasons for the reason that award contains references to 18 textbooks and other works not referred to by either side's experts or by the arbitrator in the course of the proceedings. The Court rejected the counter argument that in determining Shari'a law issues the arbitrator was deciding issues of Shari'a law as an expert not as an arbitrator. The Court stated that "On first principles however the mere agreement by the parties that the

Superior Court annulled an award that imposed a remedy that neither party had sought and that was rendered on the basis of reasons that had neither been submitted for determination nor addressed by the parties.⁷⁷² In France, the courts proclaim a duty of the arbitrators to base the award on reasons deriving from the applicable law which have been included in the

arbitrator can act as his own expert on Shari'a law issues is not sufficient it seems to me to displace his overriding duties as arbitrator under S. 33.” However, the Court did not find any irregularity on the grounds that the arbitrator was not obliged to imitate the usual practice of an English judge, who is expected to give the parties an opportunity to make submissions before acting upon an authority not cited by the parties, that the parties clearly gave the arbitrator more scope for individual initiative than was usual by agreeing that the arbitrator should have these additional expert powers to decide Shari'a law, and that there was no evidence or submission to the effect that had the arbitrator cited one or more of the authorities complained of at an earlier stage in the proceedings, Sanghi would have had the opportunity to put him right by showing the particular citation to be misleading or less than apt.

⁷⁷¹ In the relevant arbitration, the parties designated Finland as the seat and Finnish law as applicable law. The Austrian distributor had requested indemnification for the violation of a distribution agreement by the Swiss manufacturer, but the agreement had expressly excluded indemnification. The claimant argued that under the Finnish Act on Commercial Representatives and Salesman the clause excluding the indemnity was null and void. The arbitral tribunal rejected the argument that the invoked legislation was applicable, but awarded the claimant compensation on the basis of Section 36 of the Finnish Contracts Act by interpreting and amending the relevant contractual clause. Section 36 of the Finnish Contracts Act was never invoked by the claimant. The award was challenged for the ground that the arbitrators had exceeded their authority and denied the respondent the right to present arguments on this issue. The Supreme Court of Finland, in a majority decision, held that provisions such as Section 36 of the Contracts Act could be applied even if parties did not expressly argue their relevance, and the arbitrators were not in any case bound to the legal position that the parties based their claim on. The Court further stated that the tribunal did not fail to provide the parties with a sufficient opportunity to present their cases since the legal nature of the agreement itself was in dispute and the respondent had the opportunity to state its position on the factors that eventually led the tribunal to find in the claimant's favor. The Court concluded that the tribunal's compromise decision did not come as a surprise. *Werfen Austria GmbH v. Polar Electro Europe B.V. Zug Branch*, Judgment of the Supreme Court of Finland (2 July 2008), Case no. S2006/716, no. 1517, cited by Alberti, Christian P., *Iura Novit Curia in International Commercial Arbitration: How Much Justice Do You Want?*, in Stefan Kröll, Loukas A. Mistelis, P. Perales Viscasillas, & V. Rogers (eds.), *International Arbitration and International Commercial Law: Synergy Convergence and Evolution*, Kluwer Law International, 2011, at 18, 20

⁷⁷² In the case, concerned a joint venture agreement containing an ICC arbitration clause and pursuant to which each became shareholders of a German company. The agreement provided that in the event of an impasse between the parties, either party may request that the claimant buy out the defendant's shares of the company. After a dispute arose, the defendant requested arbitration, seeking a declaration that an impasse existed and that the claimant had breached the agreement thereby damaging the value of the German company. In its counterclaim, the claimant alleged breach, repudiation and violation of fiduciary duties by the defendant. The arbitral tribunal issued an award dismissing both parties' claims on the ground that the purpose of the agreement had been frustrated and that the relationship between the parties had terminated. The tribunal also ordered the claimant to buy out the defendant's shares. The claimant applied for partial annulment of the award to both the court and the tribunal, arguing that the tribunal had fashioned a remedy not sought by either party and failed to give the parties an opportunity to be heard. The Supreme Court of Quebec annulled the award on the grounds that “the Valuation and Buyout Remedy was improperly fashioned according to the Tribunal's own perception as to what was fair and equitable, rather than by respecting the scope of the mandate consented and agreed to by the parties” and more particularly “(i) violated the *audi alteram partem* rule; (ii) dealt with a dispute which was not contemplated by the parties and decided matters beyond the scope of the Terms of Reference”. The Court stated that “Notwithstanding the generally recognized and perceived flexibility and procedural freedom granted arbitration tribunals in the conduct of its proceedings, the Courts, both in Canada and elsewhere, have consistently applied and enforced the *audi alteram partem* rule in considering the validity of awards issued in matters involving commercial arbitration.” According to the Court, the award contravened public policy since “The *audi alteram partem* rule is one of public order... Its breach may give rise to annulment under the public order ground set out in Article 946.5 [the Code of Civil Procedure of Québec] notwithstanding the fact that it also constitutes a distinct ground for annulment under provisions such as article 946.4(3) [the Code of Civil Procedure of Québec] and Article V(1)(b) of the New York Convention.” *Louis Dreyfus S.A.S. v Holding Tusculum B.V.* 2008 QCCS 5903, at paras. 74, 75, 84, 105

adversarial debate between the parties who have commented upon it, thereby extending the application of the parties' right to present their case to both factual and legal issues.⁷⁷³ However, the French courts have considerably mitigated the duty of the arbitral tribunal to arrange for an adversarial debate on legal arguments, particularly where the parties agreed on the applicable law.⁷⁷⁴

In general, the vast majority of the national legal systems support the right of the parties to comment on legal sources that have not been introduced by them, and it is generally implied in those legal systems that the parties should not be taken by surprise.⁷⁷⁵ The prohibition to take the parties by surprise, which flows from their right to be heard, commands that, in ascertaining the articulated rules and discovering the established rules that are applicable in a particular case, the decision maker applying *lex mercatoria* should submit the relevant legal sources to the parties for their comments and arguments prior to rendering a final decision, to the extent that the decision maker believes they are relevant to the outcome of the dispute. He should refrain from rendering an award which both parties may be surprised by the legal reasons put forward.

In the "Recommendations for Arbitrators" adopted by the ILA Committee on International Commercial Arbitration at the Rio de Janeiro Conference of 2008 on Ascertaining the Content of the Applicable Law in International Commercial Arbitration, it is stated in Recommendation 7 that "Arbitrators are not confined to the parties' submissions about the contents of applicable law. Subject to Recommendation 8, arbitrators may question the parties about legal issues the parties have raised and about the submissions and evidence on the contents of the applicable law, may review sources not invoked by the parties relating to those legal issues and may, in a transparent manner, rely on their own knowledge as to the applicable law as it relates to those legal issues." Recommendation 8 provides that "Before reaching their conclusions and rendering a decision or an award, arbitrators should give parties a reasonable opportunity to be heard on legal issues that may be relevant to the disposition of the case. They should not give decisions that might reasonably be expected to surprise the parties, or any of them, or that are based on legal issues not raised by or with the parties."⁷⁷⁶

⁷⁷³ E.g. in a case involving the Government of the Arab Republic of Egypt and an English company, the Paris Court of Appeal, upon appeal by the Egyptian Government from the First Instance Court decision granting *exequatur*, refused the enforcement of an arbitral award rendered under the auspices of the Cairo Regional Center for International Commercial Arbitration. The Court of Appeal found that the arbitral tribunal, which had annulled the contract and awarded damages on the basis of various articles of the Egyptian Civil Code on mistake, had *ex officio* introduced in the award the legal provisions on mistake without submitting them to discussion by the parties, while the parties had only invoked and discussed principles of contractual liability on the basis of other provisions of the Egyptian Civil Code. Paris Court of Appeal, 19 June 2008 (unpublished) cited by Dimolitsa, Antonias, *The Equivocal Power of the Arbitrators to Introduce Ex Officio New Issues of Law*, *ASA Bulletin*, 27-3 (2009), at 434

⁷⁷⁴ Poudret, Jean-Francois & Sebastien Besson, *Comparative Law of International Arbitration*, London: Sweet & Maxwell, 2nd ed., 2007, at para. 551; In *SGI v. Ewbank* (Rev. arb. 1993, p. 664 ff., confirmed by Cass., Rev. arb. 1995, p. 597 ff.), the Paris Court of Appeals held that arbitrators can apply relevant foreign law, chosen in the agreement and the terms of reference, even if the parties have refrained from

discussing it in any detail during the course of the proceeding.

⁷⁷⁵ Waincymer, Jeff, *International Arbitration and the Duty to Know the Law*, *Journal of International Arbitration*, 28-3 (2011), at 215

⁷⁷⁶ International Law Association, Committee on International Commercial Arbitration, *Final Report on Ascertaining the Content of the Applicable Law in International Commercial Arbitration*, 73rd Conference, Rio de Janeiro, Brazil (August 2008), at 23

Accordingly, an arbitrator who is prepared to consider legal sources other than those cited in submissions should at least warn the parties that he is inclined to do so and allow them to make submissions accordingly.⁷⁷⁷ Thus, the decision makers applying *lex mercatoria* should inform both parties of the materials that may be subject to his specialized consolidations and, and invite them to comment upon the grounds on which he purports to rely. They should not raise legal arguments without giving the parties an opportunity to comment, unless the application of the relevant rule is prescribed by the agreement or terms of reference, or it is so general that it must be considered to be implicitly included in the pleadings of the parties.⁷⁷⁸ The decision makers that incorporate into the final decision those rules and principles not argued and expected by the parties to be applicable offend against the duty to give parties an opportunity to present their case, and also run the risk that they are exceeding their mandate. They should not deal with matters not raised, while they should clarify ambiguities, invite submissions on all key aspects including applicable law, and afford parties an opportunity to make adequate submissions, no matter how late in the process the tribunal becomes aware of an issue not addressed.⁷⁷⁹ For an efficient case management, the arbitral tribunals may facilitate their own work by partial awards or procedural rulings on these issues thereby enabling the parties to adjust their pleadings to reflect or elaborate their positions, as indicated by the tribunals.⁷⁸⁰

Transparency is required for an efficient case management in a setting of multiple legal cultures, where the diverging approaches may simultaneously direct the parties to prove the law and the arbitrators to have control over the law.⁷⁸¹ There is no good policy reason in arbitration to deny parties the opportunity to make representations if they so wish, and to decide on questions of law without notice to the parties, just as there is no general justification for separating the analytical functions pertaining to legal matters, allocating them only to adjudicators absent input from the parties' counsels. Thus, the arbitral tribunals frequently fix procedure and ascertain the applicable law by applying hybrid processes, drawn from different and several legal systems, which they consider appropriate in the circumstances and may include submissions of law by the parties, expert reports and the tribunal doing its own

⁷⁷⁷ Waincymer, Jeff, *International Arbitration and the Duty to Know the Law*, *Journal of International Arbitration*, 28-3 (2011), at 230

⁷⁷⁸ Gaillard, Emmanuel & John Savage (eds.), *Fouchard, Gaillard, Goldman on International Commercial Arbitration*, Kluwer Law International, 1999, at 949

⁷⁷⁹ Waincymer, Jeff, *International Arbitration and the Duty to Know the Law*, *Journal of International Arbitration*, 28-3 (2011), at 241

⁷⁸⁰ Kurkela, Matti, 'Jura novit curia' and the burden of education in international arbitration – a Nordic perspective, *ASA Bulletin*, 21-3 (2003), at 498; For instance, see ICC Case No 8540, available at <http://www.unilex.info/case.cfm?id=644>: "The Parties did not make an express or implied choice of a specific municipal system of law governing the [Agreement]. As stated earlier in this award, shortly after it was constituted, the Tribunal was seized of the Defendant's Application for Determination of the Proper Law. This preliminary Application was dealt with in the Tribunal's Order No. 1, wherein we indicated that we would not decide the proper law of the in limine litis, since we wanted to give full opportunity to the Parties "to present and argue their case on the intent and meaning of all provisions of the [Agreement] relevant to the present arbitration . . ." The Tribunal referred specifically to paragraphs (3) and (5) of Article 13 of the ICC Rules which, we opined, "mandate the Tribunal not to decide the applicable law until sufficient evidence has been introduced to enable the Arbitrators to understand fully the terms of the [Agreement]. Thus, we remained seized of the Application and the question of the applicable law now has to be determined."

⁷⁸¹ Kaufmann-Kohler, Gabrielle, *The Arbitrator and the Law: Does He/She Know It? Apply It? How? And a Few More Questions*, *Arbitration International*, 21-4 (2005), at 636

research.⁷⁸² However, the key is the transparency and openness in arbitral proceedings where the parties are provided with the opportunity to comment on any matter that may materially affect the tribunal's decision.

The requirement of transparency can also be linked to another procedural rule under arbitration laws, the violation of which may result in the annulment of the award or refusal to its enforcement, although usually not considered as a part of the contents of procedural public policy. This is the duty of the arbitrator to give reasons in the award. This duty is particularly important for the decision maker applying *lex mercatoria* when consolidating various materials by exercising his abstract reasoning. The duty of rendering a reasoned decision will also make it easier for the review of the national courts and prevent the arbitrators from pronouncing any rule they like.

Arbitration laws and rules usually provide a default rule in this regard by allowing the parties to dispense with reasons. Even so, it can be said that the general consensus is in favor of a reasoned award.⁷⁸³ The European Convention of 1961 provides that “the parties shall be presumed to have agreed that reasons shall be given for the award unless they (a) either expressly declare that reasons shall not be given; or (b) have assented to an arbitral procedure under which it is not customary to give reasons for awards, provided that in this case neither party requests before the end of the hearing, or if there has not been a hearing then before the making of the award, that reasons be given.” Article 31 (2) of the Model Law provides that the award shall state the reasons upon which it is based, unless the parties have agreed that no reasons are to be given or the award is an award on agreed terms under settlement. This approach is also followed by the arbitration laws of Switzerland, Germany and England.⁷⁸⁴ In France, there is no requirement that the international arbitrators should give reasons for their award and the failure to give reasons is not in itself contrary to the French international public policy.⁷⁸⁵

The institutional arbitration rules generally require the arbitrators to render a reasoned award. The UNCITRAL Rules adopt the same approach as the Model Law, and requires reasons be given unless the parties agree otherwise under Article 31 (2). This approach can also be found in the institutional rules of LCIA, AAA and SCC.⁷⁸⁶ It is observed that, in practice, the parties rarely agree otherwise.⁷⁸⁷ Thus, where the laws applicable to the procedure stipulate that reasons must be given in the absence of contrary agreement by the parties and the parties have not waived from this stipulation, non-compliance with such requirement would justify the

⁷⁸² Lew, Julian D. M., *Iura Novit Curia and Due Process*, Queen Mary School of Law Legal Studies Research Paper No., 72 (2010), available at <http://ssrn.com/abstract=1733531>, at 12

⁷⁸³ Redfern, Alan & Martin Hunter with Nigel Blackaby and Constantine Partasides, *Law and Practice of International Commercial Arbitration*, London: Sweet & Maxwell, 4th ed. Student version, 2004, at 454

⁷⁸⁴ Swiss Federal Code on Private International Law of December 18, 1987, Article 189 (2); German Code of Civil Procedure, Section 1054(2); English Arbitration Act 1996, Section 52(4);

⁷⁸⁵ In France, the requirement to give reasons pursuant to Article 1471(2) of the French Code of Civil Procedure for domestic arbitration is considered to be a rule of public policy which even applies to an *amiable compositeur*. Its violation leads to the setting aside of the award pursuant to Articles 1480 and 1484(2) (5). Poudret, Jean-Francois & Sebastien Besson, *Comparative Law of International Arbitration*, London: Sweet & Maxwell, 2nd ed., 2007, at para. 747

⁷⁸⁶ LCIA Article 26.1; AAA ICDR Article 27.2, SCC Article 36.1,

⁷⁸⁷ Redfern, Alan & Martin Hunter with Nigel Blackaby and Constantine Partasides, *Law and Practice of International Commercial Arbitration*, London: Sweet & Maxwell, 4th ed. Student version, 2004, at 454

award being set aside or refused enforcement, not as a result of violation of public policy, but on the grounds that the arbitrators failed to comply with their mandate or that the arbitral procedure was not in accordance with the agreement of the parties.⁷⁸⁸

Article 15(2) of the ICC Rules provides, without exception, that the award shall state the reasons upon which it is based. The ICC Court deems awards that are insufficiently reasoned to be defective as to form and remits to the arbitral tribunal for amendment before they are approved in accordance with Article 27 of the ICC Rules of 1998.⁷⁸⁹ This is similar to the mechanism provided by the ICSID Convention, which requires a reasoned award, without any exception, under Article 48, and the failure of the tribunal to state the reasons, on which the award is based, is explicitly stated as a ground for annulment of the award under Article 52 (1) (e). Thus, the parties' right to obtain a reasoned award may directly become a reason for the validity of an award in the institutional contexts of the ICC and ICSID. However, the extent of failure to state reasons which affects the validity of an award should be determined in line with the policy of finality of awards in order to avoid a sort of disguised appeal. As explained in the ICSID Annulment Decision in *MINE v. Guinea*, "the requirement that an award has to be motivated implies that it must enable the reader to follow the reasoning of the Tribunal on points of fact and law... the requirement to state reasons is satisfied as long as the award enables one to follow how the Tribunal proceeds from Point A to Point B and eventually to its conclusion, even if it made an error of fact or law."⁷⁹⁰

Although the procedural public policy can be invoked in theory with regard to the grave violations of the principle of due process, the practical effects of laws and institutional rules regulating international arbitration have wider implications for the procedural principles which the arbitrators are required to observe in arbitral proceedings. These principles are a part of *lex mercatoria*, as the law of principled adjudication. The arbitrators are not only bound by the mandatory rules of national laws but also bound by the terms of submission to arbitration and the procedural agreements of the parties. The failure to observe the latter may equally result in the refusal of enforcement or annulment of the award by the national courts and, thus, the duties arising from the latter will perform as safeguards against irregularities in the arbitral process.

⁷⁸⁸ Gaillard, Emmanuel & John Savage (eds.), *Fouchard, Gaillard, Goldman on International Commercial Arbitration*, Kluwer Law International, 1999, at 959

⁷⁸⁹ Redfern, Alan & Martin Hunter with Nigel Blackaby and Constantine Partasides, *Law and Practice of International Commercial Arbitration*, London: Sweet & Maxwell, 4th ed. Student version, 2004, at 454

⁷⁹⁰ Ad Hoc Committee, *Maritime International Nominees Establishment v. Republic of Guinea*, Decision partially annulling the award, December 22, 1989, *ICSID Review—Foreign Investment Law Journal*, 5 (1990), at 105; In the *Klockner* case, the ground of Article 52(1) (e) was considered as established "in the absence of a statement of reasons that are "sufficiently relevant", that is reasonably sustainable and capable of providing a basis for the decision". ICSID No. ARB/82/1, Decision on Annulment 3 May 1985, *ICSID Review—Foreign Investment Law Journal*, (1986), at 126

e. Concluding Remarks

The basic principles of *lex mercatoria* are derived both from the abstract relations that exist among the multiplicity of elements in the spontaneous order of international commerce, and from the institution of international arbitration as it is evolved under the influence of theory and practice of transnational arbitration. These basic principles direct the decision maker to resolve the contractual disputes as one of a kind, which might occur anywhere and at any time, and in a manner, which should maximize the possibility of correspondence of expectations among the elements in the spontaneous order of international commerce, by cooperating with the parties throughout the process of adjudication.

The basic principles of freedom of contract and sanctity of contracts direct the decision maker to ascertain and enforce the specific allocations of contractual rights, obligations, and risks under the articulated rules, which consists of terms of the contract and default rules chosen by the parties. In the order of international commerce and, particularly, in international arbitration, these principles are not only characterized by the consent of the parties to be legally bound by the articulated rules, but they also relate to their consent to the jurisdiction of some adjudication and enforcement mechanism and the binding force of the *ex post* decisions that resolve the contractual disputes. The basic principle of good faith and fair dealing requires the decision maker to resolve the dispute in accordance with the established rules, which give rise to reasonable expectations of the parties, and which are derived on the basis of an abstract reasoning through the specialized consolidations of national laws, trade usages or contracting practices, and a balancing exercise of various interests of elements of the order of international commerce involved in a particular case. It provides the substantive framework for the allocation of residual contractual rights, obligations and risks, and for the qualification of the principles of freedom of contract and sanctity of contracts. Under these basic principles of *lex mercatoria*, by invoking the system of legal enforcement, the parties are deemed to accept they are bound by both articulated and established rules in the particular case.

In this context, the procedural safeguards arising from both the procedural public policy contents and the consensual nature of arbitration ensure the meaningful utilization of the knowledge of particular circumstances of time and place, and the accuracy in giving effect to the reasonable expectations of the parties in a particular case. These are the principle of due process, which mainly consists of the parties' rights to a reasonable opportunity to be heard with regard to the issues of fact and law and to equal treatment in both the constitution of the tribunal and the later proceedings, the prohibition of fraud, corruption or perjured evidence and the decision maker's duty to comply with his mission, which, in most cases, includes his obligation to render a reasoned award. They reduce the possibility of arbitrariness and irregularities in the process of adjudication by a decision maker, who consolidates various materials by exercising his abstract reasoning, since they prevent the decision maker from pronouncing any rule he likes.

The argument here is not that the basic principles of *lex mercatoria* can be directly used to determine the allocations of contractual rights, obligations and risks in a particular transaction. The allocations of specific contractual rights, obligations, and risks will be determined by the parties themselves through contractual clauses or default rules they have chosen to govern their contract, and the *ex post* decision maker will respect those allocations, pursuant to the principles of freedom of contract and sanctity of contract, unless they result in a violation of the relevant public policy contents in the form of the established rules of policy under the principle of good faith and fair dealing. The decision maker will allocate residual

contractual rights, obligations and risks in accordance with the established rules in the particular circumstances of the case, which will be discovered by the decision maker in accordance with the basic principles of *lex mercatoria* in order to give effect to the reasonable expectations of the parties. In this sense, the basic principles of *lex mercatoria* can be understood as functional criteria for evaluating the articulated and established rules that are needed to make the allocational decisions with regard to contractual rights, obligations and risks.

5. APPLICATION OF LEX MERCATORIA

Lex mercatoria, as the law of principled adjudication, is applicable not only to the substantive aspects of the disputes, but also to the choice of law analyses of the decision maker. In contrast, the modern doctrine understands lex mercatoria as an equivalent or alternative to national substantive laws, and makes a distinction between cases where lex mercatoria was applied to the substance of the dispute and others where a national law was governing the substance of the dispute. This distinction theoretically restricts the relevance of lex mercatoria to the resolution of contractual disputes. The distinction is based on whether the decision maker has made an explicit reference to the terms “lex mercatoria”, “general principles of law”, “international trade usages” and alike, in dealing with the substance of the dispute. Thus, the modern doctrine excludes the group of cases, where lex mercatoria is actually applied at the stage of conflict of laws, i.e. where the decision maker determines the applicable law, not by applying the conflict of laws rules of a certain national legal system, but on the basis of general principles of private international law, or cumulative application of national rules of conflict of laws relevant to the dispute, or as a result of the interpretation of the parties’ intentions.

It is interesting that, while the second generation of proponents of lex mercatoria has commonly advocated the use of comparative analysis to find substantive solutions with regard to the merits of the dispute, which implies the application of the established rules, they have mostly disregarded the possibility of showing the comparative analysis of conflict of laws rules of national laws as an instance of the application of lex mercatoria in giving effect to the reasonable expectations of the parties. This is most likely resulted from the traditional approach of the modern lex mercatoria doctrine, which raises the concept when there is a perceived inadequacy of national laws to govern international contracts, leading to disregarding the idea that the application of lex mercatoria at the conflict of laws stage results in the application of a national substantive law for giving effect to the reasonable expectations of the parties.

Lex mercatoria as the law of principled adjudication denotes a broader concept than what is commonly understood from the term in the modern doctrine. It is an alternative to a national legal system in dealing with legal uncertainty in the resolution of contractual disputes in the order of international commerce, but it is not a legal system and never becoming one. It may govern the resolution of the contractual disputes as lex contractus but, more importantly, in international arbitration, where no national law constitutes the lex fori of the arbitral tribunal insofar as its decisions are not made on behalf of a national legal system, lex mercatoria may serve as lex fori. In this understanding, lex mercatoria will not be relevant only to those cases where the arbitral tribunal, either on its own motion or as required by the contractual parties, actively rejects to apply lex mercatoria as the law of principled adjudication and to assume the task of control of legal uncertainty, by referring to the conflict of laws of the seat of arbitration, in order to determine and ascertain the applicable national law and applying the national law in the manner a national court would apply, without the increased concern for the reasonable expectations of the parties to a particular case. As this is an unlikely case in the context of international arbitration, the application of lex mercatoria can be considered as more common in arbitral practice than the modern lex mercatoria doctrine suggests, even if the arbitrators do not consider themselves as applying it in most of the cases, when dealing with the issues of conflict of laws and substance.

Such an understanding reflects to some extent the view of the critiques of the modern *lex mercatoria* doctrine, which characterizes *lex mercatoria* as “a quasi-legal recognition of rules of common sense, equity, and reasonableness that would probably have been suggested, and used, even in the absence of any reference or thought of a *lex mercatoria*.”⁷⁹¹ This view rightly points out why the content of *lex mercatoria* has failed to represent the elements of a new legal system, but has become a way of remedying lacunae in the old legal systems, as a result of some increased capacity for abstract reasoning in the *ex post* decision making process to adapt for developing and evolving legal relationships in the order of international commerce. However, those critiques go on to question the appropriateness of arbitration for such understood *lex mercatoria*, given the finality of awards, limited review of national courts on the merits and the confidentiality of proceedings, which greatly reduce the power of precedent. It is thus argued that the dangers of arbitrary and capricious decision making are allowed to flourish by abandoning the objective standards of the national laws for the subjective standards of fairness of the arbitrator, who has the ability to abuse, misconstrue, or improperly invoke the powers of *lex mercatoria*.⁷⁹² In such a context, “[t]he specter of an arbitrator masking infidelity to his mission with a catch-all phrase of uncertain content leads to consideration of judicial control mechanisms in arbitration.”⁷⁹³

However, the problem of arbitrary or capricious decision making is not directly related to the concept of *lex mercatoria* but to the institution of arbitration. Although it is true that *lex mercatoria* is enabled by the institution of arbitration, considering it as part of the problem is not at all helpful in the present context, since it is possible for the arbitrators to apply any law arbitrarily or capriciously without ever thinking or mentioning *lex mercatoria* or similar concepts insofar as any law is inherently incomplete and, in most of the cases, there is no competent authority to correct the wrongful application of any law by an arbitral tribunal. Thus, one should not contemplate that *lex mercatoria* is aggravating those problems, but to the contrary, its application in any dispute before arbitral tribunals presents the opportunity of remedying those problems through principled decision making and by taking the reasonable expectations of the parties to the center of the dispute resolution process, as required in the order of international commerce. Under such an understanding, control mechanisms of various kinds may focus on the manifest disregard of the reasonable expectations of the parties by ensuring the integrity of proceedings in the light of the basic procedural principles and safeguarding the relevant public policy contents, rather than allowing the re-litigation of the entire dispute for manifest disregard of law.

⁷⁹¹ Hight, Keith, *The Enigma of the Lex Mercatoria*, *Tulane Law Review*, 63 (1989), at 628

⁷⁹² Weinberg, Karyn S., *Equity in International Arbitration: How Fair is “Fair”?: A Study of Lex Mercatoria and Amiable Composition*, *Boston University International Law Journal*, 12 (1994), at 249-251

⁷⁹³ Park, William W., *Control Mechanisms in the Development of a Modern Lex Mercatoria*, in Thomas E. Carbonneau (ed.), *Lex mercatoria and arbitration: a discussion of the new law merchant*, *Kluwer Law International*, Rev. ed., 1998, at 145

a. Choice of Law Analyses

In the choice of law analyses, *lex mercatoria* primarily represents a *lex fori* for the international arbitral tribunals and concerns the possibilities for the arbitrators to resolve specific difficulties relating to the conflict of laws, such as lack of proof of the relevant rule in the applicable law, the interpretation of a rule of the applicable law, a gap in the applicable law, and the problems of interpretation of the intentions of the parties as to the applicable law. It is argued that that in a large proportion of cases arbitrators feel it unnecessary, dangerous or counterproductive, to mention or discuss those difficulties and problems relating to conflict of laws, if they can avoid it, and many, if not most, cases can be decided directly by interpreting the terms of the contract in dispute and without any precise reference to the particular provisions of a given national law.⁷⁹⁴ In some arbitral awards, the choice of law analyses are indeed seen unnecessary for practical reasons.⁷⁹⁵ In other cases, it is observed that choice of law analyses of arbitral tribunals are result-oriented, based on teleological considerations and primarily concerned with not defeating the parties' reasonable expectations as to the applicable law and fulfilling their mission in agreement with the parties' mandate.⁷⁹⁶ Such arguments and observations imply that, in the context of international arbitration, as a result of its consensual nature, the interpretation of contractual intentions of the parties potentially precedes all other substantive questions relating to the resolution of the dispute. The interpretation of contract is essentially a matter of law, and in the absence of *lex fori*, the legal culture of the individual arbitrator may become his own *lex fori*. *Lex mercatoria*, as the law of principled adjudication, provides a direction for the arbitrators in such interpretations that aim to give effect to the reasonable expectations of the parties to a particular contract.

There are four possible situations in the choice of law analyses, where *lex mercatoria* can be applied in international arbitration as *lex fori* for giving effect to the reasonable expectations of the parties. First, where parties have expressly selected a national law to govern the substance of the dispute, the arbitrator should apply the rules of chosen national law as a part of the bargain underlying the contract, pursuant to the basic principles of freedom of contract and sanctity of contracts, and *lex mercatoria* can be relevant to the substance of the dispute in the application of trade usages and the interpretation or supplementation of the applicable national law. Secondly, where the parties have agreed to the application of *lex mercatoria*, the arbitrator should interpret this choice in accordance with the basic principles to determine to what extent the parties intended to prevent the decision maker from considering particular

⁷⁹⁴ Lalive, Pierre, *The UNIDROIT Principles as Lex Contractus, With or Without an Explicit or Tacit Choice of Law: An Arbitrator's Perspective*, Special Supplement, ICC International Court of Arbitration Bulletin: UNIDROIT Principles of International Commercial Contracts: Reflections on their Use in International Arbitration, 2002, at 77-78

⁷⁹⁵ ICC Award in Case No. 1990, 1972, *Yearbook Commercial Arbitration*, 3 (1978), at 218: "In so far as the questions in dispute are regulated by the parties in their contract and this contractual regulation does not contravene the mandatory rules of the two laws in question, it is permitted to resolve them on the basis of the contract. This applies in the present case to the validity, execution, rescission and adaptation to the circumstances of the contract, questions on which, moreover, the general principles of Italian and Spanish law are practically identical. These questions can therefore be resolved without a preliminary decision on the applicable law." ICC Award in Case No 3572, *Yearbook Commercial Arbitration*, 14 (1989), at 118: "the choice of the law to be applied to the agreement is of little significance, if any, under the prevailing circumstances".

⁷⁹⁶ Grigera Naón, Horacio A., *International Commercial Arbitration – The Law Applicable to the Substance of the Dispute: Present Trends*, in Patrick J. Borchers & Joachim Zekoll (eds.) *International conflict of laws for the third millennium : essays in honor of Friedrich K. Juenger*, Ardsley, N.Y. : Transnational Publishers, 2001, at 67; Grigera Naón, Horacio A., *Choice of Law Problems in International Commercial Arbitration*, *Recueil des Cours*, 289 (2001), at 28

national laws as indicating their reasonable expectations. Thirdly, where the parties have not agreed on an applicable law, the arbitrator should seek for the established rules of conflict in order to determine the materials that indicate the reasonable expectations of the parties. In this situation, the arbitrator should not refrain from applying a national law when designated by the established rules of conflict, unless the arbitrator interprets, in accordance with the basic principle of good faith and fair dealing, the absence of choice to the effect that parties have agreed to exclude the application of any given national law, including even that of a third, neutral country, while being unable to agree on any satisfactory alternative or positive formula. Fourthly, where arbitrator has been selected to act as amiable compositeur, *lex mercatoria* can be relevant to the arbitrators' considerations of equity and help them to deliver a reasoned award that accurately and persuasively gives effect to the reasonable expectations of the parties in a particular case.

i. Choice of National Law

Virtually all modern arbitration laws recognize that, the parties are free to determine the law applicable to the merits of the dispute which the arbitrators are to resolve. It is possible that the chosen national law has no connection with either the parties or the subject matter of the contract.⁷⁹⁷ Unlike a number of traditional conflict of laws rules on the law applicable to contracts, modern arbitration statutes do not specify that the parties' choice must be "unambiguously result from the provisions of the contract"⁷⁹⁸ or "be demonstrated with reasonable certainty by the terms of the contract or the circumstances of the case."⁷⁹⁹ Moreover, it is generally accepted that parties can choose the applicable law not only at the time of signing the arbitration agreement but also at any other time before or after the dispute has arisen.⁸⁰⁰ In a vast majority of cases before arbitral tribunals, the parties explicitly agree on a national law as the applicable law to their contracts. The ICC statistical reports for the years 2000-2009 show that around 80% of contracts underlying the disputes referred to ICC arbitration have contained a predetermined choice of law provision designating a national law as the applicable law.⁸⁰¹ It is reported that, in 2010, in 99% of the ICC cases, the parties chose a national law to govern the substance of their disputes.⁸⁰²

⁷⁹⁷ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 785; see on the validity of the choice of Swiss law in a contract with no connection to Switzerland, ICC Award in Case No. 4629, 1989, Yearbook Commercial Arbitration, 18 (1993), at 16: The arbitral tribunal held that "In an international contract like the present one, involving parties of different nationalities, the choice of law is entirely free, and the parties could freely decide that their relations were to be governed by Swiss law, even though the case has no connection whatsoever with Switzerland." ICC Case No. 5505 Yearbook Commercial Arbitration, 13 (1988), at 110: In a dispute between a Mozambique claimant and a Dutch respondent, the latter contested the validity of the choice of English law in the absence of sufficient contacts between the transaction and England. In rejecting this argument, the arbitrator, sitting in Switzerland, held that the choice of law was valid both under English and Swiss private international law. The arbitrator further made clear that there was no reason to believe that the choice of English law was a device to escape the application of mandatory laws of either Mozambique or the Netherlands, or that an award based on a choice of English law would not be recognized and enforced in those countries.

⁷⁹⁸ Article 2 (2) of the Hague convention of 1955 on the Law Applicable to international sale of goods

⁷⁹⁹ Article 3(1) of the Rome Convention of 1980 on the Law applicable to contractual obligations; Article 3(1) of the Rome I Regulation sets a stricter criteria by stating that "the choice shall be made expressly or clearly demonstrated by the terms of the contract or the circumstances of the case."

⁸⁰⁰ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 790; In ICC Case No 8548, the contract underlying the dispute did not contain a choice of law clause. The arbitrator reminded the parties of their freedom in determining the applicable substantive law and referred to Article 13 (3) of the ICC Rules of Arbitration, generally accepted conflict rules and Article 3 of the 1980 Rome Convention on the Law applicable to Contractual Obligations. The arbitrator noted that such a choice of law can also be made during the proceedings. On the proposal of the arbitrator, the parties agreed to the application of Dutch law to the substance of the dispute. ICC Award No 8548, *Chronique de jurisprudence arbitrale de la CCI*, in *Cahiers de l'arbitrage*, Gazette du Palais, No. 119-123, 121, (2001), at 41

⁸⁰¹ In 2009, 88% of the contracts underlying the disputes filed with ICC contained choice of law provisions. Except for 10 cases, the parties had chosen national laws. In 2008, 86.8% of the contracts contained a choice of law provision and this was a national law in 84% of cases. In 2007, 79.8% of the contracts specified the law applicable to the merits. The parties opted for national laws in all but three contracts. In 2006, 84.7% of the contracts contained a choice of law clause and except for 2% of the cases, the parties chose national laws. In 2005, in 81% of cases, parties had specified in their contracts the rules to be applied to the merits of the dispute and national laws had been chosen in 79.3% of the contracts. In 2004, 80.4% of the contracts contained a choice of law clause and national laws had been chosen in 79.1% of the contracts. In 2003, 82% of the contracts contained a choice of law clause specifying the applicable law. In 80.4% of contracts, the parties opted for a national law. In 2002, 79.4% of the contracts specified a national system as the applicable law. Except for 2.3% of contracts, the parties chose national laws. In 2001, in 78% of cases, the applicable law was specified in the

In the cases of express choice of a national law, the question is whether and to what extent *lex mercatoria* can be applied as *lex fori* to influence the general principles of the chosen national law. Even though the decision maker is required by the parties to apply a national law to a transaction governed through legal uncertainty, *lex mercatoria* may be relevant to the process of adjudication through its basic principles, which provide guidance in the resolution of contractual disputes. Particularly, in the context of arbitration laws and international conventions relating to arbitration within the national legal systems, the decision maker is not required to apply a national law in the same way it is applied by a national court, as his decision does not constitute a part of the self-referential structure of the relevant national legal system. There are differences between the mandates of a judge and an arbitrator, particularly where the rules of chosen national law and contract contradict each other.

The following statement of the arbitral tribunal in ICC Case No 9473 represents the general influence of *lex mercatoria* in the resolution of disputes in the context of international arbitration where the parties agreed to a national law as the law governing the contract: “Now, there may be doubts whether ICC arbitrators should apply the law chosen by the Parties in exactly the same manner as a judge would do in the country of that law. The arbitrator applies the law because of the Parties’ choice; in the legal system in question, he has neither mandate nor function in the application and development of the law. If the parties to a contract have chosen a ‘neutral’ law which, as in the present case, has no connection with the parties and their transaction other than that choice, it can be presumed that the law so chosen, in and of itself, has no claim to apply to the transaction. Moreover, the ICC Rules, after having set out the methods for determining the applicable law, prescribe in Article 13 (5) that ‘in all cases the arbitrator shall take account of the provisions of the contract . . . In the Tribunal’s view this provision requires that, in case of conflict between the terms of the contract and the law chosen by the parties, the arbitrator gives particular weight to the contract. In the light of these considerations an arbitrator must hesitate to apply a provision of the chosen law which would frustrate the will of the parties or would otherwise be contrary to their reasonable expectations at the time of contracting. Since it is now generally accepted that parties to international commercial transactions may choose ‘rules of law’ rather than a specific legal system in its totality, there are good arguments to interpret the parties’ choice of a particular law as exclusive of those rules which would frustrate their intentions.”⁸⁰³

However, the decision maker should not seek to substitute his own choice of law for that of the parties where there is an express and unambiguous choice of law. The premise of *lex mercatoria*, which is expressed by the basic principles of freedom of contract and *pacta sunt servanda*, is the idea that the parties’ knowledge of particular circumstances of time and place should be utilized for the preservation and restoration of the spontaneous order of international commerce. *Lex mercatoria* serves this order of international commerce to the extent that the national legal systems fail in utilizing such knowledge due to the formal consolidations in the form of rules made for the internal order of the legal system, and claim those rules as applicable in the absence of a consent of the parties to that effect, thereby

contact underlying the dispute. This was a national law in 77% of cases. In 2000, in 77% of the cases, the parties had specified in their contracts the rules of law applicable to the merits. This was a set of national laws in 75% of cases. Statistical Reports in ICC International Court of Arbitration Bulletin, Vols. 13-21.

⁸⁰² Statistical Report in ICC International Court of Arbitration Bulletin, 22 (2011)

⁸⁰³ ICC Award in Case No. 9473, 2001, (unpublished) cited by Grigera Naón, Horacio A., Choice of Law Problems in International Commercial Arbitration, *Recueil des Cours*, 289 (2001), at 276

constituting verifiability thresholds for the reasonable expectations of the parties in a particular case. Although the decision maker applying *lex mercatoria* is not bound by the isolated position of the authorities in a legal system, he is bound to apply idiosyncratic rules in the chosen national law, as part of the bargain contemplated under the contract between the parties when they are clear and not overridden explicitly or implicitly by the terms of the contract, or by trade usages in the sense of commercial practices observed in a certain sector over a sufficient period of time. Trade usages in this narrow sense add a layer of contractual relationship in question rather than defeat a choice of national law by the parties.⁸⁰⁴

Unsatisfactory result will arise if the decision maker ignores the chosen law without a legal research to be conducted in cooperation with the parties, on such grounds that the chosen national law is incomplete, inappropriate or unfair. In the abstract reasoning of the decision maker applying *lex mercatoria*, the parties to an international commercial contract can be presumed to have diligently investigated, before entering into the contract, the contents of the national law of their choice and have assumed the legal risks arising from the application of its rules as part of the bargain contemplated under the contract, to the extent they are not overridden by explicitly or implicitly the terms of the contract, or trade usages in the narrow sense. Thus, the abstract reasoning of the decision maker applying *lex mercatoria* should be motivated by the idea that once the parties agree on an identifiable set of default national rules, they become part of the bargain that was contemplated under the contract, and the parties or the decision maker cannot refer to legal sources other than the contract and the chosen default rules, in contravention to the basic principles of *lex mercatoria*, in order to reallocate those risks that have already been assumed by the parties in those articulated rules. *Lex mercatoria* in the interpretation and supplementation of the articulated rules will only be relevant when both the relevant contractual clause and the rule of chosen national law are ambiguous, and when there is a gap in both the contract and the chosen national law, which gives rise to the questions of residual allocation of contractual rights, obligations and risks.

One of the earliest theories on the basis of which arbitrators considered themselves entitled to allow *lex mercatoria* to influence the chosen national law is that of incomplete character of the chosen national law. This theory involves the arbitrators establishing that the law chosen by the parties does not provide an answer to the issue in dispute, and using that finding to justify resolving those issues on the basis of the general principles of law. In the *Aramco Case* of 1958, the arbitral tribunal considered that it need not apply Saudi Arabian law, as the contract specified⁸⁰⁵, on the grounds that “[b]ecause of this fundamental similarity [between Saudi Arabian law and the laws of Western countries on oil concession], the Tribunal will be led, in the case of gaps in the law of Saudi Arabia, of which the Concession Agreement is a part, to ascertain the applicable principles by resorting to the world-wide custom and practice in the oil business and industry; failing such custom and practice, the Tribunal will be influenced by the solutions recognized by world case-law and doctrine and by pure jurisprudence.”⁸⁰⁶ The ICSID Tribunal in the case between *Southern Pacific Properties and Arab Republic of Egypt*

⁸⁰⁴ Lew, Julian D. M., Loukas Mistelis L. A., & Stefan M. Kröll, *Comparative International Commercial Arbitration*, Kluwer Law International, 2003, at 419

⁸⁰⁵ The choice of law clause provided that disputes should be decided “in accordance with Saudi Arabian law insofar as matters within the jurisdiction of Saudi Arabia are concerned, and in accordance with the law declared by the arbitration tribunal to be applicable insofar as matters beyond the jurisdiction of Saudi Arabia are concerned.” 23 August 1958 ad hoc Award by G. Sauser-Hall, referee, M. Hassan and S. Habachy, arbitrators, *Saudi Arabia v. Arabian American Oil Co. (ARAMCO)*, *International Law Reports*, 27 (1963) at 153-154

⁸⁰⁶ *Ibid.*, at 171

reasoned that each national law is incomplete and where a lacunae occurs, it cannot be said that, there is agreement as to the application of a rule of law, which *ex hypothesi*, does not exist.⁸⁰⁷

This approach is criticized on the ground that if the arbitrators apply any law other than the one the parties have chosen, the expectations of the parties will be frustrated.⁸⁰⁸ It is argued that this approach disregards the evident fact that when the courts of chosen legal systems resolve those issues by applying their own law even if they have to resort to analogy or to general principles of their own legal system.⁸⁰⁹ Accordingly, those principles should be applied by the arbitrators in resolving the dispute in order to respect the choice made by the parties, and not the general principles of law drawn from a variety of other legal systems.⁸¹⁰

However, the arbitrators should not be concerned with the consistent application or development of the chosen national legal system, since international arbitration is not an organ of any national legal system and the duties of arbitrators are primarily towards the parties and the supervisory jurisdiction.⁸¹¹ Although the outright failure to apply the law chosen by the parties may constitute an excess of authority for the arbitrators and result in the annulment of the award or render the award unenforceable, there should be a distinction between the failure to apply the proper law and failure to properly apply the law.⁸¹² An error in the application of the law in the same manner as its country of origin is generally not a ground for annulment or non-recognition of the award. Thus, the arbitrators may refer to *lex mercatoria* in order to give effect to the reasonable expectations of the parties in a particular case thereby preserving or restoring the spontaneous order of international commerce, rather than attempting to act as an organ of the relevant national legal system, given that their decision will neither be relevant to the development of that system, nor in any way contribute to the self-referential structures of that legal system.

When the chosen national law is ambiguous or it does not cover the contingency that has become the disputed issue, the arbitral tribunal should resort to *lex mercatoria* rather than speculating about how the national court of that legal system would decide the issue. This is also supported by the practical considerations. It is rarely the case in a major international

⁸⁰⁷ ICSID Award of 20 May 1992 in case no. ARB/84/3, *Southern Pacific Properties (Middle East) Ltd. v. Arab Republic of Egypt*, *Yearbook Commercial Arbitration*, (1994), at 59: “The law of the [Arab Republic of Egypt], like all municipal legal systems, is not complete or exhaustive, and where a lacunae occurs it cannot be said that, there is agreement as to the application of a rule of law, which *ex hypothesi*, does not exist. In such a case, it must be said that there is ‘absence of agreement’, and consequently, the second sentence of Art. 42(1) would come into play....”

⁸⁰⁸ Mustill, Michael, *The New Lex Mercatoria: The First Twenty-five Years*, *Arbitration International*, (1988), at 105

⁸⁰⁹ Gaillard, Emmanuel, *Thirty Years of Lex Mercatoria: Towards the Selective Application of Transnational Rules*, *ICSID Review—Foreign Investment Law Journal*, 10 (1995), at 215

⁸¹⁰ Gaillard, Emmanuel & John Savage (eds.), *Fouchard, Gaillard, Goldman on International Commercial Arbitration*, Kluwer Law International, 1999, at 844

⁸¹¹ Waincymer, Jeff, *International Arbitration and the Duty to Know the Law*, *Journal of International Arbitration*, 28-3 (2011), at 220

⁸¹² As the *ad hoc* Committee in *Soufraki v. United Arab Emirates* stated that: “ICSID *ad hoc* committees have commonly been quite clear in their statements – if not always in the effective implementation of those statements – that a distinction must be made between the failure to apply the proper law, which can result in annulment, and an error in the application of the law, which is not a ground for annulment.” ICSID Case no. ARB/02/07, *Decision on Annulment*, 5 June 2007, para. 85.

arbitration that all arbitrators are experts in the chosen national law. In many cases, none of the arbitrators are specifically trained under the relevant national legal system.⁸¹³ The arbitrators will seek to determine and apply the substantive rules of the chosen national law to govern the issues they are asked to resolve. The counsels of both parties will often argue that the substantive applicable rules are different, supporting the cases of their respective clients. Frequently, the national rule is non-existent or unclear.⁸¹⁴ In such a circumstance, the arbitrators, having heard argument from the counsels, will decide what that legal rule is, and may engage in research, particularly in areas of law in which they are not expert, to ensure that they understand the chosen law correctly. Only after getting the chosen national law right and concluding that the chosen national law does not cover the disputed issue or recognizes a margin of discretionary power, the arbitrators should refer to *lex mercatoria* in giving effect to the reasonable expectations of the parties.

In ICC Case No 10346, where the contract had an explicit choice of law clause in favor of Colombian law, the arbitral tribunal dealing with a claim for damages took into account a clause in the contract, the text of which, in the opinion of the tribunal clearly had its origins in the Anglo-Saxon legal systems and made it necessary to venture into the area of "direct" and "indirect" loss in order precisely to understand the contractual clause. According to the tribunal, "It is not however enough to denote a loss as direct, as regard must also be had to the distinction between "foreseeable" and "unforeseeable" losses, with compensation being payable in relation to the former but not in relation to the latter, save where the debtor had acted fraudulently." In this regard, the tribunal referred to the English decision in *Hadley v. Baxendale* and Article 7.4.4 of the UNIDROIT Principles for characterizing the loss to the criterion of what is in the contemplation of the parties, after establishing that Colombian law has a limited development in case law on the rule of foreseeability of loss.⁸¹⁵

In ICC Case No 11295, the claimant, a Swiss company, initiated arbitration proceedings, alleging that the respondent, a Polish company, had disregarded the exclusive nature of the right it had granted the claimant. The sole arbitrator was required to deal with the issue whether the claimant was entitled to bring claims based on the infringement of rights it had transferred to a subsidiary and whether that subsidiary could be allowed to join the arbitration. In determining the legal effects of the transfer of rights by the claimant to its subsidiary, and in particular whether the transfer concerned both rights and obligations or only rights, the sole arbitrator examined the applicable Polish law chosen by the parties. The arbitrator, after studying Polish law, did not find any specific rule suitable to really clarify the matter. Thus, the arbitrator deemed that Polish law did not provide any specific solution on the substance of the issue. The arbitrator considered the rule of interpretation under Polish law, which provided that the contracts must be interpreted in accordance with the congruent intention of the parties and the purpose of the contract rather than relying on its literal wording. Having pointed out that rule of interpretation, the sole arbitrator held that "In International Arbitration, when the national law(s) to be applied to the dispute, does (do) not provide any specific solution to settle the point of law involved, the arbitral tribunal may subsidiarily apply international law

⁸¹³ Waincymer, Jeff, *International Arbitration and the Duty to Know the Law*, *Journal of International Arbitration*, 28-3 (2011), at 220

⁸¹⁴ Lew, Julian D.M., *The UNIDROIT Principles as Lex Contractus Chosen by the Parties and Without an Explicit Choice of-Law Clause: The Perspective of Counsel*, *Special Supplement, ICC International Court of Arbitration Bulletin: UNIDROIT Principles of International Commercial Contracts: Reflections on their Use in International Arbitration*, 2002, at 86-87

⁸¹⁵ ICC Award in Case No 10346, *ICC International Court of Arbitration Bulletin*, 12-2 (Fall 2001), at 106-115

instruments”.⁸¹⁶ However, the arbitrator found that the question was not specifically addressed by the international law instruments, including the UNIDROIT Principles, and concluded that the solution could only be found by referring to the general principles of law, which can be found on the basis of the convergence between the general Polish rules and the UNIDROIT Principles, and which, in his view, include the principle of the freedom of contract and the principle of interpretation in accordance with the common intention of the parties, the nature and purpose of the contract, good faith and fair dealing and reasonableness.

Essentially, many substantive national laws acknowledge their incompleteness and refer to some vague standards, which ultimately relate to the decision makers’ capacity for abstract reasoning and achieving justice in a particular case by taking into account the reasonable expectations of the parties. In ICC Case No 8486 which concerned an issue of hardship under a contract for the sale of a manufacturing plant that was governed by Dutch law, the sole arbitrator, interpreting the relevant provisions of Dutch law, found support for the reference to the established rules in the order of international commerce from the Dutch legal doctrine. In the doctrine, it was maintained that interpreting Dutch legal rules in international contexts and the provisions on hardship and force majeure in the new Civil Code in particular, Dutch judges should draw inspiration from the UNIDROIT Principles, which have inspired the Dutch legislature when drafting the new Code.⁸¹⁷ The sole arbitrator later stated in a monograph that the view advanced in Dutch legal doctrine was of the utmost importance, which provided the arbitrator with the necessary justification for the international construction of domestic law, and had he not received such support from the relevant domestic law, he would have risked being accused of distorting the applicable law.⁸¹⁸

The substantive rules in national laws also refer to the application of trade usages thereby guiding the decision maker in dealing with the incomplete character of the law. For example, in ICC Case No 9753, relating to an agreement between a British company and a Czech state entity to secure financing for the development of a location in the Czech Republic, the arbitrator, applying Czech law, as chosen by the parties, took into consideration that “under paragraph (1), section 264 of the Czech Commercial Code in determining the rights and duties arising from a relationship of obligations, account is also taken of the business practice (trade usage) prevalent in a particular field of business, unless these are contrary to the contents of the contract or to the law.” Noting that there are no special usages in the particular field of business, the arbitrator considered general principles of business practice have importance, such as *pacta sunt servanda* and good faith by referring to the UNIDROIT Principles, and stated that “Fair business conduct is one of the main principles of the Czech Commercial Code too (section 265).”⁸¹⁹

More generally, the arbitral tribunals refer to the specific rules on trade usages that can be found in arbitration laws and rules in considering the relevance of trade usages to the resolution of disputes. In the context of international arbitration, trade usages are commonly understood as being internal to the contract and an expression of what the parties intend or

⁸¹⁶ ICC Award in Case No. 11295, December 2001, Special Supplement, ICC International Court of Arbitration Bulletin: UNIDROIT Principles: New Developments and Applications, 2005, at 89

⁸¹⁷ ICC Award in Case No. 8486, ICC International Court of Arbitration Bulletin, 10-2 (1999), at 69-70

⁸¹⁸ Berger, Klaus Peter, *The Creeping Codification of the New Lex Mercatoria*, Kluwer Law International, 2nd rev. ed., 2010, at 230-231

⁸¹⁹ ICC Award in Case No. 9753, 1999, ICC International Court of Arbitration Bulletin, 12-2 (Fall 2001), at 83

reasonably expect.⁸²⁰ This understanding of trade usages suggests that, arbitrators are entitled to add to or to even modify the provisions of the law chosen by the parties if the reasonable expectations of the parties so require. For example Article 1496 of the New French Code of Civil Procedure instructs arbitrators to take into account international trade usages “in all cases,” that is, even where the parties have expressly chosen the law governing the dispute. The same is true for the 1961 European Convention⁸²¹, the codes of civil procedure of the Netherlands⁸²² and Germany⁸²³, and more generally, all statutes inspired by the UNCITRAL Model Law.⁸²⁴ Moreover, various international arbitration institutions require, in their rules, arbitrators to consider usages of trade in deciding contractual disputes.⁸²⁵

In ICC Case No 9593, concerning a dispute which arose from a number of exclusive distribution agreements concluded between an Ivorian distributor and a joint venture supplier of UK/Japanese origin, the agreements contained a choice of law clause in favor of Ivorian law. In addition to Ivorian law, the arbitral tribunal stated that “Pursuant to Article 13(5) of the ICC Rules, the Arbitral Tribunal shall also take into account the provisions of the contract and the relevant trade usages. In doing so, the Arbitral Tribunal will pay particular attention to the specific nature of the Agreements and to the context within which they were entered into.”⁸²⁶ The tribunal further noted that Article 1135 of the Ivorian Civil Code provides that a contract binds the parties not only according to its wording, but also to the consequences thereof resulting from equity, custom and the law. According to the tribunal, in the contractual relationship underlying the dispute, the custom to be taken into consideration within the framework of Article 1135 of the Ivorian Civil Code is to be found within the usages of international trade. The tribunal was of the opinion that the duty of the parties to cooperate in good faith to reach the common goals contractually agreed upon has become a fundamental element of the usages of international trade applicable to the case through Article 1135 of the Ivorian Civil Code and Article 13(5) of the ICC Rules. The arbitral tribunal referred to Article 5.1.3 of the UNIDROIT Principles in order to confirm its opinion.

In those cases, such as ICC Cases No 9593 and No 9753 referred to above, trade usages include not only the practices usually followed in a particular business sector, but also rules of law derived from comparative law and, thus, trade usages are absorbed into the general principles or the established rules in the order of international commerce. It is argued that if this extensive view of trade usages were to be accepted, arbitrators would be able, on the basis

⁸²⁰ Craig, W. Laurence, William W. Park & Jan Paulsson, *International Chamber of Commerce Arbitration*, Oceana Publications, 3rd ed., 2000, at 332

⁸²¹ Article VII of the 1961 European Convention on International Commercial Arbitration of 1961 done at Geneva: “The parties shall be free to determine, by agreement, the law to be applied by the arbitrators to the substance of the dispute. Failing any indication by the parties as to the applicable law, the arbitrators shall apply the proper law under the rule of conflict that the arbitrators deem applicable. In both cases the arbitrators shall take account of the terms of the contract and trade usages.”

⁸²² Article 1054 (4) of the Netherlands Code of Civil Procedure

⁸²³ Article 1051 (4) of the German Code of Civil Procedure

⁸²⁴ Article 28 (4) of the UNCITRAL Model Law: “In all cases, the arbitral tribunal shall decide in accordance with the terms of the contract and shall take into account the usages of the trade applicable to the transaction.”

⁸²⁵ For example, Article 17(2) of the Rules of Arbitration of the ICC, Article 33 (3) of the UNCITRAL Rules and Article 28 (2) of the International Arbitration Rules of the AAA require the arbitrator to take into account usages. On the other hand, the LCIA and the SCC do not have rules requiring arbitrators to consider trade usages.

⁸²⁶ ICC Award in Case No. 9593, December 1998, ICC International Court of Arbitration Bulletin, 10-2 (Fall 1999), at 107

that trade usages are taken to include general principles or law, to extend or modify provisions of the national law expressly chosen by the parties.⁸²⁷ Thus, it is suggested that trade usages should be understood as practices usually followed in a particular business sector and can only enable the arbitrator to interpret the intentions of the parties who, in the absence of an express agreement to the contrary, may be considered to have agreed to comply with trade usages.⁸²⁸

In cases of choice of a national law, the arbitrators should refer to the broader understanding of trade usages, or the general principles of law, which corresponds to the concept of the established rules in the order of international commerce, when they are in conformity with the chosen national law, in order to accommodate the pleadings of both parties, by showing that the relevant national rule is an established rule. This approach underlines that the arbitrators are not an organ of a national legal system, as they involve into their legal reasoning such materials that may not be considered as important and appropriate in the application of the national law by the authorities in the relevant legal system.

There are some awards that illustrate this approach. In ICC Case No 9651, the contract underlying the dispute was governed by Swiss law pursuant to the choice of law clause. The arbitral tribunal sitting in Zurich had to decide on the interpretation of the choice of law clause, where the issue was whether the chosen national law also covered disputes as to misrepresentation or fraud in the conclusion of the contract containing the choice of law clause. The defendant argued that the reference to Swiss law in the choice of law clause was limited to the contract while the issue of fraudulent misrepresentation during negotiations should be settled according to Indian law as the law of the place of negotiations, because the defendant as an Indian company needed various permissions to enter into such contracts, and a number of representations made by the foreign party are carried by the Indian party to the Indian Government. The defendant also argued that the principles of justice, equity and good conscience should apply, and the UNIDROIT Principles are a useful guide in relation to such principles of justice and equity as are internationally acceptable.⁸²⁹ The tribunal determined that the applicable law to the interpretation of the choice of law clause was Swiss law as the law chosen by the parties, pursuant to Article 116 (2) of the Swiss Private International Law Act.⁸³⁰ However, in interpreting the choice of law clause, the tribunal expressly referred to Articles 1.7, 4.1 and 4.2 of the UNIDROIT Principles in order to highlight the convergence of the rules of interpretation under the applicable Swiss law with the established rules, and held that according to the understanding of a reasonable businessman, the choice of law clause that was also intended to bear on any issue relating to the conclusion of the contract.⁸³¹ With respect to the merits of the case, while relying on comparative law sources to show that the respect for the choice of law of the parties was of paramount importance and finding that Swiss law applies, the arbitral tribunal pointed out that the avoidance of a contract for willful deception is a common understanding of all civilized jurisprudence and referred to Articles 2.1.15(2), 3.8 and 3.9 of the UNIDROIT Principles. Further, the tribunal stated that

⁸²⁷ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 845

⁸²⁸ *Ibid.*, at 846

⁸²⁹ ICC Award in Case No. 9651, August 2000, ICC International Court of Arbitration Bulletin, 12-2 (Fall 2001), at 78

⁸³⁰ *Ibid.*, at 78

⁸³¹ *Ibid.*, at 79

“principles of justice, equity and good conscience will be legitimately applied by the Arbitral Tribunal for the purpose of determining the scope and manner of applying the law, and what should be the nature and extent of the relief to be granted, as those principles are referred to in Swiss law (see e.g. art. 4 Civil Code and art. 42, para. 2 CO).”⁸³²

In ICC Case No 8179, concerning a contract, which was governed by Swiss law pursuant to the choice of parties, the arbitral tribunal reduced the amount of damages to be awarded to the claimant, because the tribunal found the inflexible attitude of the claimant, who refused to renegotiate the contract price after an unforeseen event, which prevented the execution of contract for more than three months, although the duty of renegotiation was explicitly provided in the contract. The tribunal found the attitude of the claimant in contravention of the provisions of Swiss law and *lex mercatoria*, both of which, according to the tribunal, require that any aggrieved party to take steps to limit its loss.⁸³³

In ICC Case No. 8240 concerning a distributorship agreement between parties from Switzerland, Singapore and Belgium, although the parties had indicated Swiss law as the law governing their contract, the sole arbitrator, in deciding the rate of exchange to be chosen for the payment in the local currency, referred to the principle of nominalism, according to which absent a specific provision in the agreement, each debtor has to pay a monetary debt at its nominal value and each party carries the risk of currency depreciation. According to the arbitrator, the principle of nominalism is a general principle of transnational law and laid down not only in Swiss court decisions and doctrinal writings, but also in Article 6.1.9(3) of the UNIDROIT Principles.⁸³⁴

In ICC Case No. 8548, where the parties agreed to Dutch law as the applicable law, the defendant undertook to pay a commission to the claimant for the conclusion of contracts with customers identified by the claimant as potential distributors and purchasers of the defendant’s products. The claimant developed many professional contacts but no contract was entered into by the defendant with these potential customers. The sole arbitrator stated that Dutch law requires that the contractual obligation of the defendant is based on the principles of good faith and justice. In order to underline the importance of these principles, the arbitrator stated that these principles are not only enacted in Dutch law but have an international dimension since they are equivalent to the principle of good faith under the UNIDROIT Principles and *lex mercatoria*. According to the arbitrator, the defendant should pursue in good faith the business opportunities identified by the claimant, must play an active role in the conclusion of contracts, and can refuse to enter into those contracts only within reasonable limits.⁸³⁵

In ICC Case No. 8908, the issue was the interpretation of a settlement agreement, which was concluded between an Italian manufacturer and a Liechtenstein distributor in order to settle their disputes arising from a number of contracts for the supply under the distribution contract. While the individual supply contracts concluded were governed by the CISG, the settlement agreement was governed by Italian law. When deciding the merits of the case, the

⁸³² *Ibid.*, at 81

⁸³³ ICC Award in Case No 8179, *Chronique de jurisprudence arbitrale de la CCI*, in *Cahiers de l'arbitrage*, *Gazette du Palais*, No. 119-123, (2001), at 40

⁸³⁴ ICC Award in Case No 8240, *ICC International Court of Arbitration Bulletin*, 10-2 (Fall 1999), at 60-62

⁸³⁵ ICC Award in Case No. 8548, *Chronique de jurisprudence arbitrale de la CCI*, in *Cahiers de l'arbitrage*, *Gazette du Palais*, No. 119-123, 121, (2001), at 41

arbitral tribunal referred, in addition to the relevant provisions of the Italian Civil Code, to provisions contained in CISG and the UNIDROIT Principles, defining both as “normative texts that can be considered helpful in their interpretation of all contracts of an international nature”. The arbitral tribunal stated that “The rules relating to interpretation and good faith contained in the UNIDROIT Principles (in particular, articles 1.7 and from 4.1 to 4.8), which are in all events a useful reference framework for applying and judging a contract of an international nature, also confirm what has been said [with regard to the rules of interpretation under Italian law].”⁸³⁶

In ICC Case No. 9594, the contract for the delivery and installation of industrial machinery contained a choice of law clause in favor of English law. The arbitral tribunal found that the defendant had failed to take all reasonable steps to mitigate the loss consequent on the claimant’s breach, but it did not only referred to the leading English cases stating the duty of mitigation but also stated that “[a] similar standard has been established internationally, primarily in the UNIDROIT Principles.”⁸³⁷

In ICC Case 10335, where the contract contained a choice of law clause in favor of Greek law, the sole arbitrator, interpreting the contract, referred to not only the relevant provisions of the Greek Civil Code, but also the similar provisions in Sections 133 and 157 of the German Civil Code, Section 914 of the Austrian Civil Code, Article 18 of the Swiss Code of Obligations and the UNIDROIT Principles in order to demonstrate that the Greek rules are “common heritage of and fundamental to most civil-law systems, and in particular to the civil codes of the so-called germanic legal family” and “modern international commercial law is evolving in the same direction.”⁸³⁸

Finally, in ICC Case No 10346 concerning a contract for the sale of electricity, between two Colombian companies, governed by Colombian law pursuant to the choice of law clause, the tribunal referred to Article 871 of the Commercial Code of Colombia as well as Article 5.1.3 of the UNIDROIT Principles, both of which provided the general principle of the duty of co-operation between the parties. Moreover, with regard to the principle of good faith, the arbitral tribunal took into account Article 1175 of the Italian Civil Code, which the Colombian Commercial Code took as its model, and Article 1.7 of the UNIDROIT Principles.⁸³⁹

The broader understanding of trade usages or the established rules in the order of international commerce may also become relevant when there is an ambiguity or gap in the chosen national law.⁸⁴⁰ *Lex mercatoria* in the sense of this broader understanding of trade usages in arbitration can be used as *lex fori* of the international arbitral tribunals, namely, as a means of interpretation of unclear provisions, or in order to fill the gaps of chosen national law, or as an indication of the likely substantive rule of the chosen national law in accordance with the

⁸³⁶ ICC Award in Case No 8908, ICC International Court of Arbitration Bulletin, 10-2 (Fall 1999), at 86

⁸³⁷ ICC Award in Case No 9594, ICC International Court of Arbitration Bulletin, 12-2 (Fall 2001), at 73-76

⁸³⁸ ICC Award in Case No 10335, ICC International Court of Arbitration Bulletin, 12-2 (Fall 2001), at 102-106

⁸³⁹ ICC Award in Case No 10346, ICC International Court of Arbitration Bulletin, 12-2 (Fall 2001), at 106-115

⁸⁴⁰ Lew, Julian D.M., *The UNIDROIT Principles as Lex Contractus Chosen by the Parties and Without an Explicit Choice of-Law Clause: The Perspective of Counsel*, Special Supplement, ICC International Court of Arbitration Bulletin: UNIDROIT Principles of International Commercial Contracts: Reflections on their Use in International Arbitration, 2002, at 86-87

reasonable expectations of the parties. However, when the chosen national law is clear on the disputed issue, the arbitrator should not allow a party to escape from the resulting specific contractual obligations on the basis of the broader understanding of trade usages or other conceptions of the general principles of law in contravention to the basic principle of *pacta sunt servanda*. In such cases, in order to deviate from the specific rules of the chosen national law, the arbitrators may only rely on explicit or implicit intentions of the parties or trade usages in the narrow sense, which add a layer to the contractual relationship.

This was the understanding that had apparently motivated the reasoning of the arbitral tribunal in ICC Case No. 9029. The case concerned a shareholders agreement for the financing of an aeronautical project between an Italian company and an Austrian company. The Italian company terminated the contract after the Austrian company failed to make payment. The contract contained a choice of law clause in favor of Italian law. The Austrian party, as the defendant, claimed that the contract was invalid or inapplicable, and based its claims on the UNIDROIT Principles, particularly the provisions on hardship, gross disparity, and the principle of good faith, as “as an authoritative source of knowledge of international trade usages”⁸⁴¹. The arbitral tribunal expressed its intention to follow a widespread interpretative trend “whereby, where the parties have expressly and precisely identified the law applicable to the relationship established between themselves and, in particular, have, as in the present case, identified it as a national law, the possibility of shaping the procedure in accordance with rules that do not belong to the national system of rules to which the contracting parties have referred is precluded.” The arbitral tribunal underlined the importance of the knowledge of the particular circumstances of time and place, and the understanding that the chosen national law constitutes a part of the bargain that is contemplated under the contract by stating that, “where the parties have availed themselves of the possibility of choosing the legal system applicable to their relationship, no-one can substitute himself for these parties in the choice of applicable laws, adapting the system at his discretion.”⁸⁴²

In this context, the tribunal stated that “international commercial usages are of strictly interpretative and integrative value, to the extent that there are gaps in national regulations that could usefully be filled by the aforesaid usages.” According to the tribunal, “when the parties have chosen national law as the law applicable to their relationship, it being certainly not possible, in such a case, to substitute international commercial usages for the national law chosen by the parties with regard to institutions, actions, and effects, for which the latter makes special provision.” Thus, as the questions of the contractual disparity, whether at the start in the form of gross disparity or that occurred after the conclusion of the contract in the form of hardship, are specifically regulated by Italian legislation, the arbitral tribunal held that the appeal to *lex mercatoria* or to the UNIDROIT Principles does not permit application of the doctrine of gross disparity and of hardship beyond the limits of or with effects different from the presuppositions that are relevant in law chosen by the parties.⁸⁴³

When the parties choose a national law, its specific rules become part of the bargain contemplated under the contract, and a party should not attempt to depart from the agreed bargain of the contract later at the stage of adjudication in contravention to the basic principle of *pacta sunt servanda*. However, the arbitral tribunal in ICC Case No 9029 went further and

⁸⁴¹ ICC Award in Case No. 9029, March 1998, ICC International Court of Arbitration Bulletin, 10-2 (Fall 1999), at 88

⁸⁴² *Ibid.*, at 90

⁸⁴³ *Ibid.*, at 91

categorically rejected the idea that trade usages in the narrow sense may override the provisions of the chosen national law by stating that “Article 834 of the [Italian] Code of Civil Procedure, which does not allocate any precedence to the various sources, does not grant to any international commercial usages that can be taken into account, in the interpretation of a contract, supremacy over the provisions of Italian law”. As the tribunal in ICC Case No. 8873 pointed out, such possibility exists on the basis of the specific reference to trade usages in the arbitration laws.

ICC Case No. 8873 concerned a dispute arising from a construction agreement between a Spanish and a French party. The parties had included a provision in their agreement according to which the contract was to be entirely governed by Spanish law, to the exclusion of any other law. The claimant contended that under the ICC Rules of Arbitration, the decision should be primarily based on the terms of the contract and the relevant trade usages and Spanish law was applicable only to the extent it was necessary to refer to a given legal system. This was rejected by the respondent, who stressed that according to Spanish law, trade usages are only applicable in the absence of statutory regulation. Referring to Article 13 of the ICC Rules and Article VII of the 1961 European Convention, which both Spain and France had ratified, the arbitral tribunal observed that it was not bound to follow strict rules of national law in determining whether and to what extent the trade usages may apply, possibly in place of provisions of the applicable national law. According to the tribunal, particularly Article VII of the European Convention established an internationally uniform principle, which applies instead of national rules on the matter, and recognizes to arbitrators a broad margin of discretion to determine the role which usages shall be given. The tribunal stated that, in the international field, the arbitrators are enabled to place trade usages in a very important position, being only limited by the need to respect the mandatory rules of the applicable law. According to the tribunal, in this understanding, trade usages were applicable when they are widely known and regularly observed in a given trade, and this assessment should be subject to the reasonable expectations of the parties.⁸⁴⁴

Finally, the arbitrator applying *lex mercatoria* may disregard the rules of chosen national law, which conflict with the contractual terms and frustrate the contractual intention of the parties. In ICC Case No 4145, the relevant agreement provided that the validity and construction of the agreement shall be governed by Swiss law, or the law of country of X, which was a Middle East country, or both. The tribunal directly applied Swiss law, on the ground that: “the law of country X might partially or totally affect the validity of the agreement. It is then reasonable to assume that from two possible laws, the parties would choose the law which would uphold the validity of the agreement. It is also a general and widely recognized principle that from two legal solutions, the judge will choose the one which favours the validity of an agreement (*favor negotii*).” Thus, the tribunal held that Swiss Law which, in its opinion, constitutes a highly sophisticated system of law, and answers all the questions that may arise from the interpretation or fulfillment of the agreement, was the applicable law, assuming that this choice corresponded to what the parties had in mind by inserting the relevant provision in the agreement.⁸⁴⁵

Where the parties agree on a particular national law as the governing law, *lex mercatoria* may serve as *lex fori* in international arbitration. In such cases, the principle of sanctity of contract

⁸⁴⁴ ICC Award in Case No. 8873, July 1997, ICC International Court of Arbitration Bulletin, 10-2 (Fall 1999), at 79

⁸⁴⁵ ICC Award in Case No.4145 (Second Interim Award), Yearbook Commercial Arbitration, (1987), at 101

implies that arbitrator should apply this law even if this law includes idiosyncratic provisions which are not supported by a widely accepted rule within the national legal systems. The application of the established rules, which are discovered by the decision maker exercising an abstract reasoning in the specialized consolidations, will be relevant to the extent that the relevant rules of the chosen national law are consistent with those established rules. The trade usages in this broader understanding will also be relevant where the chosen national law is insufficient to provide a clear answer in a particular case due to its ambiguity or lacunae. In order to override the rules of the chosen national law that do not conflict with the contractual terms through *lex mercatoria*, the decision maker should find a trade usage in the narrow sense, i.e. an established rule in the particular case, which must be evidenced that a particular conduct is expected in a specific sector in which the transaction takes place. Furthermore, *lex mercatoria* as *lex fori* may require the decision maker to refer to a law different to that chosen by the parties, where it is relevant in the sense of established rules of policy.

ii. Choice of Lex Mercatoria

In some contracts, there are references to the concept of lex mercatoria or other expressions, such as “general principles of law” or “international trade usages”, or more specific formulations, such as the general principles common to the national laws of the parties, in relation to the applicable law. The contractual clauses designating lex mercatoria, through vague standards, as the applicable law reduce ex ante transaction costs of increasing the level of knowledge for achieving a complete contract. When the parties attempt to agree on a national law or a set of identifiable rules such as the UNIDROIT Principles, they incur ex ante transaction costs which are associated with acquiring and processing knowledge relating to the possible consequences of the application of those rules. The choice of a set of rules that are easily identifiable to the decision maker implies a legal risk in the form of a foreseeable contingency and requires the parties to assess that risk and make necessary adjustments in their contract if they wish to avoid or mitigate its effect on their bargain. When the contract includes, instead, a reference to lex mercatoria, the decision making process should determine which legal materials are relevant and the weight to be assigned to each in giving effect to the reasonable expectations of the parties. In such a case, transaction costs are incurred only with respect to the decision making process, which might be avoided entirely if the parties settle or renegotiate.

The reference to lex mercatoria, if unaccompanied by a particular national law, in the choice of law clauses implies that no particular national law indicates the reasonable expectations of the parties and should become part of the bargain contemplated under the contract. Thus, the decision maker should not engage into any form of choice of law analyses. Such clauses allow the decision maker to directly apply lex mercatoria to the merits of the dispute. The decision maker is required to apply lex mercatoria as the law of principled adjudication in order to determine the established rules in a particular case thereby giving effect to the reasonable expectations of the parties. However, such choice of law clauses are rare in practice probably because the contracting parties generally do not wish to leave a great discretionary power to the decision maker in the ex post allocation of residual contractual rights, obligations and risks, whereby their transactions would be governed by legal uncertainty to a great extent, particularly when the transaction costs incurred are not so extreme as to prevent parties from seeking legal advice in relation to a set of default rules: for example, the repeated use of the same national law in choice of law clauses can considerably reduce the transaction costs involved.

In a number of instances, international organizations, both intergovernmental and representing the private sector, have recommended the use of lex mercatoria in their model contracts. This is the case, for instance, in Article 13(1) of the ICC Model Occasional Intermediary Contract and Article 12 of the ICC Model International Franchising Contract, which make reference to general principles of law and the UNIDROIT Principles.⁸⁴⁶ Similarly, under Article 24.1 A of the 2002 ICC Model Commercial Agency Contract, Article 24.1 of the 2002 ICC Model

⁸⁴⁶ Kronke, Herbert, *The UN Sales Convention, The UNIDROIT Contract Principles and the Way Beyond*, *Journal of Law and Commerce*, 25 (2005-2006), at 454: Article 13.1 of the 1999 ICC Model Occasional Intermediary Contract: “Unless otherwise agreed in writing [...] any questions relating to this Agreement shall be governed by the rules and principles of law generally recognized in international trade as applicable to international contract with occasional intermediaries together with the Unidroit Principles of International Commercial Contracts.” Art. 32A of the 2000 ICC Model International Franchising Contract: “This Agreement is governed by the rules and principles of law generally recognized in international trade together with the Unidroit Principles of International Commercial Contracts.”

Distributorship Contract–Sole Importer–Distributor, Article 23.1 (A) of the 2004 ICC Model Selective Distributorship Contract, and Article 18.1(B) of the 2004 ICC Model Mergers & Acquisitions Contract, it is provided that: “Any questions relating to this contract which are not expressly or implicitly settled by the provisions contained in this contract shall be governed, in the following order: (a) by the principles of law generally recognized in international trade as applicable to international [agency, distributorship, selective distributorship, merger and acquisition] contracts, (b) by the relevant trade usages, and (c) by the UNIDROIT Principles of International Commercial Contracts, with the exclusion [...] of national laws”.⁸⁴⁷

The freedom to choose *lex mercatoria*, as the law governing the substance of the dispute, enjoyed by the parties is signaled, in international arbitration, by the use of words “rules of law” as opposed to “the law”, when describing the rules, which the parties are free to choose pursuant to the principle of party autonomy. This terminology was first used by the 1981 French decree on international arbitration, which provided in Article 1496 of the New Code of Civil Procedure that the parties were to select the “rules of law” applicable to their dispute.⁸⁴⁸ This terminology is later codified by various arbitration codes⁸⁴⁹, UNCITRAL Model Law on Arbitration⁸⁵⁰ and rules of institutional arbitral tribunals⁸⁵¹. It is generally agreed today that this terminology indicates that the parties may choose various rules from different sources, including the non-national rules of law.

The contracting parties resort to a variety of expressions to convey their intention that *lex mercatoria* should be applicable to the substance of the dispute to the exclusion of any particular set of national rules as indicating the reasonable expectations of the parties. These expressions include “general principles of international commercial law” “generally recognized legal principles” and “principles common to several legal systems”.⁸⁵² For example, the choice of law provision in the Accords establishing the Iran-United States

⁸⁴⁷ Kronke, Herbert, *The UN Sales Convention, The UNIDROIT Contract Principles and the Way Beyond*, *Journal of Law and Commerce*, 25 (2005-2006), at 454

⁸⁴⁸ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, *Goldman on International Commercial Arbitration*, Kluwer Law International, 1999, at 802, French Code of Civil Procedure (1981) Article 1496 (1): the arbitrator shall decide the dispute in accordance with the rules of law chosen by the parties or, in the absence of such choice, in accordance with the rules of law he considers appropriate.

⁸⁴⁹ Swiss Private International Law Act (1987) Article 187 (1); Dutch Code of Civil Procedure (1986) Article 1054 (1) & (2); Italian Code of Civil Procedure Article 822. United States Federal Arbitration Act and the Arbitration Act of Sweden are silent on whether the arbitrator must act in accordance with the rules of law, and if so, what law should be applied. Arbitration rules generally address the issue. As a different approach, see English Arbitration Act 1996 Art. 46: (1) The arbitral tribunal shall decide the dispute (a) in accordance with the law chosen by the parties as applicable to the substance of the dispute, or (b) if the parties so agree, in accordance with such other considerations as are agreed by them or determined by the tribunal....

⁸⁵⁰ UNCITRAL Model Law on Arbitration (1985) Article 28 (1).

⁸⁵¹ ICC Arbitration Rules (1998), Article 17(1); AAA, International Arbitration Rules (2008), Article 28 (1); LCIA, Arbitration Rules (1998), Article 22.3; Arbitration Institute of the SCC, Arbitration Rules (2007), Article 22 (1). As a different approach to the applicability of *lex mercatoria* see China International Economic and Trade Arbitration Commission (CIETAC), Arbitration Rules (2005), Article 43 (1): The arbitral tribunal shall independently and impartially make its arbitral award on the basis of the facts, in accordance with the law and the terms of the contracts, with reference to international practices and in compliance with the principle of fairness and reasonableness.

⁸⁵² See the clauses cited by Rivkin, David W., *Enforceability of Arbitral Awards Based on Lex Mercatoria*, *Arbitration International*, (1993), at 72 et seq

Claims Tribunal provided that “The tribunal shall decide cases on the basis of respect for law, applying such choice of law rules and principles of commercial and international law as the Tribunal determines to be applicable, taking into account relevant usages of the trade, contract provisions and changed circumstances.”⁸⁵³ In many cases, the Tribunal declined to apply the national law that would govern under traditional conflict of laws principles, and, instead applied general principles of law.⁸⁵⁴ In ICC Case No. 5163, the tribunal was required to apply “the principles common to the laws of the Arab Republic of Egypt and the United States of America.”⁸⁵⁵ In ICC case No. 6378, the arbitrators were to apply “general principles of law applicable in Western Europe.”⁸⁵⁶

In ICC Case No. 12111, the dispute arose from a sales contract between a Romanian seller and a English buyer, which contained a choice of law clause providing that “the present contract is governed by international law”. In the proceedings, the parties disagreed as to the content of the law applicable to the substance of the dispute. The sole arbitrator was persuaded that the parties wished to depart from a national legal system and they did not want to apply the private international law of an undetermined national legal system. The arbitrator held that “international law” should be understood as international rules applicable to international contracts. The arbitrator referred to *lex mercatoria* and general principles of law applicable to international contractual obligations, which are reflected in the UNIDROIT Principles, and concluded that the dispute should be governed by the UNIDROIT Principles.⁸⁵⁷

In ICC Case No. 7235, the parties had indicated in their contract that any national law should be excluded in all juridical questions, and the only basis in the juridical meaning of the contract and its application was the international law and especially the rules of the International Chamber in Paris. The arbitrator interpreted the latter reference as the 1988 ICC Arbitration Rules, and the reference to international law in the contract did not, according to the arbitrator, identify the applicable law by itself. The arbitrator considered Article 13(3) and (5) of the ICC Arbitration Rules in the determination of the applicable law, and concluded that the application of these provisions and reference to international law in the contract led the arbitrator to decide any question that was not directly regulated by the contract by applying transnational law, rules of the *lex mercatoria*, trade usages, supplementary or corrective rules of a transnational public policy. The arbitrator considered such a choice of law as valid and binding upon both the parties.⁸⁵⁸

The parties’ choice of the CISG as the governing law may also be interpreted in support of a choice of *lex mercatoria* when the agreement is a long-term and complex contractual

⁸⁵³ Declaration of the Government of the Democratic and Popular Republic of Algeria Concerning the Settlement of Claims by the Government of the United States of America and the Government of the Islamic Republic of Iran, Article V, available at <http://www.iusct.org/claims-settlement.pdf>

⁸⁵⁴ Ball, M., Structuring the Arbitration in Advance - The Arbitration Clause in an International Development Agreement, in Julian D. M. Lew (ed.), *Contemporary Problems in International Arbitration*, London, 1986, at 311

⁸⁵⁵ Unpublished clause, cited by Gaillard, Emmanuel, *Thirty Years of Lex Mercatoria: Towards the Selective Application of Transnational Rules*, *ICSID Review—Foreign Investment Law Journal*, 10 (1995), at 225

⁸⁵⁶ ICC Award in Case No 6378, 1991, *Journal du droit international*, 120 (1993), at 1018

⁸⁵⁷ ICC Award in Case No 12111, 2003, *ICC International Court of Arbitration Bulletin*, 21-1 (2010), at 78

⁸⁵⁸ ICC Award in Case No 7235, *Chronique de jurisprudence arbitrale de la CCI*, in *Cahiers de l'arbitrage*, *Gazette du Palais*, No. 119-123, 121, (2001), at 37

relationship and, as such, is not in principle covered by the CISG. In ICC Case No 11849, the exclusive distributorship agreement provided that “The Arbitrator shall apply the 1980 UN Convention on the International Sale of Goods for what is not expressly or implicitly provided for under the contract. Letters of Credit shall be governed by the Uniform Customs and Practices for Documentary Credits”.⁸⁵⁹ The dispute arose from the termination of the agreement by the manufacturer. The distributor argued that a distribution agreement should not be considered as a mere sale of goods, and that the CISG would consequently be inappropriate to govern the termination of such a complex and long-term contract. The distributor submitted that the termination of the agreement should be assessed according to Italian law, while the CISG should apply to sales contracts concluded pursuant to a distributorship agreement, but not to a contract for distribution of goods over a period of years.⁸⁶⁰ The manufacturer argued that since the contract did not refer to other statutes or legal principles, the arbitrator should only rely on the contract, on the CISG and on the uniform customs and practices for documentary credits, and these documents allow the arbitrator to solve all the issues, while “a different approach would violate the contract and the parties’ original intention, which the arbitrator is required to enforce”.⁸⁶¹

The arbitrator rejected the distributor’s argument and stated that “First of all, by submitting the Agreement to the CISG (when such instrument does not, in principle apply to a long term distribution contract), and also by referring to the ICC Uniform Customs and Practices for Documentary Credits, the parties have clearly indicated their intention to avoid their respective internal law rules, and to resort to neutral solutions. Secondly, the way [choice of law clause] of the Agreement has been drafted shows that the parties did not intend to limit the application of the CISG to possible disputes related to single sales of products, but did rather submit the whole Agreement to its rules, with the only exception of what ‘is not expressly or implicitly provided’ by it. The intention of the parties to apply the CISG rules to their possible disputes has therefore been clearly expressed.”⁸⁶² The arbitrator considered that Article 7(2) of the CISG would in case of gaps lead to the subsidiary application of the appropriate rules of law according to Article 17(1) of the 1998 ICC Rules. As the CISG provides rules which can easily be applied to the termination of a distribution agreement, the arbitrator concluded that pursuant to Article 17(1) of the ICC Rules, the parties’ will to apply the CISG to their dispute should be obeyed.⁸⁶³

The parties may also decide that the international restatements of contract principles should be applied as the law governing the substance of the contract. In that case, the specific rules of those restatements become incorporated into the agreed bargain under the contract and should be treated as part of the articulated rules. In ICC Case No 8331, the arbitral tribunal recalled that, according to the parties’ agreement, “the Arbitral Tribunal shall apply the relevant agreements between the parties and, to the extent that the Arbitral Tribunal finds it necessary and appropriate, the Unidroit Principles of International Commercial Contracts of May 1994 shall be applied by the Arbitral Tribunal.”⁸⁶⁴ In such cases, the ambiguities or gaps in those restatements, which give rise to the issues of residual contractual rights, obligations and risk

⁸⁵⁹ ICC Award in Case No. 11849, 2003, Yearbook Commercial Arbitration, 31 (2007), at 153

⁸⁶⁰ Ibid., 151

⁸⁶¹ Ibid., at 152

⁸⁶² Ibid., at 152-153

⁸⁶³ Ibid., at 154

⁸⁶⁴ ICC Award in Case No. 8331, 1996, ICC International Court of Arbitration Bulletin, 10-2 (Fall 1999), at 65

allocations, will be dealt through the application of *lex mercatoria* as the law of principled adjudication.

The UNIDROIT Principles and the PECL also provide that they can be applied when the parties have agreed that their contract is governed by “general principles of law”, “*lex mercatoria*” or similar concepts.⁸⁶⁵ In a 1995 LCIA case concerning a contract between a United States company and a governmental agency of a Middle Eastern country, which contained a provision according to which any disputes which might arise would be settled on the basis of “Anglo-Saxon principles of law”, the arbitral tribunal decided to refer to expressly to the UNIDROIT Principles, and in particular to their rules of interpretation, in the absence of any further specification as to what exactly this formula might mean.⁸⁶⁶ However, in those cases, the international restatements will be applied only on the basis of their persuasive authority, assisting the consolidations of the decision maker exercising an abstract reasoning for discovering the established rules, but not as a matter of enforcing the agreed bargain contemplated under a transaction.

In some instances, the parties may provide more indication as to how the decision maker applying *lex mercatoria* should consolidate the relevant materials through his abstract reasoning in giving effect to their reasonable expectations. Such indications must take precedence, pursuant to the basic principle of freedom of contract. They may include a specified hierarchy between various sources or instructions as to the applicable legal norms. Thus, the arbitrator should firstly analyze the choice of law clause itself in order to find the appropriate method for determining the materials from which applicable legal rules will be derived. Some clauses provide that principles common to several specified legal systems are to apply. In an Ad Hoc Arbitration between Banque Arabe et Internationale d’Investissements and Inter-Arab Investment Guarantee Corporation (IAIGC), the parties to the loan guarantee contract provided the arbitral tribunal with guidance as to the determination of the applicable rules and the order in which the search for those rules should be under taken. The general conditions of the loan guarantee contract provided that “the Tribunal shall decide the dispute according to the provisions of the contract. In case of ambiguity of the terms, the Tribunal shall interpret them according to the common intention of the parties without recourse to the literal meaning of the words. If there is no applicable provision, the Tribunal shall apply the common legal principles prevailing in the member countries of [IAIGC], and the recognized principles of international law.”⁸⁶⁷ The tribunal considered that the system provided by that clause practically excluded the traditional method of conflict rules, which direct to the applicability of a given national law, and the conflict rules were replaced by the direct recourse to sources of multinational character, which included the common legal principles prevailing in the Arab world, or recognized by the world community at large as one of the components forming international law.⁸⁶⁸ In some cases, the arbitrators are required to use the “tronc commun” method and conduct a comparative analysis limited to that of the listed legal systems, unless the clause itself allows other rules to be used on a subsidiary basis. For example, the construction contract for the Channel Tunnel provided that it was governed by

⁸⁶⁵ Preamble (Purpose of the Principles) UNIDROIT Principles of International Commercial Contracts 2010; also see Article 1:101 (3) of the Principles of European Contract Law Prepared by the Commission on European Contract Law 1999

⁸⁶⁶ Abstract available at <http://www.unilex.info/case.cfm?id=712>

⁸⁶⁷ Ad Hoc UNCITRAL Award of 17 November 1994, Banque Arabe et Internationale d’Investissements et al v Inter-Arab Investment Guarantee Corporation, Yearbook Commercial Arbitration, 21 (1996), at 21

⁸⁶⁸ Ibid., at 22-23

“common principles of English and French law, and in the absence of such common principles by such principles of international trade law as have been applied by national and international tribunals”⁸⁶⁹.

The choice of a national law together with *lex mercatoria* is also observable in practice. This choice, which is common in the state contracts, indicates the parties’ intention to prevent the arbitrator from treating the rules of the national law as incorporated into the agreed bargain under the contract and considering them as the articulated rules to the extent that they reflect the isolated position of the relevant legal system in the order of international commerce. In ICC Case No 8264, which concerned an agreement relating to the design, production, start-up and initial management of industrial facilities between a US manufacturer and an Algerian state-owned industrial development corporation, the terms of reference contained the following clause: “the arbitral tribunal shall take into account: a) the applicable laws in Algeria that govern this agreement and the performance of the agreements that follow it or result from it, b) the parties’ reasonable predictions in light of the aims and objectives of the agreement and its underlying causes, and c) general principles of law and international trade usages.” In dealing the merits of the dispute, the arbitral tribunal referred to the *exceptio non adimpleti contractus*, which was provided in Algerian law in Section 200 of the Civil Code, and can be regarded as a general principle of international contract law, as it is known in most legal systems. The tribunal also referred to the UNIDROIT Principles, as representing the rules widely accepted in the legal systems and the practice of international contracts, with regard to the principle in international trade law that compensation may be due for the loss of a chance in proportion to the probability of its occurrence, apparently without discussing Algerian law’s position on the matter.⁸⁷⁰

Three arbitrations that arose out of Libya oil nationalizations exemplify this form of choice.⁸⁷¹ The choice of law clause was the same in different concession agreements that came before three different arbitrators. It provided that “this concession shall be governed by and interpreted in accordance with the principles of law of Libya common to the principles of international law and in the absence of such common principles, then by and in accordance with the general principles of law, including such of those principles as may have been applied by international tribunals.” Although, the circumstances of three cases were similar, three different arbitrators arrived at different conclusions as to the meaning of the clause. In the Texaco arbitration, the sole French arbitrator held that the clause was primarily a choice of public international law by making a distinction between the law, which governs the contract, and the international legal order from which the binding nature of the contract stems.⁸⁷² In the

⁸⁶⁹ Clause 68 of the contractual conditions attached to the construction contract signed on 13 August 1986 by Eurotunnel and Transmanche Link. Cited by Nouel, Philippe, ‘Cartesian Pragmatism’: Looking for Common Principles in French and English Law, *International Business Lawyer*, 24 (January 1996), at 22.

⁸⁷⁰ ICC Award in Case No. 8264, *ICC International Court of Arbitration Bulletin*, 10-2 (Fall 1999), at 62-65

⁸⁷¹ *Texaco Overseas Petroleum Co v The Government of Libyan Arabic Republic*, *International Legal Materials*, 17 (1978), at 3; *British Petroleum Co Ltd v The Government of Libyan Arabic Republic*, *Yearbook Commercial Arbitration*, 5 (1980), at 143; *Libyan American Oil Co v The Government of Libyan Arabic Republic*, *Yearbook Commercial Arbitration*, 6 (1981), at 89

⁸⁷² Professor René-Jean Dupuy, adopted the concept under which contracts between states and foreign private persons could be ‘internationalized’ in the sense of being subjected to public international law, and held that under certain conditions ‘contracts between states and private persons come within the ambit of a particular and new branch of international law: the international law of contracts. With this reasoning the arbitrator considered that the choice of law clause referred to the principles of Libyan law rather than to the rules of Libyan law. He stated that “The application of the principles of Libyan law does not have the effect of ruling out the application of the principles of international law, but quite the contrary: it simply requires us to combine the two in verifying

BP Arbitration, the sole Swedish arbitrator regarded it as a choice of general principles of law, which provide ultimate direction in the event of divergence between Libyan law and public international law.⁸⁷³ The sole Lebanese arbitrator in the *Liamco Arbitration* pointed out that the governing law of the contract was the law of Libya but that the clause excluded any part of that law which was in conflict with the principles of international law.⁸⁷⁴ Unlike other

the conformity of the first with the second.” He decided to refer on the one hand to the principle of the binding force of contracts recognized by Libyan law, and on the other to the principle of *pacta sunt servanda* which is a general principle of law constituting an essential foundation of international law. He found on this point that the principles of Libyan law were in conformity with international law and concluded that the Deeds of Concession in dispute had a binding force. *Texaco Overseas Petroleum Company v. The Government of the Libyan Arab Republic*, *Yearbook Commercial Arbitration*, (1979), at 181-182

⁸⁷³ Judge Gunnar Lagergren, as the sole arbitrator, stated with respect to the choice of law provision that “While the provision generates practical difficulties in its implementation, it offers guidance in a negative sense by excluding the relevance of any single municipal legal system as such. To the extent possible, the Tribunal will apply the clause according to its clear and apparent meaning. Natural as this would be in any event, such an interpretation is the more compelling as the contractual document is of a standardised type prescribed by the Respondent. The governing law clause moreover was the final product of successive changes made in the Libyan petroleum legislation in the decade between 1955 and 1965 by which the relevance of Libyan law was progressively reduced.” The arbitrator rejected the argument advanced by BP that “a principle must be supported by both Libyan law and international law in order to be justifiable under the Concession” and that conduct “is justifiable only if principles of both systems of law — Libyan and international — support it.” According to the tribunal, “the principle may still be acceptable, and the conduct justifiable, if supported by the general principle of law” and “If a particular action by a party amounts to breach of contract under one system but not under the other, the issue is one of which can only be decided by reference to the general principles of law.” The arbitrator also rejected another argument advanced by BP that “since the parties had expressly excluded the direct and sole application of Libyan law, but had made reference to the general principles of law, and since ‘a’ system must govern ‘the only system that is left is public international law.’” The arbitrator held that “the governing system of law is what that clause expressly provides, viz in the absence of principles common to the law of Libya and international law, the general principles of law, including such of those principles as may have been applied by international tribunals.” *British Petroleum Co Ltd v The Government of Libyan Arabic Republic*, *Yearbook Commercial Arbitration*, 5 (1980), at 149-150

⁸⁷⁴ Dr. Sobhi Mahmassani, as the sole arbitrator, stated that “The proper law governing LIAMCO’s Concession agreements as set forth in the amended version of said Clause 28, para. 7, is in the first place the law of Libya when consistent with international law, and subsidiarily the general principles of law.” The arbitrator noted that “it is specified in the Agreements that this covers only “the principles of law of Libya common to the principles of international law”. According to the arbitrator, the clause excludes “any part of Libyan law which is in conflict with the principles of international law.” The arbitrator went on to explore the general principles of Libyan law. He pointed out Article 1 (2) of the Libyan Civil Code, which provides two complementary sources, of Libyan law namely Islamic law and natural law and equity. He noted that “custom and natural law and equity, are also in harmony with the Islamic legal system itself, and, in the absence of a contrary legal text based on the Holy Koran or the Traditions of the Prophet, Islamic law considers custom as a source of law and as complementary to and explanatory of the contents of commercial contracts. He also stated that “Islamic law treats international law (the Law of *Siyar*) as an imperative compendium forming part of the general positive law, and that the principles of that part are very similar to those adopted by modern international legal theory.” Thus, the arbitrator considered that “Libyan law in general and Islamic law in particular have common rules and principles with international law, and provide for the application of custom and equity as subsidiary sources” and these provisions are, in general, consistent and in harmony with the contents of the proper law of the contract chosen by the parties. Noting that “in the absence of that primary law of the contract, the same Paragraph provides as a secondary choice to apply subsidiarily “the general principles of law as may have been applied by international tribunals” and “these general principles are usually embodied in most recognized legal systems, and particularly in Libyan legislation, including its modern codes and Islamic law”, the arbitrator considered them as “a compendium of legal precepts and maxims, universally accepted in theory and practice”, such as the principle of the sanctity of property, and contracts, the respect of acquired vested rights, the prohibition of unjust enrichment, the obligation of compensation in cases of expropriation and wrongful damage, etc. *Libyan American Oil Co v The Government of Libyan Arabic Republic*, *Yearbook Commercial Arbitration*, 6 (1981), at 92-94

arbitrators, the Lebanese arbitrator by utilizing his expertise looked into the sources of Libyan law, which contained Islamic law and equity, and sought for the convergence of those sources with the principles of international law. This manner of the exercise of abstract reasoning in the specialized consolidations were apparently more accurate with regard to the reasonable expectations of the parties as expressed in the choice of law clause than those can be found in BP and Texaco awards, which neglected the premises of Libyan law to a great extent.

Article 42 of the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (ICSID) provides that in the absence of a specific choice by the parties, “the Tribunal shall apply the law of the Contracting State party to the dispute (including its rules on the conflict of laws) and such rules of international law as may be applicable”. In the case of a foreign investment, the traditional conflict of laws analysis will usually point to the application of the substantive law of the host state of the investment, such as concessions relating to natural resources, or other types of investments. The reference, in the second sentence of Article 42(1), to the conflict of laws rules of the host state, enables the application of the substantive law of another country when that would be appropriate, for instance when the investment is in the form of a commercial loan. As regards the reference to international law, the ICSID Tribunals and the ad hoc Committees established under the annulment provisions of Article 52 of the ICSID Convention have usually endorsed the view that international law has, under Article 42, supplemental and corrective functions in relation to the host state law. Thus, the tribunal can apply international law only to the extent necessary to fill gaps in host state law or to correct inconsistencies between host state law and international law.⁸⁷⁵

On the other hand, the ad hoc Committee in the *Wena v. Egypt* annulment proceedings stated, in relation to the role of international law, that “the use of the word 'may' in the second sentence of [Article 42(1) of the ICSID Convention] indicates that the Convention does not draw a sharp line for the distinction of the respective scope of international and of domestic law and, correspondingly, that this has the effect to confer on to the Tribunal a certain margin and power for interpretation.... What is clear is that the sense and meaning of the negotiations

⁸⁷⁵ The ad hoc committee in *Amco Asia Corp. v. Indonesia*, held that Article 42(1) “authorizes an ICSID tribunal to apply rules of international law only to fill up lacunae in the applicable domestic law and to ensure precedence to international law norms where the rules of the applicable domestic law are in collision with such norms.” *Amco Asia Corp. v. Republic of Indonesia*, ad hoc committee decision of May 16, 1986, ICSID Reports, 1 (1993), at 515; The ad hoc committee in *Klöckner v. Cameroon* pointed out the importance of establishing first the contents of the applicable national law before resorting to the complementary or corrective functions of the international law by stating that “Article 42 of the Washington Convention certainly provides that “in the absence of agreement between the parties, the Tribunal shall apply the law of the Contracting State party to the dispute. . . and such principles of international law as may be applicable.” This gives these principles (perhaps omitting cases in which it should be ascertained whether the domestic law conforms to international law) a dual role, that is, complementary (in the case of a “lacuna” in the law of the State), or corrective, should the State's law not conform on all points to the principles of international law. In both cases, the arbitrators may have recourse to the “principles of international law” only after having inquired into and established the content of the law of the State party to the dispute (which cannot be reduced to one principle, even a basic one) and after having applied the relevant rules of the State's law. Article 42(1) therefore clearly does not allow the arbitrator to base his decision solely on the “rules” or “principles of international law.”” ICSID No. ARB/82/1, Decision on Annulment 3 May 1985, ICSID Review - Foreign Investment Law Journal (1986), at 112; The ICSID Tribunal in *SPP v. Egypt* stated that “When municipal law contains a lacunae, or international law is violated by the exclusive application of municipal law, the Tribunal is bound in accordance with Art. 42 of the Washington Convention to apply directly the relevant principles and rules of international law.” ICSID Award of 20 May 1992 in case no. ARB/84/3, *Southern Pacific Properties (Middle East) Ltd. v. Arab Republic of Egypt*, Yearbook Commercial Arbitration, (1994), at 60

leading to the second sentence of Article 42(1) allowed for both legal orders to have a role. The law of the host State can indeed be applied in conjunction with international law if this is justified. So too international law can be applied by itself if the appropriate rule is found in this other ambit.⁸⁷⁶ The rationale underlying the *Wena* holding is interpreted to the effect that, on a given issue, the rules of international law can be applied as the proper law in the same way as the law of the host state, and if the tribunal finds two equally applicable rules in host state's law and international law, it may decide that, under the circumstances of the case, it will apply the rule of international law, without any need to identify either a lacuna or an inadequacy of the law of the host state.⁸⁷⁷ This interpretation supports the argument that the wording "and such rules of international law as may be applicable" in Article 42 means that the substantive rules of international law are directly accessible to the tribunal without initial scrutiny into the law of the host state.⁸⁷⁸

Alternatively, it is argued that the operation of the host state's law should be primary over that of international law because there is a priori reference to the law of the contracting state in the text of Article 42. In this view, the question of supplementation should focus on whether or not the law of the host state addresses the issue at hand. Given that the most developed of legal systems and even the most articulated codes cannot anticipate and provide for every contingency and every possible legal dispute, if the host state's law provides a general analytical framework, the tribunal should apply that framework to the statutes, judicial precedents, and general principles of that system. After examining the host state's law to see what procedures it provides for dealing with lacunae, and finding that there is a genuine lacuna, i.e., one for which host state law does not provide a method for filling, the tribunal may turn to international law.⁸⁷⁹ Indeed, a national legal system may not address a particular issue directly, but this should not imply that it provides no response or legal framework for that issue. For instance, a particular national law may not recognize the concepts of "turnkey contract", "EPC (engineering, procurement and construction) contract", or "design-and-build contract", but it most likely recognizes such concepts as contract, *pacta sunt servanda*, and good faith. Thus, in this alternative view, the tribunal should investigate into the applicable standards of that law in order to determine the body of rules from which it can draw to resolve the issue, and if faced with a difficulty, a tribunal should resolve it by drawing from general principles of the applicable national law.⁸⁸⁰ On the other hand, the corrective function of international law would only come into play in case domestic law violates fundamental international legal norms, in other words *jus cogens*.⁸⁸¹ A mere inconsistency between domestic law and international law would not suffice, since the corrective function of international law should come into play as the transnational or international public policy.

⁸⁷⁶ *Wena Hotels Limited v. Arab Republic of Egypt* (ICSID Case No. ARB/98/4), Decision on Application for Annulment, Feb. 5, 2002, *International Legal Materials*, 41 (2002), at 941

⁸⁷⁷ Gaillard, Emmanuel, The Meaning of 'and' in Article 42(1): The Role of International Law in the ICSID Choice of Law Process, *ICSID Review—Foreign Investment Law Journal*, 18-2 (2003), at 407

⁸⁷⁸ *Ibid.*, at 408-409

⁸⁷⁹ Reisman, W. Michael, The Regime for Lacunae in the ICSID Choice of Law Provision and the Question of its Threshold, *ICSID Review—Foreign Investment Law Journal*, 15 (2000), at 371-373

⁸⁸⁰ Gaillard, Emmanuel, The Meaning of 'and' in Article 42(1): The Role of International Law in the ICSID Choice of Law Process, *ICSID Review—Foreign Investment Law Journal*, 18-2 (2003), at 394

⁸⁸¹ Reisman, W. Michael, The Regime for Lacunae in the ICSID Choice of Law Provision and the Question of its Threshold, *ICSID Review—Foreign Investment Law Journal*, 15 (2000), at 371-377

The latter view seems justified in that the second sentence of Article 42(1) constitutes a provision on choice of law and on the substantive rules at a tribunal's disposal. The tribunals should not derogate arbitrarily from the applicable national law on the basis of some presumably objective substantive standards traced by the concept of public international law which, in practice, may be largely influenced by subjective judgments of the tribunals as to its contents. In the *Wena v Egypt*, the ad hoc Committee validated the tribunal's recourse to international law, in the award of compound interest to the investor without determining that Egyptian law contained a gap as to the award of compound interest, or without establishing that the Egyptian law rule on simple interest was inconsistent with the international law rule on compound interest. The investor claimed interest, but neither specified a rate nor whether interest should be compounded. The tribunal decided that compounded interest will best restore the investor to a reasonable approximation of the position in which it would have been if the wrongful act of state had not taken place, and expressed its belief that that an award of compound (as opposed to simple) interest is generally appropriate in most modern commercial arbitrations. The tribunal's decision is construed as the direct application of international law, but the legal authorities cited by the tribunal in support of its decision were only the writings of two commentators in the field and another ICSID Award.⁸⁸²

In the *Wena v Egypt*, the ad hoc Committee considered that the rules of international law that directly or indirectly relate to the state's consent prevail over domestic rules that might be incompatible with them. The Committee stated that "under the Egyptian Constitution treaties that have been ratified and published "have the force of law." Most commentators interpret this provision as equating treaties with domestic legislation."⁸⁸³ Essentially, *Wena* sought compensation from Egypt, based on rights of nationals of the United Kingdom in respect of their investments in Egypt and arising out of the Agreement for the Promotion and Protection of Investments ("IPPA") entered into by the United Kingdom and Egypt on June 11, 1975.⁸⁸⁴ Although not referring to interest, the IPPA required that compensation must be, first, "prompt, adequate and effective" and, second "compensation shall amount to the market value of the investment expropriated immediately before the expropriation itself." According to the Committee, this provision must be read as encompassing a determination of interest that is compatible with those two principles, and the compensation must not be eroded by the passage of time or by the diminution in the market value. The Committee considered that the award of interest that reflects such international business practices meets these objectives. Thus, according to the Committee, the option the tribunal took was within the tribunal's power since the international law and ICSID practice offer a variety of alternatives that are compatible with those objectives, including the compounding of interest in some cases. The Committee held that the choice of the most appropriate option among the many alternatives available under such practice is a discretionary decision of the tribunal, and even if it were

⁸⁸² *Wena Hotels Limited v. Arab Republic of Egypt*, Award, Dec. 8, 2000, International Legal Materials, 41 (2002), at 919: The tribunal stated that "Like the distinguished panel in the recently-issued *Metalclad* decision, this Tribunal also has determined that compounded interest will best "restore the Claimant to a reasonable approximation of the position in which it would have been if the wrongful act had not taken place." The tribunal added that "Professor Gotanda has observed "almost all financing and investment vehicles involve compound interest "If the claimant could have received compound interest merely by placing its money in a readily available and commonly used investment vehicle, it is neither logical nor equitable to award the claimant only simple interest." For similar reasons, Professor Mann has "submitted that... compound interest may be and, in absence of special circumstances, should be awarded to the claimant as damages by international tribunals.""

⁸⁸³ *Wena Hotels Limited v. Arab Republic of Egypt* (ICSID Case No. ARB/98/4), Decision on Application for Annulment, Feb. 5, 2002, International Legal Materials, 41 (2002), at 941

⁸⁸⁴ *Ibid.*, at 937

established that the tribunal did not rely on the appropriate criteria, this in itself would not amount to a manifest excess of power leading to annulment.⁸⁸⁵

On the other hand, in *Aucoven v. Venezuela* case, the investor submitted on the basis of the *Wena* decision that even in the absence of an express provision in the Concession Agreement or even if Venezuelan law prohibited compound interest, international law would require an award of compound interest. The tribunal noted that *Wena* was an expropriation case, and the other ICSID precedent on which the investor based its claim for compound interest expressly drew a distinction between expropriation cases and cases “of simple breach of contract”, and noted “a tendency in international jurisprudence to award only simple interest [...] in relation to cases of [...] simple breach of contract”. The tribunal stated that “These two ICSID precedents are sufficient in and of themselves to demonstrate that there is no well established principle of international law requiring the award of compound interest in the present case”. Thus, while noting that international law does not prohibit compound interest, the tribunal rejected investor’s submission that international law requires an award of compound interest and, thus, did not award compound interest in a case of breach of contract.⁸⁸⁶

In the end, the ICSID tribunals have the duty to apply both the law of the contracting state and international law, according to the text of Article 42, but the reference to the law of the contracting state should not be rendered meaningless. In the earliest drafts of Article 42, it was provided that: “In the absence of any agreement between the parties concerning the law to be applied [...] the Arbitral Tribunal shall decide the dispute submitted to it in accordance with such rules of law, whether national or international, as it shall determine to be applicable.” The final version of Article 42(1) has substantially reduced such competence of the tribunal, in the absence of agreement, to choose so freely the applicable rules of law. This change reflects the drafters’ intentions to withdraw such a competence from the tribunal.⁸⁸⁷ As the rules to be applied are not selected at the discretion of a tribunal, as in the earlier drafts, but are largely determined by operation of the ICSID Convention, the issue of applicable law in ICSID cases becomes one of risk allocation between the parties. In negotiating contracts, the parties should take into account the application of the specific rules of the law of the host state by the ICSID tribunals in the absence of their choice of law.

The risk of application of host state law by the ICSID tribunals is an issue in drafting contracts to the extent that the parties can foresee the likelihood of the applicability of its particular rules to their contract and the results of such application, and to the extent that the rules of host state are valid under the corrective function of international law, i.e. they are not in violation of the transnational or international public policy. This legal risk affects the bargain under the contractual relationship and, requires the parties to assess the legal risk and make necessary reallocations in their contract. When the legal risk materializes, if the parties have failed to either contract out such rules or shape the bargain otherwise, the relevant rules will apply regardless of its effect on the bargain, since they will be applied as part of the bargain. Under these considerations, the supplementary function of international law depends on the absence of specific rules in the law of the contracting state, to the extent that international law is sufficiently clear to cover the lacunae. In absence of the clear position of

⁸⁸⁵ *Ibid.*, at 943

⁸⁸⁶ *Autopista Concesionada de Venezuela, C.A. (“Aucoven”) v. Bolivarian Republic of Venezuela (“Venezuela”)* ICSID Case No. ARB/00/5, Award rendered on September 23, 2003, para. 393-397

⁸⁸⁷ Reisman, W. Michael, *The Regime for Lacunae in the ICSID Choice of Law Provision and the Question of its Threshold*, ICSID Review—Foreign Investment Law Journal, 15 (2000), at 363-364

the international law as to the disputed issue, the tribunal should revert to the principles of the law of the contracting state to fill the lacunae in the national law, by consolidating them with the general principles of law as a source of international law and *lex mercatoria*, thereby avoiding both subjective judgments as to the position of international law, and speculations about how the national court of that legal system would decide the issue.

The situation is different in such ICSID cases that are brought under a bilateral investment treaty in respect of alleged violations of the substantive protections of the treaty. In these cases, the tribunals have applied the provisions of the underlying treaties, as well as public international law rules to the merits of the disputes, without referring to the host state law. In such cases, it can be said that there is an agreement on applicable rules of law, in terms of the first sentence of Article 42(1) of the ICSID Convention, where the agreement is formed by the investor's acceptance of the state's offer in the bilateral investment treaty to arbitrate on that basis. Thus, the interpretation, supplementation or correction of such rules of law chosen by the parties should be subject to public international law.

In *ADC Affiliate Ltd. v. Republic of Hungary*, the tribunal considered that "by consenting to arbitration under Article 7 of the BIT with respect to "Any dispute between a Contracting Party and the investor of another Contracting Party concerning expropriation of an investment . . ." the Parties also consented to the applicability of the provisions of the Treaty". According to the tribunal, "That consent falls under the first sentence of Article 42(1) of the ICSID Convention ("The Tribunal shall decide a dispute in accordance with such rules of law as may be agreed by the parties"). The consent must also be deemed to comprise a choice for general international law, including customary international law, if and to the extent that it comes into play for interpreting and applying the provisions of the Treaty." The tribunal added that a sole exception to this was in a provision of the BIT to the effect that compensation for any expropriation could be calculated in accordance with the law of the expropriating state. The tribunal stated that "As the reference to domestic law is used for this one isolated subject matter only, it must be presumed that all other matters are governed by the provisions of the [BIT] itself which in turn is governed by international law."⁸⁸⁸

The tribunal in *Aucon v. Venezuela* also considered that "The role of international law in ICSID practice is not entirely clear. It is certainly well settled that international law may fill lacunae when national law lacks rules on certain issues (so called complementary function). It is also established that it may correct the result of the application of national law when the latter violates international law (corrective function)... Does the role of international law extend beyond these functions? The recent decision of the ICSID Ad hoc Committee in *Wena Hotels Ltd. V. Arab Republic of Egypt* accepts the possibility of a broad approach to the role of international law, and that the arbitral tribunal has "a certain margin and power of interpretation"... Whatever the extent of the role that international law plays under Article 42(1) (second sentence), this Tribunal believes that there is no reason in this case, considering especially that it is a contract and not a treaty arbitration, to go beyond the corrective and supplemental functions of international law."⁸⁸⁹ Thus, with respect to contract claims, unless the parties have agreed otherwise, the ICSID tribunals should generally apply the applicable

⁸⁸⁸ *ADC Affiliate Limited and ADC & ADMC Management Limited v. Republic of Hungary* (ICSID Case No. ARB/03/16), award of Oct. 2, 2006, at para. 290-292

⁸⁸⁹ *Autopista Concesionada de Venezuela, C.A. ("Aucon") v. Bolivarian Republic of Venezuela ("Venezuela")* (ICSID Case No. ARB/00/5, Award rendered on September 23, 2003, para. 102)

national law in the first instance, resorting to international law only as needed to supplement or correct the national law.

When the choice of a national law is combined with the choice of *lex mercatoria*, the arbitrators should carefully analyze the intention of the parties as to the extent of the incorporation of the chosen national law into the agreed bargain under the contract and its consideration as the articulated rules. ICC Case No 7365 concerned two contracts for the sale and the installation of sophisticated military equipment, which was entered into in 1977 between a United States corporation (Cubic) and the Iranian Air Force (Iran). The contracts contained a choice of law clause designating the law of Iran.⁸⁹⁰ The contracts were duly performed until the advent of the Islamic Revolution in early 1979. The parties entered into a series of negotiations but were unable to reach an agreement as to how to proceed. Iran claimed reimbursement of payments made to Cubic in addition to damages, while Cubic argued that Iran had breached its contractual obligations by not paying the remainder of the price, and presented a counterclaim for damages. Iran argued that all issues were governed exclusively by the laws of Iran. Cubic contended that "general principles of international law, including the *lex mercatoria* and trade usages" should complement and, as necessary, supplement the applicable Iranian law. Iran agreed to the complementary and supplementary application of general principles of international law, but emphasized that there is no conflict between basic principles of Iranian law and general principles of international law by referring to Article 3 of the Iranian Civil Code of Procedure which provides that disputes must be decided in accordance, *inter alia*, with established trade usages, in particular "where the existing laws of the country are not perfect", and to Article 13 (5) of the ICC Rules. The arbitral tribunal stated that "[s]ince both Parties eventually agreed to the complementary and supplementary application of general principles of international law and trade usages, and based on Article 13 (5) of the ICC Rules, the Tribunal shall, to the extent necessary, take into account such principles and usages as well." The tribunal also stated that "As to the contents of such rules, the Tribunal shall be guided by the Principles of International Commercial Contracts, published in 1994 by the UNIDROIT Institute, Rome."⁸⁹¹

The arbitral tribunal referred to a number of provisions under the UNIDROIT Principles and examined their applicability in combination with Iranian law. The arbitral tribunal referred to Article 6.2.3 on hardship, and stated that in its restrictive and narrow form the concept of *clausula rebus sic stantibus* has been incorporated into so many legal systems that it is widely regarded a general principle of law and, as such, it would be applicable in the arbitration even if it did not form part of the Iranian law.⁸⁹² The tribunal also referred to Articles 5.1 and 5.2 with regard to the implied terms on termination of the contracts, in considering a widely accepted principle that contractual obligations of the parties may be implicit and may stem from the nature and purpose of the contract, practices established between the parties and usages, good faith and fair dealing and reasonableness. The tribunal stated that "pursuant to such criteria as good faith and fair dealing, parties to a contract may reasonably expect that similar situations should have the same or similar consequences to the extent that the applicable law or the contractual terms do not explicitly provide otherwise." As to the consequences of the termination of the contracts, the arbitral tribunal cited Article 7.3.6 of the

⁸⁹⁰ ICC Award in Case No. 7365, May 5, 1997, *Islamic Republic of Iran vs. Cubic Defense Systems, Inc.*, *Uniform Law Review*, (1999), at 796

⁸⁹¹ *Ibid.*, at 797

⁸⁹² ICC Award No. 7365, May 5, 1997, *Islamic Republic of Iran vs. Cubic Defense Systems, Inc.*, published in excerpts in *ICC International Court of Arbitration Bulletin*, 15-2 (2004), at 108

UNIDROIT Principles in support of the effect of termination that “either party may claim restitution of whatever it has supplied, provided that such party concurrently makes restitution of whatever it has received”, which also applies under Iranian law.⁸⁹³ As to the date from which the interest is to be awarded, the tribunal admitted that “[t]here is a tendency in international commercial law to award interest from the time when the payment has become due without any need for the aggrieved party to give notice of the default” and referred to Article 7.4.9 of the UNIDROIT Principles. However, the tribunal stated that “even if a generally accepted principle of international law existed in this respect, the Tribunal would only be authorized to apply it as a complementary and supplementary rule, not as a rule in clear contradiction to an unambiguous provision of the Iranian law chosen by the Parties” and referred to the relevant specific provision of the Iranian Code of Civil Procedure in accordance with the parties’ agreement on the complementary and supplementary application of general principles of international law.⁸⁹⁴

In some cases, the parties agree on a form of choice of *lex mercatoria* during the proceedings, particularly upon the advice of the decision maker, which can be regarded as an instance of application of the basic procedural principle of *lex mercatoria* that consecrates the parties’ right to an equal opportunity to comment on the applicable substantive law. In ICC Case No. 9474, the arbitration clause provided that the arbitral tribunal was to decide “fairly” and at the beginning of proceedings the parties accepted the arbitral tribunal’s proposal to apply “the general standards and rules of international contracts”. The tribunal was of the opinion that these “general principles of contract law” are not directly expressed in a specific international convention. The tribunal considered that although it is generally recognized that the CISG embodies universal principles applicable in international contracts, the CISG was not appropriate in the case since if the parties had wanted to submit their agreement to the convention, they would have introduced an express clause in that sense, and the agreement was not merely a sale of goods contract. According to the tribunal, while the PECL and the UNIDROIT Principles express the general standards and rules of commercial law, those general standards and rules have to be applied to the specific circumstances of the case and in particular to the object of the contract that reflects the intentions of the parties. The tribunal decided to tackle this issue more precisely as to each one of the specific questions it has to solve in the award. The tribunal stated that “the general principles of international contracts may also be found among various rules of domestic law, of both common and civil law systems, as applied to international contracts, such as the American Uniform Commercial Code,” but made it clear that “neither [Defendant State’s] nor [Claimant State’s] law offers relevant and applicable rules” which may be inferred again from the fact that the parties did not refer expressly to any of their domestic rules.⁸⁹⁵

The parties referred to the UNIDROIT Principles, the PECL, the UCC and the CISG in their pleadings on such issues as the existence of fraud and mistake that could affect the validity of the agreement and of estoppel that barred the claimant from claiming the defendant’s non-compliance with the agreement. As to the validity of the agreement, the tribunal held that the allegations against the validity of the agreement have not been sufficiently established and must therefore be rejected without referring to any of those instruments.⁸⁹⁶ As to the issue of

⁸⁹³ ICC Award No. 7365, May 5, 1997, *Islamic Republic of Iran vs. Cubic Defense Systems, Inc.*, *Uniform Law Review*, (1999), at 798

⁸⁹⁴ *Ibid.*, at 798-799

⁸⁹⁵ ICC Award in Case No 9474, *ICC International Court of Arbitration Bulletin*, 12-2 (Fall 2001), at 61

⁸⁹⁶ *Ibid.*, at 62

estoppel, the tribunal rejected the defendant's objection that the claimant had not given prompt notice of the defects of the goods and had therefore been prevented from terminating the contract, but the tribunal did not regard itself bound by the provisions of any international convention in particular and considered that in view of all circumstances it cannot decide to deprive the claimant of its rights to claim compensation for the violation of the agreement. In this regard, the tribunal adopted a broader perspective by referring to "a general recognized principle of commercial law that a vendor cannot rely on a buyer's failure to inspect the goods and to give timely notice of defects, if the vendor has adopted a conduct which is not in conformity with his own duties."⁸⁹⁷

The arbitrators confronting these forms of atypical choice of law cases should also take into account the legal materials that are invoked by the parties during the proceedings in determining the established rules in the particular case, given that the procedural principles of *lex mercatoria* require the arbitrators to respect the mandate given by the parties and their right to an equal and reasonable opportunity for presentation of their cases. During the proceedings for an order confirming the ICC Award No 7365 before the US Courts, Cubic contended that the award exceeded the scope of the terms of the submission to arbitration and ignored the terms of the parties' contracts thereby violating Article V (1) (c) of the New York Convention by issuing a ruling based upon legal theories not contemplated by and/or asserted by the parties and by referring to the UNIDROIT Principles and to other international principles such as good faith and fair dealing, even though they were not indicated in the Terms of Reference as the applicable law. Cubic also claimed that it was not given a meaningful opportunity to present its case because: (1) Iran shifted its factual and legal theories throughout the proceedings; (2) the tribunal issued interim decisions regarding bifurcation of the proceedings; and (3) the legal theories and remedies articulated in the Award were not previously presented.⁸⁹⁸

United States District Court, S.D. California first noted with regard to the New York Convention the following statements: "A district court's "review of a foreign arbitration award is quite circumscribed""; "There is a general pro-enforcement bias under the Convention."; and "Upon application for an order confirming the award, the "district court has little discretion: 'The court shall confirm the award unless it finds one of the grounds for refusal or deferral of recognition or enforcement of the award specified in the said Convention.'" The Court stated that "In particular, courts should narrowly construe Article V(1)(c) in accordance with the Convention's general pro-enforcement bias."⁸⁹⁹ The Court found that "The ICC Award resolves the Parties' claims arising from these Contracts and the fact that the Award is not based on the same legal theories as stated in the pleadings cannot be a basis for refusing to confirm it." With regard to the reference to the UNIDROIT Principles, the Court held that such reference does not exceed the scope of the Terms of Reference. According to the Court, one of the issues presented to the tribunal was whether general principles of international law apply to this dispute, and Cubic's disagreement with tribunal's response to the question posed by the parties was not a reason to find that the tribunal addressed issues beyond the scope of the terms of reference. Thus, the Court concluded that "The Tribunal's reference to and application of the UNIDROIT Principles and principles such as good faith and fair dealing do

⁸⁹⁷ Ibid., at 66

⁸⁹⁸ Ministry of Defense and Support for the Armed Forces of the Islamic Republic of Iran v. Cubic Defense Systems, Inc., United States District Court, S.D. California, 07.12.1998, (29 F.Supp.2d 1168), published in Uniform Law Review, (1999), at 799

⁸⁹⁹ Ibid., at 801

not violate Article V(1)(c). The Tribunal applied these principles to differences contemplated by and falling within the terms of the submission to arbitration and therefore the Award does not violate Article V(1)(c).”⁹⁰⁰ With regard to Cubic’s claim that it was “denied a meaningful opportunity to present its case”, the Court observed that Cubic’s active participation in the entire process demonstrated notification of the proceedings, and Cubic was “otherwise able to present [its] case” since two hearings were held, and Cubic had several opportunities for briefing. Thus, the Court held that Cubic had ample opportunity to present its interpretation of the facts and its legal theories to the tribunal, and the award does not violate Article V(1)(b) of the New York Convention.⁹⁰¹ After rejecting all of the objections raised by Cubic, the Court granted Iran’s petition for confirmation of the award.⁹⁰²

Although, it is rare in practice to observe that the parties agree during negotiations on the application of *lex mercatoria* to the substance of the dispute, the arbitrators should suggest the parties that option and invite them to consider a possible agreement on *lex mercatoria* during proceedings as the governing law, when the arbitrators are inclined to apply *lex mercatoria* in the absence of the choice of law by the parties. In other cases where the agreement provides a reference to *lex mercatoria* from the wide variety of expressions that can be found in the practice, and particularly where such references to *lex mercatoria* are found together with a reference to a particular national law, the arbitrators should carefully interpret such provisions and enforce the parties’ intentions as to the materials that will be utilized in ascertaining the articulated rules and discovering the established rules in order to resolve the dispute in line with the reasonable expectations of the parties.

⁹⁰⁰ *Ibid.*, at 803

⁹⁰¹ *Ibid.*, at 804

⁹⁰² This decision in the case of the Ministry of Defense and Support for the Armed Forces of the Islamic Republic of

Iran v Cubic Defense Systems, Inc. was very welcomed by the drafters of the UNIDROIT Principles as a significant recognition of the role which the UNIDROIT Principles may play in the settlement of disputes arising out of international contracts. The decision is regarded as the United States District Court’s confirmation of the implicit assumption of the arbitral tribunal that the UNIDROIT Principles represent a source of “general principles of law”, the “*lex mercatoria*” or the like, to which judges and arbitrators may resort even in the absence of an express authorization by the parties. Bonell, Michael Joachim, A Significant Recognition of the UNIDROIT Principles by an United States Court, *Uniform Law Review*, (1999), at 662

iii. Absence of choice

The contracting parties may be unable to agree on a choice of law clause, simply neglect the issue, or deem as unimportant. Whatever the reason for the absence of an express choice of law, such a gap in the contract defers the transactions costs arising from making a choice to the enforcement stage. However, since no conflict of laws system is immanently applicable in the context of international arbitration, the absence of choice of law introduces a higher degree of legal uncertainty than the choice of *lex mercatoria* as the governing law or other atypical clauses that require the arbitrator to apply *lex mercatoria* and a national law in some form of combination. The latter choices at least indicate the materials that can be taken into account by the decision maker in giving effect to the reasonable expectations of the parties and controlling the legal uncertainty arising from the issues of residual contractual rights, obligations and risk allocations. In the absence of choice, all major institutional arbitration rules currently allow the arbitrator to apply rules of law, which he deems appropriate, and which can be in the form of a national rule or non-national rule.⁹⁰³

Despite the terminological differences between “the rules of law” and “the law” under the arbitration laws with regard to the law applicable to the substance of the dispute by the arbitrator in the absence of choice by the parties, when the parties agree on a set of arbitration rules provided by a major arbitral institution, the arbitrators obtain the capacity to resort to the various methods in choice of law analyses, which allow them to decide that the contract must be subject to a particular set of rules, which can be either national or non-national, in accordance with the reasonable expectations of the parties. Moreover, as it will be seen below, the arbitrators have in practice exercised such a capacity in the choice of law analyses, even when they were required by the arbitration rules to refer to a conflict of laws rule for the determination of the applicable law.⁹⁰⁴ Finally, due to the specific references to contractual terms and trade usages in the arbitration rules and laws, the arbitrators usually consider themselves as having the capacity to give precedence to those over a national law that has been found to be applicable in the absence of choice, provided that their enforcement does not lead to a violation of the relevant public policy considerations.

⁹⁰³ ICC Arbitration Rules (1998), Article 17(1); AAA, International Arbitration Rules (2008), Article 28 (1); LCIA, Arbitration Rules (1998), Article 22.3; Arbitration Institute of the SCC, Arbitration Rules (2007), Article 22 (1).

⁹⁰⁴ See the cases cited below applying ICC Arbitration Rules of 1975 and 1988. It should be noted that similar provisions of the UNCITRAL Arbitration Rules of 1976 and the UNCITRAL Arbitration Rules, as revised and effective since 15 August 2010, do not follow the approach of institutional arbitration rules to the issue of applicable law in the absence of choice by the parties. The Working Group revising the UNCITRAL Rules of 1976 had diverging views on whether allowing the application of “rules of law,” rather than “law” should be an option that is open only to the parties or also available to the arbitrators. The Working Group had no difficulty accepting that parties should be able to submit their disputes to “rules of law”. It was suggested that this flexibility should be available to arbitrators, as well, suggesting that this would “modernize” the Rules along the lines of major institutional rules. However, a substantial number of members resisted that proposal, expressing the view that the UNCITRAL Rules should not diverge substantively from the Model Law unless there was a particular justification for doing so. In the end, the Working Group agreed that the requirement that a tribunal use the *voie indirecte* to determine the applicable law should be changed so that tribunals could select directly the applicable law they deem appropriate. Report of the Working Group on Arbitration and Conciliation on the work of its forty-seventh session (Vienna, 10-14 September 2007), UN Doc. A/CN.9/641, paras 108-111; Report of Working Group II (Arbitration and Conciliation) on the work of its fifty-first session (Vienna, 14-18 September 2009), UN Doc. A/CN.9/684, paras. 91-96; Article 35 (1) of the UNCITRAL Arbitration Rules 2010 provides that “The arbitral tribunal shall apply the rules of law designated by the parties as applicable to the substance of the dispute. Failing such designation by the parties, the arbitral tribunal shall apply the law which it determines to be appropriate.”

In the absence of an express agreement between the parties, the application of *lex mercatoria* at the conflict of laws stage requires the arbitrators to search for the established rules of conflict firstly by means of indirect choice methods, and if indirect choice fails, by resorting to the direct choice method. In resorting to the direct or indirect methods for the determination of the applicable law, the arbitrators should take into account the pleadings of both parties and render a reasoned award as to the law applicable to the substance of the dispute in accordance with the procedural safeguards of *lex mercatoria* as the law of principled adjudication.

If the established rule of conflict designate a national law which the parties reasonably expect its application to their dispute, the arbitrator will determine that national law as the applicable law and act on the presumption that the individual provisions of the national law that is designated by the established rules of conflict indicate the reasonable expectations of the parties in the context of a particular transaction. This presumption may be rebutted when those provisions are in conflict with the express or implied intentions of the parties, which will be determined through interpretation according to the basic principles of *lex mercatoria*, or when those rules reflect the isolated position of the authorities in the relevant national legal system and no longer indicate the reasonable expectations of the parties to a particular dispute. In the latter case, those provisions may be overridden by the established rules in the order of international commerce that directly apply to the substance of the dispute since, in the absence of an express choice, it is not possible to consider those national rules as part of the bargain contemplated under the contract.

In some cases, the established rule of conflict in the particular case may require the arbitrator to apply *lex mercatoria* to the substance of the dispute, to the exclusion of any national law. More frequently, the exclusive application of *lex mercatoria* to the substance of the dispute will depend on the implied intentions of the parties, which will be determined through the contextual interpretation under *lex mercatoria*. The intentions of the parties may indicate either, in a positive manner, the parties' willingness to have their contract governed by *lex mercatoria* or, in a negative manner, their desire to exclude the application of any particular national law. Thus, the intentions of the parties may override the relevant established rules of conflict in the particular case and, thereby, allow the arbitrators to make a direct choice of *lex mercatoria* in accordance with the context and circumstances of the case.

1. Indirect Choice

The arbitrators should apply *lex mercatoria* at the conflict of laws stage in order to determine whether there is an established rule of conflict in the particular case. There are two indirect methods for discovering the established rules of conflict of laws: (1) cumulative application of the different rules of conflict of laws of the national laws related to the dispute, and (2) recourse to general principles of conflict of laws. The indirect methods necessarily result in the application of a national law to the substance of the dispute. The arbitrators will name the designated national law as the applicable law and consider its rules as indicating the reasonable expectations of the parties in a particular case, but not as a part of the bargain contemplated under the contract since, in the absence of the consent of the parties, the arbitrators should disregard those rules that reflect the isolated position of the authorities in the relevant national legal system. The cumulative application of the conflict of laws of the national legal systems connected with the dispute and the application of general principles of conflict of laws are instances of specialized consolidations of the decision makers applying *lex mercatoria* at the stage of conflict of laws.

Under the first indirect method, the decision maker considers the conflict of laws rules of each of the national legal systems connected with the dispute. Even though their provisions differ, when these rules of conflict converge towards one single national law as applicable to the substance of the dispute, the decision maker may determine that law as the applicable substantive law. It is observed that this is the most frequent method used by the ICC arbitrators whereby they take into account and cumulatively apply the private international law rules of the countries connected with the dispute, such as the place of residence or nationality of the parties, the place of performance and the place of the arbitration.⁹⁰⁵ This method may accommodate reasonable expectations of the parties better than the application of conflict of laws regime of a single state, whose relationship to the dispute may not be predominant, particularly when the choice of law rules of all legal systems connected with the case point to the same law.⁹⁰⁶

In ICC Case No 6281 which concerned a contract for the international sale of a certain quantity of steel between Egyptian and Yugoslavian parties, the sole arbitrator was required to determine the applicable law in the absence of a choice of law clause. The arbitrator noted that, although the CISG was in force in Egypt and in Yugoslavia, as well as in France, where the proceedings were held, the CISG applies to such sales contracts that were concluded after the date the CISG went into force, and the contract in dispute was concluded before that date. Applying cumulatively the private international law rules of the countries concerned and Article 3 (1) of the Hague Convention of 15 June 1955 on the law applicable to international sales of goods, to which France is a party, the tribunal concluded that the applicable law was the law of Yugoslavia, as the law of the place where the seller had its principal place of business and where the contract was concluded.⁹⁰⁷

Under the second indirect method, the arbitrator refers to a rule of conflict of laws that is widely accepted in national legal systems or international conventions. This method also aims at giving effect to the reasonable expectations of the parties.⁹⁰⁸ The arbitrators often look for such principles in arbitral cases and international conventions on the subject, whether or not in force in relation to the contract underlying the dispute.⁹⁰⁹ In ICC Case No. 5713 concerning some contracts for the international sale of a product according to certain contract specifications, the tribunal held that “the general trend in conflicts of law is to apply the domestic law of the current residence of the debtor of the essential undertaking arising under the contract” by considering that the transfer of risks to the buyer took place in the country of

⁹⁰⁵ Craig, W. Laurence, William W. Park & Jan Paulsson, *International Chamber of Commerce Arbitration*, Oceana Publications, 3rd ed., 2000, at 326

⁹⁰⁶ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, *Goldman on International Commercial Arbitration*, Kluwer Law International, 1999, at 872

⁹⁰⁷ ICC Award in Case No 6281, *Yearbook Commercial Arbitration*, 15 (1990), at 96-97

⁹⁰⁸ ICC Award in Case No 9420, 1998, (unpublished), cited by Grigera Naón, Horacio A., *Choice of Law Problems in International Commercial Arbitration*, *Recueil des Cours*, 289 (2001), at 226. The tribunal stated that “As the parties have not chosen Paris as the place of arbitration, I do not consider that it was within the parties’ reasonable expectations that French conflict rules be given particular weight. However, as discussed below, the French conflict rules are consistent with those of the legal systems of the home countries of the parties . . . In the circumstances it would be appropriate to seek and apply internationally accepted principles on choice-of-law in contractual matters.”

⁹⁰⁹ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, *Goldman on International Commercial Arbitration*, Kluwer Law International, 1999, at 874

the seller, and referring to Article 3 of The Hague Convention on the law applicable to international sales of goods dated 15 June 1955. The tribunal decided to apply the law of the country of the seller, while taking into account the relevant trade usages.⁹¹⁰

In ICC Case No 7329 concerning an exclusive agency agreement for France between French agents and an Italian manufacturer, the tribunal had to determine the applicable law to the merits in absence of the parties' agreement. The tribunal decided to apply French law as the governing law of the contract since the "center of gravity" of the contract was the place of performance of the characteristic obligation, and the agent undertook the most characteristic obligation of an agency agreement, namely the search for clients. The tribunal noted that this solution was adopted by various international instruments, such as the Hague Convention of 14 March 1978 on the law applicable to agency and representation, and the Rome Convention of June 19, 1980 on the law applicable to contractual obligations. Although these instruments were not applicable to the case, the tribunal considered them as the indications of an established rule of conflict, in the sense of a generally accepted private international law rule enjoying international consensus.⁹¹¹

In ICC Case No 9771 concerning an international sales contract between Italian and Cypriot parties, the sole arbitrator referred to general principles of private international law in order to interpret the parties' intentions as to the applicable law. The sole arbitrator stated that "a general principle of private international law is that the intention of the parties to a contract with regard to the law governing the contract – when the intention is not expressed in words and agreed – is to be inferred from the terms and nature of the contract and from the general circumstances of the case".⁹¹² The sole arbitrator also noted that "it seems likely that the parties in this case – had they contemplated the matter – would not have been inclined to accept the case being treated with the application of the substantive law (or in the courts) of the other party's country", namely Italian and Cypriot laws.⁹¹³ According to the arbitrator, the insertion of an arbitration clause and agreement on Stockholm as the place of arbitration should be interpreted as an indication of the will of the parties that the Swedish conflict of law rules should apply in determining the applicable law. The arbitrator stated that "the overriding principle of Swedish conflict of law rules is based upon the idea that the law should apply which demonstrates the closest connection to the contract."⁹¹⁴ The arbitrator derived the relevant Swedish conflict of law rules in the case of an international sale of goods, from the 1955 Hague Convention on the Law Applicable to International Sale of Movables, the CISG and the 1980 Rome Convention on the Law Applicable to Contractual Obligations, even if the Rome Convention was not directly applicable to the case. The arbitrator determined the main principle of the 1955 Hague Convention as the application of the law of the jurisdiction where the seller was domiciled at the time when he received the order or, if the order is received at a permanent establishment which belongs to the seller, the law in which this is located.⁹¹⁵ The arbitrator found that the Moscow office was a permanent establishment of the seller, and actively and decisively engaged in the negotiations, signing and administration and

⁹¹⁰ ICC Award in Case No. 5713, 1989, Yearbook Commercial Arbitration, 15 (1990), at 70

⁹¹¹ ICC Final Award in Case No 7329, 1994, ICC International Court of Arbitration Bulletin, 7-1 (1996), at 93

⁹¹² ICC Award in Case No. 9771, 2001, Yearbook Commercial Arbitration, 46 (2004), at 52

⁹¹³ Ibid.

⁹¹⁴ Ibid., at 54

⁹¹⁵ Ibid.

performance of the contract.⁹¹⁶ Given that the CISG was in force in Russia and the Italian buyer was bound by the CISG, the arbitrator concluded that the CISG shall apply to the substantive issues of the case, while appropriate substantive rules of Russian law shall apply subsidiarily.⁹¹⁷

In the application of those indirect methods for determining the established rules of conflict, the decision maker applying *lex mercatoria* at the conflict of laws stage should offer the parties the opportunity to express their views on the applicable law, and take into account the pleadings of both parties in determining the applicable law. ICC Case No 7177 concerned a contract for the delivery of gasoil between the claimant, Greek agent of an Antiguan Corporation having an office in Switzerland, as seller, and the defendant, Greek purchaser. There was no clear choice by the parties of the applicable law, and the situs of the arbitration was London. The tribunal first examined the rules of conflict under English law, which was applicable according to the claimant, and under Greek law, which was applicable according to the defendant. The tribunal noted that, under the English conflict of law rule, it is the system of law “with which the transaction has its closest and most real connection” that should be the substantive law of the dispute, and found that the Greek conflict of laws rule is in effect similar to that indicated by the English conflict of law rule, i.e. the closest and most real connection. Subsequently, the tribunal noted that modern law applicable to contractual obligations has been embodied in the Rome Convention of 1980 which, however, was not applicable to the case. Even so, the tribunal considered the convention as representing “the general trend of modern international law”. Although the presumption of characteristic performance under the Rome Convention would lead to the application of Swiss law, the tribunal noted that the parties did not argue that such law should be applicable, and found no connection with Switzerland that would justify the application of the Rome Convention's presumption. The tribunal stated that “Whether it chooses the English conflict of law rule or the Greek conflict of law rule, or the Rome convention, the Tribunal must now determine the law which the contract has the closest connection.” Since the facts of the case showed that the country with which the contract was most closely connected was Greece, the tribunal held that Greek law was the substantive law of the contract.⁹¹⁸

In ICC Case No. 12112, the sole arbitrator, sitting in Switzerland, although considering that the conflict of laws of the *lex fori* was “decisive” as to the determination of the applicable law, resorted to the interpretation of the parties’ intentions under the principles of Swiss law as well as the PECL, according to which, the procedural behavior of the parties is an important element in determining the intentions of the parties in relation to the applicable law. The dispute arose from a joint venture agreement concluded between the foreign investors and the Ministry of Agriculture of State Y, which obliged the parties to create a company (“Company X”) for the cultivation of agricultural products, the breeding of livestock and the processing and sale of the resulting products. The arbitrator noted that the statute of “Company X” was without any possible doubt submitted to State Y law, but the joint venture agreement was not necessarily governed by the same legal system as the statute. However, the arbitrator considered that, as a rule, it cannot be easily admitted that the parties to such an agreement have chosen a legal system other than the legal system governing the company to the creation of which they oblige themselves by the agreement, and this legal system is

⁹¹⁶ *Ibid.*, at 55

⁹¹⁷ *Ibid.*, at 56

⁹¹⁸ ICC Partial Award in Case No 7177, 1993, ICC International Court of Arbitration Bulletin, 7-1 (1996), at 89

normally the one with which the direct relationship between the partners has, by far, the closest connection, in accordance with Article 117 (1) of the Swiss Private International Law Act (PILS).⁹¹⁹

Nevertheless, the arbitrator decided to discuss whether, as far as the primary object of the agreement and obligations between the partners were concerned, a legal system other than State Y law had been impliedly chosen. The arbitrator found that the agreement did not mention any other legal system, even not the *lex mercatoria* or the “general” (or “universal”) principles of commercial law, and considered several clauses creating obligations between the partner were also present in the statute, which was submitted to State Y law, as an indication that the parties had chosen State Y law as the legal system applicable also to the agreement. The arbitrator noted that although the parties sometimes quoted general principles of commercial law, they also referred to State Y law as far as reciprocal obligations were at stake. Thus, the arbitrator stated that “Claimants’ and Respondents’ procedural behavior – which is an element recognized as being of importance in determining the will of the Parties at the moment of the contract (see, e.g., Record of the Decisions of the Swiss Supreme Court (hereafter: ATF/BGE) 116/1989 vol. II. P. 695, No. 2b/cc at the end (p. 698)), which is a universally admitted principle arising out of good faith which is recognized as well in State Y contract law (see also, e.g. Art. 5.102 of the Principles of European Contract law (hereafter PECL)) – confirms that, according to the rules to applied by the Arbitral Tribunal (PILS and autonomous analysis), State Y law must be recognized as the substantive Law actually chosen by the Parties to apply to all obligations of the Parties. The same conclusion would be drawn out of a constructive interpretation of the Parties’ will (see ATF/BGE 123 III 3.5 or Art. 5.101 PECL) or out of the application of subsidiary rules applying in the absence of a choice of the applicable law by the Parties (cf. Art. 117(1) PILS).”⁹²⁰ Thus, the arbitrator decided to apply State Y law as the substantive legal frame of all agreements and operations relevant to the dispute.

In some cases, despite the absence of choice of law, the parties’ pleadings indicate some agreement as to the national law governing the substance of the dispute. In such cases, it seems that the parties acknowledge the established rule of conflict in the particular case. In ICC Case No 6527, regarding a sales contract between a Turkish and an Austrian party, in the absence of the parties’ choice of law, the Turkish seller suggested the application of Turkish law as the law of the place of performance of the parties’ essential obligations, stressing the conformity of this rule with the 1955 Hague Convention concerning the applicable law on international sale of movable goods. The Austrian buyer did not raise a specific objection to the application of the Turkish law, but pointed out that the tribunal should not restrict its choice to the legal provisions of a single country and should also take into account international usages and practice. The sole arbitrator, by referring to Article 13(3) of the 1988 ICC Rules, stated that “In accordance with the classical doctrine on conflicts of law, [the appropriate rule of conflict] should be determined by the law in force at the place of arbitration (*lex fori*). However, this doctrine has been widely criticized, mainly in consideration of the fact that the arbitrator, differently from the national judge, has no *lex fori*. Therefore, the arbitral tribunal considers it more appropriate to apply the general principles of international private law as stated in international conventions, particular those in the field of the sale of movable goods.” The arbitrator referred to the Hague Convention of 1985, which establishes the principles governing the determination of the law applicable to contracts for

⁹¹⁹ ICC Award in Case No. 12112, *Yearbook Commercial Arbitration*, (2009), at 81

⁹²⁰ *Ibid.*, at 82-83

the international sale of goods, and the Rome Convention of 1980 on the law applicable to the contractual obligations. Although neither of these Conventions had been ratified by Austria and Turkey, the arbitrator considered their rules of conflict as representative of the general principles in the field. On this basis, he concluded that the law applicable to the dispute was Turkish law since the contract was signed in Turkey and the seller had in Turkey its place of business at the time the contract was signed. The arbitrator held that he shall take account also of the provisions of the contract and of the relevant trade usages in conformity with Article 13(5) of the ICC Rules.⁹²¹

ICC Case No 5314 concerned a patent agreement between the claimant, a US manufacturer and, the defendant, an Italian licensor. In the absence of choice of law clause, the claimant requested the application of American law generally and Massachusetts law in particular, as substantive law, to the dispute, with reference if needed to *lex mercatoria*. The counsel of defendant informed by telex the arbitral tribunal that he considered that *lex mercatoria* should be the law applicable to the litigation, although he had no objection to the application of Massachusetts law, if the arbitrators deem such law appropriate. The tribunal did not interpret such telex as an agreement of the defendant to accept Massachusetts law as the law applicable to the dispute.⁹²² The tribunal observed that “the ICC Rules do not oblige an arbitrator to follow the choice of law rules of the seat of the arbitration, in the present case, the Swiss Rules of Conflict.” The arbitral tribunal, noting the ICC arbitration practice, decided to have recourse to the method of the cumulative application of the different rules of conflict of the countries having a relation to the dispute, and determined the countries having a relation to the dispute as Switzerland, which was the country of the seat of the arbitration proceedings, Massachusetts, where the claimant was incorporated, and Italy, where the defendant was incorporated. The tribunal examined the conflict of laws of those countries, which referred to tests of the “most significant relationship” and “closest connection”. The tribunal considered that “despite the fact that the debtor of the characteristic obligation has its place of residence in Italy, it appears that such Agreement has its closest connection with the United States, and in particular with the State of Massachusetts, considering in particular, that the place of performance and the location of the subject matter of the contract, i.e. the patent, are in the United States.”⁹²³ The tribunal evaluated this consideration in the context of the conflict of laws of the relevant national legal systems. The tribunal decided to apply the law of the State of Massachusetts as the law of the place of the closest connection by relying on Article 13 of the 1975 ICC Rules. The tribunal also recalled that Article 13(5) of the ICC rules obliges the arbitrators to take account of the relevant trade usages, and stated that “the *lex mercatoria* takes its source in the trade usages and in the principles generally applicable in international trade.”⁹²⁴ Thus, the tribunal held that “The American law generally and the law of the State of Massachusetts in particular, supplemented if needed by the *lex mercatoria*, is the law applicable to the dispute”.⁹²⁵

In some cases, the parties’ pleadings may point to a certain established rule of conflict, yet their arguments diverge with respect to its application in a particular case. In ICC Case No

⁹²¹ ICC Award in Case No. 6527, *Yearbook Commercial Arbitration*, (1993), at 46

⁹²² ICC (Interim) Award in Case No 5314, 1988, *ICC International Court of Arbitration Bulletin*, 4-2 (1993), at 70

⁹²³ ICC (Interim) Award in Case No. 5314, 1988, *Yearbook Comm. Arbitration*, 20 (1995), at 38-39

⁹²⁴ *Ibid.*, at 39

⁹²⁵ *Ibid.*, at 40

11754, the contract for international sale of goods between a government company incorporated in India, the claimant, and a private company incorporated in Singapore, the defendant, was silent as to the applicable law. The claimant submitted that Indian law should be the applicable substantive law of the contract by proposing the application of the following choice of law rules: the general principle of "closest and the most real connection", the principles of *lex mercatoria* and Article 8 of the Hague Convention of 1986 on the Law Applicable to contracts for International Sale of Goods. The defendant contended that the Singapore law should be the applicable substantive law on the basis of Article 3 (1) of the Hague Convention of 1955 on the Law Applicable to International Sale of Goods "as representative of the prevailing principles in the field", or alternatively, "the general rules of connection of international private law." According to the sole arbitrator, "although there might be some difference in details of their respective proposals, it seems to be that the principle of closest connection is a concurrent proposal made by both parties." Thus, the arbitrator deemed the rule of closest connection appropriate for determining the law to be applied to the merits of the dispute in the case, regardless whether it is to be referred to as the Indian private international law or the general rule of connection of international private law. The arbitrator took into account the nationalities of the parties, the place of contracting and the place of performance of the contract, and held that the dispute under the contract had the closest connection with India, and held that the law of India should be the applicable substantive law.⁹²⁶

2. Direct Choice

Apart from the indirect methods for determining the substantive law governing the contract, the arbitrators have also the capacity to resort to the direct choice method, whereby they are not required to refer to such common solutions of the conflict of laws of the national legal systems, but able to rely on their abstract reasoning in consolidating other materials, such as international contracting or arbitral practice. In contrast to the indirect methods, the determination of the applicable law through direct method may lead to the application of a national law and/or *lex mercatoria* to the substance of the dispute.

The element of abstract reasoning in the specialized consolidations of the arbitrators within the meaning of *lex mercatoria* seems to prevail in such cases where the arbitrators decide to apply a particular conflict rule without naming the legal system, to which that rule belongs, or without disclosing the materials, from which they derived the rule. In an arbitral case under the auspices of the SCC, the contract between Swedish and Chinese parties did not contain an explicit choice of law clause, but provided that the parties agreed that in the performance of the contract, they shall comply with all applicable laws, rules, regulation and orders of China. The arbitral tribunal did not admit this clause as a choice of law clause, and decided to apply conflict of laws principles. The Swedish claimant argued that Swedish substantive law was the proper law of the contract since Stockholm was designated as the venue of the arbitration proceedings or, under the applicable Swedish conflict of laws rules, the contract should be governed by the laws of Hong Kong, or it should be governed by the general principles of international commercial law. The tribunal rejected the first proposition and considered that third proposition was not elaborated.⁹²⁷ The Chinese defendant argued that the claimant

⁹²⁶ ICC Award in Case No 11754, 14 February 2003, Special Supplement, ICC International Court of Arbitration Bulletin: Decisions on ICC Arbitration Procedure: A Selection of Procedural Orders issued by Arbitral Tribunals acting under the ICC Rules of Arbitration (2003-2004), 2010

⁹²⁷ SCC Final Award, July 13, 1993, Yearbook Commercial Arbitration, 22 (1997), at 203

should be deemed to have either explicitly chosen or implicitly accepted that Chinese law would govern the contract or, alternatively, under the applicable conflict of laws principles, particularly the center of gravity rule, Chinese law should be applied to the contract. The tribunal rejected the defendant's first proposition for the lack of evidence that supported it, and stated that the proper law of the contract must be determined with the aid of the application of conflict of laws principles or rules. The tribunal held that it was immaterial whether it adopted cumulative method, application of general principles of conflict of laws, or direct method, because the center of gravity rule was common to all conflict of laws systems, which may be resorted to. Upon full consideration of all facts and circumstances relating to the contract and the transaction envisaged therein, the tribunal decided to apply Chinese law as the proper law of the contract since the overwhelming majority of the activities contemplated by the contract were to be carried out in China.⁹²⁸

The materials that can be utilized by the arbitrators, resorting to the direct choice method in the search for established rules of conflict, are not limited to the conflict of laws rules of the national legal systems or international conventions. Thus, the arbitral tribunals have relied on the interpretation of contractual intentions, and taken into account the context of the contract and the relevant contracting or arbitral practice in support of their decisions on the applicable substantive law rendered on the basis of direct choice. In ICC Case No. 4650, the tribunal took into account the common intentions of the parties and international practice of engineering contracts in exercising its abstract reasoning to determine the law applicable to the substance of the dispute. The dispute arose from an agreement regarding a building project between an American architect and a Saudi Arabian company. The American architect, as the claimant, argued that the applicable law should be the law of the State of Georgia, as all significant work provided under the agreements was carried out there. The claimant also submitted in the alternative that Swiss substantive law, being the law of the place of arbitration, or, possibly, *lex mercatoria* should apply. Finally, the claimant relied on "analogous international rules regarding the provision of engineering services which suggest that the law of the place of domicile of the engineer rather than of the employer will govern the legal relations between the parties, in the absence of any express agreement to the contrary". The defendant submitted that Saudi Arabian law should be applied because claimant's obligations were partly performed in Georgia and partly in Saudi Arabia, whilst the defendant's obligations were to be wholly performed in Saudi Arabia. With regard to trade usages, defendant contended that there existed no such usages which have any direct bearing on the provision of architectural services by an American architect for a project in Saudi Arabia. Finally, the defendant argued that neither Swiss substantive law nor *lex mercatoria* should be applied.⁹²⁹

The tribunal held that the evidence presented as to the question of the governing law did not appear to have been discussed between the parties and it would seem obvious that no tacit agreement or understanding had been reached. Due to the absence of any evidence regarding an actual agreement or concurrent intentions of the parties, the arbitral tribunal concluded that it cannot consider that the parties had chosen *lex mercatoria* or a neutral national law. On the basis of the evidence produced by the parties regarding the services under the agreement, the arbitrators found that such services were predominantly performed in Georgia. Without deciding on a specific rule of conflict to designate the proper law of the contract and considering that most major rules in some form or other point to the place of the characteristic

⁹²⁸ Ibid.

⁹²⁹ ICC Award in Case No. 4650, 1985, *Yearbook Commercial Arbitration*, (1987), at 111

or dominant work, the arbitrators decided to apply the laws of the State of Georgia. According to the tribunal, “a decision in favour of the laws of the State of Georgia would be consistent with international rules regarding the provision of engineering services”.⁹³⁰

The direct choice method is promoted by the modern *lex mercatoria* doctrine for the applicability of *lex mercatoria*. Unlike the indirect methods, the direct choice method can be completely free of the constraints of the traditional conflict of law regimes. In arbitral proceedings, the reference to direct choice method will usually raise the questions of *lex mercatoria* as the substantive law exclusively governing the dispute. However, in most cases, a mere absence of choice of law will not lead to the exclusive application of *lex mercatoria* to the substance of the dispute by means of the direct choice method.

In ICC Case No 9459, which concerned a share purchase agreement between French seller and Spanish buyer, the arbitral tribunal, sitting in Belgium, considered that none of the potentially relevant domestic laws, i.e. French, Belgian and Spanish law, allowed it to infer an implicit expression of the will of the parties from mere silence in the absence of additional elements showing the existence of such will, and that this view was supported by the general principles of interpretation under the UNIDROIT Principles and, therefore, constituted an international consensus. Following this line of reasoning, the tribunal rejected the application of *lex mercatoria*, which it defined as the set of transnational rules established by the trading community, since the silence of the parties cannot be considered as an implied will of the parties to submit their dispute to *lex mercatoria*. The tribunal also rejected the connecting factor relating to the characteristic performance on the grounds that the contract was not a simple agreement for the sale of shares, since it involved three parties and imposed such obligations and responsibilities that were not found commonly in a contract of sale. The tribunal held that the applicable law was the Spanish law because the parties did not agree implicitly or explicitly on an applicable law, and the contract had the closest connection with Spain.⁹³¹

In some cases, on the other hand, the context and contents of a particular contract can be the main factors supporting the arbitral tribunal’s decision on the question of in which manner *lex mercatoria* should govern the substance of the dispute in the absence of choice of law by the parties. In ICC Case No. 8540, the tribunal stated that it cannot designate a national law as the applicable law under which there would be found a legal nullity, or one under which the parties’ key obligation would be found to be unenforceable given that Article 13 (5) of the 1988 ICC Rules requires the tribunal to take account of the provisions of the contract in all cases and the parties could not have intended that the governing law of the would render this contractual obligation unenforceable. The dispute arose from a pre-bid agreement between a supplier of telecommunications systems in the United States, the claimant, and a Middle Eastern manufacturer of telecommunications cables, the defendant, whereby the parties undertook to negotiate in good faith the supply of cables in the event that claimant's bid to become prime contractor for a telecommunications expansion project succeeded. The tribunal had to determine whether an obligation to negotiate in good faith is enforceable under the law applicable to the merits of the dispute. The claimant argued that “The obligation to negotiate in good faith is unenforceable under any of the laws that might be applied to the [Agreement] – English, Saudi Arabia, Georgia, New York or New Jersey.” The defendant requested the

⁹³⁰ Ibid., at 112

⁹³¹ ICC Award in Case No 9459, *Chronique de jurisprudence arbitrale de la CCI*, in *Cahiers de l'arbitrage*, *Gazette du Palais*, No. 119-123, 121, (2001), at 43

tribunal to reject the application of English or Saudi law, since an obligation to negotiate in good faith is unenforceable under the former, whereas application of the latter would result in the agreement being void. The defendant submitted that the parties' obligation to negotiate in good faith is enforceable under the laws of Georgia, New York or New Jersey, and subsidiarily, invited the tribunal to apply the UNIDROIT Principles, under which the parties' express contractual commitment to negotiate in good faith is clearly enforceable.⁹³²

According to the tribunal, neither the law of Saudi Arabia nor the law of England can be designated as the proper law of the agreement in these circumstances. The tribunal stated that "In an international commercial transaction such as this contract between and, where the Parties have not indicated the applicable law and where there are many disparate connections to many different municipal systems of law, we are of the opinion that international arbitrators are fully justified to turn to general principles of law." However, the tribunal considered the fact that a non-disclosure agreement, which had been signed by the parties at the inception of the discussions concerning the agreement in dispute, and which was explicitly referred to by the agreement in dispute, contained a choice of law clause in favor of the law of New York, where the parties provided that "the parties are familiar with the principles of New York commercial law, and desire and agree that the law of New York shall apply in any dispute arising with respect to this Agreement." Due to this connection, the tribunal determined the applicable law as the law of New York, but decided to look to general principles of law to compare the conclusion, which results from the application of the law of New York, with the conclusion that would be obtained were the tribunal to apply these general principles. The tribunal stated that "In determining the content of these general principles, we feel entirely justified in referring to the UNIDROIT Principles which we consider a useful source for establishing general rules for international commercial contracts."⁹³³

ICC Case No 9797 concerned a dispute that was truly global in its dimensions. The claimants were 44 Andersen Consulting Business Unit member firms ("ACBU") operating in 37 countries, while the defendants were most of the 97 Arthur Andersen Business Unit member firms ("AABU"), operating in 57 countries, and Geneva based Andersen Worldwide Société Coopérative ("AWSC").⁹³⁴ ACBU and AABU were the two business units of the Andersen Worldwide Organization ("AWO"), which was set up to cope with the worldwide expansion of Arthur Andersen and Co. All member firms were linked to each other through Member Firm Interfirm Agreements ("MFIFAs"). MFIFAs were stipulated between individual member firms and AWSC, an administrative organ of AWO whose task was to coordinate the activities of the individual member firms.⁹³⁵ The claimants argued that MFIFAs were terminated since AWSC breached the contract by failing to coordinate and ensure compatibility between the practices of the member firms, and AABU member firms breached their material obligations under their MFIFAs by competing with ACBU member firms, causing marketplace confusion and misappropriating the Andersen Consulting name.⁹³⁶ The arbitration clause in the MFIFAs stated that: "[t]he arbitrator shall decide in accordance with

⁹³² ICC Award in Case No 8540, 4 September 1996, available at <http://www.unilex.info/case.cfm?id=644>

⁹³³ Ibid.

⁹³⁴ Bonell, Michael Joachim, A 'Global' arbitration decided on the basis of the UNIDROIT Principles: In re Andersen Consulting Business Unit Member Firms v. Arthur Andersen Business Unit Member Firms and Andersen Worldwide Société Coopérative, *Arbitration International* 17 (2001), at 250

⁹³⁵ Ibid.

⁹³⁶ ICC Award in Case No 9797, *ICC International Court of Arbitration Bulletin*, 12-2 (Fall 2001), at 89

the terms of this Agreement and of the Articles and Bylaws of [AWSC]. In interpreting the provisions of this Agreement, the arbitrator shall not be bound to apply the substantive law of any jurisdiction but shall be guided by the policies and considerations set forth in the Preamble of this Agreement and the Articles and Bylaws of [AWSC], taking into account general principles of equity.”⁹³⁷ Although, this provision already indicated the choice of *lex mercatoria* to the exclusion of any national law by the parties, the arbitral tribunal still stated that, “If the MFIFAs and the AWSC Articles and Bylaws are silent or do not provide guidelines for a decision, the Tribunal shall, pursuant to Article 17.1 of the ICC Rules, apply the rules of law it deems appropriate; those rules of law shall be the general principles of law and the general principles of equity commonly accepted by the legal systems of most countries.” The tribunal decided that “The Unidroit Principles of International Commercial Contracts are a reliable source of international commercial law in international arbitration for they contain in essence a restatement of those 'principes directeurs' that have enjoyed universal acceptance and, moreover, are at the heart of those most fundamental notions which have consistently been applied in arbitral practice”.⁹³⁸

In ICC Case No. 8817, there was no choice of law clause in an agreement for the exclusive distribution and sale of food products between a Spanish company, as distributor, and a Danish company, as principal. The distributor maintained that the applicable law must be determined according to Article VII of the European Convention on International Commercial Arbitration and to Article 4 (2) of the Rome Convention of 1980 on the Law Applicable to Contractual Obligations. The distributor pointed out that it was the party effecting the characteristic performance, namely distribution, and that its seat was in Spain. The distributor added that the contract was drawn up in Spanish, the parties mostly corresponded in Spanish, and the goods were always to be delivered in Spain. On the basis of these connections, the distributor argued for the application of Spanish law.⁹³⁹ The principal maintained that the Spanish party was partly a distributor and partly a buyer since it bought most products for its own industrial use, and argued for the application of the CISG or alternatively Danish law being the law of the domicile of the seller, as the governing law. As far as the distributorship contract was concerned, if this was to be separated from the international sale contract, the Danish party maintained that Danish law should apply since the goods produced by the Danish party in Denmark were the essential element of the distributorship contract.⁹⁴⁰

The sole arbitrator first noted that since the contractual relationship between the parties ended, and the arbitrator had the only task to settle this dispute, he would not examine the applicable law which the parties could have chosen when entering into the contract. The arbitrator considered that the starting point for determining the applicable law was the claims and counterclaims filed in the dispute. Upon the analysis of the claims, the arbitrator determined that the claim for damages was based on less than a tenth of the claimant’s loss of profit on the products produced by it. Thus, looking at this business relationship globally, the arbitrator concluded that the character of a sale contract prevailed over the distributorship. Moreover, the arbitrator stated that “according to established jurisprudence in arbitration practice, a criterion for the appropriateness of a provision is that provision’s presence in the legal

⁹³⁷ Bonell, Michael Joachim, A ‘Global’ arbitration decided on the basis of the UNIDROIT Principles: In re Andersen Consulting Business Unit Member Firms v. Arthur Andersen Business Unit Member Firms and Andersen Worldwide Société Coopérative, *Arbitration International* 17 (2001), at 250, at 252

⁹³⁸ ICC Award in Case No 9797, *ICC International Court of Arbitration Bulletin*, 12-2 (Fall 2001), at 89

⁹³⁹ ICC Award in Case No. 8817, 1997, *Yearbook Commercial Arbitration Volume*, 25 (2000), at 356-357

⁹⁴⁰ *Ibid.*, at 357

systems of both parties.”⁹⁴¹ According to the arbitrator, this was the case of the CISG, which was in force both Spain and Denmark at the time of proceedings. Even though the CISG was not in force in Spain when the contract was signed, the arbitrator reasoned that it was long enough in force by the time of the award for the CISG to have been studied and specifically commented upon in Spain. Thus, the arbitrator held that the CISG and its general principles, “as presently elaborated in the UNIDROIT Principles on International Commercial Contracts, are perfectly suited to the settlement of the present dispute” and, in order to facilitate the future task of the parties, the arbitrator mentioned the relevant articles of the CISG in the interim award.⁹⁴²

In ICC Case No. 8502, the arbitral tribunal considered that the particular circumstances surrounding the contract indicated the parties’ willingness to have their contract governed by *lex mercatoria*. The contract between the French and Dutch buyers and the Vietnamese exporter contained no choice of law clause, and the arbitral tribunal, having regard to the correspondence exchanged between the parties, was of the opinion that no implied choice of law can be inferred from the relationship between the parties. The contract referred to international trade usages, such as the INCOTERMS 1990, with respect to the price, and of the Uniform Customs and Practice for Documentary Credits (UCP) 500, with respect to force majeure. In the arbitral tribunal’s view, the reference to both the Incoterms and the UCP indicated the parties’ intent that their contract be governed by recognized trade usages and generally accepted principles of international trade. According to the arbitral tribunal, “the application of relevant trade usages is consistent with Article 13(5) of the 1988 ICC Rules and with the arbitral practice.” In particular, the arbitral tribunal referred to the provisions of the CISG or to the UNIDROIT Principles, “as evidencing admitted practices under international trade law”.⁹⁴³ The tribunal referred to the CISG with respect to calculation of amount of compensation due to buyers caused by the seller’s default since the INCOTERMS 1990 and the UCP 500 contain no provision regarding the effect of the failure by one party to fulfill its obligations under the contract, even though the CISG was not as such directly applicable to the contract as Vietnam has not ratified the CISG. The arbitral tribunal was of the opinion that the principles embodied in the CISG reflect widely accepted trade usages and commercial rules, and it may refer to its provisions as the expression of usages in the world of international commerce.⁹⁴⁴ The tribunal also referred to the relevant provisions of the UNIDROIT Principles in support of its decision.⁹⁴⁵

The arbitrators may resort to the application of the method of direct choice without considering indirect choice methods, under the “rules of law” terminology of the most of the institutional arbitration rules. However, under the basic principles of *lex mercatoria* as the law of principled adjudication, the decision maker is not liberated from the duty to give a reasoned award, which implies that reasons should be stated for choosing the substantive law in question even if the choice seems obvious to the decision maker. The decision maker should not rely on the direct choice method without an attempt to demonstrate to the parties that they could not reasonably expect the decision maker to apply any law other than the one finally determined. Thus, under *lex mercatoria* as the law of principled adjudication, the decision

⁹⁴¹ Ibid., at 358

⁹⁴² Ibid., at 358-359

⁹⁴³ ICC Award in Case No. 8502, ICC International Court of Arbitration Bulletin, 10-2 (Fall 1999), at 72-73

⁹⁴⁴ Ibid., at 73

⁹⁴⁵ Ibid., at 74

maker should resort to their capacity to resort to the direct choice method after considering whether a satisfactory solution can be found through indirect methods.

In ICC Case No 13012, a contract between a French company and a U.S. company was silent as to the applicable law. In the proceedings, both parties had recourse to the cumulative method as well as to the direct choice method for the determination of the applicable law. The French company submitted that the rules of law with which the case had the closest connection are those of France, while according to the U.S. company, the laws of Illinois had the closest connection to the matters at issue. The tribunal considered that none of the connecting factors used by the parties to select the applicable law was satisfactory, such as the parties' domicile, the place of contracting or the place of performance of the contract. According to the tribunal, a strict choice of law analysis was inappropriate in the instant case where the parties' rights and obligations under the contract at stake were perfectly symmetrical. The tribunal noted that "in situations where the parties did not select the material law governing their agreement, arbitrators have frequently filled up this lacuna by a recourse to the general principles of law or *Lex Mercatoria*." The tribunal decided to have recourse in the instant case to the UNIDROIT Principles as a primary set of guidelines in determining international rules of law applicable to the parties' contract and to take into account the provisions of the contract and the relevant trade usages, in accordance with Article 17 (2) of the 1998 ICC rules.⁹⁴⁶

In ICC Case No 9875, the claimant, a French company, and the defendant, a Japanese company, entered into a license agreement according to which the claimant was given an exclusive license to manufacture, sell and distribute the defendant's products in Europe. The agreement between the parties did not include a choice of law clause. The claimant argued French law should be determined as the applicable law through the direct choice method involving the examination of different factors. According to the claimant, although the place of the characteristic performance, in a license agreement, is often considered as that of the licensor, the issues submitted to the tribunal were wider than questions related to the defendant's industrial property rights. In its view, the "proper law of the contract" could only be French law, since France was the country from which all operations included in the territorial exclusivity were conducted, it was the country where the formulas and know-how allegedly misappropriated by the defendant were developed, and it was in France that the consequences of the breach of the license contracts were felt.⁹⁴⁷ The defendant considered Japanese law should apply since the contract was executed in Japan and the characteristic performance, in a license contract, is that of the licensor. The defendant pointed out that the territory of the license agreements was not limited to France, that the choice of the law of the place where the alleged prejudice was suffered might be relevant in a tort case, but not in a contractual dispute, and that the alleged breaches had no link to France.⁹⁴⁸

The tribunal looked into the provisions of the contract, which contained various references to France and other European and non-European countries as well as to Japan. The tribunal did not consider the neutral choice of Brussels as the seat of the arbitration to imply a choice of Belgian law as the law applicable to the contract. The tribunal noted that although, in license

⁹⁴⁶ ICC Award in Case No 13012, cited by Jolivet, Emmanuel, *L'harmonisation du droit OHADA des contrats: l'influence des Principes d'UNIDROIT en matière de pratique contractuelle et d'arbitrage*, *Uniform Law Review*, (2008), at 137 fn 29

⁹⁴⁷ ICC Award in Case No 9875, *ICC International Court of Arbitration Bulletin*, 12-2 (Fall 2001), at 96

⁹⁴⁸ *Ibid.*

agreements, the appropriate law is sometimes considered to be that of the country where the licensor is located, assuming the most characteristic performance of such contracts would be that of the licensor, this is not an absolute rule, and for example, the law of the licensee is sometimes preferred. However, the arbitral tribunal considered that “the difficulties to find decisive factors qualifying either Japanese or French law as applicable to the contract reveal the inadequacy of the choice of a domestic legal system to govern a case like this.”⁹⁴⁹ According to the tribunal, a contract concluded between Japanese and French companies concerning a license to manufacture products and to sell them in various parts of the world was not appropriately governed by the national law of one of the parties, failing agreement on such a choice. Therefore, the tribunal held that the most appropriate rules of law to be applied were those of *lex mercatoria*, which was defined by the tribunal as “the rules of law and usages of international trade which have been gradually elaborated by different sources such as the operators of international trade themselves, their associations, the decisions of international arbitral tribunals and some institutions like Unidroit and its recently published Principles of International Commercial Contracts.” The tribunal also noted that it would take into account “any relevant national laws concerning intellectual property rights issues raised during this procedure.”⁹⁵⁰

In Paris Chamber of Arbitration Award in case no. 9246, the arbitral tribunal applied *lex mercatoria* in the absence of a choice of law clause in an agency agreement between Austrian and Egyptian parties which was to be performed in several countries. The claimant maintained that, as the contract was concluded in Egypt, one of the parties was Egyptian and the contract was partly performed in Egypt, Egyptian law should apply. The defendant neither explicitly agreed nor objected. The tribunal was not convinced by the connecting factors suggested by the claimant, which would lead to the application of Egyptian law. The tribunal noted that the contract was performed partly in Egypt and partly in State X. Considering that the arbitrator may apply the rules of law which he deems appropriate, the arbitral tribunal stated that it could refer to the provisions of the Hague Convention of 14 March 1978 on the Law Applicable to Agency, of which Art. 6 provides for a general principle of applicable law in international matters, based on the main criterion of the habitual residence of the party providing the characteristic performance. However, the arbitral tribunal deemed it “more proper to refer to the body of rules of international commerce which have been developed by practice and affirmed by the national courts (*lex mercatoria*).”⁹⁵¹

In ICC Case No 11265, an international sales contract entered into between a company situated in the Bermudas and a company situated in Rwanda was silent as to the applicable law. The claimant invoked the application of the CISG supplemented, if necessary by the UNIDROIT Principles. The defendant objected to the application of the CISG, but not to that of national principles and rules and in this respect expressed its preference for the UNIDROIT Principles instead of the vague principles of *lex mercatoria*. The arbitral tribunal first pointed out that according to Article 1054(4) of the Dutch Code of Civil Procedure as well as according to Article 17 (2) of the 1998 ICC Rules of Arbitration absent an agreement between the parties as to the applicable law it should apply “the rules of law which it determines to be appropriate” and “in any case take into account the relevant trade usages”. The tribunal considered the reference in the contract to INCOTERMS as reflecting the

⁹⁴⁹ Ibid., at 97

⁹⁵⁰ Ibid.

⁹⁵¹ Paris Chamber of Arbitration Award in Case No. 9246, March 8, 1996, Yearbook Commercial Arbitration, 22 (1997), at 31

willingness of parties to have their relationship governed by accepted international trade practices. The tribunal also believed that the contract should not be subjected to the application of any national law since the contract had no significantly close connection to any particular national law but equally strong or loose contacts with a number of jurisdictions, such as the company situated in the Bermudas used to act through an intermediary situated in Paris and the goods had to be delivered in part in Rwanda and in part in Tanzania. The tribunal noted that the claimant and the defendant had no objection to the application of principles of international trade law, and considered this as an agreement between the parties as to the possibility of applying the UNIDROIT Principles. The tribunal concluded from those considerations that it was allowed to rely on the UNIDROIT Principles, as they constitute a codification of commercial and express the general principles of contract law.⁹⁵²

Although the indirect choice methods seem available in a particular case, the decision maker may resort to the direct choice method for the application of *lex mercatoria* on the basis of the positions and arguments adopted by the parties during the proceedings in order to give effect to their reasonable expectations. In ICC Case No 9455, the arbitrator had to determine the applicable law to a contract for the supply of equipment concluded between Turkish and Italian parties. The claimant sought the application of Turkish law on the ground that the equipment was delivered to and assembled in Turkey, while the defendant argued for the application of Italian law where the party undertaking the characteristic performance had its seat. The arbitrator noted that the parties neither established the contents of the laws they deem applicable nor sought the enforcement of specific legal provisions cited in support of their claims. The arbitrator also noted that, during the proceedings, the parties were not opposed to the suggestion of the arbitrator to apply the CISG, but the parties relied on principles of contract law rather than the specific provisions of the CISG in support of their claims. The arbitrator considered that the parties did not sufficiently prove their claims and, taking into account the nature of the dispute in question, he decided to apply the general principles of contract law or *lex mercatoria* and the principles of contract law invoked by the parties.⁹⁵³

In some cases, the confusion as to the concept of *lex mercatoria*, which arises from the theories of the modern *lex mercatoria* doctrine, leads to such statements of arbitral tribunals that the pleadings of the parties based on *lex mercatoria* in the resolution of substantive matters should be rejected, since a national law is found to be applicable. What such tribunals reject in essence is the application of *lex mercatoria* to the exclusion of any national law in dealing with the substance of the dispute since they discover an established rule of conflict in a particular case by means of direct or indirect methods, which directs them to apply the rules of the designated national law as representing the reasonable expectations of the parties. However, the arbitrators should not disregard the applicability of *lex mercatoria* as the law of principled adjudication and as the *lex fori* of the international arbitral tribunals, given that they do not apply that national law as a result of the orders of any national legal system, but to give effect to the reasonable expectations of the parties in a particular case as required by the basic principle of good faith and fair dealing under *lex mercatoria*.

⁹⁵² ICC Award in Case No 11265, October 2003, ICC International Court of Arbitration Bulletin, 21-1 (2010), at 68

⁹⁵³ ICC Award in Case No 9455, *Chronique de jurisprudence arbitrale de la CCI*, in *Cahiers de l'arbitrage*, Gazette du Palais, No. 119-123, 121, (2001), at 42

The arbitral tribunal in ICC Case No 6149, concerning some international sale contracts, resorted to both general principles of conflict of laws and the cumulative application of the conflict of laws of the national legal systems connected with the dispute in order to determine the established rule of conflict in a particular case, but rejected the application of *lex mercatoria* to the substance of the dispute. The tribunal stated that two different sets of conflict of law rules are ‘the appropriate law’ in the sense of Article 13(3) of the ICC Rules. The first set is composed of the conflict of law rules of states most closely connected with the contract, and the second materializes in the general principles of conflict of laws. The sales contracts were most closely connected with the Republic of Korea (seat of seller; place of contracting); with Jordan (seat of buyer); with Iraq (final place of delivery of goods sold); and with France (place of arbitration). The arbitral tribunal consulted the conflict of law rules of these four states. The tribunal stated that “A comparison of the conflict of law rules of the states most closely connected with the subject-matter of the present arbitration shows that they all are in harmony with each other and that they therefore have to determine the proper law of contract” and decided to apply Korean law as the governing law of the contract since according to the established rule of conflict, the substantive law most closely connected with the contract should be applied, and the ‘home law’ of the seller is such substantive law”.⁹⁵⁴ According to the tribunal, its decision was further supported by some other general principles prevalent in modern conflict of laws, which were found in the Hague Convention on the Law relating to International Sales of Corporeal Movable Property and the 1980 Rome Convention on the Law Applicable to Contractual Obligations.⁹⁵⁵

The claimant had argued that the application of Korean law would be impracticable and that the arbitrators should therefore directly choose the law to be applied to the contract. According to the claimant, such choice should lead to the application of the “so-called *lex mercatoria* which, in its turn, would essentially mean the application of the Vienna Convention on the International Sale of Goods of 11 April 1980; and that, where said Convention would be silent, French law subsidiarily would have to be applied as the law in effect at the seat of the arbitration.” The confusion of concepts as to *lex mercatoria*, as demonstrated by the claimant’s argument, can also be found in the tribunal’s reasoning. The tribunal stated that “Apart from the fact that it is highly disputed whether such theory is viable and whether it would withstand the scrutiny by a state court eventually reviewing this interim award, the application of the so-called *lex mercatoria* would not solve all conflict of law problems possibly arising in the present arbitration proceedings” since the tribunal considered that the application of the *lex mercatoria* would be tantamount to the application of the CISG. The tribunal noted that it would have to decide on claims based upon an unjust enrichment of the buyer and/or upon the limitation of any claim introduced by claimant into this arbitration, which were not covered by the CISG. The tribunal discarded *lex mercatoria* as the proper law of the contract since it decided that all claims introduced into the present arbitration proceedings were to be governed by one and the same proper law of contract and that a concurrent application of different national laws would not take place.⁹⁵⁶ The tribunal correctly identified an established rule of conflict and already applied *lex mercatoria* at the conflict of laws stage in concluding that Korean law should be the applicable law. However, the tribunal’s misconception of *lex mercatoria* leads to its categorical rejection in the case, although *lex mercatoria* could further be relevant to the merits of the dispute, to the extent that the rules of Korean law reflect the isolated position of the authorities in Korean legal system.

⁹⁵⁴ ICC (Interim) Award in Case No. 6149, 1990, Collection of ICC Arbitral Awards Vol. III (1991-1995), at 327

⁹⁵⁵ *Ibid.*, at 328-329

⁹⁵⁶ *Ibid.*, at 330

Some arbitrators reject the concept of *lex mercatoria* even though finding that no national law should be applied to the substance of the dispute under the specific circumstances of the case. In ICC Case No 10385, rejecting the applicability of *lex mercatoria* to the substance of the dispute, the tribunal deferred the question of applicable law to an uncertain stage in the proceedings. The case concerned a construction contract between the Government of a West African State and an African construction company. The contract was silent as to the applicable law. The arbitral tribunal observed that Article 17 (1) of the 1998 ICC Rules, which refers to the rules of law that the tribunal deems appropriate to govern the contract in the absence of choice by the parties has a particular aim to give more freedom to the tribunal than the regulation of the matter under Article 13 (3) of the 1988 ICC Rules. According to the tribunal, this change reflected the modern arbitral regulations and practice. In determining the applicable rules of law, the tribunal considered that the parties had not chosen a particular domestic law as the law governing their contract and had agreed to submit any dispute that might arise to arbitration to be held in Switzerland, that the contract was between a state and foreign private company and that the construction project was being financed by an international organization. Particularly, the tribunal noted that the state party did not request or require the application of its own law to the contract. Although, the contract contained several references to the laws of the state party, they were only of administrative and mandatory laws, which were applicable regardless of the chosen law. The tribunal interpreted the restrictive nature of those references to the effect that the implied will of the parties was to exclude the law of each party. The tribunal also found that there was no clearly prevailing connecting factor to a single national law since there were multiple places of performance, and the connection to the residence of the debtor of the characteristic performance did not provide a satisfactory solution. The conclusion that no national law was applicable to the contract led to the discussion of the applicability of *lex mercatoria*. However, the tribunal rejected this possibility since there was no express or implicit reference to *lex mercatoria* in the contract, and the very definition and scope of *lex mercatoria* was far from being unanimously accepted among scholars and in international arbitration practice. The tribunal held that since most questions posed by the dispute could be resolved within the context of the contract, it was possible to examine the question of the law when and if indeed it appears necessary to deviate from the provisions of the contract, and to apply "the rules of law" it considered most appropriate, when necessary.⁹⁵⁷

Some arbitral tribunals have resorted to a strict form of interpretation of the applicable arbitration rules, which required them to designate the applicable law by means of indirect choice method, and conclude that they do not have the capacity to apply *lex mercatoria* to the substance of the dispute to the exclusion of any particular national law as a result of the parties' choice of such arbitration rules. ICC Case No 9419 concerned an accord for the exportation of goods between a Swiss company and a Liechtenstein company. The Swiss claimant based its claims on universally acknowledged principles of international trade, as the accord did not contain any choice of law clause, and requested that the arbitral tribunal solve the dispute in accordance with *lex mercatoria*, "a kind of codification of which can be found in the principles of international commercial contracts drawn up by UNIDROIT". Alternatively, the claimant argued that, in the event that reference needs to be made to a national law, French law has to be applied, given that the subsequent sales agreement became an integral part of the accord and the application of French law was explicitly provided in the

⁹⁵⁷ ICC Award in Case No. 10385, March 2002, Special Supplement, ICC International Court of Arbitration Bulletin, UNIDROIT Principles: New Developments and Applications, 2005, at 80-83

said agreement. The sole arbitrator stated that “While acknowledging the authoritativeness of the school of thought that has posited the existence of such an unwritten and supranational law, based on principles and usages generally accepted by players in international commerce (the so-called mercatores), and although aware that there have even been awards in international commercial arbitration where explicit reference is made to *lex mercatoria*, the undersigned arbitrator sides with the other school of thought that does not believe in the existence of *lex mercatoria* and which firmly believes that the search for a law that can be applied to a contractual relationship must necessarily lead to the identification of a national law.” The arbitrator found support for this “belief” in a strict interpretation of Article 13 (3) of the 1988 ICC Rules whereby the arbitrator is required to apply the law that is applicable on the basis of the rules of conflict that he considers to be appropriate. According to the arbitrator, in the absence of contractual choice of law, his power is not to choose the applicable law in a direct way, but is limited to identifying the rule of conflict that he considers to be the most appropriate thereby necessarily arriving at the designation of a specific national legal system.⁹⁵⁸

Nevertheless, the arbitrator noted that he must in all events take account not only of the contractual stipulations, but also of trade usages, as provided for in Article 13 (5) of the ICC Rules and stated that “precisely due to their general acceptance by the mercatores community, trade usages can be considered to be tacitly acknowledged by the parties in their contractual relationship.”⁹⁵⁹ The arbitrator stated that “the Unidroit Principles could certainly be used for reference by the parties involved for the voluntary regulation of their contractual relationship, in addition to helping the arbitrator in confirming the existence of particular trade usages, but they cannot constitute a normative body in themselves that can be considered as an applicable supranational law to replace a national law, at least as long as the arbitrator is required to identify the applicable law by choosing the rule of conflict that he considers most appropriate, in accordance with the provisions laid down by the international conventions and as provided for in the rules of arbitration within the scope of which he operates.” Rather than resorting to an appropriate conflict of laws rule, the arbitrator accepted the claimant's second argument regarding the applicability of French law, and stated that, “the arbitrator replaces the parties in the search for an applicable law only when no “indication” whatsoever has been expressed by the parties in this respect (Article 13.3 of the ICC Rules), which precisely means that it is up to the arbitrator to discover the intent of the parties, wherever possible, also by means of elements pointing to an implicit intent.”⁹⁶⁰ The arbitrator held that having incorporated the agreement into the accord, the parties implicitly expressed their wish to submit their contractual relationship to French law, and since most claims were based on alleged breaches of contract for the supply of goods, the arbitrator decided to first of all apply the CISG.⁹⁶¹

In ICC Case No. 4237, although the applicable arbitration rules are interpreted strictly, requiring the designation of the applicable law by means of indirect choice method, the sole arbitrator still adopted the same techniques of thought that should be exercised under *lex mercatoria*, in dealing with the merits of the dispute. The issue was the determination of the applicable law to a sales contract between a Syrian claimant and a Ghanaian defendant. The

⁹⁵⁸ ICC Award in Case No. 9419, September 1998, ICC International Court of Arbitration Bulletin, 10-2 (1999), at 105

⁹⁵⁹ Ibid.

⁹⁶⁰ Ibid., at 106

⁹⁶¹ Ibid.

sole arbitrator, sitting in Paris, noted that Article 1496 of the French law of civil procedure, in the absence of a choice by the parties, allowed the arbitrator to decide the dispute according to the rules of law as he deems appropriate. The arbitrator stated that “it is argued in literature that international arbitrators should, to the extent possible, apply the *lex mercatoria*.” However, the arbitrator considered that the contents of *lex mercatoria* are not easy to determine and neither party argued that a *lex mercatoria* should be applied, but rather, each party strenuously argued on the basis of a national law, i.e., Syrian and Ghanaian/English law respectively. Accordingly, the arbitrator decided to “follow the implied desire of the parties to apply a national law.” The sole arbitrator also considered himself to be obliged to determine conflict rules in order to arrive at the law governing the substance of the dispute, by virtue of Article 13 (3) of the 1975 ICC Rules, which, in the arbitrator’s view, constituted a contractual elaboration of the conflict rules contained in Article 1496 of the French Law, and specified how the arbitrator has to determine the appropriate rules.⁹⁶²

The arbitrator noted that he was not bound to follow conflict rules of a national system of law as Article 13(3) constituted contractual conflict rules contained in international arbitration rules. The arbitrator applied directly the closest connection test as the established rule of conflict. He stated that “In view of the international character of the present arbitration, the Arbitrator deems it appropriate to apply those conflict rules which are generally followed in international arbitrations of the kind under consideration. The decided international awards published so far show a preference for the conflict rule according to which the contract is governed by the law of the country with which it has the closest connection.” Accordingly, the arbitrator stated that Ghanaian law would in principle be applicable. As the arbitrator found the defendant’s argument that English law should be applied as convincing and, considering that English law is not different from Ghanaian law, the arbitrator held that the dispute was to be resolved on the basis of English law.⁹⁶³ Thus, the arbitrator apparently rejected the exclusive application of *lex mercatoria* to the substance of the dispute. However, the arbitrator not only applied *lex mercatoria* at the conflict of laws stage by referring to the established rules of conflict, but also resolved the disputed matters when dealing with the merits of the case by referring to the common solutions found under Syrian, Ghanaian and English law regarding the incorporation of general conditions and the measure of damages and, on the basis of the contractual clauses and his abstract reasoning with respect to force majeure issues, all of which can be regarded as the instances of the application of *lex mercatoria* to the substance of the dispute.⁹⁶⁴

⁹⁶² ICC Award in Case No. 4237, *Yearbook Commercial Arbitration*, (1985), at 55

⁹⁶³ *Ibid.*

⁹⁶⁴ With regard to the general conditions the arbitrator stated that “According to [Syrian, Ghanaian and English laws], a clause in a contract subjecting the contract to a specific set of General Conditions has in principle as legal effect that the General Conditions are incorporated in the contract, provided that the party, by exercising reasonable care, could have become aware of the contents of the General Conditions.” In rejecting the force majeure argument, the arbitrator concluded the issue with a general remark: “if every governmental reshuffle and accompanying public excitement constitutes force majeure, world trade would in modern times be bogged down by uncertainty.” In determining the damages, the arbitrator stated that “The generally accepted rule in world trade is that the measure of damages in the case of non-delivery of goods is the difference between the contract price and market price of the goods at the time when they ought to have been delivered, where there is an available market for the goods in question. This rule is also law in both English (Ghanaian) and Syrian law.... This rule is predicated on the assumption that upon non-delivery the buyer can mitigate his loss by buying substitute goods on the open market. To the extent to which he suffers further loss by not going to the market, he cannot hold the seller responsible.” ICC Award in Case No. 4237, *Yearbook Commercial Arbitration*, (1985), at 56-59

Essentially, in contrast to the case that the parties expressly agree on a national law, where the parties are silent as to the applicable law and there is an established rule of conflict designating a particular national law as the governing law, the decision maker applying *lex mercatoria* should not consider idiosyncratic provisions of that national law as part of the bargain contemplated under the contract and may disregard such provisions by substituting them with the established rules in a particular case, arising from trade usages or general principles of law, in order to give effect to the reasonable expectations of the parties. The decision maker may also fill in any lacunae in the applicable national laws by applying *lex mercatoria*, as the law of principled adjudication. There are examples of arbitral awards, where the arbitrators have referred to the specific provisions of arbitration rules and laws requiring them to take into account trade usages in disregarding idiosyncratic provisions of the applicable national law that diverge from the established rules in the order of international commerce. In some cases, the arbitrators have applied the designated national law completely in a different manner from the national courts in the country of origin, due to their greater concern for the particularities of the dispute rather than the development of a legal system through legal decisions.

In ICC Case No 5713, the arbitral tribunal stated that it would take into account the relevant trade usages in accordance with Article 13(5) of the ICC arbitration rules, and considered that the provisions of the applicable national law appeared as an exception to the generally accepted trade usages, as reflected in the CISG, since they imposed extremely short and specific time requirements in respect of the buyer giving notice to the seller in case of non-conformity of goods. Thus, the tribunal applied the relevant provisions of the CISG, instead of the formal consolidations of the applicable national legal system, to resolve the dispute.⁹⁶⁵

In ICC Case No 6527 where Turkish law was determined as applicable in the absence of choice by the parties, the arbitrator applied Turkish law to the substance of the dispute in a manner completely different from what one could expect from Turkish courts dealing with a similar case. The issue was whether the seller's termination of contract for the delay of the buyer in opening the letter of credit was justified, and when the buyer should have opened the credit in absence of an express stipulation as to the time for this opening. The arbitrator first referred to the relevant provision of the Swiss Code of Obligations, which was adopted by Turkish law, rather than citing directly the provisions of Turkish code or relevant Turkish case law. The Swiss Code provided that in the absence of a time limit fixed by the contract or resulting from the nature of the deal, the obligation may be fulfilled and its performance may be requested immediately. The arbitrator investigated whether the nature of the deal in the case was such as to imply a particular time limit. The arbitrator cited an English case and a writing of Clive Schmitthoff as representing prevailing principles in this area, which led to the conclusion that the credit had to be opened within a reasonable time before shipment.⁹⁶⁶ After finding that the deadline fixed by the seller for the buyer to open a letter of credit was not adequate to allow a reasonable time, the arbitrator referred to some arbitral awards, which had indicated that the buyer's delay in opening a letter of credit did not give rise to the seller's right to terminate the contract, rather than the provisions of the applicable national law governing the right to terminate the contract, in support of his holding that the seller's termination of the contract was unjustified.⁹⁶⁷

⁹⁶⁵ ICC Award in Case No. 5713 of 1989, *Yearbook Commercial Arbitration*, 15 (1990), at 73

⁹⁶⁶ ICC Award in Case No. 6527, *Yearbook Commercial Arbitration*, (1993), at 48

⁹⁶⁷ *Ibid.*, at 51-52

In ICC Case No 6281, the arbitrator referred not only to the relevant provisions of the applicable Yugoslavian law, but also to the established rules in the order of international commerce. On the one hand, the arbitrator demonstrated that provisions of Yugoslavian law were in line with the established rules on the question of change of circumstances after the conclusion of the contract by referring to Anglo-American, German and Austrian laws and the CISG. On the other hand, the arbitrator rejected the seller's contention that buyer's cover purchase cannot be interpreted as a purchase in replacement, since seller was not informed in advance of buyer's specific purchasing intention, as required by the relevant rule under Yugoslavian law. The arbitrator referred to the CISG, which simply requires the cover purchase to be made in a reasonable manner and within a reasonable time. Subsequently, the arbitrator indicated that the outcome would have been the same if he had applied the CISG which, in the opinion of the arbitrator, would soon become "universal law, on account of the large number of ratifications and accessions that are intended in the near future."⁹⁶⁸

In ICC Case No 9117, which concerned a contract for the sale of goods concluded between a Russian seller and a Canadian buyer, the contract did not contain a choice of law clause. The tribunal exercised its abstract reasoning to find the most appropriate conflict rule by benefiting "from a wide freedom when determining such "appropriate" conflict rule". The tribunal determined Russian law as applicable to any issue that cannot be solved "by having regard in the contractual terms, or an interpretation thereof, or the relevant trade usages, and where no answer can be found in or derived from the CISG."⁹⁶⁹ In dealing with the merits of the case, the arbitral tribunal stated that, "although the UNIDROIT Principles of International Commercial Contracts shall [not] directly be applied, it is nevertheless informative to refer to them because they are said to reflect a world-wide consensus in most of the basic matters of contract law".⁹⁷⁰ However, the tribunal "directly" applied the UNIDROIT Principles rather than Russian law in relation to matters not expressly covered by the CISG. The tribunal applied Articles 2.1.17 and 2.1.18 of the UNIDROIT Principles in examining the effect of merger clauses and written modification clauses on the interpretation and supplementation of the contract and in concluding that the defendant could not rely on any kind of verbal promises or assurances, or any kind of written references which were not at the same time reflected in an amendment or supplement to the contract. The tribunal also made reference to Article 4.3 of the UNIDROIT Principles in order to determine whether a course of dealing was established between the parties which could fairly be regarded as a common basis of understanding to interpret their statements and other conduct.⁹⁷¹

3. Implied Choice

When there is an established rule of conflict designating a particular national law as applicable, and in the absence of indications that enable the recourse to direct choice method, the application of *lex mercatoria* to the exclusion of any particular national law depends on the implied common intention of the parties to avoid the *ex post* consideration of the rules of any particular national law as indicating their reasonable expectations. Although in theory, the

⁹⁶⁸ ICC Award in Case No 6281, *Yearbook Commercial Arbitration*, 15 (1990), at 99-100

⁹⁶⁹ ICC Award in Case No. 9117, *March 1998, ICC International Court of Arbitration Bulletin*, 10-2 (Fall 1999), at 99

⁹⁷⁰ *Ibid.*, at 100

⁹⁷¹ *Ibid.*, at 101

rules of interpretation should be found in the contract or in the applicable law chosen by the parties, when an international contract does not contain provisions or a reference to a set of default rules for the interpretation of the contract, it would be unrealistic to determine what is supposed to be the proper approach in determining the common intentions of both parties as to rules of interpretation by reference to a national law which may be found to be applicable.⁹⁷² A broader approach, an approach based on a concept of *lex fori* in arbitration, is preferable, and *lex mercatoria*, as the law of principled adjudication, can provide a *lex fori* for the arbitrators.⁹⁷³ In such an interpretation, the parties' history of negotiations and their

⁹⁷² Mayer, Pierre, *The Role of the UNIDROIT Principles in ICC Arbitration Practice*, in Special Supplement, ICC International Court of Arbitration Bulletin: UNIDROIT Principles of International Commercial Contracts: Reflections on their Use in International Arbitration, 2002, at 117

⁹⁷³ This form of interpretation is most apparent in the interpretation of arbitration agreements by the arbitral tribunals. For example, in ICC Case No 3380, the arbitrators are required to interpret two contradictory clauses regarding the law applicable to substance. The arbitration clause in the contract provided that "Arbitration shall be held at Geneva. (Switzerland) and shall judge according to the general principles of law and justice", which replaced the original text stating that the arbitrators were to decide *ex aequo et bono*. On the other hand, Article 25 of the contract contained a choice of law clause which stated "This Agreement shall be subject to and constructed [sic] in accordance with the Laws in Syria." This resulted in a controversy between the parties. The claimant requested the tribunal to use article 19.6 exclusively as a basis and pointing to amiable composition and equity as the principal source, whereas the defendant argued that the general principles referred to in article 19.6 were legal principles common to Syrian and Italian law and since that was not possible Syrian law should be solely or principally applied. The tribunal first noted that article 19.6 did not affirm with all desirable certainty that the parties had intended to give it the power of amiable composituers. Without reference to any national law, the arbitral tribunal stated that article 19.6 "should be interpreted following the usual methods of interpretation, according to its text and to its context", and "only if those methods do not yield any reasonable meaning, might the arbitral tribunal eventually envisage falling back, in this respect, on the history of negotiations and oral evidence." The tribunal added that "the interpretation should seek to reconcile the various clauses of the same contract. Therefore, it cannot accept the respective contentions of the parties, who both of them reduce a contractual provision to a kind of 'clause de style' without meaning, in disregard of the principle of useful effect ('ut res magis valeat quam pereat')." The arbitral tribunal decided that it shall take into account both articles and "the contract is governed by and should be interpreted in accordance with Syrian law in its entirety, under the reservation of the "general principles of law and justice", according to which the arbitrators have to decide under article 19.6." According to the tribunal, these general principles include those which are derived from the Syrian legal system, as well as those which are developed in international arbitral case-law and they are partly the same as trade usages. The tribunal also stated that "this interpretation does not really seem to contradict the positions taken by the parties, especially during the hearings, wherein they both referred to the international arbitration practice and to certain general principles." ICC Award in Case No. 3380, *Yearbook Commercial Arbitration*, (1982), at 116-119; In ICC Case No 4185, the arbitral tribunal interpreting an arbitration clause relied on principles of interpretation common to the law of all legal systems showing relevant connection with the dispute (Swiss law and the law of an Arab country, as possible proper laws, and Austrian law as the law of the arbitral seat) and stated that "the clear intentions of the parties has to prevail over an incorrect or imprecise wording" and "this interpretation, based on the investigation of the real intention of the parties, has nothing to do with extensive or restrictive interpretation." ICC Award in Case No.4145 (First Interim Award), *Yearbook Commercial Arbitration*, (1987), at 100; In ICC Case No 9759, the arbitration clause in the contract underlying the dispute required interpretation. The arbitral tribunal stated that "the principles of interpretation of an arbitration agreement" lead the tribunal (i) to look for the parties' real intent, taking *inter alia* into account the consequences which they have reasonably and legitimately contemplated, and (ii) to give they have reasonably and legitimately contemplated, and (ii) to give effect to the parties' intent. According to the tribunal, this approach was in line with the rules of interpretation under the UNIDROIT Principles and the decisions in several ICC awards, which indicated that the appreciation of the validity and effectiveness of an arbitration agreement goes beyond the requirements of a strict literal interpretation. ICC Award in Case No 9759, ICC International Court of Arbitration Bulletin, 12-2 (Fall 2001), at 84-88. In ICC Case No 10422, the arbitral tribunal stated that the relevant clause titled "Competent Forum" "must be interpreted by searching for the parties' common intention, without dwelling on the literal meaning of the words, on the basis of a widespread principle that has also been incorporated in Article 4.1 of the UNIDROIT Principles." The tribunal also considered that the persons who drew up and negotiated the clause were not jurists and did not therefore have a clear idea of the legal meaning of the concepts of competent forum, arbitration and applicable law. According to the tribunal "In order

pleadings with respect to the applicable law during the proceedings are the determinant factors that should be taken into account by the arbitrator in deciding on this issue. The validity of this implied choice is also confirmed by the decisions of several national courts, in the proceedings for setting aside and enforcement of those awards, where *lex mercatoria* was applied exclusively to the substance of the dispute, even if the relevant rules of arbitration required the tribunals to apply the law designated as the proper law by the rule of conflict which it deems appropriate.

The tribunal in ICC Case No 3131 did not refer to an implied choice of the parties as to the applicability of *lex mercatoria*, but still applied *lex mercatoria* to the substance of the dispute to the exclusion of any national law, and the award was attacked for that reason in both setting aside and enforcement proceedings before national courts. The dispute arose from the termination of a commercial agency contract between Norsolor, a French company and Pabalk, a Turkish company. The parties did not determine the law to be applied to the substance of the dispute. The arbitral tribunal considered that “In comparative law, the legislations of European countries are, in general, in favour of the law of the country of performance in questions of international agency.” Accordingly, Turkish law should have been the applicable law, but the tribunal was of the opinion that “such is generally only the case as regards the dealings of the agent and parties contracting with him under his agency when it falls to decide the powers of the agent and their limits” in order to “protect third parties to the agency contract, who must be in a position to refer to the law of the place where the same is performed.”⁹⁷⁴ The tribunal stated that “when it is solely a matter of the relationship between the agent and his principal, reference to the law of the place where the agency is performed is no longer required for the protection of third parties.” In this context, the tribunal stated that the law of the principal can appear the most appropriate, since it is by reference to legislation familiar to him that he has in all likelihood defined the position of his representative, the application of the law of the principal allows the preparation of standard contracts governing in a uniform manner his relationship with his various representatives, and the law of the principal will afford the latter a security which he might have greater difficulty in finding under the laws of some developing countries. The tribunal also noted that “One can equally well contemplate the application of the proper law (*la loi d’autonomie*) of the contract, disregarding any overriding connection with the law of the place of performance or of the place of business of the principal.”⁹⁷⁵ However, the tribunal found no indication capable of revealing a sufficiently clear common intent with regard to the applicable law in the drafting of the agreement in France by Norsolor and its acceptance in Turkey by Pabalk.

to understand the meaning of the provision one would have to put oneself in the condition the parties were in (or that of a reasonable person of the same kind as the parties). The parties, not having had legal training, tend to confuse the concepts of applicable law and jurisdiction, their main concern being to put into effect the most neutral solution possible for the settlement of disputes that might arise.” The tribunal also referred to Article 4.5 of the UNIDROIT Principles, according to which contract terms shall be interpreted so as to give effect to all the terms rather than to deprive some of them of effect. ICC Award No. 10422, 2001, Excerpts of the original French version of the award have been published in *Journal du droit international*, (2003), pp. 1142-1150 Available in English at <http://www.unilex.info/case.cfm?pid=2&do=case&id=957&step=FullText> For more cases adopting this line of reasoning in the interpretation of the arbitration agreements, see Grigera Naón, Horacio A., *Choice of Law Problems in International Commercial Arbitration*, *Recueil des Cours*, 289 (2001), at 86

⁹⁷⁴ ICC Award in Case No. 3131, Oct. 26, 1979, *Yearbook Commercial Arbitration*, 9 (1984) at 109

⁹⁷⁵ *Ibid.*, at 110

Due to the difficulty of choosing a national law, the tribunal “considered that it was appropriate, given the international nature of the agreement, to leave aside any compelling reference to a specific legislation, be it Turkish or French, and to apply the international *lex mercatoria*”, although the proceedings were governed by the 1975 ICC Rules, which required the tribunal, in the absence of a choice of law by the parties, to determine the applicable law by applying the rule of conflict that it deems appropriate. The tribunal emphasized the basic principle of good faith and fair dealing under *lex mercatoria*, and maintained that such emphasis “placed on contractual good faith is moreover one of the dominant tendencies revealed by ‘the convergence of national laws on the matter’.”⁹⁷⁶ In this understanding, the tribunal stated that “Good faith expresses not only a state of mind, the knowledge or ignorance of a fact, but also ‘reference to customs, to an ethical rule of conduct . . . It thus expresses a required conduct which can be linked to the general principle of responsibility. In accordance with the principle of good faith which inspires the international *lex mercatoria*, the Tribunal sought to determine whether, in the present instance, the breach of the agency was attributable to the conduct of one of the parties and whether it had caused damage to the other which would thus be without justification and which equity would hence require to be remedied.”⁹⁷⁷ On the basis of these considerations, the arbitral tribunal ordered Norsolor to pay various sums, which were evaluated in equity as the amount of damages due to Pabalk, since Norsolor’s general conduct was scarcely compatible with the maintaining of good commercial relations and its termination of agency caused damages to Pabalk as a result of its inactivity during one year, its loss of customers and the blow to its commercial reputation.⁹⁷⁸

During the proceedings for the enforcement of the award in ICC Case No 3131, the Court of First Instance of Paris granted leave for enforcement despite the allegation of Norsolor that the arbitrators, not being authorized by the parties, had decided on equity. The Court of First Instance of Paris considered that the arbitrators had applied the law designated as the proper law by the rule of conflict which they deemed the most appropriate, in conformity with Article 13 of the ICC Rules, and they had not decided as “*amiables compositeurs*” even if they had twice in their reasoning used the term “equity”.⁹⁷⁹ The Court of First Instance held that it was not qualified to examine whether the arbitrators had correctly applied the rule of law which they had found applicable and had made an error in assessment of damages. The French Supreme Court also confirmed that the arbitrators, in applying *lex mercatoria*, had acted within the scope of their mandate under the 1975 ICC Rules.⁹⁸⁰

On the other hand, Norsolor sought to set aside the award in Austria and claimed that “The arbitrators, who were not entitled to act as ‘*amiables compositeurs*’, did not apply French or Turkish law but, referring to ‘the principle of good faith which inspires the international *lex mercatoria*’ awarded damages on the basis of equity.”⁹⁸¹ The Court of Appeal of Vienna partially set aside the arbitral award, and upheld Norsolor’s claim. The Court held that the arbitrators, in violation of Article 13 of the ICC Rules, had not determined the national law

⁹⁷⁶ Ibid.

⁹⁷⁷ Ibid., at 110-111

⁹⁷⁸ Ibid., at 111

⁹⁷⁹ Court of First Instance of Paris, March 4, 1981, *Yearbook Commercial Arbitration*, 11 (1986) at 484

⁹⁸⁰ Cour de Cassation (Supreme Court) (First Civil Chamber), October 9, 1984, *Yearbook Commercial Arbitration*, 11 (1986) at 489-491

⁹⁸¹ Oberster Gerichtshof (Supreme Court), November 18 1982, *Yearbook Commercial Arbitration*, 9 (1984), at 159

applicable, limited themselves to refer to *lex mercatoria*, a worldwide law of uncertain validity, and based their decision only on the principle of loyalty and good faith, refusing any connection with a national legal order. However, the Austrian Supreme Court reversed the decision of the Court of Appeal by holding that “In this case the arbitral tribunal, by refusing to apply national conflict of law rules and by invoking the *lex mercatoria*, resorted to the principle of good faith for the solution of the question regarding Claimant's liability It thereby applied a principle inherent in the private law systems which in no way is contradictory to strict legal regulations of the countries here concerned.... According to the opinion of this Court the application of equity (*die Anwendung billigen Ermessens*) by the arbitral tribunal without special authorization from the parties does not involve a transgression of its competence”⁹⁸² Thus, the Supreme Court ruled that the arbitrators, applying good faith principles which did not violate national mandatory rules of the countries concerned, had acted within their mandate under the ICC Rules, and the award was not set aside.

In ICC Case No 3572, the dispute arose from an agreement relating to exploration of oil and gas. The tribunal noted that the relevant contracts were between, on the one hand, a number of companies organized under various national laws and represented by DST, and, on the other hand, a state and a government company, Rakoil, which was an agency of that state. According to the tribunal, “reference either to law of any one of the companies, or of such State, or of the State on whose territory one or several of these contracts were entered into, may seem inappropriate, for several reasons”. The arbitral tribunal decided to refer to “what has become common practice in international arbitration particularly the field of oil drilling concessions and especially to arbitrations located in Switzerland.” The tribunal stated that “this practice, which must have been known to the parties, should be regarded as representing their implicit will.” Thus, the tribunal held “internationally accepted principles of law governing contractual relations to be the proper law applicable to the merits of this case.”⁹⁸³ When dealing with the merits of the dispute, on the basis of the evidence, the tribunal rejected the allegations of the defendants that such contracts were void on the ground of misrepresentations since it did not find, as a fact, that the defendants were induced to enter into the relevant contracts as a result of representations made by the consortium. The tribunal also noted that there were no facts or circumstances that can give rise to questions of invalidity of the contracts on the grounds of mistake on the part of the defendants or for any other reason. The tribunal concluded that “For these reasons, the choice of the law to be applied to the agreements is of little significance, if any, under the prevailing circumstances.”⁹⁸⁴

When the award in ICC Case No 3572 was attempted to be enforced in England against Rakoil, the oil company argued that English public policy prevented enforcement of an award where the parties’ rights and obligations were based on “unspecified, possibly ill-defined, internationally accepted principles of law.” Rejecting this argument, Sir John Donaldson from the Court of Appeal stated that; “I agree ... that parties can validly provide for some other system of law to be applied to an arbitration tribunal. Thus, it may be.... that the parties could validly agree that a part, or the whole, of their legal relationships should be decided by the arbitral tribunal on the basis of a foreign system of law, or perhaps on the basis of principles of international law ... I see no reason why an arbitral tribunal in England should not, in a

⁹⁸² *Ibid.*, at 160

⁹⁸³ ICC Award in Case No. 3572, 1982, *Yearbook Commercial Arbitration*, 14 (1989), at 117

⁹⁸⁴ *Ibid.*, at 118

proper case, where the parties have so agreed, apply foreign or international law.”⁹⁸⁵ Subsequently, Sir John Donaldson proposed a three-part test for courts, when faced with such applicable laws, to determine their validity and thus enforceability: (1) Did the parties intend to create legally enforceable rights and obligations?; (2) Is the resulting agreement sufficiently certain to constitute a legally enforceable contract?; and (3) Would it be contrary to public policy to enforce the award, using the coercive powers of the state?⁹⁸⁶ In response to these questions with regard to the specific case, Sir John Donaldson held that “by choosing to arbitrate under the Rules of the ICC and in particular, Art. 13 (3), the parties have left proper law to be decided by the arbitrators and have not in terms confined the choice to national systems of law. I can see no basis for concluding that the arbitrators’ choice of proper law - a common denominator of principles underlying the laws or the various nations governing contractual relations - is outwith the scope or the choice which the parties left to the arbitrators.”⁹⁸⁷

Later, in *Home and Overseas Insurance Co Ltd v Mentor Insurance Co*, Lord Lloyd, referring to *DST v. Rakoil* case, stated that: “Counsel for [the claimant] argued that *DST v. Rakoil* was concerned only with the enforcement of a foreign award, and that it has no bearing on the present case, where the contract calls for arbitration in London. But why not? If the English courts will enforce a foreign award where the contract is governed by a “system of ‘law’ which is not that of England or any other state or is a serious modification of such a law” ..., why should it not enforce an English award in like circumstances? And if it will enforce an English award, why should it not grant a stay? Counsel for [the claimant] argued that it would be impossible for the court to supervise an arbitration unless it is conducted in accordance with a fixed and recognisable system of law: he even went so far as to submit that the arbitration clause in the present case is not an arbitration agreement within the meaning of the Arbitration Acts 1950 to 1979. It is sufficient to say that I disagree. I would only add (although it cannot affect the argument) that if [he] is right, no ICC arbitration could be held with confidence in this country for fear that the arbitrators might adopt the same governing law as they did in *DST v. Rakoil*”.⁹⁸⁸

In ICC Case No 5953 where the dispute arose from a contract between Valenciana, a Spanish company, and Primary, a US company, under which, Primary was to deliver certain quantities of coal to Valenciana’s cement plant in Spain. There was no choice of law clause in the

⁹⁸⁵ *Deutsche Schachtbau- und Tiefbohrgesellschaft mbH v R’as Al Khaimah National Oil Co (UAE) and Shell International Co Ltd (UK)*, *Yearbook Commercial Arbitration*, 13 (1988), at 532

⁹⁸⁶ Rivkin, David W., *Enforceability of Arbitral Awards Based on Lex Mercatoria*, *Arbitration International*, (1993), at 76

⁹⁸⁷ *Deutsche Schachtbau- und Tiefbohrgesellschaft mbH v R’as Al Khaimah National Oil Co (UAE) and Shell International Co Ltd (UK)*, *Yearbook Commercial Arbitration*, 13 (1988), at 535; This statement was in clear contrast with the traditional position of English courts with regard to the modern *lex mercatoria* doctrine. Five years prior to Sir John Donaldson’s statements, in the case of *Amin Rasheed Shipping Corporation v. Kuwait Insurance Company* before the House of Lords, Lord Diplock stated that “the purpose of entering into a contract being to create legal rights and obligations between the parties to it, interpretation of the contract involves determining what are the legal rights and obligations to which the words used in it give rise. This is not possible except by reference to the system of law by which the legal consequences that follow from the use of those words is to be ascertained.” Lord Diplock also added that “contracts are incapable of existing in a legal vacuum. They are mere pieces of paper devoid of all legal effect unless they were made by reference to some system of private law which the obligations assumed by the parties to the contract by their use of particular forms of words and prescribes the remedies enforceable in a court of justice for failure to perform any of those obligations.” [1983] 3 W.L.R. 241, at 245, 249.

⁹⁸⁸ *Home and Overseas Insurance Co Ltd v Mentor Insurance Co (UK) Ltd* [1989] 3 All ER 74, at 84-85

contract and each party pleaded for the application of their own national law. The sole arbitrator, sitting in Paris, rendered a partial award on the applicable law. The arbitrator stated that in the absence of a clear choice of law by the parties, he must determine the applicable law in an objective manner, but considering that the choice may not be limited to a national law. According to the arbitrator, in the absence of common will expressed in the contract, it should be sought, initially, through the objective connecting factors of the contract to the law of a particular state. After examining such objective factors, the arbitrator concluded that Spanish law or the law of the State of New York, or any other national law should not govern the contract. The arbitrator, after noting that the *lex arbitri* allowed it to apply international trade usages, considered that the absence of the choice of law clause in the contract was not inadvertent and denoted the will of the parties to exclude the application of any national law and to submit to a truly international law. According to the arbitrator, the application of *lex mercatoria*, which refers to the ensemble of rules of international commerce, is characterized by being truly international, and becomes the only possible solution when a common will on an applicable national law is missing. The arbitrator stated that the rules of *lex mercatoria*, although uncodified, are gradually developed in practice and confirmed as legal rules since they belong to the same category as national usages and customs, recognized as legal sources both in common law countries, as the State of New York, and in countries of a Roman-Germanic tradition, such as Spain, Italy or France. The tribunal concluded that “the usages of international trade, otherwise designated as *lex mercatoria*” should be the law governing the contract.⁹⁸⁹

Valenciana sought to have the award set aside by French courts. It contended that the arbitrator exceeded the mandate by failing to choose a conflict of laws rule in order to determine the law applicable to the dispute as required by the 1988 ICC Rules and to explain the appropriateness of *lex mercatoria*. The Court of Appeal stated that, according to the ICC Rules, the arbitrator was not required to make use of a conflict rule belonging to a given legal system in order to determine the law applicable to substance, but was free to refer to the principles governing this matter.⁹⁹⁰ The Court noted that the arbitrator “examined the connecting factors invoked, rendered a final decision that none of them justified the application of a national law, and decided to apply the body of principles and trade usages called *lex mercatoria*, i.e. international norms which can apply to the solution to such a dispute in the absence of a determined [national] jurisdiction.” The Court held that “by so deciding, the arbitrator conformed to his terms of reference” and rejected this ground for setting aside the award.⁹⁹¹ On appeal, the French Court of Cassation also held that by referring to “the rules of international commerce developed in practice and having been sanctioned in the jurisprudence of various nations”, the arbitrator decided according to law, as he was

⁹⁸⁹ ICC Partial Award in Case No. 5953, 1988, *Primary Coal Inc. (U.S.A.) v. Compania Valenciana de Cementos Portland*, *Revue de l'arbitrage*, (1990), at 701 et seq.

⁹⁹⁰ *Cour d'Appel de Paris* of July 13, 1989; *Compania Valenciana de Cementos Portland S.A. v. Primary Coal Inc.*, *Yearbook Commercial Arbitration*, 16 (1991), at 144

⁹⁹¹ Valenciana also contended that the arbitrator failed to respect the principle of adversarial process, by deciding *ex officio* to apply *lex mercatoria* without hearing the parties. The Court found that according to the award and other documents of the arbitral proceedings, Primary subsidiarily invoked the applicability of *lex mercatoria* to the substance of the dispute and, in its reply, Valenciana implicitly rejected its applicability. Thus, the Court rejected this ground for setting aside the award since, according to the Court, the issue of applicability of *lex mercatoria* to the dispute was raised during the proceedings and the principle of adversarial process was respected. *Cour d'Appel de Paris* of July 13, 1989; *Compania Valenciana de Cementos Portland S.A. v. Primary Coal Inc.*, *Yearbook Commercial Arbitration*, 16 (1991), at 144

obliged to do by the terms of reference, which provided that the ICC Rules and the French New Code of Civil Procedure shall govern the procedure.⁹⁹²

In general, the ICC arbitrators were not constrained by the restrictive provisions of the ICC Rules of 1975 and 1988, which required them to apply a conflict of laws rule when determining the applicable law.⁹⁹³ When commenting on the 1975 ICC Rules, Frédéric Eisemann, a former Secretary General of the ICC International Court of Arbitration, stated that the 1975 ICC Rules indicated that the parties could choose, and in the absence of such a choice, the arbitrators could determine, the applicable law, without specifying that it should be a national law, and either parties or arbitrators could decide that *lex mercatoria* would govern the substance of the dispute.⁹⁹⁴ Thus, even if some parties to international contracts have tried to challenge the arbitral awards, which explicitly referred to the concept of *lex mercatoria* and excluded the application of national laws in the absence of contractual choice of law, on the ground that an arbitral tribunal exceeded their mandate by applying *lex mercatoria*, the national courts of legal systems that contain modern arbitration laws refused to consider such application as a factor invalidating an award, or as taking the position of an *amiable compositeur*, which requires express authorization for the validity of the ensuing award. In light of those court decisions, the Resolution on Transnational Rules adopted at the 65th International Law Association Conference, held in Cairo in 1992, recommended that “the fact that an international arbitrator has based an award on transnational rules (general principles of law, principles common to several jurisdictions, international law, usages of trade etc.) rather than on one law of a particular state should not in itself affect the validity or enforceability of the award ... where the parties have remained silent concerning the applicable law.”⁹⁹⁵

Although, an arbitral award applying *lex mercatoria* to the exclusion of any national law in the absence of choice by the parties, even when the tribunal is required to apply a conflict rule, will unlikely become invalid, the decision maker applying *lex mercatoria*, as the law of principled adjudication, should carefully interpret the contractual intentions of the parties

⁹⁹² French, Cour de Cassation, October 22, 1991, *Compania Valenciana de Cementos Portland SA v. Primary Coal Inc.*, Yearbook Commercial Arbitration, 18 (1993), at 138-139; Similarly, in the case *Banque du Moyen-Orient v Fougerville*, the Paris Court of Appeals had to decide whether the arbitrators had decided in law or had usurped the powers of *amiables compositeurs*, thereby exceeding their mandate in an ICC award made in Geneva by applying, in the absence of a choice of law, “general principles of contract law generally applicable in international trade”. The dispute concerned an agency contract which was terminated before the agent, Fougerville, had completed the mission which it had been assigned. Hence, the arbitrators awarded partial remuneration for services rendered based on “general principles of contract generally applicable in international trade”. According to the Court of Appeals, the reasoning of the award demonstrated that the arbitrators implicitly but necessarily referred to a usage of international trade which were obviously applicable, and their decision was based on rules of law and within the scope of the submission. June 12, 1980 *Revue de l'arbitrage* (1981), at 292 (second case). The French Court of Cassation also held that in referring to ‘general principles of contract generally applicable in international trade’ the arbitrators conformed to the duty imposed upon them by the terms of reference to define the law applicable to the agreement. December 9, 1981, *Revue de l'arbitrage*, (1982), at 183 (second case)

⁹⁹³ Grigera Naón, Horacio A., *Choice of Law Problems in International Commercial Arbitration*, *Recueil des Cours*, 289 (2001), at 213

⁹⁹⁴ Eisemann, Frédéric, *Le nouveau règlement d'arbitrage de la Chambre de commerce internationale*, *Droit et pratique du commerce international*, 1 (1975), at 355-365

⁹⁹⁵ International Law Association, *Committee on Transnational Rules in International Commercial Arbitration*, Report of the 65th Conference, Cairo, (21 to 26 April 1992), *International Law Association Reports of Conferences*, London, 1993, at 7

through a contextual approach as required by the basic principle of good faith and fair dealing in order to decide whether or not he should apply *lex mercatoria* exclusively. In the absence of indications that enable the exclusive application of *lex mercatoria* to the substance of the dispute through the direct choice method, the decision maker should find an implied negative choice of national laws, for the exclusive application of *lex mercatoria*. In many cases, each party will request the application of its own national law to the substance of the dispute and try to demonstrate that the application of the law of the other party will not be in accordance with the contractual intentions or with the established rules of conflict. Although, the common intention of the parties regarding the applicable law, in the absence of any explicit choice, can often be deduced with reasonable certainty through a contextual interpretation, the decision makers should still be cautious about reading in a contract an implied choice of law, in order to avoid a decision based on a fictitious choice of law, given the numerous reasons for a missing choice of law clause in the contract.

Indeed, the notion of implied choice of law “has met with great skepticism.”⁹⁹⁶ It is argued that the notion comes close to the old German theory of hypothetical choice of law, which has been rejected within the EU and particularly in Germany.⁹⁹⁷ The theory directs the decision maker to apply the law that the parties, or reasonable persons in the same position as the parties, would have chosen as the governing law if they had given some thought to the question of choice of law. It was correctly pointed out that there could be no true tacit choice of governing law unless it could be shown that two conditions were fulfilled simultaneously: (1) that the parties had been aware of the problem of choice of applicable law and (2) that it had been their common intent to solve that problem.⁹⁹⁸ It is argued on the basis of the arbitral experience that the parties to international contracts have often agreed to exclude the application of any national law, including even that of a third, neutral country, while being unable to agree on any satisfactory alternative or positive formula and, in such cases, the ultimate aim of giving effect to the reasonable expectations of the parties requires the arbitrators to give as much respect to such a negative choice as to a positive one.⁹⁹⁹

Some tribunals seem to readily conclude that the parties tacitly wished to exclude any particular national law from the resolution of the substance of the dispute. Those tribunals have given significant weight to the facts that the contract before them had an international character and that it contained an arbitration clause, both aspects considered as indications for the intention of the parties to detach the contract from the sphere of any particular national law. The combined effects of these two aspects have served as the justification for the application of *lex mercatoria* to the exclusion of any particular national law.¹⁰⁰⁰ In ICC Case No 8261, the dispute arose from a supply contract between an Italian company and a government agency of a Middle Eastern country. The contract did not contain any choice of

⁹⁹⁶ Berger, Klaus Peter, *International Arbitral Practice and the UNIDROIT Principles of International Commercial Contracts*, *American Journal of Comparative Law*, 46-1 (1998), at 144

⁹⁹⁷ Mistelis, Loukas, *Unidroit Principles Applied as "Most Appropriate Rules of Law" in a Swedish Arbitral Award*, *Uniform Law Review*, (2003), at 637

⁹⁹⁸ Lalive, Pierre, *The UNIDROIT Principles as Lex Contractus, With or Without an Explicit or Tacit Choice of Law: An Arbitrator's Perspective*, *Special Supplement, ICC International Court of Arbitration Bulletin: UNIDROIT Principles of International Commercial Contracts: Reflections on their Use in International Arbitration*, 2002, at 81

⁹⁹⁹ *Ibid.*

¹⁰⁰⁰ Berger, Klaus Peter, *International Arbitral Practice and the UNIDROIT Principles of International Commercial Contracts*, *American Journal of Comparative Law*, 46-1 (1998), at 144-145

law clause. The tribunal referred to Article 13 (3) of the ICC Rules and examined the relevant principles of conflicts of laws, including the 1980 Rome Convention on the law applicable to contractual obligations. The tribunal noted that those principles would lead to the designation of a national law even if this was not intended by the parties. The tribunal decided to refer to the common will of the parties rather than the relevant conflict of laws principles. The arbitral tribunal considered that by agreeing to an international arbitration institution, having decided that no arbitrator would have the nationality of the parties, and having chosen the place of arbitration in a third country, the parties specifically denied that any national law should govern their contract in dispute. According to the tribunal, this consideration was confirmed by the parties' attitudes during the proceedings where both parties insisted on the application of their own national law, and such an attitude demonstrated their willingness to seek a balance between those laws. Thus, the tribunal held that the parties intended the contract to be governed by the general principles applicable to international trade and constituting the *lex mercatoria*, and noted that this solution was also accepted by the parties in their briefs.¹⁰⁰¹

In ICC Case No 8261, although the circumstances were apparently not sufficient for the implied negative choice to override an established rule of conflict, the decisive justification for the exclusive application of *lex mercatoria* was the parties' acceptance of such a solution in their pleadings. On the other hand, the tribunal in ICC case No 3131 seemed to lack any justification for the exclusive application of *lex mercatoria*. The tribunal decided to apply *lex mercatoria* exclusively to an international contract for commercial agency due to the difficulty to find the applicable national law, but in the majority of similar cases other tribunals have applied the law of the agent in the absence of contractual choice of law, particularly when the territorial scope of the agency is limited only to the country of the agent.¹⁰⁰² Moreover, as far as apparent from the published excerpts, the tribunal did not discuss the possibility of an implied choice in its decision to override the established rule of conflict. The decision makers should refer to the common intentions of the parties in order to override such established rules of conflict designating a national law as applicable. However, the decision makers should not act solely on the basis of the consideration that each party invoking the application of its own national law in the proceedings indicates that the application of national law of one of the parties would disturb the equilibrium established under the bargain between the parties. Any rule that is applied *ex post* by the decision maker may potentially affect the initial bargain, regardless of whether it is a general principle of law or a rule of the national law of either party. The rules that can be considered appropriate for a particular bargain should merely reflect the reasonable expectations of the parties in the particular case.

Under *lex mercatoria* as the law of principled adjudication, the decision maker should treat differently the appropriateness of default rules, where the contract contains an express choice of national law, and where the established rule of conflict directs the decision maker to apply the national law of one of the parties. In the former case, the chosen national becomes part of the bargain contemplated under the contract pursuant to the basic principles of freedom of contract and sanctity of contract, so the decision maker shall apply even the idiosyncratic provisions of that law unless they are overridden by the terms of the contract or trade usages

¹⁰⁰¹ ICC Award in Case No 8261, *Chronique de jurisprudence arbitrale de la CCI*, in *Cahiers de l'arbitrage*, *Gazette du Palais*, No. 119-123, 121, (2001), at 40

¹⁰⁰² Bortolotti, Fabio, *International Commercial Agency Agreements and ICC Arbitration*, *ICC International Court of Arbitration Bulletin*, 12-1 (2001), at 52-53: (“[ICC Case No 3131] would appear to be the only instance in which the *lex mercatoria* theory was actually applied to a commercial agency agreement.”)

in the narrow sense. In the latter case, the isolated or “inappropriate” rules of the national law found to be applicable can be disregarded by the decision maker and replaced by the established rules in the order of international commerce in accordance with the basic principle of good faith and fair dealing, since such rules cannot be considered as part of the bargain contemplated by the parties, absent an express agreement of the parties to that effect.

This does not mean, however, that where the parties are silent as to the applicable law, there is no difference as to the outcome of the decision between the exclusive application of *lex mercatoria* to the substance of the dispute, and the application of *lex mercatoria* as the law of principled adjudication where a national law is found to be applicable to the substance. In order to disregard a national rule for being idiosyncratic or “inappropriate”, the decision maker should be able to discover at least an established substantive rule in the order of international commerce. There are many areas of law where the approaches of national legal systems diverge significantly. If the decision maker in a particular case confronts such a divergence among the national laws that are considered in the specialized consolidations to discover an established rule, the relevant rules of the applicable national law cannot be disregarded by the decision maker, since such a decision would be arbitrary: it would reflect the subjective reasoning of the decision maker about the expectations of the parties, despite the availability of objective considerations through the established rules of conflict. The decision maker should only consider itself competent to resort to its subjective reasoning in controlling the legal uncertainty arising from such divergences, where there are no established rules of conflict that designate a national law, or where the parties expressly or implicitly intended to avoid the application of any particular national law, i.e. in the cases of the application of *lex mercatoria* to the substance of the dispute to the exclusion of any particular national law.

Thus, the decision makers should not hesitate to apply one of the national laws of the parties when it is applicable pursuant to an established rule of conflict. Accordingly, the approach of the tribunal in ICC Case No 6500 concerning a dispute that arose from a contract for commercial agency seems more convincing than that of ICC Case No 3131 in its attempt to give effect to the reasonable expectations of the parties to an international commercial agency contract. In the case, the US principal requested the application of *lex mercatoria* rather than the national law applicable pursuant to conflict of laws rules, but the tribunal decided to apply the law of the agent's country, i.e. Lebanese law. The tribunal noted that, although Lebanese law was the law of one of the parties, when a contract involves the implementation of activities by either party for the achievement of the purpose and object of the contract, the applicable law should be the country where such activities are performed. According to the tribunal, *lex mercatoria* should not be applied exclusively by disregarding the applicable national law designated by the conflict rule, because, even in the absence of any express provision, the contract had clearly a close connection with a particular national law and its international character arose solely from the fact that the different nationalities of the parties and the reciprocal movement of goods and money from one country to another. The tribunal held that the application of *lex mercatoria* could only be involved by combining, if necessary, the law of that country with the general principles and practices of international trade, as Article 13 (5) of the ICC Rules suggests.¹⁰⁰³

Similar considerations can be found in ICC Case No 12193 concerning a distribution contract between a German manufacturer, and a Lebanese distributor. The contract was silent as to the

¹⁰⁰³ ICC Award in Case No. 6500, *Journal du Droit International*, (1992), at 1016-1017

applicable law but contained a clause referring to the International Chamber of Commerce in Basle, as the place of performance and legal jurisdiction, for all disputes arising from the contract. The Lebanese distributor argued that the arbitral tribunal had to rely on the Swiss conflict of law rules as Switzerland was the place of arbitration and to apply, in accordance with Article 187 of the Swiss Act on Private International Law, the law of Lebanon as the law of the country most closely connected with the contract. The German party contended that the parties clearly had intended to exclude the application of the national laws of both parties and implicitly chosen a neutral national law, Swiss law, as the law governing the contract by indicating the International Chamber of Commerce of Basle as the place of performance and of jurisdiction. The German party also argued that that the arbitral tribunal should determine the applicable law directly without referring to any domestic conflict of law rules (“voie directe”) and, requested the arbitral tribunal to apply subsidiarily the general principles of law or the *lex mercatoria* as expressed in the UNIDROIT Principles.¹⁰⁰⁴

The tribunal first noted that the true intention of the parties with regard to the reference to International Chamber of Commerce in Basle could not be identified with certainty from the available evidence, and the relevant clause did not reflect the expression of a clear and unambiguous choice of the parties in favor of Swiss law. The arbitral tribunal, on the basis of the evidence, was not convinced that the parties expressed their intention to submit their contract to Swiss law by means of the clause designating the place of performance as being located in Basle when in fact the contract was executed in Lebanon. The tribunal resorted to the method of the cumulative application of the conflict rules, namely, those of the laws of the parties (Lebanon and Germany), and the law of the seat of arbitration (Switzerland), to verify that they converge towards the application of Lebanese law as the law governing the contract. According to the tribunal, this solution is consistent with the economic analysis of the distribution contract, which aims at the exploitation of a particular market, and it is fairly generally accepted by the international arbitral awards, which resorted to the cumulative method and designated the law of the distributor as the governing law. The tribunal stated that same solution would have been reached had it resorted to the direct method as put forward by the German party, since the tribunal was of the opinion that arbitral jurisprudence holds commonly the place of characteristic performance as a criterion for determining the applicable law, and cited the holding in ICC Case No 6500. With regard to the applicability of UNIDROIT Principles and *lex mercatoria*, the tribunal considered that they could become applicable only as a complement of Lebanese law, but there was no reason to disregard Lebanese law, which does not differ significantly from the general principles of law. The tribunal noted that the use of *lex mercatoria* to the exclusion of any national law would be justified where the distributor was operating in several countries, but in the case at hand, there were close links between the contract and the national law determined to be applicable. Finally, the tribunal stated that *lex mercatoria* could still be applicable to the substance of the dispute if the Lebanese law provided no right to damages in the event of termination of the distribution, but this was not the case either. According to the tribunal, although the application of *lex mercatoria* to the exclusion of any other national law was not suitable for this case, the content of *lex mercatoria* could still be used in order to confirm that the Lebanese law of agency and distribution agreements was not in opposition to it.¹⁰⁰⁵

¹⁰⁰⁴ ICC Final Award in Case No 12193, June 2004, ICC International Court of Arbitration Bulletin, 19-1 (2008), at 122 et seq.

¹⁰⁰⁵ *Ibid.*

These considerations are also relevant to other forms of contract, such as construction contracts, which are closely connected to a single national law in view of its performance. In ICC Case No 5835, the arbitral tribunal did not admit a clause, which provided that the sub-contractor undertook to abide by the regulations and customs in Kuwait and to follow the rules of Kuwaiti law, as a choice of law clause. The tribunal stated that by choosing such a restricted wording, the parties did obviously not deal with much wider question as to which law shall be applicable to their agreement in general. The claimant argued that the issues of the entire dispute should still be governed by Kuwaiti law, as the proper law of the contract, according to all the relevant criteria of Kuwaiti and other rules of conflict of laws. The defendant submitted that the parties made a "negative choice", according to which each party intended to avoid the other party's national law, i.e. Kuwaiti or Italian law, and the law of a third country was likewise excluded. According to the defendant, the parties have chosen, as the law applicable to the merits, that part of the Kuwaiti and Italian legislation which was common to them at the time the agreement was entered into. The tribunal did not deem necessary to designate a national conflict of laws in view of the fact that all rules of conflict which may be found in legislations which have some connection with the case, indicate to Kuwaiti law as the proper law of the agreement. However, the tribunal concluded that Kuwaiti law and, to the extent necessary, principles generally applicable in international commerce would govern the merits, "in accordance with a well-established practice in international commercial arbitration" since "this provisio is particularly justified in view of the fact that the parties expressly refrained from choosing explicitly Kuwaiti law . . ." ¹⁰⁰⁶

The awards in ICC Cases No 7110 and 7375 reflect in detail the reasoning of the tribunals deciding for the exclusive application of *lex mercatoria* to the substance of the dispute, by means of an implied negative choice. In ICC Case No. 7110, an English company and a government agency of a Middle Eastern country entered into a number of contracts covering the sale, supply, modification, maintenance and operation of certain equipments, and support services relating to them. There was no express choice of law provision in favor of a national law in the contracts, but some of them contained provisions referring to settlement according to laws or rules of natural justice. The claimant argued for the application of the law of the Middle Eastern country, where the contracts were signed and some of them were to be performed. Later in the proceedings, the claimant alternatively contended that the contracts should be governed by the general principles of law. The respondent argued that English law should apply as the law most closely connected with the contracts or as the law of the place of habitual residence or central administration of the party whose performance is characteristic to each contract, or, alternatively, that the tribunal should apply general principles of law. ¹⁰⁰⁷ Thus, the alternative claims of the parties coincided with respect to the applicability of *lex mercatoria* to the substance of the dispute.

The tribunal considered the contracts not in isolation, but as interrelated expressions of a long-term relationship between the parties spanning more than ten years. The tribunal referred to "an objective test revealing what would have been the reasonable intention and expectations of the parties regarding the applicable law as evidenced by all the circumstances surrounding the negotiation of the Contracts, as well as by contractual terms likely to evidence the applicable law, i.e. a "contextual" approach..." ¹⁰⁰⁸ In the tribunal's view, the question of the

¹⁰⁰⁶ ICC Interim Award in Case No 5835, 1989, *The ICC International Court of Arbitration Bulletin*, 10-2 (1999), at 35

¹⁰⁰⁷ ICC Award in Case No. 7110, *ICC International Court of Arbitration Bulletin*, 10-2 (1999), at 40-41

¹⁰⁰⁸ *Ibid.*, at 43

applicable law was clearly an important issue in the course of the negotiation of the contracts, where each party in its efforts advanced the application of its respective national law, and the neutrality of the applicable law and of the dispute resolution mechanism were at the foreground of the parties' concerns and discussions. The tribunal noted that central to the considerations of each party in the course of contractual negotiations was its clear resolve not to accept the application of its counterpart's national law to the contracts, and the presence of the expressions of "natural justice" may not be ignored for assessing if and to which extent the parties have indicated the laws or principles governing the contracts. The tribunal concluded that no national law was judged adequate or adapted to govern such transactions without the risk of disturbing the balance of neutrality between the parties since "(i) there is no express choice-of-law stipulation designating the law of any of the parties or of a third country and where neutrality regarding the applicable law was a paramount concern denoted by the parties' rejection of each other's law and the absence of any explicit or implicit reference to the laws of a third country; and (ii) the parties have buttressed neutrality as to the applicable law by agreeing to submit their contractual disputes to international commercial arbitration, albeit without empowering the Tribunal to act *ex aequo et bono* or as *amiable compositeur*".¹⁰⁰⁹

The tribunal stated that "Such "negative" choice by the parties commands as much respect as any express choice of law would have commanded, had the parties inserted choice of law stipulations in the Contracts... Such interpretation is particularly appropriate if the only alternative left in absence of express or implied choice-of-law stipulations would be resorting to supposedly choice-of-law neutral and dispassionate criteria, such as a talismanic notion of the localization of the characteristic obligation or an amorphous grouping of contacts or the closest connection noticeable in some national legal systems, which would, by the rule-of-thumb and without taking into account the parties' concerns and expectations as to substantive justice, including neutrality as to the applicable law, impose the law of one of the parties or of a third state which would or might defeat the parties' intentions."¹⁰¹⁰ The tribunal also considered that five of the contracts contained international arbitration clauses providing for panels not to be integrated with nationals from the country of any of the parties, and the parties' later decision to globally submit disputes arising out of the contracts to international arbitration under the ICC Rules confirmed that the parties favored the delocalization of the dispute resolution system in connection with all the contracts in consonance with their strong concerns regarding the neutrality of the substantive and procedural legal framework related to their long-term relationship embodied in the contracts.¹⁰¹¹ According to the tribunal, when the parties negotiated and finally entered into the contracts, they only left room for the application of general legal rules and principles adequate enough to govern the contracts but not originated in a specific municipal legal system. According to the tribunal, its mandate required that, to the extent possible, some precisions be given as to the substance of such legal rules and principles. For that purpose, the tribunal referred to UNIDROIT Principles, which reflected general legal rules and principles enjoying wide international consensus, applicable to the contracts.¹⁰¹²

¹⁰⁰⁹ *Ibid.*, at 43-46

¹⁰¹⁰ *Ibid.*, at 46

¹⁰¹¹ *Ibid.*, at 47

¹⁰¹² *Ibid.*, at 48-49

In ICC Case No. 7375, there was no choice of law clause in the contract for the supply of goods, which gave rise to a dispute between a United States seller, as the defendant, and an Iranian buyer. The determination of the applicable law was of a key importance, since the defendant contended that any and all of the claimant's claims were time-barred, because of the four-year statute of limitation according to the laws of Maryland, which in its view was the law applicable to the dispute, as the place where the significant contractual obligations, i.e., the manufacture of the goods, had been performed. The claimant argued that the tribunal must apply Iranian law, according to which, the claimant's claims were still valid and not time-barred, since the contract was negotiated and concluded in Iran, its performance was most closely related to Iran, and the situs of the subject matter of the contract was Iran. As an alternative to Iranian law, the claimant argued that the dispute should be decided according to general principles of law. The arbitral tribunal stated that “the absence of an express choice of law does not have the necessary consequence, in the opinion of this Tribunal, that the Parties could not have made an implied choice of law or, at least, impliedly intended to exclude the application of national legal systems. The contemplation of an implied choice by the Parties under Article 13 (3) ICC Rules would be consistent with the interpretation of, e.g., the UNCITRAL Arbitration Rules and the UNCITRAL Model Law.” In the determination of the applicable law, the tribunal decided to follow a two step approach: (1) objective approach that would consist in applying the usual criteria for determining the substantive rules of law which were to govern a contract, i.e. by applying an appropriate conflict of laws rule, as provided for in Article 13 (3) of the ICC Rules and; (2) subjective approach that would aim to determine whether the designated national law by the objective approach was in line with the will of the parties as revealed by the subjective interpretation, by focusing on the history of the negotiations of the contracts, as accepted by most civil law countries and the interpretation rules of UNIDROIT Principles.¹⁰¹³

Under the objective approach, the tribunal first determined the established rule of conflict as the closest connection rule, since it has received, on a worldwide basis, the strongest support, and is common to most national conflict of laws. The tribunal stated that “Most private international laws, as well as most arbitral awards, when aiming to determine the closest connection of a particular contractual relationship, attach a preponderant weight to the place of business or habitual residence of the Party which has to perform the so-called “characteristic performance”.” The tribunal noted that applying the closest connection test and taking into account the characteristic performance and all other objective connecting factor would lead to the application of the law of the defendant. However, the tribunal considered that the objective approach was unsatisfactory because it ignored the facts that the contract contained no choice of law clause, and that the parties declared they would never have concluded the contract if the contract was subject to the application of the law of the other party. Thus, the tribunal continued with the subjective approach and stated that “if a contract such as Contract No. 1 does not contain a choice of law provision, then this must be viewed as a “shouting silence”, at least an “alarming silence”, “un silence inquiétant”; thus, a silence which must ring a bell and requires the Tribunal to look “behind” so as to understand why the Parties have failed to include “the obvious”.” Even though, due to the Iranian Revolution, pre-contractual material either disappeared, or was destroyed, or otherwise became unavailable to the parties, the tribunal was convinced that none of the parties, when entering into the contract, would have been prepared to accept the other party's national law, and construed the absence of a choice of law clause as an “implied negative choice” of the parties. According to

¹⁰¹³ ICC Award in Case No. 7375, 11 Measley's International Arbitration Report, 1996, A-1 A-69, available online at <http://www.unilex.info/case.cfm?pid=2&do=case&id=625&step=FullText>

the tribunal, the implied rejection by one party of submitting itself to the other party's national law as the governing law of contract was “an implied term of contract”.¹⁰¹⁴

The tribunal considered three possibilities; the application of a neutral national law, the *trunc commun doctrine*, and a-national or transnational rules of law and general principles of law, “including rules that are said to form part of the *lex mercatoria*, and taking into account the UNIDROIT Principles promulgated in 1994, and trade usage”. Considering the advantages and disadvantages of each of those possibilities, the tribunal decided to apply general principles of law, while noting the difficulty for a tribunal to decide a case by the only reference to, and guidance by, general principles of law. The tribunal stated that the application of the general principles of law in the case would protect both parties against the application of a national law which might contain particular provisions which they had not expected, and which may not be suitable in a truly international context of the present nature, and a decision based on generally accepted principles had the advantage to ascertain foreseeability of the outcome and certainty of law. Pointing out the inaccuracies in terminology and concepts relating to the concept of general principles of law, the tribunal specified the general principles of law as “rules of law and which have earned a wide acceptance and international consensus in the international business community, including notions which are said to form part of a *lex mercatoria*, also taking into account any relevant trade usages as well as the UNIDROIT Principles, as far as they can be considered to reflect generally accepted principles and rules.” The tribunal was of the opinion that “these "General Principles of Law" (in the wide understanding as described above) are established in sufficiently concrete fashion so as to enable the Tribunal to adjudicate any and all issues as may arise in the framework of this arbitration.”¹⁰¹⁵

The arbitral tribunal also questioned the enforceability of an award based on the application of general principles of law. First, it noted that the application by an arbitral tribunal of a-national legal rules, general principles of law and *lex mercatoria* is recognized under Swiss law, as the law of the seat of arbitration. The tribunal stated that it was not aware that, in connection with a potential enforcement of the award against the defendant in the USA, or in European countries, where assets might exist, the enforcement could be refused on the ground that the tribunal applied general principles of law and a-national rules of law, instead of applying a particular national law. Finally, the tribunal also clarified that it did not interpret the implied negative choice of the parties in the sense that they would, by their silence, have tacitly authorized the tribunal to act as *amiables compositeurs* or empowered the tribunal to rule merely on the basis on the basis of "natural justice" or "fairness", or on an *ex aequo et bono* basis.¹⁰¹⁶

While ICC Cases No 7110 and 7375 were state party contracts, the practice of interpreting the silence of the parties as a negative choice can also be found in awards relating to private contracts. In ICC Case No 10422, the absence of a choice of law clause and an indication in the contract that a neutral law should govern the contract was considered as sufficient to bring about the exclusive application of *lex mercatoria* as a result of the implied negative choice. The defendant, a European manufacturer, and the claimant, a Latin-American distributor, entered into an agreement for the exclusive distribution of the defendant's products in the

¹⁰¹⁴ Ibid.

¹⁰¹⁵ Ibid.

¹⁰¹⁶ Ibid.

claimant's country. As to the applicable law, the agreement provided that it shall be governed in all respects by the ICC or by a neutral legislation specified by mutual agreement by the parties. Given that no ICC legislation exists and the parties did not specify a neutral law, the tribunal concluded that the parties have not expressly chosen the applicable law. The tribunal held that, in order to determine the most appropriate rules of law, the fact that the parties wanted a neutral solution had to be taken into account. In the absence of an express indication as to the national law of a third country, the tribunal considered that the most appropriate solution in the case in which the parties express their desire for a neutral solution was to apply the general rules and principles of international contracts, "the so-called *lex mercatoria*". In this context, the tribunal cited, among others, ICC Awards No 7110 and 7375 in support of its reference to the UNIDROIT Principles, which, in the opinion of the tribunal, "has been recognised in numerous arbitral awards as an expression of the *lex mercatoria* or of international trade usages."¹⁰¹⁷

Thus, while the exclusive application of *lex mercatoria* should not be based on the mere fact that each party pleads the application of its own national law in the proceedings, the explicit or implicit intentions of the parties as to the neutrality of the applicable substantive law may indicate an implied negative choice of the national laws, and lead to the exclusive application of *lex mercatoria* to the substance of the dispute, due to the speculative nature of designating a third country law as the neutral law. Moreover, in a situation where there is evidence of the intentions of the parties as to the exclusion of the national laws of the parties, and where one of those laws could be designated to be applicable by the established rules of conflict, the decision maker should not reject the exclusive application of *lex mercatoria* to the substance of the dispute, without considering whether the application of the designated national law would amount to holding one of the parties to a bargain, which he specifically attempted to avoid and managed to persuade the other party to defer the issue until the time of dispute for a more satisfactory solution.

In ICC Case No 7319, the contract underlying the dispute contained a choice of law clause which provided that "This Agreement shall be construed (sic) in accordance with and governed by laws and regulations applying to members of the European Economic Community." According to the claimant, the parties intended not to choose any particular national law but to refer to an international system of law, similar at least in principle, to *lex mercatoria* or, for example, to clause 68 of the Channel Tunnel Contract. The defendant argued that the choice of law clause was without meaning and, therefore, necessarily invalid as a purported expression of an agreed choice of applicable law since it cannot be deemed to refer to a system of law derived by extracting the common elements of the twelve different national laws of the EEC member states. According to the defendant, the law governing the agreement must be determined by applying the appropriate rules of conflict.¹⁰¹⁸

The sole arbitrator first observed that neither of the parties accepted the national law of the other party, i.e. French and Irish laws. The arbitrator did not find the wording of the clause to be totally meaningless, but considered the wording as being a reference to European Community law, where applicable, including the European Treaties and the secondary body

¹⁰¹⁷ ICC Award in Case No. 10422, 2001, Excerpts of the original French version of the award have been published in *Journal du droit international*, 2003, pp. 1142-1150 Available in English at <http://www.unilex.info/case.cfm?pid=2&do=case&id=957&step=FullText>

¹⁰¹⁸ ICC Partial Award in Case No 7319, 1992, *ICC International Court of Arbitration Bulletin*, 5-2 (1994), at 56 et seq.

of Community legislation. However, the arbitrator did not consider the wording as having a meaning going beyond that. In particular, the arbitrator maintained that the wording did not support the view that it meant a reference to international legal or trade principles, such as *lex mercatoria*, or the common principles of the twelve member states of the European Community. The arbitrator stated that “If this has been the intention of the parties, they could have chosen and agreed on wording expressly indicating such a reference, as, for example, in Article 68 of the Channel Tunnel Contract, or by specifically referring to *lex mercatoria*.” The arbitrator stated that, “the failure of the parties to agree on the law governing the Agreement cannot, in the sole arbitrator’s opinion, be interpreted as an implied reference to some vague international legal or trade principles. Such reference must be made expressly and, if not expressly, then in an implied manner which gives reasonable certainty to the arbitrators or the courts, respectively, that the parties indeed agreed to submit their dispute to a national law or international trade principles, particularly considering the fact that such national laws and principles, if not properly defined, are difficult if not impossible to assess.” The arbitrator decided to refer to the method of cumulative application of the different rules of conflict of the countries having a relation to the dispute and to apply both the Irish and the French rules of conflict, given that these were the only ones having a direct connection with the parties and the dispute. He concluded that Irish law was the applicable law, since more factors pointed to Ireland and not to France, such as the place of performance of the substantive obligations of the agreement, and the form of the agreement and its terminology was that followed by the common law system rather than that followed by the French system.¹⁰¹⁹

However, the initial draft of the contract submitted to the claimant by the defendant had suggested Irish law as the applicable law, supplemented, 'where applicable', by the laws and regulations of the EEC. The reference to Irish law was subsequently removed during negotiations. The arbitrator reasoned that by leaving the issue of applicable law unresolved, each party assumed the risk that the sole arbitrator would designate the other party's law as the law applicable to the agreement.¹⁰²⁰ It appears that the arbitrator’s decision enforced a bargain that the claimant had specifically wished to avoid. The arbitrator failed to consider whether, had the parties been able to agree on Irish law, their contract would have been different from what the arbitrator had before him, or whether the claimant would have entered into the contract, had it contained a choice of law clause in favor of Irish law. The main reason for the arbitrator not to resort to the exclusive application of *lex mercatoria* to the substance of the dispute seems to be the difficulties in establishing the contents of *lex mercatoria* or common principles of the laws of the members of the European Economic Community. Unfortunately, the PECL was not available, when this award was rendered in 1992. Had the PECL been available to assist the arbitrator in exercising his abstract reasoning and in providing a solution through specialized consolidations without resorting to the substantive national laws, which the parties attempted to avoid, his conclusion as to the applicable law could have been different and more appropriate, or the parties could have envisaged the possibility of referring to the PECL at the stage of contract drafting or during the arbitral proceedings.

On the other hand, in some cases, the arbitral tribunals, after implying a negative choice of law into the contract, decided to apply general principles of law to the substance of the dispute and found such principles in the UNIDROIT Principles, but reasoned that the parties wished to exclude only the application of their own national laws to the substance of the dispute and they decided to apply a neutral national law to supplement the UNIDROIT Principles because

¹⁰¹⁹ Ibid.

¹⁰²⁰ Ibid.

of their incomplete character. In SCC Case No.117/1999, the tribunal decided to apply the UNIDROIT Principles, to be supplemented by Swedish law, to a dispute between a Luxembourgish company as the claimant and a Chinese company as the defendant. Under the contract, both parties were licensee and licensor and exchanged licenses to parts of their respective industrial technology. According to the claimant, it was clear that neither party wished the other party's law to apply. The claimant argued that if choice of law rules were to be applied, Swedish international private law rules and those of the 1980 Rome Convention on the law applicable to contractual obligations both lead to the conclusion that Swedish law should be applied or, alternatively, that Luxembourg law should be applied, since the 'characteristic performance' of the obligations at issue was the license from the claimant domiciled in Luxembourg from where the performance emanates.¹⁰²¹ The defendant contended that the choice of Sweden as the seat of the arbitration did not suffice as an indication of the parties' intentions with the respect to applicable law since the standard for a finding of an inferred choice of law should be extremely high and only proper where it is reasonably clear that there is a genuine choice by the parties. The defendant argued for the application of Chinese law on the ground that Swedish conflict of laws principles require the application of the law with the closest connection to the contract and the contract was negotiated, signed, and largely performed in China.¹⁰²²

The tribunal noted that no evidence had been submitted with respect to the intentions of the parties on applicable law at the signing of the contract. Although the SCC Rules allowed the tribunal to apply the law or rules of law which the tribunal considers to be most appropriate in the absence of an agreement between the parties, the tribunal decided to first investigate whether there are Swedish conflicts rules that would effectively designate the applicable law. According to the tribunal, the governing principle under the 1980 Rome Convention, as by and large was also the case under Swedish law before Sweden's ratification, is that the applicable law shall be the law of the country to which the agreement has the closest connection. However, the tribunal noted the special character of the contract, which was "a form of barter agreement" and under which the parties agreed to exchange technology and knowhow without any simultaneous arrangement for payments by either side to the other. It was a contract on a cross licence arrangement where performance and obligations were, on the face of it, evenly distributed and symmetrical in nature. Thus, the tribunal held that either of the Chinese and Luxembourg laws cannot be considered to be the exclusive governing law for the contract. According to the tribunal, *déçepage* was not an option in the case since "In a contract where the parties exchange licences it cannot be a reasonable assumption that the alleged breaches of one party should be treated differently than the breaches of the other party, as a result of different laws or rules of law being applicable to each party's obligations." As to the applicability of Swedish law, the tribunal agreed with the tendency of arbitral tribunals to disregard the choice of seat as an indication of a choice of governing law on the ground that the choice of the place of arbitration may be influenced by a number of practical considerations that have no bearing whatsoever on the issue of applicable law.¹⁰²³

The tribunal was of the opinion that the parties deliberately refrained from agreeing on the applicable law to the contract and it was "reasonable to assume that the contracting parties expected that the eventual law chosen to be applicable would protect their interest in a way

¹⁰²¹ Stockholm Arbitration Report, (2002:1), at 60-61

¹⁰²² *Ibid.*, at 61

¹⁰²³ *Ibid.*, at 64

that any normal business man would consider adequate and reasonable, given the nature of the contract and any breach thereof, and without any surprises that could result from the application of domestic laws of which they had no deeper knowledge.”¹⁰²⁴ The tribunal concluded that “the issues in dispute between the parties should primarily be based, not on the law of any particular jurisdiction, but on such rules of law that have found their way into international codifications or suchlike that enjoy a widespread recognition among countries involved in international trade.... Apart from international conventions, ... the only codification that can be considered to have this status is the UNIDROIT Principles of International Commercial Contracts.” The tribunal held that the appropriate rules of law on the merits of the issues in dispute between the parties are those contained in UNIDROIT Principles, supplemented by Swedish law if and to the extent the UNIDROIT Principles do not give any guidance on a particular issue.¹⁰²⁵

In ICC Case No 15089 concerning a contract for high-technology based services between parties from different Middle Eastern countries, the claimant argued that there had been a tacit choice of English law as the law governing the contract due to the use of the English language, the choice of London as seat of the arbitration and the neutrality of English law. Following an invitation by the tribunal, the claimant conceded, however, that application of the UNIDROIT Principles was an acceptable second-best solution. The defendant argued in favor of the applicability of the law of its country, but submitted that certain rules of the *lex mercatoria* might be considered as an alternative but cautioned that the UNIDROIT Principles, taken in their entirety, were still too little known for them to be chosen as the law governing the contract. The arbitral tribunal decided that the law governing the contract shall be the UNIDROIT Principles. The tribunal stated following reasons in support of its decision: (1) There had been a ‘negative choice’ as regards the laws of A and B, and there had been no shared expectations of the parties in this respect; (2) There was no clearly identifiable ‘objective’ connecting factor or other conflict-of-laws rule; (3) The UNIDROIT Principles were shaped by the laws of the community of trading nations and constituted an international re-statement (and pre-statement) of modern contract law in its most authoritative form. (4) In the meantime, they were well-known, not least due to many hundreds of publications and more than 150 documented arbitral awards and court decisions. (5) The United Nations Commission on International Trade Law (UNCITRAL) had endorsed the UNIDROIT Principles. However, the tribunal also stated that, if and where necessary, the UNIDROIT Principles would be supplemented by the otherwise applicable law as determined in accordance with Article 17 of the ICC Rules.¹⁰²⁶

In these cases, the arbitral tribunals reasoned that the implication of a negative choice of law did not necessarily lead to the application of *lex mercatoria* to the exclusion of any national law, but to the determination of the UNIDROIT Principles as governing law and supplementary application of a neutral national law. Such determination of the applicable law reflects to some extent the suggestion that can be found in the preamble of the UNIDROIT Principles for the parties to provide that their agreement be governed by the Principles primarily and by a particular national law supplementarily.¹⁰²⁷ This suggestion has also been

¹⁰²⁴ Ibid.

¹⁰²⁵ Ibid., at 65

¹⁰²⁶ ICC Award in Case No 15089, unpublished, abstract available at <http://www.unilex.info/case.cfm?id=1440>

¹⁰²⁷ Following approval by the Governing Council in 1999, the UNIDROIT Principles provide an official footnote with two suggested texts for choice of law clauses, formulated by Professor Farnsworth: (1) “This contract shall be governed by the UNIDROIT Principles (2004) [except as to Articles ...]”; and (2) “This

provided in the model contracts prepared by the some international organizations.¹⁰²⁸ The commentators observed that the UNIDROIT Principles are still incomplete even within general contract law and contain no rules for specific contract types, so it is argued any choice should be supplemented with that of a national law.¹⁰²⁹ While the idea of supplementing the UNIDROIT Principles, an instrument that remain constantly incomplete, with a national law is obvious for the parties drafting a contract, who have to determine to what extent their transaction should be governed under the conditions of legal uncertainty, such a reasoning adopted by an arbitral tribunal in the absence of a choice of law by the parties seems unsatisfactory and complicating the choice of law analyses.

The arbitral tribunals may decide to apply the UNIDROIT Principles in order to obtain assistance from them in their consolidations for discovering the established rules under *lex mercatoria*. This implies that the arbitral tribunals may resort to the UNIDROIT Principles only when they decide to apply *lex mercatoria* either as the law of principled adjudication for the tribunal thereby interpreting, supplementing and correcting otherwise applicable national law, or as governing the substance of the dispute to the exclusion of any national law. However, the tribunals' approach in the ICC and SCC awards cited above seems as substituting the parties' decision regarding to what extent their transaction should be governed under the conditions of legal uncertainty. While the parties are free to incorporate the UNIDROIT Principles or any other sets of default rules in to the contents of contract, by agreeing on a national law for the purpose of supplementing the contents of contract, the arbitrators should not act on such freedom of the parties and decide on behalf of them. The arbitrator should render a reasoned award that reflects the reasonable expectations of the parties. When the arbitrator decides to apply the UNIDROIT Principles primarily and a national law supplementarily, the Principles do not serve any longer the specialized consolidations of the decision maker exercising an abstract reasoning, but become incorporated into the contents of the contract, which is actually governed by the "supplementary" national law.

contract shall be governed by the UNIDROIT Principles (2004) [except as to Articles...], supplemented when necessary by the law of [jurisdiction X]". See: Governing Council, 78th session (Rome, 12-16 April 1999), Summary of the Conclusions Reached by the Governing Council at its 78th Session, Item No. 10 on the agenda; UNIDROIT 1998 - Study L - Doc. 57, Draft Model Clause Prepared by Professor A.E. Farnsworth, Rome, June 1998

¹⁰²⁸ Such a clause can be found in the 1999 ITC Model Contract for the International Sale of Perishable Goods, which is prepared by International Trade Centre UNCTAD/WTO in response to needs expressed by exporting and trade associations from 115 countries and aims to offer balanced, reliable and flexible general-purpose legal instruments which are simple to use by all and especially by small and medium-sized enterprises. Article 14 of the 1999 ITC Model Contract provides that "In so far as any matters are not covered by the foregoing provisions, this Contract is governed by the following, in descending order of precedence: The United Nations Convention on Contracts for the International Sale of Goods; The UNIDROIT Principles of International Commercial Contracts, and; For matters not dealt with in the above-mentioned texts, the law applicable at _____ or, in the absence of a choice of law, the law applicable at the Seller's place of business through which this Contract is to be performed." In the User's Guide to the 1999 ITC Model Contract, it is stated that "the parties should be aware that the CISG and UNIDROIT Principles do not cover all potential legal eventualities as regards any given transaction. It is therefore appropriate to stipulate the domestic law which will apply in addition. The parties are invited to specify the domestic law which they consider to be appropriate to their transaction." International Trade Center UNCTAD/WTO, International Commercial Sale of Perishable Goods Model Contract and Users' Guide (1999), available at <http://www.jurisint.org/en/con/339.html>

¹⁰²⁹ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC), Oxford University Press, 2009, at 41

Moreover, in such cases, the manner of the determination of the applicable “supplementary” national law becomes controversial, as observed in the two arbitral awards rendered in this way. In the ICC award mentioned above, the tribunal left unresolved the issue of which national law should be applied as supplementing the UNIDROIT Principles, probably hoping that the Principles would be sufficient to resolve the dispute. However, should the Principles prove to be insufficient to resolve the disputed issue, the parties might have considerable difficulties in updating their arguments in their pleadings, and their right to reasonable opportunity to present their cases and comment on the applicable law may not be given full effect, since the parties might not be able to foresee which national law the tribunal will deem appropriate or whether the tribunal will exercise its capacity to directly refer to the established rules in order of international commerce.

In the SCC award, the tribunal decided to apply Swedish law in a supplementary manner without any strong justification for such an application, given that, earlier in the award, the tribunal expressed its agreement with the tendency of arbitral tribunals to disregard the choice of seat as an indication of a choice of governing law. The decision to apply Swedish law in a supplementary manner is only based on the perceived neutrality of Swedish law with respect to the national laws of the parties and the fact that the parties requested for arbitration with the Arbitration Institute of the Stockholm Chamber of Commerce. However, the neutrality of any set of rules can only be determined by reference to the reasonable expectations of the parties, but not on the basis of the national origins of the rules. Absent any indications from the parties as to their consideration of a particular set of rules as being neutral to their bargain, the neutrality of applicable rules can only be achieved through such a flexibility that enables the decision maker to account for the particularities of the case, in other words, by the application of *lex mercatoria*, as the law of principled adjudication.

The international arbitration practice tends to give less importance to the choice of the seat of arbitration as an indication of the parties’ implied choice of the substantive law of the seat in the absence of an express choice by the parties.¹⁰³⁰ This tendency originates in the continental legal tradition, according to which the choice of a place of arbitration in itself is not considered a choice of applicable law.¹⁰³¹ By contrast, in English law, it has long been held that the decision to resort to arbitration in England is a strong indication that English law has been chosen as the applicable law by the parties.¹⁰³² However, this position of English law is

¹⁰³⁰ ICC Award in Case No. 5717, 1988, ICC International Court of Arbitration Bulletin, 1-2 (1990), at 22: “In complex international relationships such as that under review, a widely accepted choice of law principle in most jurisdictions, including England, Liechtenstein and France, is the center of gravity, or the connection, test. Under this test, the arbitrator selects the substantive law of the jurisdiction that has the greatest connection with the dispute... the choice of London as the place of arbitration and English as the language of the contract does not, in itself, indicate an intention of the parties that English law should govern the validity of the agreement to arbitrate.” ICC Award in Case No. 4132, Yearbook Commercial Arbitration, (1985), at 52: “The Agreement has been executed and performed partly in Italy and partly in Korea. At the time the Agreement was made the parties did not express themselves as to the law that would govern their contractual relationship. Lacking such choice of law by the parties and all further direct points of contact which could be decisive for the determination of the governing law, the Centre of Gravity test, as proposed by the defendant, could indeed be relevant in order to decide this question.”

¹⁰³¹ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 788

¹⁰³² For example, in the *Tzortzis and Sykias v Monark Line A/B* case of 1968, Lord Denning stated that “the circumstance that parties agree that any differences are to be settled by arbitration in a certain country will lead to an inference that they intend the law of that country to apply”. [1968]1 W.L.R. 406, at 411; Lord Denning went even further and stated that “although the contract was most closely connected to Swedish law, the

later disputed.¹⁰³³ Although the presumption that when the parties agree on a forum they may reasonably expect that this forum will apply its own substantive law makes sense when the reference is to a national court, which is an organ of a national legal system, such a presumption becomes unreasonable in the case of arbitration since the place of arbitration can be chosen for many reasons unconnected with the law of that place and the arbitral tribunal does not have a *lex fori* in the sense of a national legal system.¹⁰³⁴ Since the UNIDROIT Principles purport to assist the decision maker applying *lex mercatoria* in their specialized consolidations for discovering the established rules, there is no justification in applying the national law of the arbitral seat or another national law of perceived neutrality with respect to the national laws of the parties, for supplementing *lex mercatoria*, which should be considered as *lex fori* for an international arbitral tribunal for all forms of supplementary purposes.

presumption in favor of English law arising from the arbitration clause was irresistible". [1968]1 W.L.R. 406, at 413

¹⁰³³ Lord Wilberforce stated in the *Compagnie Tunisienne* case of 1971 that "an arbitration clause is an indication to be considered together with the rest of the contract and the relevant surrounding facts". *Compagnie Tunisienne de Navigation SA v Compagnie d'Armement Maritime SA* [1971] AC 572, at 596

¹⁰³⁴Redfern, Alan & Martin Hunter with Nigel Blackaby and Constantine Partasides, *Law and Practice of International Commercial Arbitration*, London: Sweet & Maxwell, 4th ed. Student version, 2004, at 143

iv. Amiable Composition

In international arbitration, the parties may agree to amiable composition or arbitration *ex aequo et bono*, whereby the arbitrator is allowed to decide on the basis of what he deems just and fair in resolving the contractual dispute. This opportunity granted to the parties mostly results from the historical perception of arbitration as a procedural device permitting to find an amicable resolution for differences or controversies without too much emphasis on strictly legal issues and to give effect to the reasonable expectations of the parties on the basis of a compromise acceptable to all of them rather than on a principled legal attribution of rights and obligations.¹⁰³⁵

For an amiable composition or arbitration *ex aequo et bono* clause to be effective, there are in principle two basic requirements. First, the express authorization of the parties is required, and, secondly, this authorization must be permitted by the relevant arbitration law.¹⁰³⁶ Pursuant to Article VII (2) of the European Convention on International Commercial Arbitration of 1961, the arbitrators act as amiables compositeurs if the parties so decide and if they may do so under the law applicable to the arbitration. Article 28 (2) of the UNCITRAL Model Law on Arbitration provides that the arbitral tribunal shall decide *ex aequo et bono* or as amiable compositeur only if the parties have expressly authorized it to do so. In France, Article 1497 of the New Code of Civil Procedure provides that the arbitrator shall rule as amiable compositeur if the agreement of the parties conferred this mission upon him or her. In Switzerland, Article 187 (2) of the Private International Law Act allows the parties to authorize the arbitral tribunal to decide *ex aequo et bono*. In England, it was once considered impossible to grant to an arbitrator the powers of amiable compositeur since it was deemed a matter of public policy that an arbitrator must decide according to the law.¹⁰³⁷ With the adoption of Article 46 (1) (b) of the Arbitration Act of 1996 and the words “in accordance with such other considerations as are agreed by the parties” in that article, the parties are authorized to agree to amiable composition or equity arbitration.¹⁰³⁸ In the United States, the

¹⁰³⁵ Grigera Naón, Horacio A., Choice of Law Problems in International Commercial Arbitration, *Recueil des Cours*, 289 (2001), at 210

¹⁰³⁶ However, the arbitration laws of some countries assume that the arbitrators will decide *ex aequo et bono* unless it is expressly stated that they must decide in law. For instance, Article 3 of Ecuador’s law of arbitration (145/1997), Redfern, Alan & Martin Hunter with Nigel Blackaby and Constantine Partasides, *Law and Practice of International Commercial Arbitration*, London: Sweet & Maxwell, 4th ed. Student version, 2004, at 141 In the same vein, in China, Article 43 of the CIETAC Rules implies that parties desiring to prevent a CIETAC tribunal from rendering an award as amiables compositeurs should make an express provision to that effect in the arbitration agreement. Lew, Julian D. M., Loukas Mistelis L. A., & Stefan M. Kröll, *Comparative International Commercial Arbitration*, Kluwer Law International, 2003, at 473

¹⁰³⁷ *Czarnikow Ltd v Roth Schmidt & Co* [1922] 2 KB 478: “The amiable compositeur and the arbitrator-non judge in general are not to be trusted. As long as the Courts of this country have a statutory supervisory jurisdiction over arbitrators in England, it must remain a firm principle of the law governing arbitrations that that which is, in English law, a question of law shall remain in all aspects and for all purposes a question of law”. *David Taylor & Son v Barnett Trading Co* [1953] 1 Lloyd’s 181: “There is not one law for the arbitrator and another for the Court. There is only one law for all of them”. *Orion Compania Espanola de Seguros v Belfort Maatschappij voor Algemene Verzekering* [1962] 2 Lloyd’s Rep 257: “Arbitrators cannot be allowed to apply some different criterion such as the views of the individual arbitrator or umpire on abstract justice or equitable principles... By virtue of English public policy the arbitrator must apply a defined and recognized legal system”.

¹⁰³⁸ Born, Gary B., *International Commercial Arbitration*, Vol. II, Kluwer Law International, Alphen aan den Rijn, 2009, at 2239; The negative stance against the amiable composition faded gradually even before the adoption of Arbitration Act of 1996. For instance, in *Eagle Star Insurance Co. v. Yuval Insurance Co.* 1978 1 Lloyd’s Rep. 357 Lord Denning held valid a contract between two insurance companies dispensing the

concept of arbitration in a domestic context bears resemblances to amiable composition and retains some of its features even without being denominated as such.¹⁰³⁹ In some other common law countries, the option of amiable composition and arbitration *ex aequo et bono* is presented to the parties by means of the adoption of the UNCITRAL Model Law.¹⁰⁴⁰ In general, it can be observed that many national laws and almost all institutional arbitration rules provide for the option of amiable composition or decisions *ex aequo et bono* in the context of international arbitration.¹⁰⁴¹

arbitrators from respecting strict rules of law and inviting them to settle the dispute “according to an equitable rather than a strictly legal interpretation of the provision of this Agreement”. Lord Denning held that such a clause did not violate public policy, but was reasonable since it did not oust the jurisdiction of the courts, but only “technicalities and strict constructions.” Also see *Home Insurance v Administratia Asigurarilor de Stat*, [1983] 2 Lloyd's Rep. 674 QB holding that a contract which should be interpreted “as an honourable engagement” was binding on the parties, who wished to submit to arbitration and dispense the arbitrators from the application of strict rules.; *Home and Overseas Insurance v Mentor Insurance*, [1989] 1 Lloyd's Rep. 473 CA [303] recognizing the validity of a clause inviting the arbitrators to give a reasonable interpretation rather than a literal one, but adding that it would be different if the clause authorized the arbitrators to decide without regard for the law and according to their own notions of what would be fair

¹⁰³⁹ Born, Gary B., *International Commercial Arbitration*, Vol. II, Kluwer Law International, Alphen aan den Rijn, 2009, at 2238; Weinberg, Karyn S., *Equity in International Arbitration: How Fair is “Fair”: A Study of Lex Mercatoria and Amiable Composition*, *Boston University International Law Journal*, 12 (1994), at 240-241; for example in *Fudickar v. Guardian Mutual Life Insurance Co.*, it was held: “Arbitrators may, unless restricted by the submission, disregard strict rules of law or of evidence, and decide according to their sense of equity.” 62 NY, 392 (1875). Similarly, in *Spectrum Fabrics Corp. v. Main Street Fashion*, it was stated that “The fact is that an agreement to arbitrate, as authorized by statute, is a contractual method for settling disputes in which the parties create their own forums, pick their own judges, waive all but limited rights of review or appeal, dispense with the rules of evidence, and leave the issues to be determined in accordance with the sense of justice and equity that they may believe reposes in the breasts and minds of their self-chosen judges.” (quoted by Rubino-Sammartano, Mauro, *International Arbitration Law and Practice*, Kluwer Law International, 2nd rev. ed., 2001, at 460) In *J.B. Harris Inc. v. Razei Bar Indus Ltd.*, the court rejected the public policy objection to an arbitration clause providing that “the arbitrator will not be bound by the substantive law and laws of procedure” by considering this clause as “unremarkable in the arbitration context” given that arbitrators are presumptively free from “principles of substantive law or rules of evidence.” 181 F.3d 82 (2d Cir. 1999); In *International Standard Electric Corp. v. Bidas Sociedad Anonima Petrolera, Industrial Y Comercial*, where the parties agreed on the ICC arbitration and the application of the laws of the State of New York to the substance of the dispute, the United States District Court, Southern District of New York held that even if an arbitrator were to act as amiable compositeur without authority, the New York Convention would not allow a court to refuse enforcement of the arbitral award, even for “manifest disregard of the law.” The Court said that it would frustrate the purposes of the New York Convention to permit judges to make a *de novo* inquiry into whether the law supposedly applied by the arbitrators was in fact properly applied by them. 745 F. Supp. 172 (S.D.N.Y. 1990), at 181-182

¹⁰⁴⁰ Australia, Bermuda, Canada, common law provinces and territories, Hong Kong, Scotland, New Zealand and the States of California, Connecticut, Illinois, Louisiana, Oregon and Texas in the United States of America by adopting Model Law, as a rule maintain the possibility of Article 28 (3) to authorize arbitrators to decide *ex aequo et bono*.

¹⁰⁴¹ Lew, Julian D. M., Loukas Mistelis L. A., & Stefan M. Kröll, *Comparative International Commercial Arbitration*, Kluwer Law International, 2003, at 470, Examples include Article 1054 (3) of the Netherlands Code of Civil Procedure; Article 1700 (1) of the Belgian Judicial Code (Law of May 19, 1998); Article 1051 (3) of the German ZPO (Law of December 22, 1997); ICC Rules of Arbitration Article 17 (3), AAA ICDR Rules Article 28.3, SCC Rules Article 22.3, LCIA Rules Article 22.4 (the LCIA Rules adds a third, typically English concept, that of “honourable engagement” dispensing the arbitrator from strictly adhering to the terms of the contract); However, there are also arbitration laws which does not include this possibility. For instance, in Russia, under the International Commercial Arbitration Act of 1993, although mainly based on the UNCITRAL Model Law, the possibility of deciding cases *ex aequo et bono* or amiable composition has not been pursued and therefore is omitted. Nacimiento, Patricia and Alexey Barnashov *Recognition and Enforcement of Arbitral Awards in Russia*, *Journal of International Arbitration*, 27-3 (2010), at 297

There is a wide variety of terms used in the arbitration laws, rules and clauses, which confer on the arbitrators the power to act as *amiable compositeurs* or to decide *ex aequo et bono*. In arbitration clauses, there are references, for instance, to the appointment of an arbitrator “who has the power of an *amiable compositeur* and is to decide the case according to the principles of equity without needing to observe legal or procedural rules”¹⁰⁴² or who shall act as “*amiable compositeur*” and decide the case “according to the principles of equity”¹⁰⁴³, or to disputes to be “decided by the arbitrators *ex aequo et bono*”¹⁰⁴⁴, or to arbitrators “deciding *pro bono et aequo*.”¹⁰⁴⁵

The variety of expressions has led to some distinctions of the legal doctrine between *amiable composition* and the arbitrators’ power to decide *ex aequo et bono*. The distinction is sometimes based on the doctrinal origin of these two concepts, namely arbitration *ex aequo et bono* as found in Swiss law and *amiable composition* in French law. Under this distinction, the authority to decide *ex aequo et bono* releases the arbitral tribunal from applying a particular law or rules of law, including the mandatory provisions of the domestic law that would be applicable to the dispute, and the tribunal may solely base its findings on fairness and equity, while limited only by the relevant public policy considerations.¹⁰⁴⁶ This understanding of *ex aequo* power is wider than the notion of *amiable composition* in French jurisprudence, which merely authorizes the arbitral tribunal to moderate the effects of the application of a particular law or rules of law to the dispute in order to satisfy equity. In French jurisprudence, the *amiable compositeur* should first evaluate the claims of each party in accordance with the applicable law and if the resulting solution seems unjust to him, he should adapt the solution in accordance with equity.¹⁰⁴⁷ Accordingly, it is argued that arbitration *ex aequo et bono* should focus on the particular circumstances of the case and result in a decision based exclusively on equity, without regard to legal rules, while *amiable composition* should start with an analysis of the applicable law and of the contract to possibly moderate their effects if they are too rigorous.¹⁰⁴⁸

Another distinction between these two concepts is made on the basis of the differences in some jurisdictions between procedural arbitration, in which the arbitrators reach a decision similar to a judge’s decision, and contractual arbitration, in which the parties grant to the arbitrators a contractual mandate to settle their dispute. Thus, some authors refer to *amiable composition* as contractual arbitration, a settlement and not a decision, a notion which is wider than that of an arbitrator deciding *ex aequo et bono*.¹⁰⁴⁹ It is argued that an arbitrator deciding *ex aequo et bono* still renders a decision in law and can only replace certain parts of

¹⁰⁴² ICC Award in Case No. 9483, 1998, ICC International Court of Arbitration Bulletin, 18-1 (2007), at 82

¹⁰⁴³ ICC Award in Case No. 9704, 2000, ICC International Court of Arbitration Bulletin, 18-1 (2007), at 87

¹⁰⁴⁴ ICC Award in Case No. 12772, 2004, ICC International Court of Arbitration Bulletin, 18-1 (2007), at 113

¹⁰⁴⁵ ICC Award in Case No. 12070, 2004, ICC International Court of Arbitration Bulletin, 18-1 (2007), at 108

¹⁰⁴⁶ Blessing, Marc, The New International Arbitration Law in Switzerland, *Journal of International Arbitration*, 5-2 (1988), at 64; Weinberg, Karyn S., Equity in International Arbitration: How Fair is “Fair”: A Study of *Lex Mercatoria* and *Amiable Composition*, *Boston University International Law Journal*, 12 (1994), at 231 fn 26

¹⁰⁴⁷ Bertrand, Edouard, *Amiable Composition: Report of ICC France Working Group*, *International Business Law Journal*, (2005), at 756

¹⁰⁴⁸ Poudret, Jean-Francois & Sebastien Besson, *Comparative Law of International Arbitration*, London: Sweet & Maxwell, 2nd ed., 2007, at para. 710

¹⁰⁴⁹ Rubino-Sammartano, Mauro, *International Arbitration Law and Practice*, Kluwer Law International, 2nd rev. ed., 2001, at 473

applicable law, which in a given situation would produce unjust results, with the considerations of equity. Thus, in this view, whenever the arbitrator deciding *ex aequo et bono* finds that there is no difference between statutory provisions and equity considerations, he will apply the former and he cannot set aside mandatory provisions of the applicable law even if he considers that they conflict with equity.¹⁰⁵⁰

In the practice of international arbitration, those distinctions have mostly lost their importance, and usually those two concepts are treated as synonyms. This is mainly because, in all cases, the arbitrators should respect the relevant public policy considerations, the violation of which would lead to the setting aside of the award or the refusal of its enforcement, and the finality of awards and the limited review of the awards on the merits by the national courts do not lead to a consistent guidance or control on the proper scopes and methods of those two different denominations. Thus, Article 17 (3) of the ICC Rules refers to both of those concepts and, in a commentary on the Rules, it is stated that “historically, both terms are products of civil law and have to do with an arbitrator deciding a case on the basis of fairness and equitable considerations.”¹⁰⁵¹ Occasionally, this distinction is discussed in arbitral awards. In ICC Case No. 12772, the arbitrator enquired into this distinction and, after citing some doctrinal writings on the issue, concluded that such “discussion is, for the purposes of this case, of academic nature only.”¹⁰⁵² In ICC Case No. 10728, the arbitrator noted that it is unanimously accepted that to decide *ex aequo et bono* is to decide in equity, and scholars overwhelmingly consider that when arbitrators are empowered to rule in equity, they rule as *amiable compositeurs*. According to the arbitrator, arbitral case law does not make any distinction between the powers of an *amiable compositeur* and the power to judge *ex aequo et bono*.¹⁰⁵³ In ICC Case No 7986, the tribunal observed that until recently, the question of extent of the powers held by arbitrators acting as *amiable compositeurs* was controversial as some scholars attempted to distinguish between *amiable composition* and arbitration in equity. The tribunal was of the opinion that recent thinking has regarded such distinction as artificial, as in either case arbitrators could choose to have their sense of what justice requires prevail over any other considerations.¹⁰⁵⁴

A clear distinction between those two concepts and *lex mercatoria* has also been subject to debate in the doctrine. It has been difficult to distinguish those two concepts from *lex mercatoria*, as all of them contain equitable considerations in decision making process and aim to achieve justice in a particular case. This led to a controversy during the emergence of the modern *lex mercatoria* doctrine. The opponents of modern *lex mercatoria* doctrine equated “*lex mercatoria*” to “equity” as opposed to “rules of law”.¹⁰⁵⁵ Modern *lex mercatoria* doctrine

¹⁰⁵⁰ Rubino-Sammartano, Mauro, *Amiable Compositeur (Joint Mandate to Settle) and Ex Bono et Aequo (Discretionary Authority to Mitigate Strict Law)*, *Journal of International Arbitration*, 9-1 (1992), at 12-13

¹⁰⁵¹ Derains, Yves & Eric A. Schwartz, *A Guide to the New ICC Rules of Arbitration*, Kluwer Law International, 2nd ed., 2005, at 245

¹⁰⁵² ICC Award in Case No. 12772, *ICC International Court of Arbitration Bulletin*, 18-1 (2007), at 114

¹⁰⁵³ ICC Award in Case No. 10728, *ICC International Court of Arbitration Bulletin* 18-1 (2007), at 98

¹⁰⁵⁴ ICC Award in Case No. 7986, *ICC International Court of Arbitration Bulletin* 18-1 (2007), at 72

¹⁰⁵⁵ Mann, F.A., *England Rejects ‘Delocalized’ Contracts and Arbitration*, *International and Comparative Law Quarterly*, 33 (1984), at 196-97: “One of the purposes of that doctrine is to eliminate the search for the proper law of the contract or, more generally, the rules of the conflict of laws. More than that, the purpose is to substitute ill-defined “equity” for rules of law, to rely on what is considered fair and conforming to usage. It is difficult to imagine a more dangerous, more undesirable and more ill-founded view which denies any measure of

has attempted to explain the distinction between *lex mercatoria* and equity on the basis of the argument that *lex mercatoria* functions like a substantive national law in the context of international arbitration since, should *lex mercatoria* be understood as a form of amiable composition or arbitration *ex aequo et bono*, the arbitrators would not be able to apply *lex mercatoria* without an express authorization by the parties. Goldman examined the relationship between the authority of amiable compositeurs and the application of *lex mercatoria*. In his view, *lex mercatoria* differs from amiable composition in that *lex mercatoria* has the status of law, which is, in its application, indifferent to whether the results in a particular case are equitable. The rules of *lex mercatoria* are applied as they are, independently of the equitable or inequitable results.¹⁰⁵⁶ Nevertheless, he argued that an amiable composition clause may encourage the arbitrator to apply *lex mercatoria* since customary rules of international commerce generally correspond to equity inasmuch as they are founded on the particular needs of international trade and on the rule of good faith.¹⁰⁵⁷

Many commentators in international arbitration consider an authorization to decide in equity as an invitation for taking into consideration the general principles of law and international trade usages, as nothing prevents an arbitrator in equity from taking inspiration from *lex mercatoria* to guide or strengthen his sense of equity.¹⁰⁵⁸ There are also objections to taking this approach too seriously and considering this as a duty of the arbitrators in equity. Those objections are based on the distinction between arbitration in law and in equity. It is argued that an amiable compositeur or an arbitrator in equity does not have to resort to another “law” in order to exercise his powers and to search for the solution in another legal order which, purportedly, consists in the *lex mercatoria*.¹⁰⁵⁹ Even so, it is generally acknowledged that an arbitrator empowered to act as amiable compositeur or to decide *ex aequo et bono* may take inspiration from the *lex mercatoria*, although he does not have to apply it in order to adopt a solution, which derogates the applicable national law, or even provisions of the contract.

In essence, the distinction between *lex mercatoria* on the one hand and the amiable compositeur and the arbitration in equity on the other can be made on the basis that arbitrators, in the latter cases, can resort entirely to their sense of equity which is a form of

predictability and certainty and confers upon parties to an international commercial contract or their arbitrators powers that no system of law permits and no court could exercise.”

¹⁰⁵⁶ Goldman, Berthold, *Lex mercatoria*, *Forum Internationale* No. 3, Deventer, November 1983, at 19; It is similarly argued that in spite of common traits, there is a difference between *lex mercatoria* and equity that *lex mercatoria* obliges the arbitrator to base his decision on the law merchant even when equity might lead him to another result. Lando, Ole, *The Lex Mercatoria in International Commercial Arbitration*, *International and Comparative Law Quarterly*, 34 (1985), at 754-755

¹⁰⁵⁷ Goldman, Berthold, *Lex mercatoria*, *Forum Internationale* No. 3, Deventer, November 1983, at 12

¹⁰⁵⁸ Maniruzzaman, A. F. M., *The Arbitrator’s Prudence in Lex Mercatoria: Amiable Composition and Ex Aequo et Bono in Decision Making*, *Mealey’s International Arbitration Report*, 18-12 (December 2003), at 4: “It is well known that the *lex mercatoria* is not a well developed or mature legal system and is in fact in a state of flux. In such a fluid situation of the *lex mercatoria* the arbitrator may arrive at *lex* via amiable composition and *ex aequo et bono*. Thus the arbitrator can develop the *lex mercatoria* by equity, fairness and natural justice principles which are not already part of the *lex mercatoria* but are made part of it by virtue of their appropriateness or suitability in the circumstances to reach a fair settlement of the dispute at his disposal.... It has thus to be acknowledged that it is not so much of the *lex mercatoria* itself as a body of rules or principles that is important, but the quality of its being contextual as well as its responsiveness to the legitimate expectation of the parties what make it acceptable to the parties. It is where the strength of the *lex mercatoria* lies in the international business community here and now and will well do into the distant future.”

¹⁰⁵⁹ Poudret, Jean-Francois & Sebastien Besson, *Comparative Law of International Arbitration*, London: Sweet & Maxwell, 2nd ed., 2007, at para. 716

abstract reasoning, without consolidating any materials, in giving effect to the reasonable expectations of the parties. Thus, amiable composition and arbitration in equity denote a wider delegation by the parties to the specialized decision maker in the control of legal uncertainty. While *lex mercatoria* would involve the application of the established rules in a particular case that should be discovered by means of the specialized consolidations of the decision maker exercising an abstract reasoning, amiable composition or arbitration *ex aequo et bono* would authorize arbitrators to depart from any established rule and to look to the fairness of their decision on the basis of a purely abstract reasoning. The modern *lex mercatoria* doctrine attempts to draw a clear line between application of the *lex mercatoria* and amiable composition or arbitration in equity by maintaining that *lex mercatoria* requires the decision maker to apply rules of law and not to solely base its decision on equity, in order to avoid criticism that arbitrators acted as amiables compositeurs or decided *ex aequo et bono* without being duly authorized by the parties. However, their distinction rests upon the assumption that *lex mercatoria* at least consists of autonomous legal rules, which can be easily distinguished from the considerations of equity. Since their position with regard to trade usages and general principles as autonomous rules or composing an autonomous legal system is not convincing and they can easily be considered as sources of equity, their conclusion that application of the *lex mercatoria* cannot be identified with amiable composition or arbitration in equity may also be questioned.

For international contracts, the application of equity within the context of *lex mercatoria* means that a decision maker has certain amount of power of discretion, i.e. the capacity for exercising an abstract reasoning in specialized consolidations, to interpret, supplement and correct the articulated rules, which includes both terms of contracts and, if any, the chosen set of default rules, on the basis of the established rules. Whenever a decision maker is empowered to decide in accordance with *lex mercatoria*, the understanding of equity is in the sense of both *infra legem*, i.e. equity within the law between the parties, where the decision maker is allowed to select from one of several possible interpretations of the law so as to achieve the most equitable result, and may inspire himself by equity particularly if the law leaves to him a margin of discretionary power in interpreting, supplementing or intervening in the articulated or established rules, and *praeter legem*, i.e. equity in addition to the law between the parties, where the decision maker will make use of equity to fill such a gap in the law that it is no longer possible to refer to equity *infra legem*. A decision maker's capacity to act as amiable compositeur or to decide *ex aequo et bono* give seems to imply a decision on the basis of "absolute equity" and the power to act *contra legem*, namely in derogation of the law, through abstract reasoning and without any specialized consolidations, when the enforcement of articulated or established rules lead to an inequitable result according to the sense of equity of the decision maker.

In accordance with such an understanding of equity, the amiable composition and arbitration *ex aequo et bono* have been defined "in an essentially negative fashion as the arbitrators' power not to restrict themselves to applying rules of law, thereby allowing them not only to ignore rules of law altogether, but also to depart from them to the extent that their conception of equity requires."¹⁰⁶⁰ The equity in this definition reflects the decision maker's power to act *contra legem*. Thus, in the context of amiable composition and arbitration in equity, the main issues are "whether and, if so, to what extent, an arbitrator who is so authorized can disregard

¹⁰⁶⁰ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 837

either the provisions or law that would otherwise apply or the terms of the parties' contract."¹⁰⁶¹

However, the arbitrators may not be willing to base their decisions solely on their abstract reasoning in the form of equity contra legem, when they are concerned about rendering accurate and persuasive decisions. Moreover, as the national courts have constantly recalled, an amiable compositeur or arbitrator in equity is not dispensed from respecting procedural principles, such as the right to be heard, the duty to give reasons or the prohibition of deciding ultra petita.¹⁰⁶² While amiable composition or arbitration in equity only concerns the decision on the merits, and not the procedure to be followed, lex mercatoria is about the whole process of the adjudication, including both substance and procedure. Thus, lex mercatoria has still relevance to those arbitrators empowered to act as amiable compositeurs or to decide ex aequo et bono, through procedural safeguards, particularly pursuant to the duty to give a reasoned award established under institutional arbitration rules and arbitration laws.¹⁰⁶³ The application of lex mercatoria at the conflict of laws stage or to the substance of the dispute may help the arbitrators empowered to act as amiable compositeurs or to decide ex aequo et bono in rendering an accurate decision through a proper reasoning and giving effect to the reasonable expectations of the parties, which should be the ultimate aim of any arbitral proceedings. Thus, some arbitrators tend to apply lex mercatoria as the law of principled adjudication at the conflict of laws stage or to the substance of the dispute, despite being authorized to act as amiable compositeurs or to decide ex aequo et bono thereby empowered to use equity contra legem.

The relationship between the powers of amiable compositeur or arbitrator in equity and the legal rules of the otherwise applicable law first depends on the formulation of such arbitration clauses giving the arbitrators those powers. The parties may stipulate a certain national law applicable to the dispute, while giving the arbitrators the power of an amiable compositeur. In such cases, the arbitrators may depart from the application of that national law, if its application would produce unfair results. ICC Case No. 2216 where the contract stipulated, on the one hand, that a certain national law is applicable to the resolution of any dispute and, on the other hand, that the arbitrators shall have the power of amiable compositeurs, the arbitral tribunal held that the use of amiable composition, to the extent that the arbitrators do not disregard the mandatory rules of law of the chosen national law, implies the freedom to override non-mandatory rules and to rule in equity.¹⁰⁶⁴ In a similar situation, the sole arbitrator in ICC Case No. 10728 decided to start from the application of the law chosen by the parties, but retaining the possibility of departing from that law by ruling in equity, if need

¹⁰⁶¹ Derains, Yves & Eric A. Schwartz, *A Guide to the New ICC Rules of Arbitration*, Kluwer Law International, 2nd ed., 2005, at 245

¹⁰⁶² Poudret, Jean-Francois & Sebastien Besson, *Comparative Law of International Arbitration*, London: Sweet & Maxwell, 2nd ed., 2007, at para. 716

¹⁰⁶³ For example, in ICC arbitration, this duty flows from the ICC court's practice applicable to all awards to be approved by it whether arbitrators are deciding strictly according to the law or not, and is based on the principle that the parties have a right to be informed of the reasons for the award. Jarvin, Sigvard, *The Sources and Limits of the Arbitrator's Powers*, *Arbitration International*, 2 (1986), at 158; French courts have reinforced the duty to give reasons, holding that if an amiable compositeur decides solely based on rules of law, he should explain why these rules or the provisions of the contract were in conformity with equity, and why he felt it unnecessary to depart from them in the case. Poudret, Jean-Francois & Sebastien Besson, *Comparative Law of International Arbitration*, London: Sweet & Maxwell, 2nd ed., 2007, at para. 716

¹⁰⁶⁴ ICC Award in Case No 2216, *Collection of ICC Arbitral Awards*, Vol. I (1974-1985), at 224

be.¹⁰⁶⁵ Thus, when the amiable composition clause is combined with choice of a national law, the chosen national law is subordinated to the powers of amiable compositeur, and equity considerations prevail over the national law, except for the relevant public policy considerations.

In an arbitral award rendered under the auspices of Camera Arbitrale Nazionale e Internazionale di Milano, the contract underlying the dispute did not contain a choice of law clause, but, at the outset of the arbitral proceedings, the parties agreed that the dispute would be settled in conformity with the UNIDROIT Principles and *ex aequo et bono*, thereby combining the powers of amiable compositeur with a form of choice of *lex mercatoria*. The sole arbitrator, although empowered to decide *ex aequo et bono*, applied a number of provisions of the UNIDROIT Principles.¹⁰⁶⁶ The arbitrator exercised his *ex aequo et bono* powers only in reducing the amount of damages at his discretion, by deducting the costs which the aggrieved party would have incurred in the performance of the contract, but this form of equity should be considered as *infra legem*. At the end of the award, the arbitrator stated that the conclusions reached by the application of the UNIDROIT Principles “are not to be modified or mitigated in equity, the application of which the parties wished to moderate possible excesses of the law” since “[t]he application of the law appears to lead to a satisfying balance of interests.”¹⁰⁶⁷

In most cases, the parties simply include an amiable composition clause without any further indication as to the applicable law. In such cases, the arbitrators are by no means obliged to apply a national law or *lex mercatoria* to the substance of the dispute.¹⁰⁶⁸ They may resolve the dispute simply by exercising their abstract reasoning without consolidating any materials for discovering the established rules in a particular case. In ICC Case No. 3267, for example, it is stated that “the arbitral tribunal needs not to decide which specific law governs the contractual relationship between the parties.”¹⁰⁶⁹ Similarly, in ICC Case No. 9669, the arbitral tribunal held that “it is generally accepted that an arbitrator acting as amiable compositeur does not have to apply a specific legal system, but enjoys a greater flexibility and may resort

¹⁰⁶⁵ ICC Award in Case No. 10728, ICC International Court of Arbitration Bulletin, 18-1 (2007), at 98

¹⁰⁶⁶ In particular, the sole arbitrator referred to Article 1.3 in relation to the principle of *pacta sunt servanda*; Articles 4.1 and 4.2 for the interpretation of a party’s written notice of termination; Article 7.3.1 on the question of fundamental non-performance as a requirement for termination and in excluding the right to terminate the contract for an event which the parties had made express provision for the renegotiation of the contract; Article 7.3.5 to confirm the validity of a contract term which, in the event of termination, expressly grants to the principal the right to restitution of promotional material and to the agent the right to a commission for orders so far received; Articles 7.4.1 and 7.4.2 with regard to the principle of full compensation for the harm the aggrieved party sustained as a result of the other party’s non-performance but to exclude compensation for emotional suffering and distress, where the aggrieved party being a corporate entity; Article 7.4.4 containing the principle of foreseeability in excluding compensation for the costs incurred by the aggrieved party for the purchase of a house in the place where the contract was to be performed; Article 7.4.9 to grant, as a last resort, interest at the statutory rate fixed by the law of the state of the currency of payment; Article 7.4.13 in upholding a contract term providing for a higher rate of interest for the delay in the payment of certain specific debts. Chamber of National and International Arbitration of Milan, Final Award in Case No. 1795, December 1, 1996, Yearbook Commercial Arbitration, 24a (1999), at 196-206

¹⁰⁶⁷ *Ibid.*, at 206

¹⁰⁶⁸ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 837

¹⁰⁶⁹ ICC Award in Case No 3267, 1979, Yearbook Commercial Arbitration, 7 (1982), at 98

to other criteria, such as the factual circumstances of the case, as well as, the terms of the relevant contract, in order to reach an equitable result.”¹⁰⁷⁰

Lex mercatoria as the law of principled adjudication may provide guidance for the arbitrators empowered to decide as amiable compositeurs or ex aequo et bono, by directing them to look for reasonable expectations of the parties in the established rules in a particular case, which may be in the form of a national law or derived from the common solutions provided by the various legal systems connected with the dispute. In ICC Case No 5118, the arbitral tribunal was of the opinion that the power of amiable composition in no way ruled out an assessment of the parties' respective rights with regard to a given system of law. According to the tribunal, starting from this assessment of the parties' respective rights, it should decide, as amiable compositeur, whether it intends to use this power conferred upon it by the parties so as to adopt in its award a solution more in keeping with equity than with the strict application of rules of law. Thus, the tribunal applied lex mercatoria at the conflict of laws stage in order to find the established rule of conflict applicable in the case. The arbitral tribunal found the established rule of conflict by considering the private international laws of the countries connected to the dispute, “international custom”, and the 1955 Hague Convention on the law applicable to contracts for the international sale of goods, although not ratified by all legal systems connected to the dispute, and decided to apply a national substantive law and to exclude its effects if need be.¹⁰⁷¹

The arbitrators empowered to act as amiable compositeurs or to decide in equity should take into account that such authorizations by the parties may indicate their unwillingness to have their contract governed by the particular provisions of the national laws. However, the arbitrators may still look into the parties' pleadings during the proceedings, which may provide indications as to the legal sources that can be utilized in the considerations of equity. In ICC Case No. 10049, where the parties invoked the application of different national laws although having authorized the arbitrators to act as amiable compositeurs, the tribunal determined one of those national laws as applicable. The tribunal stated that “When requested to act as “amiable compositeurs”, the arbitrators must take into account the equities of the case, in order to reach a decision which is “equitable”. In doing so, they may take into consideration - in whole or in part - or not take into consideration, the applicable law (subject only to application of its rules of public policy).” According to the tribunal, amiable composition should form the basis of its authority since, from the very beginning of the arbitration, none of the parties challenged the concept that the tribunal should act as amiables compositeurs.¹⁰⁷²

In ICC Case No. 12070, the tribunal stated that “the authorization to decide ex aequo et bono does not place the Tribunal in a legal vacuum, completely unrelated to the legal regime or particular national law to which each party ... must have conferred when determining its conduct in concluding and performing its rights and obligations. In this respect, arbitrators, when deciding ex aequo et bono, may refer to the applicable substantive law, but they are not bound to apply it.”¹⁰⁷³ The tribunal also considered that there was no evidence “that would demonstrate that the parties had the intention to restrict the Tribunal's power to the effect that

¹⁰⁷⁰ ICC Award in Case No. 9669, ICC International Court of Arbitration Bulletin, 18-1 (2007), at 86

¹⁰⁷¹ ICC Award in Case No 5118, 1986, Journal Du Droit International, (1987), at 1027

¹⁰⁷² ICC Award in Case No. 10049, ICC International Court of Arbitration Bulletin, 18-1 (2007), at 89

¹⁰⁷³ ICC Award in Case No 12070, ICC International Court of Arbitration Bulletin, 18-1 (2007), at 109-110

it must strictly abstain from taking any guidance from the ratio scripta contained in national law.” The tribunal stated that “When taking a particular national law into consideration . . . , an Arbitral Tribunal invested with the power to decide ex aequo et bono is not bound to apply each particular rule of such law (except for public policy reasons which are not relevant in this dispute). The Tribunal's decision has to be based on equity considerations which may lead to solutions different from those resulting from the applicable law.” The tribunal added that, “Such an approach is important and useful when a transaction involves parties from different countries and legal cultures. In such a case, equity and fairness may require not to confront one party with legal solutions which are familiar to the other party only.”¹⁰⁷⁴

The parties’ pleadings during the proceedings, as indications of their reasonable expectations, may also direct the arbitrators, who are empowered to act as amiable compositeurs or to decide ex aequo et bono, to resort to lex mercatoria when they wish to accommodate such pleadings in the final award for more accurate and persuasive decisions. In ICC Case No 3540, although the arbitrators were empowered to act as amiable compositeurs, both parties pleaded for the application of different national laws on the basis of conflict of laws arguments. The tribunal noted that “the most recent and authoritative doctrine as well as the jurisprudence of arbitrators, especially that of the ICC acknowledge that, in determining the substantive law, arbitrators may avoid the rules of conflict of the forum, the more so if they have the power of amiables compositeurs” and “in practice, one of the methods used by international arbitrators is that of the ‘direct approach’ (*voie directe*), either by the direct determination of an applicable national law chosen in view of the circumstances of the contract and of the dispute, or by basing themselves uniquely on the contract and the general and common legal principles.”¹⁰⁷⁵ By adopting the direct method, the tribunal decided to apply lex mercatoria to the substance of the dispute as the implicit choice of the parties at the moment when the contract was concluded. However, the tribunal held that it was not appropriate to avoid all references to a national law and it should examine whether the solution contained in its award based on lex mercatoria would be fundamentally different from that resulting from national law or rather from the two national laws invoked by the parties: Swiss law and French law.¹⁰⁷⁶

Thus, in some cases, the arbitrators empowered to act as amiable compositeurs or to decide in ex aequo et bono have considered the application of lex mercatoria to the substance of the dispute as the most appropriate method of reaching equitable conclusions. In an ad hoc arbitration in Buenos Aires, the contract did not contain a choice of law clause and the parties authorized the arbitrators to act as amiables compositeurs. Although both parties based their claims on specific provisions of Argentine law, the tribunal decided to apply the UNIDROIT Principles because, according to the tribunal, they constituted “usages of international trade reflecting the solutions of different legal systems and of international contract practice”, and, according to Art. 28(4) of the UNCITRAL Model Law on International Commercial Arbitration, they should prevail over any domestic law.¹⁰⁷⁷

¹⁰⁷⁴ Ibid., at 109

¹⁰⁷⁵ ICC Award in Case No. 3540, 1980, Yearbook Commercial Arbitration, 7 (1982), at 128

¹⁰⁷⁶ Ibid., at 129

¹⁰⁷⁷ Ad hoc Arbitration, Buenos Aires, 10 October 1997, Abstract published in English and French in Uniform Law Review, (1998), at 178-180

In another ad hoc award dated November 3, 1977, the arbitrators were empowered to decide as amiable composituers in the resolution of a dispute between Belgian and English parties. The tribunal noted that under English law, amiable composition could not effectively take place, and under Belgian law, its validity was dependent on the confirmation, which was lacking in the case. However, as the arbitration took place in France and the application of French law corresponded to the objective criterion of the localization of the arbitral tribunal, the tribunal held the amiable composition clause valid and effective. The tribunal went on to determine the intention of the parties as to the application of a specific law. In the absence of any serious indication to that effect, the tribunal considered the objective localization of the contract through the criterion of the characteristic performance, which, in its view, was most generally acknowledged. This would lead to the application of English law, but, according to the tribunal, the parties “clearly expressed as their intention that they have indeed sought to give the amiable composition an extremely comprehensive meaning and sought to help possible litigations escape from any national law.” The tribunal also noted “in an arbitration of this nature ‘the arbitrator is not necessarily obliged to determine a national law applicable to the substance’”. “Having established that the character of the contract, and the place where it has its effect, necessarily exclude an obligatory application of either Belgian or English law”, the arbitrators decided to “abide by the ‘lex mercatoria’ in the exercise of their power as *amiabiles composituers*.”¹⁰⁷⁸

In ICC Case No 3267, where the arbitrators were empowered to act as amiable composituers, none of the parties referred to a specific legal system at no point in the proceedings, except for Belgian law, which was referred to by the claimant in connection with the authority of the arbitral tribunal to act as amiable composituers.¹⁰⁷⁹ The claimant argued that the legal issues in the proceedings may be resolved with reference to general principles of commercial law, while the defendant reserved its arguments on the matter. Thus, the tribunal considered that the pre-determination of a specific legal system was unnecessary to enable the tribunal to decide upon the issues in the proceedings, given the silence of both parties on the question of governing legal system. The tribunal decided to apply “the widely accepted general principle governing commercial international law with no specific reference to a particular system of law.”¹⁰⁸⁰ In dealing with the merits of the dispute, although noting that no national legal system should have a significant effect on a dispute to be resolved under the general law of contract by arbitrators acting as amiable composituers, the tribunal found it worth mentioning that the method of compensation of damages adopted by the tribunal was also acceptable under Belgian law.¹⁰⁸¹

Thus, the reasoning of the arbitrators granted with the powers of amiable composituers or arbitrators in equity reflects a tendency to consolidate the solution in equity with a solution at law.¹⁰⁸² Moreover, the arbitrators still have to observe the relevant public policy contents of national legal systems, even if they are entitled to act as amiable composituers or to resolve the dispute ex aequo et bono. In ICC Case No. 3540, the arbitrators stated that “Considering

¹⁰⁷⁸ Ad hoc Award in *Mechema Ltd v. S.A. Mines, Minerais et Metaux*, *Yearbook Commercial Arbitration*, 7 (1982), at 79

¹⁰⁷⁹ ICC Award in Case No 3267, 1979, *Yearbook Commercial Arbitration*, 7 (1982) at 97

¹⁰⁸⁰ *Ibid.*, at 98

¹⁰⁸¹ *Ibid.*, at 103

¹⁰⁸² Kiffer, Laurence, *Amiable Composition and ICC Arbitration*, *ICC International Court of Arbitration Bulletin*, 18-1 (2007), at 56

that, having the power of *amiables compositeurs*, the arbitrators should look even closer at the circumstances of each specific case, and accompany their partial decision with measures to safeguard the legitimate rights of each party, since ‘they have been given the opportunity to put the principles of equity above the strictness of law, deciding in accordance with their conscience, *ex aequo et hono*’ ... or ‘in equity’...; that the *amiable compositeur* is thus authorized to set aside the application of the law within the limits set by the mandatory provisions of the applicable legal system”.¹⁰⁸³ In ICC Case No 9669, the parties agreed to give the arbitrator the powers of an *amiable compositeur* and to decide the case “according to the principles of equity”, and the parties neither disputed this provision nor argued that a specific legal system should be the governing law of the arbitration. The arbitrator noted that “the arbitrator, in the exercise of his powers of *amiable compositeur*, must still adhere to the terms of the contract and only deviate from them when it is necessary for the sake of fairness” and cited ICC Case No 3267 where it was stated that “the paramount duty of the arbitrator, even as ‘*amiable compositeur*’, is to apply the contract of the parties, unless it is shown that the provisions relied on are clearly against the true intent of the parties, or violate a basic commonly accepted principle of public policy.” Moreover, according to the arbitrator, “the powers of *amiable compositeur* do not discharge the arbitrator from his duty to motivate the award.” On the basis of these considerations, the arbitrator decided to apply the terms of the contract between the parties, and general principles of international commercial law in the light of the specific circumstances of the case.¹⁰⁸⁴

Another issue related to the powers of the arbitrators as *amiable compositeurs* or deciding *ex aequo et bono* is that whether they can depart from the provisions of the contract where they consider that to apply them directly would lead to inequitable results. The idea that the arbitrators acting as *amiable compositeurs* or deciding in equity may utilize the powers of equity *contra legem* makes this issue more delicate in view of the potential of arbitrary decision making. It is argued that the terms of the contract may not be modified by the *amiable compositeur* or arbitrator in equity.¹⁰⁸⁵ This argument is supported by the wording of some arbitration laws and rules. The UNCITRAL Model Law includes *amiable composition* in the article titled “Rules Applicable to Substance of Dispute”, which further provides in the last paragraph that “in all cases, the arbitral tribunal shall decide in accordance with the terms of the contract”. Similarly, ICC Rules of Arbitration of 1998 requires the arbitrators to take account of the provisions of the contract and the relevant trade usages in all cases, and this requirement is included into the same article with the provision on *amiable composition* and arbitration *ex aequo et bono*, namely Article 17.

However, the formulation found in the ICC Rules have led to questions about whether the arbitrators are really bound by that requirement even in those cases where they can act as *amiable compositeurs* or decide *ex aequo et bono*. It is argued that the requirement to take into account contractual terms only concerns the arbitration in law. Arbitration in law is regulated in the paragraph 1 of Article 17 of the 1998 ICC Rules, and the requirement to take into account contractual terms is interposed in the paragraph 2 of the same article, while the possibility to grant the power of *amiable compositeur* is introduced by the paragraph 3. This argument is also supported by the observation that the previous version of the ICC Rules of Arbitration (1988) presented a different order, which placed the requirement to take into

¹⁰⁸³ ICC Award in Case No. 3540, 1980, Yearbook Commercial Arbitration, 7 (1982), at 131

¹⁰⁸⁴ ICC Award in Case No. 9669, ICC International Court of Arbitration Bulletin, 18-1 (2007), at 86

¹⁰⁸⁵ Jarvin, Sigvard, The Sources and Limits of the Arbitrator's Powers, Arbitration International, 2 (1986), at 158

account contractual terms in the last paragraph thereby indicating to cover both arbitration in law and amiable composition.¹⁰⁸⁶ The new ICC Rules of Arbitration in force as from 1 January 2012 has retained the order of the paragraphs of the relevant provision of the 1998 version, and even removed the phrase “in all cases” with regard to the arbitrator’s obligation to take into account the contract terms and trade usages.¹⁰⁸⁷

In the doctrine, it is generally argued that amiable compositeurs or arbitrators in equity may not rewrite the contract, but they may adjust or disregard certain contractual provisions without creating new obligations.¹⁰⁸⁸ This view has also been adopted in some arbitral awards. In ICC Case No 9704, the arbitrators acting as amiable compositeurs held that they may not alter the bargain of the parties, so “while keeping within the basic terms of the Parties’ bargain, [the arbitrator] shall free, if she deems it fair and equitable, to depart from the strict application of the Contract”.¹⁰⁸⁹ In ICC Case No. 7913, it was held that amiable compositeurs can reduce or remove the effects of a contractual provision that would appear to be excessive for one of the parties or that would be unfair, given the nature of the contract and the circumstances.¹⁰⁹⁰

The premise of this approach is that, as arbitrators empowered to rule in equity are entitled not to apply legal rules where they consider that those rules would lead to an inequitable result, they could decide, on the same basis, not to apply the rule that contracts are binding.¹⁰⁹¹ This view is challenged by others, who argue that, since it is within the framework of the contract that the parties confer on the arbitrator the power of amiable compositeur so as to be able to correct the inequitable effect of applicable legal provisions, it is unrealistic to presume that the parties intended to oust not only the law, but also the contract itself. It is pointed out that such a presumption contradicts such legal provisions that simultaneously impose that the arbitrator should conform in all events, and thus also in the context of amiable composition, to the provisions of the contract.¹⁰⁹²

Regardless of the formulations of the relevant arbitration laws or rules with regard to the relationship between the powers of amiable compositeurs and the arbitrator’s duty to take into account the terms of the contract, the basic principle of *pacta sunt servanda* under *lex mercatoria* should be the starting point for the decision making process in such cases. The arbitrator in ICC Case No. 12772 concluded that he should take into account contract terms on the basis of the principle of *pacta sunt servanda*. Considering that the limits of the power of amiable compositeur as being the principles of public policy and that “one of those principles

¹⁰⁸⁶ Bertrand, Edouard, *Amiable Composition: Report of ICC France Working Group*, *International Business Law Journal*, (2005), at 759

¹⁰⁸⁷ Article 21 of the ICC Rules of Arbitration, in force as from 1 January 2012

¹⁰⁸⁸ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 840

¹⁰⁸⁹ ICC Award in Case No. 9704, 2000, ICC International Court of Arbitration Bulletin, 18-1 (2007), at 88

¹⁰⁹⁰ ICC Award in Case No. 7913, June 1996, ICC International Court of Arbitration Bulletin, 18-1 (2007), at 67

¹⁰⁹¹ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 840; ICC Award in Case No 4972, *Journal du Droit International*, (1989), at 1000: The tribunal found that based on its authority to mitigate strict law it may also mitigate, i.e. not apply in their strict sense, contractual provisions, the application of which would conflict with equity.

¹⁰⁹² Poudret, Jean-Francois & Sebastien Besson, *Comparative Law of International Arbitration*, London: Sweet & Maxwell, 2nd ed., 2007, at para. 715

is the doctrine of *pacta sunt servanda*”, the arbitrator believed that he should respect the terms as established in the agreement between the parties since the parties “should see that their fair and reasonable expectations are respected.” Moreover, the arbitrator considered himself as “bound by the terms of the agreements between the parties through Article 17 (2) of the Rules”. According to the arbitrator, the formulation of Article 17 of the 1998 ICC Rules should not be “interpreted in a way that an arbitrator acting under the Rules and applying ‘*ex aequo et bono*’ is not bound by the terms of the agreement between the parties.”¹⁰⁹³ In ICC Case No 9669, the arbitrator stated that “The Arbitrator, even acting as *amiable compositeur*, is bound by the general principle “*pacta sunt servanda*” and thus must respect and apply the contractual provisions. Pursuant to the principle “*pacta sunt servanda*”, the Defendant was obliged to abide by the provisions of the Contract which are the expression of the free will of the Parties.”¹⁰⁹⁴

The basic principle of *pacta sunt servanda* should be inherent to the equity considerations of the arbitrators, even if they understand equity in the sense of *contra legem*, in order not to defeat the parties’ reasonable expectations. This view was also expressed by the arbitral tribunal, in ICC Case No. 3938 of 1982 where it was held that “the view most widely accepted by authors and international arbitral practice is that an arbitrator acting as *amiable compositeur* remains bound by the contract...; the considerations which may lead the arbitrator to correct distortions which may result from a strict application of the provisions of the law to the particular circumstances of the case are not valid with regard to the contract, which is a special set of rules resulting from the parties’ own intentions.”¹⁰⁹⁵ Thus, it can be argued that, in order to depart from the contract terms and from the basic principle of *pacta sunt servanda*, the arbitrators acting as *amiable compositeurs* or deciding *ex aequo et bono*, rather than relying entirely on equity *contra legem*, may consider the equity *infra* or *praeter legem* through the basic principle of good faith and fair dealing under *lex mercatoria* thereby drawing inspiration from such established rules as *rebus sic stantibus* or abuse of rights, in order to decide on the matter in a reasoned manner giving effect to the reasonable expectations of the parties.

In ICC Case No 3267, the tribunal stated that “Although some legal writers have expressed the opinion that arbitrators sitting as ‘*amiables compositeurs*’ may disregard the provisions of the agreement between the parties, this view has not been accepted in international arbitration. On the contrary, it is a generally accepted principle in international arbitration that the paramount duty of the arbitrator, even as ‘*amiable compositeur*’, is to apply the contract of the parties, unless it is shown that the provisions relied on are clearly against the true intent of the parties, or violate a basic commonly accepted principle of public policy.” The tribunal added that “the arbitrators sitting as ‘*amiable compositeur*’ is entitled to disregard legal or contractual rights of a party when the insistence on such right amounts to an abuse thereof.” According to the tribunal, “this authority is of particular importance in legal systems that have not developed an extensive theory of ‘abuse of right’, such as Swiss law under Art. 2 of its Civil Code.”¹⁰⁹⁶

¹⁰⁹³ ICC Award in Case No. 12772, 2004, ICC International Court of Arbitration Bulletin, 18-1 (2007), at 114

¹⁰⁹⁴ ICC Award in Case No. 9669, ICC International Court of Arbitration Bulletin, 18-1 (2007), at 87

¹⁰⁹⁵ French Purchaser v. Dutch Seller, *Journal du Droit International*, 111 (1984), p. 926 cited by Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 839

¹⁰⁹⁶ ICC Award in Case No 3267, 1979, *Yearbook Commercial Arbitration*, 7 (1982), at 105

This approach is in line with the classic formulation of national contract laws, which allow the judge to ignore, modify or sanction contractual provisions when their assertion amounts to an abuse of right in certain circumstances, such as the doctrines of lesion, changed circumstances, and reduction of excessive penalty clauses. For instance, the arbitrator in ICC Case 12772, without referring to any national law, stated that “an arbitrator deciding under the authority of *ex aequo et bono* should, to the extent the wording of the agreement is clear, not alter the terms of the agreement; he may do so only under very specific circumstances, in particular if he is to apply the further principle of *clausula rebus sic stantibus*.”¹⁰⁹⁷

In ICC Case No. 10504 regarding a dispute arising from a set-off agreement whereby the respondent undertook to compensate the claimant for the loss it suffered as a result of the fraudulent disappearance of goods under the respondent’s custody and control, the arbitrator, having found as a fact that the respondent signed the set-off agreement under pressure, stated that “Threat is considered in all systems of law as a legitimate ground for the party to avoid the contract” and referred to Article 3.9 and 3.11 of the UNIDROIT Principles. The arbitrator, using his powers of “*amiable compositeur*”, held that although the party who has been victim of a threat may usually at law avoid the contract totally or partially and receive damages, “it is fair and reasonable having regard to the circumstances to reduce by half the amount of damages which the Claimant was entitled to be paid under the Set-off Agreement.”¹⁰⁹⁸

In ICC Case No. 12099, the arbitral tribunal, as an *amiable compositeur*, stated that “The contractual interest rate, as interpreted by the parties, appears to be vastly in excess of interest rates currently enforced in dollar-based international loans.” The tribunal apparently attempted to use equity *infra legem* by considering that it is “entitled, when a contractual provision may be interpreted in several ways, to interpret that provision in the manner producing the best results from the standpoint of equity.” The tribunal was of the view that “its powers of *amiable compositeur* allow it to reduce the amount due under a contractual default interest formula if this amount would be inequitable, or to interpret or apply a contractual default interest formula in a manner yielding equitable results.” According to the tribunal, this was particularly the case in the present circumstances where the party owing the interest does not appear to have negotiated, or had an opportunity to negotiate the details of the contractual terms, but instead to have simply signed off a standard order form presented by the other side. Thus, the arbitral tribunal stated that, “equity is best served by interpreting the contractual interest formula as saying that the rate of 1.8% per month referred to in the Contract is to be understood as a one month rate in a manner consistent with the practice of international financial markets, namely as a per annum rate computed monthly on a compounded basis.”¹⁰⁹⁹

More frequently, due to the increased capacity of arbitrators for abstract reasoning, which results from their authorization to act as *amiable compositeurs* or to decide *ex aequo et bono*, it is possible to observe arbitral awards, where the arbitrators solely rely on equity *contra legem* without broadly qualifying the circumstances of the case that direct them to disregard or adjust a contractual term through abstract insight of the established rules. Such arbitral practice has also been affirmed by some national courts.¹¹⁰⁰

¹⁰⁹⁷ ICC Award in Case No. 12772, 2004, ICC International Court of Arbitration Bulletin, 18-1 (2007), at 114

¹⁰⁹⁸ ICC Award in Case No. 10504, 2000, ICC International Court of Arbitration Bulletin, 18-1 (2007), at 97

¹⁰⁹⁹ ICC Award in Case No. 12099, 2003, ICC International Court of Arbitration Bulletin, 18-1 (2007), at 111

¹¹⁰⁰ In a case where the arbitration clause provided that the arbitrators should decide *ex aequo et bono*, the arbitral tribunal considered to be entitled to disregard the application of a contractual clause limiting excessively

In some cases, while the arbitrators referred to trade usages with regard to the applicable rate of interest, they generally did not explain, on the basis of an inspiration from the established rules, why they overrode the freedom of the parties to set the contractual rate of interest, but focused on the circumstances of the case and relied on their powers of equity *contra legem*. In ICC Case No 8874, the sole arbitrator acting as *amiable compositeur* in accordance with principles of equity, disregarded the contractual rate of interest. With the powers of "*amiable compositeur*", the arbitrator took into account a major accident with important direct and secondary effects on the defendant, but he did not consider the relevant event within the broad terms of *rebus sic stantibus*. Instead, the arbitrator considered that the defendant warned, although in a manner neither formal nor strictly rightful, the claimant, which acknowledged the new situation, and the defendant even showed a token of good faith by offering some indemnity. According to the arbitrator, the contractual interest rate was fixed at a level which is considerably higher than the rates which were usually put in practice in these matters, such as the US Prime Rate, recommended by the UNIDROIT Principles. Thus, the arbitrator stated that "In deciding a case "according to the principles of equity", my view is that the initial contractual interest rate, if applied to the considered amount and period of time, would be disproportionate with the economic and commercial conditions of this case", and substituted the US Prime Rate to the initial contractual rate for the delayed payment owed to the claimant by the defendant.¹¹⁰¹

In ICC Case No. 9483, the arbitrator who had the powers of an *amiable compositeur*, considered himself entitled to review the consequences of contractual provisions and to depart from a strict enforcement of such provisions within the limits of the contract's global balance. The arbitrator, considering that ICC Rules of Arbitration compels him to apply not only the contract terms but also trade usages, did not grant the claim of interest based on the contractual interest rate for a payment in US dollars, which was "too high in view of equity and trade usages and should be adapted in order to cope with the evolution of the economic circumstances" since "such a rate would (1) not serve the sole purpose of serving as interest rate without a massive depreciation of the US dollar and (2) would too hardly damage the Defendant, especially in view of the fluctuation of the exchange rates between US dollar and the [State X currency]."¹¹⁰²

In other cases, the reasoning of equity *contra legem* in striking down the contractual rate of interest was even more prevalent. In ICC Case No. 9655, the arbitral tribunal, using its powers to decide the case according to the principles of equity, reduced the contractual interest rate in view of the evolution of the general trends of interest rates, apparently without

the amount of damages. The Swiss Federal Tribunal approved this solution, but it also pointed out such decision was not in contradiction with the understanding of equity *infra legem* by stating that "even if it had not been entitled to decide in equity", the arbitral tribunal could have reached the same result in application of French or Swiss law, so that "disregard of the disputed contractual provision is in no way incompatible with public policy". 19 February 1990 - Tribunal fédéral, 1ère Cour civile, ASA Bulletin (1990), at 171, 179 ; The French Court of Cassation also held that the *amiable compositeurs* complied with its task in mitigating the excessive effects of a clause in order to strike a balance between the literal wording of an international long term agreement and its good faith performance in circumstances which would overturn the contractual balance between the parties. *Dame Krebs v. Milton Stern*, Cour de Cassation, 28 April 1987, *Revue de l'Arbitrage*, (1991), at 345

¹¹⁰¹ ICC Award in Case No. 8874, December 1996, ICC International Court of Arbitration Bulletin, 10-2 (1999), at 83

¹¹⁰² ICC Award in Case No. 9483, 1998, ICC International Court of Arbitration Bulletin, 18-1 (2007), at 83

looking into trade usages or practices in that regard.¹¹⁰³ In ICC Case No. 9704, the sole arbitrator held that “it has been confirmed in prior cases and by legal commentators that an arbitrator acting as *amiable compositeur* may decide to reduce penalties under a contract or the interest rate by virtue of his/her powers of *amiable compositeur*”, and she decided to reduce the contractual interest rate, which appeared higher than statutory interest for late payment in the concerned countries and higher than the usual average inter-bank rate for the concerned period.¹¹⁰⁴

It is true that the *amiable compositeurs* or arbitrators in equity are not obliged to discover and apply the established rules in a particular case. Even so, their reasoning can be more accurate with regard to the reasonable expectations of the parties, if they reveal some abstract connections between the facts and the established rules, in explicating their analyses as to why they should disregard or adjust the contractual clauses, since such an approach may allow the parties to the dispute to comment on the reasoning of the arbitrators, and better serve the procedural integrity of the proceedings by enabling the cooperation of the parties for the purposes of accurate determination and giving effect to their reasonable expectations. In the end, although *amiable composition* or *ex aequo et bono* implies the possibility of equity *contra legem*, an extra-legal standard, while applying extra-legal standards, the arbitrator still has to be objective, and not arbitrary or capricious, in his goal to arrive at a fair and just result.¹¹⁰⁵ Thus, a reasoning that draws some inspiration from *lex mercatoria* as the law of principled adjudication may result in a more objective and accurate decision.

¹¹⁰³ ICC Award in Case No. 9655, 1998, ICC International Court of Arbitration Bulletin, 18-1 (2007), at 84

¹¹⁰⁴ ICC Award in Case No. 9704, 2000, ICC International Court of Arbitration Bulletin, 18-1 (2007), at 88

¹¹⁰⁵ Maniruzzaman, A. F. M., *The Arbitrator’s Prudence in Lex Mercatoria: Amiable Composition and Ex Aequo et Bono in Decision Making*, Mealey’s International Arbitration Report, 18-12 (December 2003), at 2

v. Concluding Remarks

The application of *lex mercatoria* at the conflict of laws stage results in two situations under the particular circumstances of the case, as far as the relevance of *lex mercatoria* to the substance of the dispute is concerned. Firstly, *lex mercatoria* as *lex contractus* may govern the substance of the dispute to the exclusion of any particular national law, while the articulated rules are limited to those expressed in the contract. Secondly, *lex mercatoria* as *lex fori* may govern the substance of the dispute in addition to the contractual terms and the rules of a national law, which become applicable either as a result of the choice of the parties or pursuant to the established rules of conflict of laws. In both of these situations, the application of *lex mercatoria* to the substance of the dispute has an *ex post* effect on the articulated rules and on the allocation of the residual contractual rights, obligations and risks under the transactions governed through legal uncertainty.

When the articulated rules include a particular national law chosen by the parties, *lex mercatoria* as *lex fori* require the decision maker to apply its ascertainable rules as part of the bargain and creating specific contractual rights, obligations and risk allocations, regardless of idiosyncrasies of such rules, as long as they are not overridden by the terms of the contract, the implied intentions of the parties, or trade usages in the narrow sense. In the abstract reasoning of the decision maker applying *lex mercatoria*, the contracting parties can be presumed to have diligently investigated, before entering into the contract, the contents of the national law of their choice, and have assumed the legal risks arising from the application of its rules. Those national rules can be overridden mainly by the contractual clauses, which are to be ascertained by interpretation, and by the implied intentions of the parties through specific supplementation, in accordance with the chosen national law. The rules of a chosen national law can also be disregarded through an autonomous understanding of trade usages under *lex mercatoria*, in the sense of commercial practices observed in a certain sector over a sufficient period of time. When the chosen national law does not cover the disputed issue or recognizes a margin of discretionary power, the decision maker should resort to *lex mercatoria* in order to give effect to the reasonable expectations of the parties.

When a national law is presumed to indicate the reasonable expectations of the parties pursuant to an established rule of conflict, the established substantive rules may override and replace the idiosyncratic default rules in accordance with the basic principle of good faith and fair dealing for the purpose of maintaining and preserving the order. However, in order to disregard a national rule, which is found to be applicable pursuant to an established rule of conflict, for being idiosyncratic, the decision maker should at least be able to discover an established rule in the order of international commerce. There are many areas of law where the approaches of national legal systems diverge significantly. If the decision maker in a particular case confronts such a divergence among the national laws that are considered in the specialized consolidations to discover an established rule, the relevant rules of the applicable national law cannot be disregarded by the decision maker for being idiosyncratic, since such a decision would be arbitrary: it would reflect the subjective reasoning of the decision maker about the expectations of the parties, despite the availability of objective considerations through the established rules of conflict. The decision maker should only consider itself competent to resort to his subjective reasoning in controlling the legal uncertainty arising from such divergences, where there are no established rules of conflict that designate a national law, or where the parties expressly or implicitly intended to avoid the application of any particular national law, i.e. in the cases of the application of *lex mercatoria* as *lex contractus* to the substance of the dispute to the exclusion of any particular national law.

Apart from those two situations, *lex mercatoria* can be relevant to the decision maker's considerations of equity, where the decision maker has been authorized by the parties to act as *amiable compositeur* or to decide *ex aequo et bono*, and help him to deliver a reasoned award that accurately gives effect to the reasonable expectations of the parties in a particular case. The capacity to act as *amiable compositeur* or to decide *ex aequo et bono* give implies the power to act *contra legem*, through abstract reasoning and without any specialized consolidations, when the enforcement of articulated or established rules lead to an inequitable result according to the sense of equity of the decision maker. Nevertheless, *lex mercatoria* has still relevance to those decision makers empowered to act as *amiable compositeurs* or to decide *ex aequo et bono*, through procedural safeguards, particularly pursuant to the duty to give a reasoned award. Thus, the arbitrators granted with the powers of *amiable compositeurs* or arbitrators in equity may prefer to consolidate their solution in equity with a solution under *lex mercatoria*. *Lex mercatoria* may also be relevant to the public policy considerations, which the arbitrators have to take into account, even if they are entitled to act as *amiable compositeurs* or to resolve the dispute *ex aequo et bono*. Besides, the basic principle of sanctity of contracts under *lex mercatoria* should be inherent to the equity considerations of such decision makers, even if they understand that equity in the sense of *contra legem* allows them to disregard the contract terms. Thus, in order to depart from the contract terms, the decision makers acting as *amiable compositeurs* or deciding *ex aequo et bono*, rather than entirely relying on equity *contra legem*, may consider the basic principle of good faith and fair dealing under *lex mercatoria* thereby drawing inspiration from such established rules as *rebus sic stantibus* or abuse of rights in explicating their analyses as to why they should disregard or adjust the contractual clauses. Such an approach may allow the parties to the dispute to comment on the reasoning of the decision makers, and better serve the procedural integrity of the proceedings by enabling the cooperation of the parties for the purposes of accurate determination and giving effect to their reasonable expectations.

b. Substance of the Dispute

The application of *lex mercatoria* to the substance of the dispute denotes three activities of the decision maker. First, the decision maker interprets the contract under the guidance of the basic principles of *lex mercatoria* in order to determine and ascertain its meaning and to enforce the specific contractual rights, obligations and risk allocations of the parties. Secondly, when there are some contingencies that are not covered by the ascertainable meaning of the contract, the decision maker supplements the contract with implied terms, which prevail over the default rules that are chosen by the parties or found to be applicable by means of the established rules of conflict. Thirdly, the decision maker intervenes in the contract and determines the limits of the principle of freedom of contract in the order of international commerce by means of the established rules. Through these activities, the decision maker reveals and enforces the law between the parties to a particular contract, which includes the articulated and established rules. The application of *lex mercatoria* to the substance of the dispute requires the decision maker to accurately give effect to the reasonable expectations of the parties to a particular case in accordance with the abstract relations constituting the spontaneous order of international commerce, by maximizing the possibility of expectations of the elements of the order being fulfilled, matched and not conflicting.

These three activities of the decision maker correspond to the functions that Papinian, an influential Roman jurist, attributed to the *ius honorarium* with respect to the *ius civile*: concretization or interpretation (*adiuvare*), supplementation (*supplere*), and correction or limitation (*corrigere*).¹¹⁰⁶ During the classical period of Roman jurisprudence the *ius civile*, which applied to Roman citizens, was administered primarily in the court of the praetor urbanus, while the *ius honorarium*, which was to serve the needs of commerce with aliens, was administered by the praetor peregrinus.¹¹⁰⁷ *Ius honorarium* resulted from the need of adapting the earlier system of remedies under *ius civile*, which had been evolved in terms of typical actions and become stereotyped, to the new circumstances. In order to meet this need, instead of being enlarged, the earlier system was supplemented by another system of remedies, administered in a separate court.¹¹⁰⁸ In effect, the praetor was not making new (substantive) law, but creating new remedies or eroding old ones, and exercising a procedural power. Indirectly, the grant of a remedy in a new case amounted to the recognition of a new right, and the denial of an old remedy to the abolition of the right on which it was based. Although, the Romans adhered to the theory that the praetor had no law-making power, the jurists still referred to these new remedies as *ius honorarium*, ‘law made in office’, to be contrasted with *ius civile*.¹¹⁰⁹ Thus, the praetor had to help, supplement and correct the *ius civile*.¹¹¹⁰

¹¹⁰⁶ Hesselink, Martijn W., The Concept of Good Faith, in A.S. Hartkamp, E.H. Hondius, M.W. Hesselink, C.E. du Perron & M. Veldman, (eds.), *Towards A European Civil Code*, Kluwer Law International, 2004, at 478

¹¹⁰⁷ Yntema, Hessel E., Equity in the Civil Law and the Common Law, *American Journal of Comparative Law*, 15-1/2 (1966-1967), at 61

¹¹⁰⁸ *Ibid.*

¹¹⁰⁹ Johnston, David, *Roman Law in Context, Key Themes in Ancient History*, Cambridge University Press, 1999, at 4

¹¹¹⁰ Du Plessis, Paul J., *Borkowski's Textbook on Roman Law*, OUP Oxford, 4th ed., 2010, at 35

The distinction of Papinian was used by Wieacker in 1956 in order to provide an understanding of the principle of good faith under Section 242 of the German Civil Code and in order to make it teachable to his students.¹¹¹¹ Wieacker tried to assimilate the functions of good faith to those which Papinian had attributed to the praetorian law. These functions are very similar to the distinctions made, although not always clearly, with regard to the functions of good faith in the civilian legal doctrine in general. Under civil legal traditions, first, all contracts must be interpreted according to good faith. Second, good faith has a “supplementing” function as the supplementary rights and duties not expressly provided in the contract or in statutory law. Third, good faith has a “derogating” or “restrictive” function whereby a rule, which binds the parties and is provided in either the text of the agreement or by statute does not apply to the extent that its effect would be contrary to good faith.¹¹¹² It is argued that this distinction of functions of good faith could be regarded as the European common core, if the subtleties were ignored.¹¹¹³

This distinction with regard to the functions of the principle of good faith can also be observed in the framework of the PECL and the UNIDROIT Principles. Under the PECL, all contracts have to be interpreted according to good faith. Furthermore, rights and duties not expressly provided in the contract or in the PECL may be implied into the contract on the basis of the principle of good faith, and a contract term binding upon the parties does not apply to the extent that, in the given circumstances, this would be unacceptable according to the criteria of reasonableness and equity.¹¹¹⁴ Similarly, all three functions of good faith are covered by the UNIDROIT Principles, and this is made explicit in the comments to Article 1.7 referring to a number of provisions of the UNIDROIT Principles, which either directly or indirectly apply the principles of good faith and fair dealing. First, the reference to Articles 4.1 and 4.2 reflects the interpretive function of good faith. Second, the supplementing function is apparent in the reference to Article 5.1.2, which provides that implied obligations may stem from good faith and fair dealing as well as from reasonableness. Finally, the derogating and restrictive function of good faith can be found in the comments of Article 1.7, which mention the “abuse of rights” and refer to Article 7.1.6, which provides that unreasonable exemption clauses may not be invoked, and Article 7.4.13, which provides that a specified sum, stipulated for the case of nonperformance, may be reduced if it is grossly excessive.¹¹¹⁵

Attribution of these functions to the principle of good faith in civil legal traditions results from the awareness that the rules provided by an outsider for a general order can only temporarily fix a legal system in specific rules in which the system is made more explicit, and changes in the society lead to new ramifications. The outsider rule-makers cannot discard the fact that fixed system at a certain point in time does not mean that it will remain unchanged and closed, and an ex post interpretation, supplementation or correction of the existing rules

¹¹¹¹ Schlechtriem, Peter, *Good Faith in German Law and in International Uniform Laws*, Centro di Studi e Ricerche di Diritto Comparato e Straniero, Saggi, conferenze e seminari 24, Rome, 1997

¹¹¹² Hartkamp, Arthur, *The Concept of Good Faith in the UNIDROIT Principles for International Commercial Contracts*, *Tulane Journal of International and Comparative Law*, 3 (1995), at 65-66

¹¹¹³ Hesselink, Martijn W., *The Concept of Good Faith*, in A.S. Hartkamp, E.H. Hondius, M.W. Hesselink, C.E. du Perron & M. Veldman, (eds.), *Towards A European Civil Code*, Kluwer Law International, 2004, at 477

¹¹¹⁴ Lando, Ole, *Is Good Faith an Over-Arching General Clause in the Principles of European Contract Law?*, *European Review of Private Law*, 6 (2007), at 852

¹¹¹⁵ Hartkamp, Arthur, *The Concept of Good Faith in the UNIDROIT Principles for International Commercial Contracts*, *Tulane Journal of International and Comparative Law*, 3 (1995), at 65-66

in individual cases will be required in the hindsight of the decision maker in order to achieve justice in a particular case. Thus, with regard to German law, it is argued that the principle of good faith is “neither ‘queen of rules’ nor ‘baneful plague’ but an invitation, or reminder, for courts to do what they do anyway and have always done: to specify, supplement and modify the law, i.e. to develop it in accordance with the perceived needs of their time.”¹¹¹⁶

The exercise of these functions of the principle of good faith not only in relation to the terms of the contract but also as to the formal consolidations provided by the legal systems depends on the extent of capacity of the ex post decision maker for exercising an abstract reasoning in ex post consolidations thereby rendering decisions for a particular case in accordance with the reasonable expectations of the parties. In a legal system, the rules arising from formal consolidations and the terms of the contract are generally treated, although not so clearly, as constituting two different sources for the rights and obligations of the parties, particularly where the applicable rules are of mandatory character. While one source is provided by an outsider ex ante, expected to stabilize the expectations of individuals and, thus, applied through some objective connecting factors, the other is provided by the parties and characterized by the element of consent. This conceptual distinction between the sources of parties’ rights and obligations is not appropriate in the order of international commerce in the absence of an outsider possessing sufficient authority with the capacity to direct the relevant knowledge and to establish a legal system. Under *lex mercatoria*, the reasonable expectations of the parties to a particular contract become the single source of their contractual rights, obligations and risk allocations.

¹¹¹⁶ Whittaker, Simon & Reinhard Zimmermann, Good faith in European Contract Law: Surveying the Legal Landscape, in Reinhard Zimmermann and Simon Whittaker (eds.), *Good faith in European Contract Law*, Cambridge University Press, 2000, at 32

i. Interpretation of the Contract

The interpretation of the contract under *lex mercatoria* focuses on the ascertainment of the meaning of the contract in accordance with the common intentions of the parties. In the context of international arbitration, it is the interpretation of the contract that some arbitrators strongly feel themselves freed from the constraints of formal consolidations under national legal systems. In ICC Case No. 1434, where the arbitrators determined French law as the law governing the contract, the arbitrators stated that: “The interpretation of contracts is one of the fields in which international commercial arbitrators are most inclined to free themselves of national laws and refer to general principles of law.” In that case, the arbitrators decided to interpret the disputed contractual clause in the light of general principles of the interpretation of contracts, and particularly those which appear in Articles 1156 et seq. of the French Civil Code, beginning with a literal and grammatical interpretation of the words used, without failing to place them in their context and to consider the contract as a whole, so as to discover the genuine common intention of the parties, referring in particular, if the terms are ambiguous, to the principle of good faith and resorting, if need be, to extrinsic interpretational indicators, which may be found, for example, in the historic context and in the relations between the parties.¹¹¹⁷

The arbitral tribunals may also disregard the idiosyncratic rules of interpretation under a national law, unless the parties specifically agreed on that national law to govern the substance of their dispute. For example, in ICC Case No 7920, where the parties did not agree on the applicable law, the sole arbitrator stated that “Under certain circumstances, ..., the arbitrator can depart from the general conflicts of law theory which generally refers, for the rules of interpretation, to the law of the contract. The arbitrator may depart from the applicable national law, but should not bend it by voluntarily ignoring its jurisprudential rules.” On the basis of this argument, the arbitrator avoided the application of an interpretation rule of Spanish law, holding that a clause which is ambiguous as to the arbitral body can only be null and void. According to the arbitrator, this Spanish jurisprudence is at odds with the established rule in order of international commerce, which was identified by the arbitrator as “the principle of the *effet utile* (*ut res magis valeat quam pereat*), also called principle of effectiveness”, since the Spanish rule reduced the contractual clause in question to a meaningless formula.¹¹¹⁸ The arbitrator decided to search for the real intention of the parties under a contextual approach and stated that “Pre-contractual negotiations are an excellent indicator of the real intention of the parties.”¹¹¹⁹

The established rules of interpretation under *lex mercatoria* require the decision maker to start with the text of the contract, while considering the contract as a whole together with its nature and purpose, i.e. the internal context of the contract, but if there is persistent ambiguity, to continue with a reference to external context of the contract, which consists of preliminary negotiations between the parties, practices that the parties have established between themselves, the conduct of the parties subsequent to the conclusion of the contract and trade usages, in order to determine the common intentions of the parties. The materials that can be used by the decision maker resorting to the external context for the purposes of interpretation may be limited by the rules of interpretation of a particular national law, which is chosen by

¹¹¹⁷ ICC Award in Case No 1434, *Journal du Droit International*, (1976), at 982

¹¹¹⁸ ICC Award in Case No. 7920, *Yearbook Commercial Arbitration* (1998), at 82-83

¹¹¹⁹ *Ibid.*, at 83

the parties as the applicable law, or by the rules of interpretation contained in the contract, but such limitations are subject to the qualifying function of the basic principle of good faith and fair dealing under *lex mercatoria*. Where there is still doubt with regard to the common intentions of the parties despite the considerations of the internal and external context, the decision maker may resort to the interpretative presumptions in the form of established rules, which aid the interpretation of the contract.

1. Common Intention of the Parties

Under *lex mercatoria*, the basic principle of freedom of contract requires that the primary object of interpretation is giving effect to the common intention of the parties. The respect for freedom of contract has also a major influence on the interpretation methods under the national laws of civil legal tradition. The civil legal tradition generally sets the initial goal of interpretation as determination of the common actual intentions of the parties. For example, Section 133 of the German Civil Code provides that when interpreting an expression of intention, the actual intention shall be sought without regard to the declaration's literal meaning. In the context of the contract, this provision requires the judge to focus on determining what the parties actually meant with the terms of the contract.¹¹²⁰ Article 1156 of the French Civil Code requires that the judges should seek the common intentions of the parties rather than keeping to the literal meaning of the words which they use. Where no real common intention of the parties can be established, the task of the judge under French law is to ascertain what must, in light of all the circumstances, be taken to be what the parties must reasonably have intended.¹¹²¹ Thus, in civil law countries, if the parties have attached a specific meaning to the wording of the terms contained in the contract, this subjective meaning should be revealed and applied even if it does not reflect the ordinary usage of a particular expression.

Although common law traditionally disregards the initial goal of determining the common actual intentions, it tries to achieve a fair balance in interpretation by equating the common intentions of the parties to the objective meaning of the words used in the contract.¹¹²² This form of literal interpretation is based on "the plain meaning" rule, which gives rise to two presumptions. The first is a presumption that words have a finite number of ordinary or commonly understood meanings, and the second is that parties intend that the words included in their contracts be given those meanings. The plain meaning rule stands for the proposition that an unambiguous writing is conclusive evidence of actual intent.¹¹²³ The orthodox approach of English courts to interpretation of contracts was summarized by Lord Wilberforce in the case of the *Diana Prosperity*: "No contracts made are in a vacuum: there is always a setting in which they have to be placed. The nature of what is legitimate to have regard to is usually described as 'the surrounding circumstances' but this phrase is imprecise: it can be illustrated but hardly defined. In a commercial contract it is certainly right that the

¹¹²⁰ Kötz, Hein, & Axel Flessner, *European Contract Law*, Vol. 1, Formation, validity, and content of contracts, Contract and third parties, Oxford University Press, 1997, at 108

¹¹²¹ Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 670

¹¹²² Whincup, Michael H., *Contract Law and Practice: the English System and Continental Comparisons*, Kluwer Law International, 4th rev. and enl. ed., 2001, at 16

¹¹²³ Dubroff, Harold, *The Implied Covenant of Good Faith in Contract Interpretation and Gap-Filling: Reviling a Revered Relic*, *St. John's Law Review*, 80 (Spring 2006), at 568

court should know the commercial purpose of the contract and this in turn presupposes knowledge of the genesis of the transaction, the background, the context, the market in which the parties are operating ... When one speaks of the intention of parties to the contract, one is speaking objectively--the parties cannot themselves give direct evidence of what their intention was--and what must be ascertained is what is to be taken as the intention which reasonable people would have had if placed in the situation of the parties ... what the court must do must be to place itself in thought in the same factual matrix as that in which the parties were.”¹¹²⁴

Nevertheless, English law provides a remedy for the party who argues that the written agreement, as interpreted, fails to reflect the agreement which the parties actually reached. In such a case, the court may be asked to rectify the document, so that it reflects the common actual agreement between the parties. Thus, rectification is a process whereby a document, the meaning of which has already been ascertained, is rectified to reflect the common intentions of the parties. As an equitable discretionary remedy, the rectification is available in the discretion of the court. However, the courts will rectify a document only when “convincing proof” is provided in cases where the document fails to record the common intention of the parties, or where one party mistakenly believes that the document correctly expresses the parties’ common intention, and the other party is aware of that mistake.¹¹²⁵

Although to differing extents and under different conditions, the national laws generally take into account subjective considerations in order to uphold the freedom of contract. This consideration is also relevant to the interpretation of a contract under *lex mercatoria*. Under *lex mercatoria*, the decision maker seized of a dispute should try to determine what the parties actually intended by the wording of their contract and will give effect to that intention in order to utilize the parties’ knowledge of particular circumstances of time and place.¹¹²⁶ However, where the contract contains clear and express provisions, the principles of freedom of contract and sanctity of contract require that those provisions should be respected and enforced in their natural meaning. For example, in France, although the Cour de cassation has accepted that questions of interpretation of contracts are in principle a matter of fact for the “sovereign power of assessment” of the judge, and are, therefore, immune from its interference, the Cour has intervened in order to ensure that clear and precise clauses are given their intended effect, and to prevent the lower courts from excluding the legal consequences of agreements “under the pretext of equity”.¹¹²⁷ Similarly, in the Official Comments to Article 5:101 of the PECL, it is stated that “the judge must not, under the guise of interpretation, modify the clear and precise meaning of the contract. This would be to ignore the principle of the binding force of contract.”¹¹²⁸ As held in the *Aramco Award*, “the starting point of any process of interpretation is the text agreed upon by the parties. Obviously, the essence of a contract is to be found in the concordant will of the parties; without such harmony in the terms, no rights, no obligations could result. In the art of interpretation of texts, the written word comes first. It

¹¹²⁴ *The Diana Prosperity or Reardon Smith Line Ltd v Yngvar Hansen-Tangen and Sanko SS & Co Ltd* [1976] 1 WLR 989, at 995-997

¹¹²⁵ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 202-204

¹¹²⁶ Lew, Julian D. M., *Applicable Law in International Commercial Arbitration: A Study in Commercial Arbitration Awards*, Oceana, 1978, at 494

¹¹²⁷ Bell, John, Sophie Boyron & Simon Whittaker, *Principles of French law*, Oxford University Press, 2nd ed., 2008, at 329-330

¹¹²⁸ Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law, Parts I and II*, Kluwer Law International, 2000, at 287-288

must be consulted and accepted in the first place, and the words used by the parties must be given their natural meaning.”¹¹²⁹ Any consideration of reasonable expectations on the basis of specialized consolidations, which may transform the ascertainable meaning of the contract on the basis of its text into a factor of secondary importance, is contrary to the basic principle of sanctity of contracts under *lex mercatoria*. In ICC Case No 9117, the arbitral tribunal stated that “Respecting the unambiguous contractual terms agreed upon by both parties is, beyond any doubt, the basis of any international business and trade. The notion of *pacta sunt servanda* is reflected in any national law known to the present Arbitrators.”¹¹³⁰

This precedence given to the text of the contract does not necessarily imply a literal interpretation of contract under *lex mercatoria*. Literal interpretation may be relevant when the common intention of the parties as expressed in the contract is not doubtful, i.e. when it is not ambiguous, or disputed by one of the parties offering some evidence as to their common intention.¹¹³¹ Even when it seems unambiguous, the common intention of the parties will usually be in dispute due to the tendency of the parties to avoid any form of restrictive interpretation, such as literal interpretation, whereby one of the parties seeks to limit its undertakings arising from the contract.¹¹³² However, the restrictive or extensive nature of the interpretation is not the relevant point in this question for the decision maker applying *lex mercatoria*. As argued in Amco award, “in the first place, ..., [an agreement] ... is not to be construed restrictively, nor, as a matter of fact, broadly or liberally. It is to be construed in a way which leads to find out and to respect the common will of the parties: such a method of interpretation is but the application of the fundamental principle *pacta sunt servanda*, a principle common, indeed, to all systems of internal law and to international law.”¹¹³³ Thus, the desire to give effect to the common intentions of the parties results from not only freedom of contract, but also the principle of sanctity of contracts.¹¹³⁴ The question is then to what extent such evidence should be admitted in the determination of common intentions of the parties.

In determining to what extent the evidence relating to the common intention of the parties is admissible, the decision maker will act on the view that, in availing themselves of the faculty of entering into a contract, the parties intend to pursue a purpose which, in accordance with the basic principles of *lex mercatoria*, the contract must be considered to fulfill.¹¹³⁵ The

¹¹²⁹ August 23, 1958, ad hoc award, Saudi Arabia v. Arabian American Oil Co. (ARAMCO), International Law Reports, 27 (1963) at 173

¹¹³⁰ ICC Award in Case No. 9117, March 1998, ICC International Court of Arbitration Bulletin, 10-2 (Fall 1999), at 99

¹¹³¹ ICC Award in Case No. 5485, 1987, Yearbook Commercial Arbitration, (1989), at 168-169: “Whereas Art. 4(9) of the Basic Agreement is clear and, from the evidence presented in this arbitration, effectively reflects what the parties wanted to contract (and effectively did contract, and should therefore be literally applied: *in claris non fit interpretatio*. [See Art. 1281 of Spanish Civil Code, which reads “If the terms of a contract are clear and leave no doubt as to the intention of the contracting parties, the clauses shall be interpreted literally.”]”

¹¹³² Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 825

¹¹³³ ICSID Award on Jurisdiction, September 25, 1983, Amco Asia Corporation et al. vs. Indonesia, International Legal Materials, 23 (1984), at 359

¹¹³⁴ Lew, Julian D. M., Applicable Law in International Commercial Arbitration: A Study in Commercial Arbitration Awards, Oceana, 1978, at 496

¹¹³⁵ In the Aramco award, it was held that “the interpreter must . . . remember that the parties intended by their agreements to establish a reasonable contractual situation, in conformity with the common aim they had in

principle of good faith and fair dealing implies that if a party attempts to abuse that faculty by relying on the plain meaning of the contract thereby reducing it to the level of a device to act opportunistically and dishonestly during adjudication and to gain benefits not arising from that purpose, he cannot rule out the contingency that the decision maker will adopt a contextual approach to the interpretation in order to reflect the common intentions of the parties.¹¹³⁶ Therefore, the decision maker should interpret the contract in accordance with its purpose and in good faith “that is to say by taking into account the consequences of their commitments, the parties may be considered as having reasonably and legitimately envisaged.”¹¹³⁷ Accordingly, the principle of good faith may require that a literal interpretation should not prevail over an interpretation reflecting the parties’ intentions on the basis of the purpose of the contract.¹¹³⁸

In view of this potential opportunism at the enforcement stage under a literal interpretation, even the plain meaning rule of common law has been subject of a large number of exceptions. For instance, in England, in addition to the remedy of rectification, the evidence as to the common actual intentions of the parties may become admissible in interpretation to prove the factual background known to the contracting parties, which is called as the “matrix of fact” and includes “absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man”¹¹³⁹ and to ascertain the true meaning of ambiguity in a written agreement.¹¹⁴⁰ As argued by Lord Steyn the rationality of the law is important, and if the rule that the task of the court is simply to ascertain the meaning of the language of the contract was absolute and unqualified it would sometimes defeat the reasonable expectations of commercial men. There has been, as he observes, a shift away from a black-letter approach to questions of interpretation in England.¹¹⁴¹ The literalist methods are in decline and the awareness of the importance of contextual approach has become apparent.¹¹⁴² In the United States, it is accepted that if the parties have attached different meanings to a contract, it is to be interpreted in accordance with the meaning

view.” August 23, 1958, ad hoc award, Saudi Arabia v. Arabian American Oil Co. (ARAMCO), International Law Reports, 27 (1963) at 173

¹¹³⁶ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 257: “The first and most widely accepted principle of interpretation applied to arbitration agreements is the principle of interpretation in good faith.... In fact, this rule of interpretation means that a party's true intention should always prevail over its declared intention, where the two are not the same. An example of bad faith will be the conduct of a party relying on an argument of pure form, which is wholly out of context or plainly contrary to the structure or the purpose of the agreement, in a bid to evade obligations which it had clearly undertaken to perform but which were expressed in ambiguous terms. Here, “interpretation in good faith” is simply a less technical way of saying that 'when interpreting a contract, one must look for the parties' common intention, rather than simply restricting oneself to examining the literal meaning of the terms used.” However, the moral connotation or the expression “interpretation in good faith” is more in keeping with the tenor or general principles of law.”

¹¹³⁷ ICSID Award on Jurisdiction, September 25, 1983, Amco Asia Corporation et al. vs. Indonesia, International Legal Materials, 23 (1984), at 359

¹¹³⁸ Lew, Julian D. M., Loukas Mistelis L. A., & Stefan M. Kröll, Comparative International Commercial Arbitration, Kluwer Law International, 2003, at 470

¹¹³⁹ Investors Compensation Scheme v. West Bromwich Building Society [1998] 1 WLR 896, at 912-913

¹¹⁴⁰ Beatson, Jack, Anson's Law of Contract, Oxford University Press, 27th ed., 1998, at 130

¹¹⁴¹ Steyn, Johan, Contract Law: Fulfilling the Reasonable Expectations of Honest Men, Law Quarterly Review, 113 (1997), at 440

¹¹⁴² McKendrick, Ewan, Contract law, Palgrave Macmillan, 2007, at 196

attached by one of them if the other party “knew the meaning attached by the first party” or “had reason to know the meaning attached by the first party.”¹¹⁴³ Thus, it is established in US law that when the parties have attached the same meaning to a contract, it should be interpreted by the decision maker in accordance with that meaning. It is argued that the principle of good faith in US law provides a justification for courts to look beyond the plain language of an agreement to inquire into the context of a particular bargain and determine the actual intentions and expectations of the parties.¹¹⁴⁴

As a result of such contextual interpretation, the decision maker applying *lex mercatoria* may eventually find that a literal interpretation is required and represents the true will of the parties.¹¹⁴⁵ In those cases, the freedom of contract requires the legal enforcement of the contracts that parties actually agreed, not the contracts that a decision maker with a concern for fairness would prefer them to have agreed. Enforcement of agreements presupposes a theory of interpretation. The decision maker should give effect to both the choice of a contract’s substantive terms and the choice of the interpretive method that will be used to enforce those terms.¹¹⁴⁶ Even so, when there is doubt as to the common intentions of the parties as expressed in the contract under its particular purpose, the principle of good faith and fair dealing under *lex mercatoria*, which recognizes the significance of the individual case and the knowledge of particular circumstances of time and place, leads to the adoption of a contextual approach to the interpretation of the contract for giving effect to reasonable expectations of the parties in a particular case. This consideration is the reason for such superiority the contextual approach, as an element of interpretation, enjoys over the formalist approach and plain meaning rule in the order of international commerce.

Under the international restatements of contract principles and the CISG, the interpretation of the contract aims to ascertain the parties’ actual intention and to establish whether parties shared a common understanding at the time the contract, which was to have effect with respect to the expressions used in the contract.¹¹⁴⁷ Interpretation of contracts is regulated in Article 8 of the CISG. Article 8 (1) of the CISG provides that the statements made by and other conduct of a party are to be interpreted according to his intent where the other party knew or could not have been unaware what the intent was.¹¹⁴⁸ Thus, if the parties shared a

¹¹⁴³ Section 201 of the Restatement (Second) of Contracts (1981); Farnsworth, E.A., *The American Provenance of the UNIDROIT Principles*, *Tulane Law Review*, 72 (1998), at 1991

¹¹⁴⁴ Dubroff, Harold, *The Implied Covenant of Good Faith in Contract Interpretation and Gap-Filling: Reviling a Revered Relic*, *St. John's Law Review*, 80 (Spring 2006), at 569

¹¹⁴⁵ ICC Award in Case No.1434 of 1975, *Journal du Droit International*, (1976), at 980: The tribunal held that a party cannot hide behind the writing of the particular clause, read it literally and isolated from the context of the agreement in order to release itself from responsibility, unless it is established in a given case, that a formalistic interpretation is required and is the real intention of the parties, interpreted in good faith and the spirit of the operation.

¹¹⁴⁶ Schwartz, Alan & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, *Yale Law Journal*, 113 (Nov/Dec 2003), at 618

¹¹⁴⁷ Farnsworth, E.A. Article 8, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 98

¹¹⁴⁸ Although the wording of this provision only refers to the interpretation of the parties' individual statements, it is submitted that they should also apply to the interpretation of “the contract” as such. Huber, Peter, *Some introductory remarks on the CISG*, *Internationales Handelsrecht*, (2006/6), at 234, Farnsworth, E.A. Article 8, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 101 and Enderlein, Fritz & Dietrich Maskow, *International*

common understanding as to the contract, that understanding will prevail regardless of what a reasonable person might have understood.¹¹⁴⁹ Article 5:101 of the PECL provides that “A contract is to be interpreted according to the common intention of the parties even if this differs from the literal meaning of the words”, and adds that “If it is established that one party intended the contract to have a particular meaning, and at the time of the conclusion of the contract the other party could not have been unaware of the first party's intention, the contract is to be interpreted in the way intended by the first party.” Article 4.1 (1) of the UNIDROIT Principles provides that “A contract shall be interpreted according to the common intention of the parties”. The Official Comments to this article explain that a contract is to be interpreted according to the common intention of the parties, even if this differs from the literal sense of the language used or from the meaning which a reasonable person would attach to it, provided that such a different understanding was common to the parties at the time of the conclusion of the contract.¹¹⁵⁰ Article 4.2 (1) of the UNIDROIT Principles, which deals with the interpretation of unilateral statements or conduct, mirrors Article 8 of the CISG and provides that the statements and other conduct of a party shall be interpreted according to that party's intention if the other party knew or could not have been unaware of that intention.¹¹⁵¹

Lord Hoffmann, in the House of Lords decision on *Chartbrook Ltd v Persimmon Homes Ltd*, stated that international instruments, such as the CISG, the UNIDROIT Principles and the PECL, reflect “the French philosophy of contractual interpretation” which “regards the intentions of the parties as a pure question of subjective fact, their *volonté psychologique*, uninfluenced by any rules of law” so that “any evidence of what they said or did, whether to each other or to third parties, may be relevant to establishing what their intentions actually were.”¹¹⁵² He saw this approach as conflicting with the approach of English law to interpretation, which “mixes up the ascertainment of intention with the rules of law by depersonalizing the contracting parties and asking, not what their intentions actually were, but what a reasonable outside observer would have taken them to be.”¹¹⁵³

Essentially, under *lex mercatoria* and in the order of international commerce, the common intention of the parties that is sought by the decision maker should be neither entirely subjective in the sense of the parties' inner intent, nor strictly objective in the sense of what the party should have intended in reference to what a reasonable person would have intended. Although it may be difficult to ascertain, the common actual intentions of the parties should not be disregarded entirely because of the importance of utilizing knowledge of the particular circumstances of time and place in the order of international commerce. Moreover, the heterogeneous nature of the society of merchants in the order of international commerce

Sales Law: United Nations Convention on Contracts for the International Sale of Goods: Convention on the Limitation Period in the International Sale of Goods: Commentary, Oceana Publications, 1992, at 63

¹¹⁴⁹ Huber, Peter, Some introductory remarks on the CISG, *Internationales Handelsrecht*, (2006/6), at 235

¹¹⁵⁰ Official Comment 1 to Article 4.1 of the UNIDROIT Principles

¹¹⁵¹ According to the Official Comments, the principal field of application of this article will be in the process of the formation of contracts, where parties make statements and engage in conduct whose precise legal significance may have to be established in order to determine whether or not a contract is ultimately concluded, and unilateral acts performed after the conclusion of the contract which may give rise to problems of interpretation: for example, a notification of defects in goods, notice of avoidance or of termination of the contract, etc. Official Comment 1 to Article 4.2 of the UNIDROIT Principles

¹¹⁵² Lord Hoffmann in *Chartbrook Limited (Respondents) v Persimmon Homes Limited and others (Appellants) and another (Respondent)* [2009] UKHL 38

¹¹⁵³ *Ibid.*

should require the decision maker to consider with care any objective standards of reasonable person in order to avoid the undue influence of his own subjective judgments about reasonableness on his final decision. In this context, the decision maker should consider that, the circumstances pointing towards a common actual intention that deviates from the plain or reasonable meaning of the contract must be compelling to justify a deviation. An earlier draft of the Comments to Article 4.1 of the UNIDROIT Principles added “that the less vague or ambiguous a contract terms is, the more difficult it will be to admit that in a particular case it may be given a meaning which differs from that normally attached to it.”¹¹⁵⁴ If not discarded, such a clarification in the Comments of Article 4.1 would have properly articulated an established rule of interpretation in the order of international commerce, and could have diminished the criticism that the approach of the UNIDROIT Principles is based entirely on such a philosophy of contractual interpretation as argued by Lord Hoffmann.

2. Internal Context of the Contract

Under the contextual approach of *lex mercatoria*, the decision maker should first resort to the internal context of the contract. He should make the most of the contract itself in his search for the common intentions of the parties to resolve the ambiguity or the disputes of interpretation. Thus, the decision maker applying *lex mercatoria* should interpret the contractual provisions by taking into account the purpose and nature of the contract before resorting to extrinsic factors in determining the common intentions of the parties. Similarly, under public international law, in Articles 31 and 32 of the Vienna Convention on the Law of the Treaties, and, in the practice of WTO panels, the correct interpretation process entails looking at the text of the provision first, followed by ascertaining the object and purpose of the treaty, where resort to the supplementary tools of interpretation, including the *travaux préparatoires* or the circumstances of a treaty's conclusion, is only available when the meaning of the text is equivocal or inconclusive or when confirmation of the correctness of the reading of the text is desired.¹¹⁵⁵

Such a distinction between internal and external context of the contract is not formally recognized by the international restatements of contract principles. In the Official Comments to Article 5:101 of the PECL, it is explained that “In seeking this common intention the judge should pay particular attention to the relevant circumstances as set out in Article 5:102.”¹¹⁵⁶ The Official Comments to Article 4.1 of the UNIDROIT Principles provides that in order to establish whether the parties had a common intention and, if so, what that common intention was, regard is to be had to all the relevant circumstances of the case, the most important of which are listed in Article 4.3.¹¹⁵⁷ Both Article 4.3 of the UNIDROIT Principles and Article 5:102 of the PECL include the elements relating to both internal and external context of the contract as circumstances that can be considered in determining the common intentions of the parties. These circumstances are also relevant where the common intention cannot be established and, in this regard, Article 4.1 (2) of the UNIDROIT Principles and Article 5:101 (3) of the PECL provide recourse to interpretation according to the meaning that reasonable persons of the same kind as the parties would give to it in the same circumstances.

¹¹⁵⁴ UNIDROIT 1988 – Study L – Doc. 42, Rome, May 1988, at 6

¹¹⁵⁵ Cameron, James, & Kevin R. Gray, *Principles of International Law in the WTO Dispute Settlement Body*, *International and Comparative Law Quarterly*, 50-2 (Apr., 2001), at 256

¹¹⁵⁶ Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law, Parts I and II*, Kluwer Law International, 2000, at 287

¹¹⁵⁷ Official Comment 3 to Article 4.3 of the UNIDROIT Principles

The draft of the UNIDROIT Principles was criticized by some members of the Working Group, for being unclear about the question of the hierarchy of the sources of interpretation. During the meeting of Working Group for the preparation of UNIDROIT Principles, it was suggested that all the rules of the Principles which referred to the subjective rules of interpretation should be brought together, and placed in their hierarchical position and once these subjective rules of interpretation had failed, attention should be given to the objective test of interpretation; what reasonable persons would have intended or the usages of the trade, the terms that are generally accepted in a particular trade or in general circumstances.¹¹⁵⁸ However, it was questioned whether it really was that important for the Principles to establish an explicit hierarchy, and instead, the Working Group opted for an implicit hierarchy by providing that the intention of the parties should be considered first. In the doctrine, it is also pointed out that, under the national laws of civil countries, there is no strict concept of priority between the different aspects which play a role in the process of interpretation such as the meaning of the words, the purpose, the context or the origins of a contractual clause and these aspects are combined with one another on the basis of their persuasiveness under a balancing approach.¹¹⁵⁹

In line with the understanding of civil law systems, Article 4.3 of the UNIDROIT Principles provides a non-exhaustive list of factors to be taken into account by the decision maker in determining the intention of the parties without making a distinction between subjective test of paragraph 1 and reasonableness test of paragraph 2 of Article 4.1.¹¹⁶⁰ The list includes (a) preliminary negotiations between the parties; (b) practices which the parties have established between themselves; (c) the conduct of the parties subsequent to the conclusion of the contract; (d) the nature and purpose of the contract; (e) the meaning commonly given to terms and expressions in the trade concerned; (f) usages.¹¹⁶¹ In the comments, it is stated that “although in principle all the circumstances listed may be relevant in a given case, the first three are likely to have greater weight in the application of the “subjective” test,” whereas, “the remaining circumstances listed in this article, i.e. the nature and purpose of the contract, the meaning commonly given to terms and expressions in a trade concerned and usages, are important primarily, although not exclusively, in the application of the “reasonableness” test.”¹¹⁶²

It was also suggested during the process of drafting Article 4.3 of the UNIDROIT Principles that the purpose and nature of the contract should be placed first in the order of the factors

¹¹⁵⁸ UNIDROIT 1991 – P.C. – Misc. 15, Rome, April 1991 at 6

¹¹⁵⁹ Canaris, Claus-Wilhelm, & Hans Christoph Grigoleit, Interpretation of Contracts, in A.S. Hartkamp, E.H. Hondius, M.W. Hesselink, E. du Perron & M. Veldman, (eds.), *Towards A European Civil Code*, Kluwer Law International, 2004, at 456

¹¹⁶⁰ Similarly, Article 5:102 of the PECL: Relevant Circumstances: “In interpreting the contract, regard shall be had, in particular, to: (a) the circumstances in which it was concluded, including the preliminary negotiations; (b) the conduct of the parties, even subsequent to the conclusion of the contract; (c) the nature and purpose of the contract; (d) the interpretation which has already been given to similar clauses by the parties and the practices they have established between themselves; (e) the meaning commonly given to terms and expressions in the branch of activity concerned and the interpretation similar clauses may already have received; (f) usages; and (g) good faith and fair dealing.”

¹¹⁶¹ In line with the policy of the Working Group, which was to stick to the precedents of the CISG, unless there were good reasons to depart from them, Articles 4.1-4.3 were formulated on the basis of the Article 8 of the CISG. UNIDROIT 1991 – P.C. – Misc. 15, Rome, April 1991 at 9

¹¹⁶² Official Comment 2 to Article 4.3 of the UNIDROIT Principles

listed, but this was rejected since the Working Group considered the nature and purpose of the contract as having an objective aspect and one should start with the preliminary negotiations, and move on to the factors having more objective aspects if some priority is given to the intention of the parties.¹¹⁶³ The reference in Article 4.3 to the nature of the contract is inspired by the terminology of the Romanist Civil Codes, under which the “nature” refers to the characteristic content of the type of the contract in question (sale, lease, etc.). The reference to the “purpose” is linked to the notion of the “nature of the contract” and the idea is to ask what parties in similar transactions typically intend to achieve. Therefore, the reference is made to the typical interests of the parties in an objective sense.¹¹⁶⁴

However, the purpose and nature of a contract do not necessarily lead the decision maker to consider the typical interests of the parties engaged in similar transactions on the basis of a traditional classification of types of the contracts. For the decision maker applying *lex mercatoria*, the purpose and nature of the contract retains the utmost importance in giving effect to the common intention of the parties within the internal context of the contract. The nature of the contract not only denotes a traditional type of the contract, but also requires the consideration of certain features of the particular contract in dispute that indicate whether it is a transaction governed through legal uncertainty, such as its duration, atypical elements, and level of complexity or innovation. Similarly, the purpose of the contract should not only be determined on the basis of what parties in similar transactions typically intend to achieve, but should primarily be based on the contractual relationship in question, namely the purpose contemplated by the parties.

The nature and purpose of the contract have a distinct character from the other factors since, in some cases, the purpose and nature of the contract can only be determined on the basis of extrinsic factors, such as relevant industry or trade, so that they may relate to both subjective and objective considerations. This implies that the focus on the nature and purpose of legal arrangements should generally prevail in all stages of interpretation under *lex mercatoria* for the transactions governed through legal uncertainty. In ICC Case No 8908 where the dispute concerned the complex and diverse relationship between two companies, the arbitral tribunal had to interpret the scope of a settlement agreement, which was concluded between an Italian manufacturer and a Liechtenstein distributor in order to settle their disputes arising from a number of contracts for the supply of pipes. In view of the insufficiency of the letter of the contract in dissolving the dispute, the arbitral tribunal decided that the letter needed to be supplemented with the purpose being pursued by the parties and with the starting situation and any stated or potential reciprocal objections. Applying Italian law and referring to the corresponding rules contained in the UNIDROIT Principle, the arbitral tribunal stated that “among the methods taken into consideration, there is first and foremost the so-called logical interpretation, which includes the identification of the purpose of the contract”.¹¹⁶⁵

While common intention, if it can be ascertained, must not be sacrificed to presumptions and technical rules of interpretation, it does not necessarily follow that the express manifestation of a common intention in relation to any specific provision of a contract is an essential condition of its operation. The contract as a whole transcends any of its individual provisions or even the sum total of its provisions since the contract is more than the expression of the

¹¹⁶³ UNIDROIT 1991 – P.C. – Misc. 15, Rome, April 1991 at 16

¹¹⁶⁴ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 513-514

¹¹⁶⁵ ICC Award in Case No 8908, 1998, ICC International Court of Arbitration Bulletin, 10-2 (Fall 1999), at 86

intention of the parties.¹¹⁶⁶ It is part of the law between the parties and, thus, part of *lex mercatoria* in the particular case, and must be interpreted against the general background of its basic principles. As stated in the *Aramco Award*, “while looking for the common intention of the parties, the declared intentions should prevail, and that the meaning of the contract is to be found in the context of the agreement, including a consideration of all the terms used by the parties for they constitute a whole.”¹¹⁶⁷

The need for an interpretation of the contract or of its various constituent parts in light of the whole contract has generally been recognized in the arbitral practice. It is sometimes applied as part of a national law¹¹⁶⁸ or without reference to national law.¹¹⁶⁹ The Iran-United States Claims Tribunal also referred to the general rule of contract interpretation, which dictates that contracts are to be interpreted so as to give meaning to their texts as a whole.¹¹⁷⁰ This rule of interpretation also appears in UNIDROIT Principles, which provides in Article 4.4 that “Terms and expressions shall be interpreted in the light of the whole contract or statement in which they appear.” It is also a rule of public international law with regard to the interpretation of treaties. The duty to interpret a treaty as a whole has been clarified by the Permanent Court of International Justice¹¹⁷¹ and followed by the International Court of Justice¹¹⁷² and adopted by the WTO Appellate Body.¹¹⁷³ This rule of interpretation

¹¹⁶⁶ Lauterpacht, Hersch, *Restrictive Interpretation and the Principle of Effectiveness in the Interpretation of Treaties*, *British Year Book of International Law*, 6 (1949), at 76

¹¹⁶⁷ August 23, 1958, *ad hoc award*, *Saudi Arabia v. Arabian American Oil Co. (ARAMCO)*, *International Law Reports*, 27 (1963) at 173

¹¹⁶⁸ E.g. ICC Award in Case No. 10335, 2000, *ICC International Court of Arbitration Bulletin*, 12-2 (Fall 2001), at 103 Applying Greek law, the arbitral tribunal stated that “It is submitted that the language of the provision as such does neither permit to answer the question as to the Agreement’s sphere of application ... the sphere of application, of course, will only be revealed if one looks at the Agreement in its entirety.” ICC Award in Case No. 5485, 1987, *Yearbook Commercial Arbitration*, (1989), at 167: Applying Spanish law, the arbitral tribunal stated that “Art. 1285 CC, Chapter IV of said Book IV [Book IV ('Obligations and contracts')], Title II ('Interpretation of contracts') states: Each article of a contract should be interpreted in view of the content of the others, attributing the sense extracted from the articles taken as a whole, to those whose meaning is not clear; ...; and there is no Spanish norm in which consent, object and cause [three requirements imposed by Art. 1261 CC for the validity of a contract] are set out as requirements for each article of a contract... The Tribunal can infer from the above that under Spanish law (1) the three conditions of Art. 1261 CC are required for the existence of any contract as a whole, but not for the existence of each article of that contract; (2) the articles of a contract are not independent of one another, but are always interdependent...”

¹¹⁶⁹ E.g. *Award on Jurisdiction in the Matter of the Arbitration between Amco Asia Corporation et al and Indonesia*, *International Legal Materials*, 23 (1984), at 365-366: “the Tribunal will consider the issue in having essentially regard to what is, in its view, the crux of the matter, that is to say the true common will and intention of the parties, keeping in mind the fact that such will and intention are not to be drawn from a " restrictive " nor from a " liberal " interpretation of the arbitration clause, but from the normal expectations of the parties, as they may be established in view of the agreement as a whole, and of the aim and the spirit of the Washington Convention as well as of the Indonesian legislation and behavior”.

¹¹⁷⁰ Wühler, Norbert, *Application of General Principles of Law*, in Albert Jan van den Berg (ed.), *Planning efficient Arbitration Proceedings - The Law Applicable in International Arbitration*, *ICCA Congress Series No. 7*, Kluwer Law International 1999, at 558

¹¹⁷¹ *Competence of the I.L.O. to Regulate Agricultural Labour* (1922), *PCIJ*, Series B, Nos. 2 and 3, at 23.

¹¹⁷² *Ambatielos Case* (1953) *ICJ Reports*, at 10; *Reservations to the Convention on the Prevention and Punishment of the Crime of Genocide* (1951) *ICJ Reports*, at 15; and *Case Concerning Rights of United States Nationals in Morocco* (1952) *ICJ Reports*, at 196-199.

¹¹⁷³ *Appellate Body Report, Korea – Definitive Safeguard Measure on Imports of Certain Dairy Products*, *WT/DS98/AB/R*, 1999, para. 8: “a treaty should be interpreted as a whole, and, in particular, its sections and parts should be read as a whole. Article II:2 of the WTO Agreement expressly manifests the intention of the

corresponds to the logical hermeneutic principle that words cannot be understood in isolation. Accordingly, sentences have to be understood in the light of the clause which they belong. Clauses are to be looked at in the context of the respective part of the contract. Headings, which summarize contractual provisions, may also indicate the common intentions of parties.¹¹⁷⁴

The preambles, or recitals, are particularly frequent in transactions governed through legal uncertainty, because parties often feel the need to give some explanation as to the complex or original nature and purpose of their transactions, particularly where the transactions are to be implemented over a certain length of time.¹¹⁷⁵ It is observed that, in international contracting practice, the preambles have become the place of refuge for items, which are specific to a particular contract, and which individualize and personalize the contract.¹¹⁷⁶ Thus, the preambles are important in the interpretation of transactions governed through legal uncertainty and in the application of *lex mercatoria*, which recognizes the significance of the individual case. The preambles provide diverse information about the nature of the contractual relationship, such as the respective skills and attributes of contracting parties, the objectives sought by the parties or the spirit at the time of entering into the contract, the circumstances which have preceded or surrounding the contract including commercial, political, technical and other elements affecting the contract as well as the allocation of risks decided by the parties, or the different stages of negotiations which have led to the making of the contract.¹¹⁷⁷ This information can be used to clarify the common intention of the parties as to the operative part in the interpretation of the contract as a whole.¹¹⁷⁸ Some arbitral awards confirm such interpretative value of the preambles.¹¹⁷⁹

Recourse may also be had to other agreements concluded between the parties that are part of the same overall economic transaction.¹¹⁸⁰ Sometimes, the preambles provide references to links with other contracts and these references have some role in the interpretation of the

Uruguay Round negotiators that the provisions of the WTO Agreement and the Multilateral Trade Agreements included in its Annexes 1, 2 and 3 must be read as a whole.”

¹¹⁷⁴ However, in international contract practice, contract drafters usually prefer to exclude any interpretative value of headings due to the fear of inconsistencies between the clause and its heading. For example, FIDIC Red Book provides that “The headings and marginal words in these Conditions shall not be deemed part thereof or be taken into consideration in the interpretation or construction thereof or of the Contract.” (Clause 1.2 of the Conditions of Contract for Works of Civil Engineering Construction – the Red Book, FIDIC, Lausanne, 4th ed., 1987) For further examples see: Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 152

¹¹⁷⁵ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 61

¹¹⁷⁶ *Ibid.*, at 90

¹¹⁷⁷ *Ibid.*, at 89

¹¹⁷⁸ *Ibid.*, at 93; For example, the reference to particular qualifications and attributes of a party in the preambles can be used in the determination of the standard by which the performance of its obligations under the contract will be judged. Similarly, listing pre-contractual documents in the preamble may provide clues as to the parties’ true intentions in the event of a subsequent dispute as to the meaning of certain provisions in the contract.

¹¹⁷⁹ ICC Award in Case No 7181, *Yearbook Commercial Arbitration* (1996), at 102, ICC Award in Case No 7639, 1994, *Yearbook Commercial Arbitration*, (1998), at 67

¹¹⁸⁰ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 522

contract in which they are contained.¹¹⁸¹ Thus, the scope of rule of interpretation of the contractual provisions in light of the whole contract can be extended to contracts under a framework or master agreement or a group of contracts. In ICC Case No. 9875, the arbitral tribunal adopted this kind of approach and considered, in the interpretation of a contract between a licensee and a licensor, the contractual relationship of the same licensor with another licensee. The dispute arose from a license agreement, concluded in 1983 between the claimant, a French company, and the defendant, a Japanese company, according to which the claimant was given an exclusive license to manufacture, sell and distribute the defendant's products in Europe. The defendant entered into a similar agreement with an American company in 1983 for the North American market. In 1996, the defendant entered into a new agreement with the American company granting it an exclusive license for the North American market and a non-exclusive license for other countries. According to the claimant, the defendant, by not expressly excluding Europe from those other countries, had violated its agreement with the claimant. The arbitral tribunal, after determining in a partial award that the dispute was to be settled on the basis of *lex mercatoria* including the UNIDROIT Principles, as a reflection of the rules of law and usages of international trade, decided to interpret the intention of the parties "in the full context of the whole contractual set-up between [the defendant] and its two licensees, as it was organized in 1983 and as it may have evolved in 1996".¹¹⁸² The tribunal stated that "the contractual relationships between [the defendant] and [the claimant] on one side, and between [the defendant] and [the American company] on the other side, should not be analyzed separately." In the tribunal's view, "the main issue is to determine whether [the defendant]'s and [the claimant]'s intention, in 1996, was to allow [the American company] to enter the European market though this would be in violation of [the defendant]'s obligations towards [the claimant] under their still applicable 1983 agreement."¹¹⁸³ For that purpose, the arbitral tribunal compared the 1983 contracts and the 1996 contract in their sensitive provisions.

3. Extrinsic Factors

In a particular case, the common intentions of the parties may not be established solely on the basis of internal context of the contract, which consists of the nature and purpose of the contractual relationship considered as a whole. In those cases, establishing the parties' understanding with respect to the expressions used in the contract becomes a matter of evidence. The recognition of the significance of the individual case and the knowledge of particular circumstances of time and place under *lex mercatoria* should require the priority of the ascertainable common intention of the parties on the basis of extrinsic evidence relating to the subjective considerations over the objective considerations of reasonableness.

a. Subjective Considerations

There are different approaches in national legal systems as to the degree of admitting extrinsic evidence in the interpretation of contracts. In civil law countries, the admissible extrinsic evidence includes a very wide range of factors, such as the time and place of the formation of the contract, the drafting and negotiating history, prior dealings between the parties, the statements made by the parties, the aim and purpose of the transaction, the parties' conduct

¹¹⁸¹ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 95

¹¹⁸² ICC Award in Case No 9875, ICC International Court of Arbitration Bulletin, 12-2 (Fall 2001), at 98

¹¹⁸³ *Ibid.*

prior to formation and subsequent conduct, common practices and trade usages, without making a hierarchy or distinction between objective and subjective considerations.¹¹⁸⁴

English law is traditionally against the admissibility of extrinsic evidence of subjective considerations in interpreting contracts due to its objective approach. The English courts have regard to the relevant surrounding circumstances that constitute the context in which the document was drafted.¹¹⁸⁵ The relevant surrounding circumstances generally include evidence of objective considerations, such as industrial and commercial practice, technical terminology as understood by experts and professionals and market conditions.¹¹⁸⁶ The evidence of subjective considerations, such as those relating to statements prior to the time of the making of the contract is generally considered unhelpful and consequently inadmissible.¹¹⁸⁷ While the use of such evidence for the purpose of drawing inferences about what the contract meant is excluded, the English courts are allowed to use such evidence for other purposes, such as, to establish that a fact which may be relevant as background that was known to the parties, or to support a claim for rectification or estoppel. These are not exceptions to the rule of inadmissibility of such extrinsic evidence, but operate outside of it. Similarly, the evidence relating to the conduct subsequent to the making of the contract is rejected by the English courts on the ground that meaning of the contract is determined at the time the contract is made and cannot be altered by subsequent conduct, except for the pleas of estoppel.¹¹⁸⁸ It is observed that the courts have resorted to estoppel to temper the rigidity of rule regarding the inadmissibility of subsequent conduct.¹¹⁸⁹ On the other hand, due to its contextual approach to interpretation, the courts in the United States take into account extrinsic evidence to a greater extent than in England. The UCC and Restatement Second Contracts allow for the

¹¹⁸⁴ Kornet, Nicole, *Contract Interpretation and Gap Filling: Comparative and Theoretical Perspectives*, Intersentia, 2006, at 103

¹¹⁸⁵ McMeel, G., *Prior Negotiations and Subsequent Conduct – the Next Step forward for Contractual Interpretation*, *Law Quarterly Review*, 119 (2003), at 277

¹¹⁸⁶ Chuah, Jason, *The Factual Matrix In The Construction Of Commercial Contracts – The House Of Lords Clarifies*, *International Company and Commercial Law Review*, 12 (2001), at 295

¹¹⁸⁷ Lord Wilberforce in *Prenn v Simmonds* [1971] 1 WLR 1381, at 1384-1385: “The reason for not admitting evidence of these exchanges is not a technical one, or even mainly one of convenience (though the attempt to admit it did greatly prolong the case and add to its expense). It is simply that such evidence is unhelpful. By the nature of things, where negotiations are difficult, the parties' positions, with each passing letter, are changing and until the final agreement, though converging, still divergent. It is only the final document which records a consensus ... It may be said that previous documents may be looked at to explain the aims of the parties. In a limited sense this is true: the commercial, or business object, of the transaction, objectively ascertained, may be a surrounding fact ... And if it can be shown that one interpretation completely frustrates that object, to the extent of rendering the contract futile, that may be a strong argument for an alternative interpretation, if that can reasonably be found.”

¹¹⁸⁸ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 201; McMeel, G., *Prior Negotiations and Subsequent Conduct – the Next Step forward for Contractual Interpretation*, *Law Quarterly Review*, 119 (2003), at 276; *Whitworth Street Estates (Manchester) Ltd v James Miller & Partners* [1970] A.C. 583. It was held that a contract cannot be construed by reference to subsequent conduct of the parties. Lord Wilberforce said: "Unless it were found an estoppel or a subsequent agreement, I do not think that subsequent conduct can be relevant to this question."

¹¹⁸⁹ Steyn, Johan, *Contract Law: Fulfilling the Reasonable Expectations of Honest Men*, *Law Quarterly Review*, 113 (1997), at 440; McMeel, G., *Prior Negotiations and Subsequent Conduct – the Next Step forward for Contractual Interpretation*, *Law Quarterly Review*, 119 (2003), at 290-294

consideration of various kinds of extrinsic evidence, such as parties' subsequent conduct, prior negotiations, or trade usages.¹¹⁹⁰

Under the CISG, Article 8(3) lists certain circumstances which the decision maker must take into account: "the negotiations, any practices which the parties have established between themselves, usages, and any subsequent conduct of the parties."¹¹⁹¹ Article 8(3), while giving primary importance to those specified circumstances, also invites the decision maker to give consideration "to all relevant circumstances." Thus, the CISG allows the decision maker to take into account both subjective and objective elements in the determination of common intentions of the parties, and the interpretation methodology under the CISG is not constrained by evidentiary rules of interpretation under national laws. The relevant national rules of interpretation, which excludes the extrinsic evidence, are superseded by the CISG since the latter includes a specific rule in this regard.¹¹⁹² The approach of the CISG as to the admissibility of extrinsic evidence in the interpretation of the contract is also followed by the international restatements of the contract principles.¹¹⁹³

Under *lex mercatoria*, when the common intention of the parties cannot be established solely on the basis of the internal context of the contract, the decision maker should first allow extrinsic evidence relating to subjective elements, such as preliminary negotiations between the parties, practices which the parties have established between themselves, and the conduct

¹¹⁹⁰ Section 2-202 (2) of the UCC provides that "Terms in a record may be explained by evidence of course of performance, course of dealing, or usage of trade without a preliminary determination by the court that the language used is ambiguous." Section 1-205 (3) provides that "A course of dealing between parties and any usage of trade in the vocation or trade in which they are engaged or of which they are or should be aware give particular meaning to and supplement or qualify terms of an agreement." Although the comments to pre-revised Section 1-205 refer to course of performance, the section itself deals with only course of dealing and usage of trade. The Revision remedies this omission by adding course of performance to course of dealing and usage of trade as relevant in ascertaining the meaning of the parties' agreement and supplementing its express terms. Thus, in the revised Section 1-303 (d) provides that: "A course of performance or course of dealing between the parties or usage of trade in the vocation or trade in which they are engaged or of which they are or should be aware is relevant in ascertaining the meaning of the parties' agreement, may give particular meaning to specific terms of the agreement, and may supplement or qualify the terms of the agreement." Rowley, Keith A., *The Often Imitated, But (Still) Not Yet Duplicated, Revised UCC Article 1*, UNLV William S. Boyd School of Law Legal Studies Research Paper No. 08-17, (May 15, 2008), available at <http://ssrn.com/abstract=1123744>, at 7; Section 222 of the Restatement regarding usage of trade states "(3) Unless otherwise agreed, a usage of trade in the vocation or trade in which the parties are engaged or a usage of trade of which they know or have reason to know gives meaning to or supplements or qualifies their agreement." Section 223 regarding course of dealing states: "(1) A course of dealing is a sequence of previous conduct between the parties to an agreement which is fairly to be regarded as establishing a common basis of understanding for interpreting their expressions and other conduct. (2) Unless otherwise agreed, a course of dealing between the parties gives meaning to or supplements or qualifies their agreement."

¹¹⁹¹ Schlechtriem, Peter, *Uniform Sales Law: The UN-Convention on Contracts for the International Sale of Goods*, Manz, Vienna, 1986, at 39

¹¹⁹² Enderlein, Fritz & Dietrich Maskow, *International Sales Law: United Nations Convention on Contracts for the International Sale of Goods: Convention on the Limitation Period in the International Sale of Goods: Commentary*, Oceana Publications, 1992, at 66

¹¹⁹³ Article 4.3 of the UNIDROIT Principles: "In applying Articles 4.1 and 4.2, regard shall be had to all the circumstances, including (a) preliminary negotiations between the parties; (b) practices which the parties have established between themselves; (c) the conduct of the parties subsequent to the conclusion of the contract..."; Article 5:102 of the PECL: "In interpreting the contract, regard shall be had, in particular, to: (a) the circumstances in which it was concluded, including the preliminary negotiations; (b) the conduct of the parties, even subsequent to the conclusion of the contract; ... (d) the interpretation which has already been given to similar clauses by the parties and the practices they have established between themselves..."

of the parties subsequent to the conclusion of the contract. As stated in ICC Case No 11440, “as a first step and the predominant aim of any interpretation, the Arbitral Tribunal must try to find out what the common ‘real intentions’ of the parties were when they concluded the contract... They are of factual nature, and therefore, must be alleged and in the case of dispute proved by the party who wishes to rely on it”.¹¹⁹⁴

The importance of subjective considerations, under *lex mercatoria*, results from the complex or atypical nature of the transactions governed through uncertainty, which requires a case-specific approach of recognizing their degree of individualization vis-à-vis common contracting practices. It is argued that the arbitrators take into account prior negotiation and the conduct of the parties subsequent to their entry into the contract and until the dispute arises, because those will reflect the parties' own interpretation of the disputed contract an entering into it.¹¹⁹⁵ In ICC Case No. 10335, the sole arbitrator was required to interpret the shareholder agreement between the claimants and the defendants in order to determine the ambiguous scope of obligation of one of the defendants, who may have breached. Applying Greek law and also referring to the similar provisions in the German Civil Code, the Austrian Civil Code, the Swiss Code of Obligations and UNIDROIT Principles in order to demonstrate that “modern international commercial law is evolving in the same direction”, the arbitrator considered that the interests of the parties in the case being entirely subjective and took into account the contractual documents in its entirety, surrounding facts, negotiations and purpose of the agreement being reflected in the preamble of the agreement and in the history from the various drafts to the final agreement. The arbitrator stated that “Shareholders' agreements are highly negotiated made-to-measure documents. Consequently, custom as one of the accepted tools for interpreting declarations of will is not of assistance.”¹¹⁹⁶

Under the influence of Anglo-American contracting techniques, international contracts usually include “entire agreement clauses.” These clauses, also referred to as “merger clauses” or “integration clauses”, exclude the extrinsic evidence relating to prior negotiations in establishing terms on which the parties may have agreed and that may contradict the agreement in writing, or in proving that the parties have agreed on additional terms not reflected in the written agreement.¹¹⁹⁷ International contracts are often the result of lengthy negotiations under which the bargain evolves to its final state. Many large law firms have standard, “boilerplate”, entire agreement clauses, which are included in contracts as a matter

¹¹⁹⁴ ICC Award in Case No. 11440, 2003, Yearbook Commercial Arbitration, 31 (2006), at 131

¹¹⁹⁵ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 826

¹¹⁹⁶ ICC Award in Case No 10335, 2000, ICC International Court of Arbitration Bulletin, 12-2 (Fall 2001), at 102-106.

¹¹⁹⁷ Fontaine, Marcel & Filip De Ly, Drafting International Contracts: An Analysis of Contract Clauses, Brill Academic Publishers, 2009, at 131 providing a simple example which reads as follows; “This contract, including all the schedules attached hereto which represent an integral part hereof and have been signed by the parties, constitutes the entire agreement between the parties.” Article 15.2 of the ICC Model Mergers & Acquisitions Contract provides that “this agreement constitutes the entire agreement between the parties in relation to the sale and purchase of the Shares and other matters covered by it and supersedes any previous agreement between the parties in relation to those matters, which shall cease to have any effect.” Article 26.1 of the ICC Model Commercial Agency Contract provides that “this contract replaces any other preceding agreement between the parties on the subject”. Article 35.1 of the ICC Model Contract for the Turnkey Supply of an Industrial Plant provides that “this contract constitutes the entire agreement between the Supplier and the Purchaser with respect to the subject matter of the Contract and supersedes all communications, negotiations and agreements (whether written or oral) of the Parties with respect thereto made prior to the date of the contract.”

of routine. These clauses reflect the general understanding that a negotiated document is executed with the object of integrating the bargain and superseding all prior negotiations.¹¹⁹⁸ Thus, they are generally against the possibility of implication of terms into the contract on the basis of the prior negotiations, but their widespread use also tends to discourage decision makers from engaging in a more liberal approach to the admission of extrinsic evidence in the interpretation of contracts.¹¹⁹⁹

In US law, if the parties have adopted an entire agreement clause, i.e. written contract as a final expression of their agreement, and the language of the contract is plain, the courts cannot take into account extrinsic evidence relating to matters prior to entering into contract. If the language of the written contract is ambiguous, i.e. the language is susceptible to two reasonable meanings, the admissibility of such evidence generally depends on a two-stage process. The court will firstly decide whether or not the language is ambiguous and, if it finds that the language is ambiguous, it will consider all of the relevant extrinsic evidence with regard to the contract interpretation in the second stage. However, the courts differ with respect to what a court may consider in the first stage. For instance, the courts in New York strictly adhere to the “four corners” rule, and not only interpret an unambiguous contract according to its terms, without recourse to extrinsic evidence, but also refuse to consider extrinsic evidence to determine whether the writing is ambiguous.¹²⁰⁰ The majority of the courts in the United States at least take into account the surrounding circumstances, such as the nature of the parties and the background of the transaction, in order to determine whether the language of the contract is ambiguous. Some state courts adopt a more liberal view and consider all extrinsic evidence in the first stage.¹²⁰¹ While it is possible for the parties to incorporate a provision, which limits the consideration of extrinsic evidence in the first stage to the surrounding circumstances, it is argued that they cannot include a provision barring the use of extrinsic evidence in the second stage when the language is ambiguous since such a provision will be unenforceable, on the ground that it is against public policy to require a court to interpret a contract like a horse “wearing judicial blinders”.¹²⁰²

In English law, the question of whether the inclusion of an entire agreement clause negates the contextual approach to interpreting contracts has not yet been addressed conclusively. It is suggested that such clauses do not restrict the courts to the four corners of the contract in determining what obligations the parties have undertaken.¹²⁰³ However, it is also observed that there are cases that demonstrate the effectiveness of an entire agreement clause in

¹¹⁹⁸ Peden, Elisabeth, & John Carter, Entire Agreement – and Similar – Clauses, *Journal of Contract Law*, 22-1 (2006), at 2

¹¹⁹⁹ Katz, Avery W., The Economics of Form and Substance in Contract Interpretation, *Columbia Law Review*, 104-2 (2004), at 508

¹²⁰⁰ It is argued that the New York courts are certainly very much aware that their case law on contract interpretation is of particular importance to commercial transactions. Although it is unclear whether the New York courts have followed this approach with a view to maintaining the attractiveness of New York law to foreign litigants in particular, the four corners rule has been explicitly justified on the grounds that it imparts “stability to commercial transactions.” Dammann, Jens & Henry Hansmann, *Globalizing Commercial Litigation*, *Cornell Law Review*, 94 (2008), at 36

¹²⁰¹ Farnsworth E. A., The Interpretation of International Contracts and the Use of Preambles, *International Business Law Journal*, (2002), at 276

¹²⁰² *Ibid.*, at 277 citing *Garden State Plaza Corp. v. S.S. Kresge Co.*, 189 A.2d 448 (N.J. Super. 1963)

¹²⁰³ McMeel, G., Prior Negotiations and Subsequent Conduct – the Next Step forward for Contractual Interpretation, *Law Quarterly Review*, 119 (2003), at 295 footnote 97

limiting the range of contextual material available for consideration by the court and reducing the options for the court seeking to give effect to implicit understandings or reasonable expectations at the expense of contract terms.¹²⁰⁴ In *ProForce Recruit Ltd. v. The Rugby Group Ltd*, the agreement between the parties contained a clause stating "[t]his Agreement ... constitutes the entire contract between the parties and supersedes all prior representations, agreements, negotiations or understandings whether oral or in writing."¹²⁰⁵ In High Court (Queen's Bench Division), Field J held that the evidence of pre-contract negotiations between the parties was not admissible in aid of the construction of a term in the agreement. In his opinion the effect of the wording of the entire agreement clause was that the things superseded, including the pre-contractual negotiations between the parties, were to have no bearing on the meaning of the agreement and such evidence forms no part of the factual matrix to be used in construing the agreement.¹²⁰⁶ On appeal, the Court of Appeal unanimously overruled the High Court's decision and deferred the case to trial for further findings of fact concerning the meaning the parties intended to attach to the expression in question in the course of pre-contractual negotiations.¹²⁰⁷ The Court of Appeal held that the exploration of the surrounding circumstances, including pre-contractual negotiations, is not completely ruled out either by the authorities on the admissibility of extrinsic evidence or by the agreement. Mummery LJ referred, among others, to *Partenreederei Karen Oltmann v. Scarsdale Shipping Co. Ltd.*,¹²⁰⁸ admitting evidence of what the parties said in negotiations at least where it is sought to show that the parties negotiated on an agreed basis that the words used bore a particular meaning.¹²⁰⁹ Mummery LJ concluded that in the case at hand any evidence of pre-contract negotiations relevant for the purpose of ascertaining the meaning of a term also should be admitted. In his view, "it [was] reasonably arguable" that by this clause

¹²⁰⁴ Mitchell, Catherine, *Interpretation of Contracts: Current Controversies in Law*, Routledge-Cavendish, 2007, at 132

¹²⁰⁵ *ProForce Recruit Ltd. v. The Rugby Group Ltd.*, [2006] EWCA (Civ) 69

¹²⁰⁶ *Rugby Group Ltd. v. ProForce Ltd.*, [2005] EWHC 70 (Q.B.)

¹²⁰⁷ *ProForce Recruit Ltd. v. The Rugby Group Ltd.*, [2006] EWCA (Civ) 69, 36, 38

¹²⁰⁸ *Partenreederei Karen Oltmann v. Scarsdale Shipping Co. Ltd.*, [1976] 2 Lloyd's Rep. EWHC (Comm) 708, 712, [31] (Eng.). Kerr J pointed out: "If a contract contains words which, in their context, are fairly capable of bearing more than one meaning, and if it is alleged that the parties have in effect negotiated on an agreed basis that the words bore only one of the two possible meanings, then it is permissible for the court to examine the extrinsic evidence relied upon to see whether the parties have in fact used the words in question in one sense only, so that they have in effect given their own dictionary meaning to the words as the result of their common intention. Such cases would not support a claim for rectification of the contract, because the choice of words in the contract did not result from any mistake. The words used in the contract would ex hypothesi reflect the meaning which both parties intended." However, it must be noted that this decision was criticized by a recent decision of House of Lords with regard to the exclusionary rule on admission of extrinsic evidence of negotiations. Lord Hoffmann stated that "On its facts, the *Karen Oltmann* was in my opinion an illegitimate extension of the "private dictionary" principle which, taken to its logical conclusion, would destroy the exclusionary rule and any practical advantages which it may have. There are two legitimate safety devices which will in most cases prevent the exclusionary rule from causing injustice. But they have to be specifically pleaded and clearly established. One is rectification. The other is estoppel by convention, which has been developed since the decision in the *Karen Oltmann*: see *Amalgamated Investment & Property Co. Ltd. v. Texas Commerce International Bank Ltd.* [1982] QB 84. If the parties have negotiated an agreement upon some common assumption, which may include an assumption that certain words will bear a certain meaning, they may be estopped from contending that the words should be given a different meaning. Both of these remedies lie outside the exclusionary rule, since they start from the premise that, as a matter of construction, the agreement does not have the meaning for which the party seeking rectification or raising an estoppel contends." *Chartbrook Limited (Respondents) v Persimmon Homes Limited and others (Appellants) and another (Respondent)* [2009] UKHL 38

¹²⁰⁹ *ProForce Recruit Ltd. v. The Rugby Group Ltd.* [2006] EWCA (Civ) 69, 30-36

the parties intended to exclude “ascertaining the contents of [their] written contract ... by reference to prior representations, agreements, negotiations and understandings,” but not to inhibit “ascertaining the meaning of a term contained in [their] written contract by reference to pre-contract materials.”¹²¹⁰

It is argued that, in civil law countries, the entire agreement clauses can be interpreted as waivers and their effectiveness may be weakened by their boilerplate nature or in the absence of express references as to their effects.¹²¹¹ Thus, the final written terms may be preempted by the principle of good faith, despite an entire agreement clause in the contract. The enforcement of entire agreement clauses in civil law jurisdictions seems to be possible when they are clearly drafted, yet subject to the general reservations of abuse of rights and the principle of good faith. It can be said that the civil law position regarding the effect of entire agreement clauses on interpretation would require the decision maker first to admit the evidence of prior negotiations, and then to reject it, if it is unconvincing, rather than to declare it inadmissible from the outset.

The CISG does not deal with entire agreement clauses. Since Article 6 of the CISG allows the parties to derogate from or vary the effect of any of its provisions, the effect of an entire agreement clause may be to derogate from the rules of interpretation contained under Article 8. The CISG Advisory Council, in its Opinion No. 3, noted that there is authority for the proposition that a properly worded entire agreement clause bars the consideration of extrinsic evidence.¹²¹² However, the Council suggested that extrinsic evidence should not be excluded, unless the parties actually intended the entire agreement clause to have this effect, and this question should be resolved by reference to the criteria set out in Article 8, which requires an examination of all relevant facts and circumstances. The Council concluded that the entire agreement clause may prevent recourse to extrinsic evidence for the purpose of interpretation if specific wording, together with all other relevant factors, make clear the parties' intent to derogate from Article 8 for purposes of contract interpretation.¹²¹³

Article 2.1.17 of the UNIDROIT Principles provides that “A contract in writing which contains a clause indicating that the writing completely embodies the terms on which the parties have agreed cannot be contradicted or supplemented by evidence of prior statements or agreements. However, such statements or agreements may be used to interpret the writing.” As the UNIDROIT Principles do not contain a plain meaning rule, the evidence of prior negotiations is admissible even if the language is not ambiguous.¹²¹⁴ A similar provision is set out in Article 2:105 of the PECL. It is provided that if a written contract contains a merger clause, any prior statements, undertakings or agreements which are not embodied in the writing do not form part of the contract, but they may be used to interpret the contract. Article 2:105 also adds that if the merger clause is not individually negotiated it will only establish a presumption that the parties intended that their prior statements, undertakings or agreements

¹²¹⁰ Ibid., 39-41

¹²¹¹ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 139

¹²¹² CISG-AC Opinion No. 3, Parol Evidence Rule, Plain Meaning Rule, Contractual Merger Clause and the CISG, Rapporteur: Professor Richard Hyland, Rutgers Law School, Camden, NJ, USA, 2004, para. 4.5

¹²¹³ Ibid., para. 4.6

¹²¹⁴ Farnsworth E. A., *The Interpretation of International Contracts and the Use of Preambles*, *International Business Law Journal*, (2002), at 277

were not to form part of the contract. As the PECL are intended to restate contract law in the European Union relevant to both consumer transactions and commercial transactions, the protection against standard conditions was considered necessary since these clauses are boilerplate in many transactions. When expressly stated, Article 2:105 allows for the exclusion of pre-contractual statements even for interpretative purposes. However, Article 2:105 also provides that a party may, by its statements or conduct, be precluded from asserting an entire agreement clause to the extent that the other party has reasonably relied on those statements or that conduct.

The function of such clauses, in the manner they are generally drafted in practice, is to prevent implication of additional or contradicting terms, which were not contemplated or included in the written agreement, on the basis of the evidence of negotiations. These clauses particularly focus on the pre-contractual circumstances, such as drafts to agreements, correspondence, and protocols from negotiations, arising from the prior contact between parties. They are not drafted in a way to exclude the admissibility of evidence of negotiations in the interpretation of the contract, i.e. the determination of what the terms in the written agreement mean. Thus, generally, in the presence of these clauses, all sorts of extrinsic evidence can be used to interpret ambiguous elements in the final documents, subject to the default rules of interpretation chosen by the parties, but the evidence of negotiations can not to give rise to new rights or obligations.

In an arbitral award rendered under the auspices of Camera Arbitrale Nazionale e Internazionale di Milano, the arbitral tribunal had to decide about the proper meaning of the price adjustment clause in the presence of an entire agreement clause¹²¹⁵ in a contract between a U.S. company and a Luxembourg company for the purchase of part of a third company owned by one of the parties. The contract was governed by Italian law. One party argued that the clause in question was to be interpreted in the light of Article 1362 (2) of the Italian Civil Code, i.e. in accordance with the common intent of the parties to be determined in the light of their conduct or any agreement prior or subsequent to the conclusion of the contract. The other party, invoking the entire agreement clause, argued that the parties' intention was only contained in the contract and that therefore any other understanding prior or subsequent to its conclusion was to be disregarded. The arbitral tribunal confirmed that the provision in question was to be considered a merger clause. It held that such a clause simply indicates that there are no binding agreements between the parties other than those contained in the contract, but does in no way affect the rules of interpretation established under the applicable Italian law. In support of this holding, the arbitral tribunal also referred to Article 2.1.17 of the UNIDROIT Principles and its comments.¹²¹⁶

In ICC Case No. 10335, the sole arbitrator interpreted the scope of obligation of the defendant, in order to determine whether the defendant was in breach of a shareholder agreement. The parties agreed that the principles of interpretation under the applicable Greek law required the arbitrator “to strike a balance between a subjective and an objective approach to determine what the "true" meaning is, when the parties to a contract, at a later stage, find

¹²¹⁵ The clause read that “this agreement encompasses the entire understanding between the parties with respect to the subject matter of this agreement, and supersedes all prior agreements or statements regarding the subject matter and there are no representations, warranties, covenants, agreements, or collateral understandings oral or otherwise, express or implied, affecting this agreement if not expressly set forth or provided for herein”

¹²¹⁶ Abstract of the decision dated 28.11.2002 is available at <http://www.unilex.info/case.cfm?pid=2&do=case&id=995&step=Abstract>

themselves in disagreement.” The parties also agreed on the elements of interpretation, namely the document in its entirety, surrounding facts, related documents, negotiations, interests of the parties, purposes of the agreement and custom.¹²¹⁷ The arbitrator first considered the contract in its entirety, and found that the defendant was not in breach. The shareholder agreement was signed after a successful second bid concerning the purchase of shares in a company listed on the Athens stock exchange from a Greek state entity. There was a Cooperation Agreement regulating the relationship of the same parties with regard to their unsuccessful first bid and giving some content to the scope of obligation of the defendant. The arbitrator, while stating that the Cooperation Agreement was certainly a predecessor in the history of the transaction, held that it “cannot provide guidance as to the interpretation of the Shareholders’ Agreement” because the shareholder agreement contained an entire agreement clause.¹²¹⁸ The arbitrator took into account that the parties to the shareholders agreement apparently deliberately dropped a clause contained in the Cooperation Agreement that was superseded by the entire agreement clause. Moreover, the arbitrator noted that a new draft Cooperation Agreement, which contained a clause identical to the previous one, was suggested but remained unexecuted.¹²¹⁹ Thus, the arbitrator took into account the evidence of negotiations despite the existence of an entire agreement clause in the shareholders agreement, and essentially found that the evidence as to the common intentions of the parties precluded the arbitrator from interpreting the scope of obligations of the defendant by reference to an earlier and superseded agreement.

Under *lex mercatoria*, in the absence of clear indications as the effect of an entire agreement clause on the rules of interpretation, the contextual approach is required in determining the scope of the entire agreement clause with regard to whether the exclusion of certain materials is only relevant to supplementing or modifying the contract, or extends to ascertaining the meaning of the contract. The materials that can be utilized by this contextual approach depend on the default rules of interpretation chosen by the parties. The contextual approach may show either that the parties’ actual understanding as to a particular contractual clause may displace the text of the contract, or that they intended to be bound solely by the plain wording of the written agreement and not their common understanding from negotiations. In the latter case, if the plain meaning of the agreement is still ambiguous, the decision maker should resort to extrinsic factors other than the prior negotiations of the parties, such as trade usages or subsequent conduct of the parties, depending on the circumstances of the case.

An entire agreement clause covers only prior statements or agreements between the parties and does not preclude subsequent informal agreements between them, and the application of entire agreement clause may become waived by conduct. Thus, the parties may wish to extend such exclusion to the evidence relating to their subsequent conduct.¹²²⁰ In international

¹²¹⁷ ICC Award in Case No 10335, 2000, ICC International Court of Arbitration Bulletin, 12-2 (Fall 2001), at 104

¹²¹⁸ *Ibid.*, at 105: “This agreement included the complete agreement of the Parties hereto as to its subject matter and supersedes to any prior written or oral agreement between the Parties which are hereby declared null and void.”

¹²¹⁹ *Ibid.*

¹²²⁰ For example, in England, in the case *SAM Business Systems Limited v. Hedley and Company*, the High Court held that the entire agreement clause was waived by SAM, who could otherwise have relied on the clause. The court found that SAM treated post-contractual conversations and letters that clearly indicated the claimant’s comprehension of the agreement “as incorporated into the contract”. This was seen as a waiver of a subsequent allegation that the entire agreement clause precluded such an understanding. *SAM Business Systems Limited v. Hedley and Company* [2003], All ER (Comm) 465

contracting practice under the influence of Anglo-American contract drafting, “No Oral Modification clauses” (also referred to as “No Oral Amendment clauses,” “Written Modifications clauses” or “No Oral Variations clauses”) have been widely used for that purpose.¹²²¹ These clauses require that amendments be made in writing and, in a way, complement entire agreement clauses in their attempt to bar the use of extrinsic evidence relating to the subsequent conduct of the parties for implication of additional or contradicting terms to the written agreement.

Against the traditional reluctance of courts to enforce these clauses, which may lead to unfair results in a particular case, there is a tendency to seek for intermediate positions.¹²²² For example, with regard to sales contracts, Section 2-209 (2) of the UCC provides that a signed agreement, which excludes modification or rescission except by a signed writing may not be otherwise modified or rescinded. However, Section 2-209(4) provides that if parties include such a clause, but later “attempt” to modify their agreement without satisfying that clause, their “attempt” can operate as a waiver. Similarly, Article 29 (2) of the CISG recognizes the validity of these clauses by providing that “A contract in writing which contains a provision requiring any modification or termination by agreement to be in writing may not be otherwise modified or terminated by agreement.” However, the second sentence of the Article 29 (2) makes this recognition subject to a waiver provision by providing that “a party may be precluded by his conduct from asserting such a provision to the extent that the other party has relied on that conduct.” This approach has also been adopted by the UNIDROIT Principles, which use the identical wording in Article 2.1.18. Article 2:106 of the PECL provides that a no oral modification clause establishes only a presumption that an agreement to modify or end the contract is not intended to be legally binding unless it is in writing, and a party may by its statements or conduct be precluded from asserting such a clause to the extent that the other party has reasonably relied on them. The Official Comment to PECL indicates that the guiding principle is good faith and it would be contrary to good faith to deny a party the right to prove a modification or termination if the other party agreed to that effect but later invokes the no oral modification clause.¹²²³

Although these clauses, as they are drafted in practice, do not aim directly to bar the relevance of extrinsic evidence relating to subsequent conduct in the interpretation of the contract, the decision maker should consider whether they may have an effect on the relevance of such evidence in the interpretation of the contract. In ICC Case No. 9117, the arbitral tribunal considered the effects of both the entire agreement clause and no oral modification clause contained in a contract for the sale of goods between a Russian seller and a Canadian buyer. The tribunal determined the applicable law as the CISG, the relevant usages of trade, and Russian law. The tribunal characterized both of those clauses as typical clauses, and stated that “there can be no doubt for any party engaged in international trade that the clauses mean, and must mean, what they say.” By referring to the UNIDROIT Principles, the tribunal held

¹²²¹ Article 26.2 of the ICC Model Commercial Agency Contract provides that “No addition or modification to this contract shall be valid unless made in writing. However, a party may be precluded by his conduct from asserting the invalidity of additions or modification not made in writing to the extent that the other party has relied on such conduct.” This article has been adopted from Article 29 (2) of the CISG.

¹²²² Hillman, Robert A., Article 29(2) of the United Nations Convention on Contracts for the International Sale of Goods: A New Effort at Clarifying the Legal Effect of “No Oral Modification” Clauses, *Cornell International Law Journal*, 21 (1988), at 451

¹²²³ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 162

that the entire agreement clause makes sure that only terms as reflected in the signed agreement will form part of the contractual obligations, thus excluding any extrinsic understandings, oral explanations, assurances or representations during prior negotiations which are not as such reflected in the written contract, and prior negotiations could thus only be relevant for purposes of interpretation. With regard to the no oral modification clause, the tribunal stated that it has the same effects as the merger clause with regard to any future negotiations, promises and any other extrinsic evidence which otherwise might be adduced for supplementing, altering or contradicting the written contract.¹²²⁴

Both “entire agreement clauses” and “no oral modification clauses” may have a bearing on the relevance of extrinsic evidence relating to subjective elements to the interpretation of contracts, although the way these clauses are drafted in practice usually does not indicate that the parties intend to bar the use of such evidence for the purpose of interpretation.¹²²⁵ While the use of extrinsic evidence relating to subjective considerations in the interpretation of contract may be barred by the parties with explicit contractual clauses, or as a result of their common intentions determined through a contextual approach, their enforcement in the particular circumstances of the case should not result in a violation of the basic principle of good faith and fair dealing. Where the limitations are effective, the decision maker applying *lex mercatoria* will resort to objective considerations, such as trade usages, customs or other practices, in order to determine the meaning of a contractual term. Similar considerations will also prevail in cases where the parties expressly agree on a set of default rules, which bars the extrinsic evidence of subjective elements in the interpretation of the contract, such as English law. Such a choice will limit the admissibility of extrinsic evidence to objective considerations in the interpretation of the contract, which must be observed by the decision maker applying *lex mercatoria*, since those default rules of interpretation should be treated as articulated rules and part of the bargain underlying the contract.

In general, however, the established rules of interpretation in the order of international commerce allow the decision maker to take into account the evidence of negotiations and subsequent conduct in the interpretation of the contract and, thus, those established rules may supersede the idiosyncratic rules of English law, when they are applicable pursuant to the established rules of conflict. The isolated position of the authorities in the English legal system with regard to the inadmissibility of evidence of negotiations and subsequent conduct in the interpretation of contract is even questioned by the lower English courts, other common law courts and the legal doctrine.¹²²⁶ Above all, the rules that deny outright such evidence in

¹²²⁴ ICC Award in Case No. 9117, March 1998, ICC International Court of Arbitration Bulletin, 10-2 (Fall 1999), at 100

¹²²⁵ Farnsworth E. A., *The Interpretation of International Contracts and the Use of Preambles*, *International Business Law Journal*, (2002), at 277

¹²²⁶ McMeel, G., *Prior Negotiations and Subsequent Conduct – the Next Step forward for Contractual Interpretation*, *Law Quarterly Review*, 119 (2003), at 294-297; Finn J, delivering the judgment of the Federal Court in *Australian Medic-Care Company Ltd v Hamilton Pharmaceutical Pty Limited*, commented on the decision of the House of Lords in *Chartbrook Limited v Persimmon Homes Limited* [2009] UKHL 38, which confirmed the inadmissibility of evidence of negotiations in the interpretation of the contract. He stated that “I would note without disrespect that this rule does not as of course commend itself in all parts of the common law world and, in particular, in parts of the United States” and added that “in a case ... where there are both a dispute as to whether the contract is or is not partly oral and claims as well of misleading or deceptive conduct in the negotiations for the contract, the evidence of the parties’ negotiations can be admitted on those issues and can result in the court obtaining an informed appreciation not only of the object and intent of the contract itself but also of individual clauses of it.” *The Federal Court of Australia, Australian Medic-Care Company Ltd v Hamilton Pharmaceutical Pty Limited*, 30 October 2009, (ACN 008 204 635) [2009] FCA 1220, para. 118 Also

the interpretation of contract are inappropriate in the order of international commerce, due to their undue limitation upon the utilization of the knowledge of the particular circumstances of time and place in the ex post process of adjudication. Thus, under *lex mercatoria*, such evidence, where available and the plain meaning of the contract is ambiguous, should even prevail over other objective considerations, unless the parties express their intent for the inadmissibility of such evidence by including entire agreement or no oral modification clauses that clearly excludes the use of such evidence in the interpretation of the contract, or by choosing English law as the law governing the substance of the dispute.

a. Objective Considerations

Where the decision maker cannot determine the common intentions of the parties solely on the basis of the subjective considerations, the decision maker will resort to the objective considerations and combine them with the text, nature and purpose of the contract as a whole, and extraneous factors relating to subjective elements, to the extent that they are available, in order to ascertain the specific contractual rights, obligations and risk allocations.

In the civil legal systems, where the decision maker cannot find a common understanding between the parties about the meaning of the contract, he is required to resolve the diverging understandings of parties in a fair balance, because if an interpretation which one of the parties neither intended nor could discern was regarded as authoritative, his freedom of contract would be disregarded.¹²²⁷ Thus, when the common actual intentions of the parties cannot be determined, the objective considerations require a process of determination of the rights and obligations of the parties on the basis of a reasonable standard of good faith. In those cases, the law adopts the perspective of a reasonable party as the basis of interpretation and allows a wide variety of other materials to be considered in addition to the meaning of the words, thereby providing a test which works equally for and against both parties.¹²²⁸ For example, Section 133 of the German Civil Code is complemented and used in conjunction with Section 157 of the German Civil Code, which provides that contract shall be interpreted according to good faith giving consideration to common practice. The common practices are factors and circumstances that must be considered in the interpretation of the contracts in order to establish what is expected under good faith. Thus, Section 157 introduces objective considerations into the process of interpretation in the case that the parties understood the expressions in the contract differently and a common actual meaning cannot be established.¹²²⁹

As the approach of English law is not interested in finding the subjective intentions of the parties, the perspective to be adopted by the courts when interpreting contracts is that of an

see: Court of Appeal of New Zealand, 27 November 2000, (2000) NZCA 350, *Hideo Yoshimoto v Canterbury Golf International Limited*, and Court of Appeal of England, *Chartbrook Limited v. Persimmon Homes Limited*, 2008 EWCA Civ 183, discussed above in Chapter II, b, iii, a

¹²²⁷ Canaris, Claus-Wilhelm, & Hans Christoph Grigoleit, *Interpretation of Contracts*, in A.S. Hartkamp, E.H. Hondius, M.W. Hesselink, E. du Perron & M. Veldman, (eds.), *Towards A European Civil Code*, Kluwer Law International, 2004, at 448

¹²²⁸ *Ibid.*, at 451

¹²²⁹ Zweigert, Konrad & Hein Koetz, *An Introduction to Comparative Law*, translated by Tony Weir, Oxford University Press, 3rd rev. ed., at 404

objective third party, the reasonable man.¹²³⁰ Lord Steyn argues that, for reasons of commercial convenience, English law insists on an objective theory of contract. He points out that this involves adopting an external standard given life by using the concept of the reasonable person and, in contract law, effect must be given to the reasonable expectations of honest people. The expectations which will be protected are those that are, in an objective sense, common to both parties. In his view, the function of the law of contract is to provide an effective and fair framework for contractual dealing, a function which requires adjudication based on the reasonable expectation of parties.¹²³¹ Thus, under English law, the written contract is binding in its interpretation as it would reasonably have appeared to someone in the party's position, thus protecting the reasonable understandings of parties to a contract.¹²³²

Under CISG, if the common intentions of the parties cannot be established on the basis of the parties' actual intentions, the courts will attempt to define such intentions using the "reasonable person" test, which is described in Article 8(2).¹²³³ Accordingly, statements made by and other conducts of a party are to be interpreted according to the understanding that a reasonable person of the same kind as the other party would have had in the same circumstances. Similarly, when the common intention cannot be established, Article 4.1 (2) of the UNIDROIT Principles refers to the understanding of reasonable persons, and provides that, in such cases, the contract shall be interpreted according to the meaning that reasonable persons of the same kind as the parties would give to it in the same circumstances. Article 5:101 (3) of the PECL provides that if an intention cannot be established according to paragraphs (1) or (2), the contract is to be interpreted according to the meaning that reasonable persons of the same kind as the parties would give to it in the same circumstances.

In the arbitral awards, the use of this form of reasonableness test can be observed fairly frequently, since it enables the decision maker to exercise an abstract reasoning in his specialized consolidations and to use imperfect knowledge creatively through his specialization. It is argued that the arbitrators are influenced by certain criteria extraneous to the contract even though it is rarely admitted or verbally expressed, but appears from simple reading of an arbitral award that the arbitrators have influenced by socio-commercial criteria, such as justice between the parties, commercial bona fides and the needs of international trade, and this approach is considered as one of the major strengths of international arbitration.¹²³⁴ Such criteria can be seen as the abstract reasoning exercised by a specialist in the control of legal uncertainty arising from the ambiguities in the contract. Thus, such reasoning forms the basis of reasonableness test under *lex mercatoria*. Under this reasoning, the actual understanding of a party, who has acted upon what he honestly believed, becomes irrelevant. Rather, the decision maker exercises his abstract reasoning about the tacit

¹²³⁰ *Investors Compensation Scheme Ltd v West Bromwich Building Society*, [1998] 1 WLR 896: "Interpretation is the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract."

¹²³¹ Steyn, Johan, *Contract Law: Fulfilling the Reasonable Expectations of Honest Men*, *Law Quarterly Review*, 113 (1997), at 433-434

¹²³² Cartwright, John, *Protecting Legitimate Expectations and Estoppel in English Law*, *Electronic Journal of Comparative Law*, 10.3 (December 2006), available at <http://www.ejcl.org/103/article103-6.pdf>, at 19

¹²³³ Zeller, Bruno, *Determining the Contractual Intent of Parties under the CISG and Common Law-- A Comparative Analysis*, *European Journal of Law Reform*, 4-4 (2002), at 629

¹²³⁴ Lew, Julian D. M., *Applicable Law in International Commercial Arbitration: A Study in Commercial Arbitration Awards*, Oceana, 1978, at 508

knowledge of a party, who should have acted in accordance with requirements of the established rules under the basic principle of good faith and fair dealing, by taking into account whether he has put forth his best efforts and exercised due diligence in performing his contractual undertakings, upheld the common contractual purpose, and avoided abuse of rights acquired under the contract or interference with the other party's performance.

In an arbitral award from Zurich Chamber of Commerce, the arbitrators, applying Swiss law in the interpretation of an arbitration clause of a sales contract between European and Canadian/Chinese parties, stated that “parties to a contract are bound by the meaning of the contractual provision as it must be understood by the average honest and diligent businessman” in the sense that “a party must be protected in its confidence that a contractual provision will have the meaning as will be conferred to it by the 'average/diligent businessman' (disregarding thus the purely subjective meaning one particular party for itself may confer to a particular contractual provision)”. According to the tribunal, this rule of interpretation “reflects a general and indeed world-wide consensus..., for instance, ... the most recent elaboration in respect of the legal rules applicable to international contracts, namely the 1994 UNIDROIT Principles which have been established by a large international working party consisting of specialists in contract law selected from all different parts of the world, including for instance Mainland China, Korea and Japan.”¹²³⁵ Similarly, in ICC Case No 9651, the arbitral tribunal, applying Swiss law in the interpretation of the choice of law clause contained in a supply contract between German and Indian parties, elaborated the “principle of confidence” in contract interpretation and found similarities with the approach of UNIDROIT Principles. The arbitral tribunal stated that “according to that principle, the declaration is neither understood in the sense of what the declaring party may have had in mind nor in accordance with the literal sense of the wording, but in the meaning which the addressee could in good faith attribute to it. As good faith requires the addressee to consider all aspects allowing the understanding of the declared intent, the wording is not the only test. Article 4.2(2) of the Unidroit Principles provides for the same test, article 1.7 of the same Principles imposing further the overriding duty of good faith.”¹²³⁶ In order to solve the dispute as to interpretation, the arbitral tribunal referred to the understanding of “reasonable businessmen” with regard to a choice of law clause.

Of course, the interpretation of contract should not be based exclusively on an abstract reasoning about objective considerations, where it is possible to find trade usages in the narrow sense: in the absence of any indication to the contrary, the parties will be deemed to have agreed that such usages that add a layer to the contractual relationship should apply.¹²³⁷ In ICC Case No 9117, the arbitral tribunal stated that, “in the first instance, the contractual terms as agreed by the Parties in the framework of their contractual relationship shall be looked at and applied to determine the disputed issues. In case of ambiguity and in the extent necessary, contractual terms may have to be interpreted by the Tribunal. In addition to the foregoing, the Tribunal has to have regard to the relevant usages of the trade, for two reasons: First, the Parties had specifically referred to the Incoterms 1990 [...] Second, trade usages are

¹²³⁵ Zurich Chamber of Commerce, Preliminary Award, November 25, 1994, Yearbook Commercial Arbitration, 22 (1997), at 218

¹²³⁶ ICC Award in Case No. 9651, August 2000, ICC International Court of Arbitration Bulletin, 12-2 (Fall 2001), at 79

¹²³⁷ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 827

to be observed on the basis of Article 13(5) ICC Rules (which Rules had been chosen by the Parties).¹²³⁸

It is suggested that, absent subjective considerations relating to the common intentions of the parties, the parties' common intentions is most likely to be satisfied by trade usages in this narrow sense that interpret the express terms of the contract to reflect the commonsense expectations of the relevant community.¹²³⁹ The principal argument of this suggestion is that, in line with the Hayekian understanding of the dispersed bits of incomplete knowledge, certain bits of knowledge may be shared by and accessible to only certain associations of persons and the recognition of the significance of such knowledge may amount to the recognition of the importance of an individual case.¹²⁴⁰ However, the trade usages in the context of a heterogeneous community of international merchants may be inherently vague and indeterminate, and often found in the general principles of law under a broader understanding. This is because the understanding of the trade usage among the members belonging to such a community may "lack definition, its boundaries and qualifications will be hazy and even its central core may prove to be a matter of debate."¹²⁴¹ This broader understanding of trade usages requires intuitive use of incomplete knowledge by the decision maker, who is to identify the trade usage and determine the conditions under which it applies. Above all, a trade usage in the narrow sense will be unlikely to form the subject of a dispute arising from a transaction governed through legal uncertainty.

However, even in identifying trade usages in the narrow sense, the use of reasonableness test, based on "the goals, beliefs, and other normative premises of the person doing the identifying", are relevant.¹²⁴² It is true that such usages can be in the form of bright-line rules, which are uniform across all members of a community and, in this situation, the decision maker could take those usages into consideration rules without any further assessment.¹²⁴³ Apart from this situation, the abstract reasoning under reasonableness test converts incomplete knowledge into a workable format. The abstract reasoning can be exercised by the decision maker, who is required to consolidate the relevant materials indicating commercial practices and/or by an expert, who is required to provide a more precise formulation of the trade usage in his witness testimony. In these cases, the abstract reasoning will reflect the specialization of the individuals identifying or ascertaining trade usages in the narrow sense according to their beliefs and experience. In the context of international arbitration, which is freed from the constraints of formal consolidations of national legal systems in the identification of trade usages, it is observed that there are arbitrators "who seem willing to infer international trade usage on the flimsiest of evidence or even on no evidence at all

¹²³⁸ ICC Award in Case No. 9117, March 1998, ICC International Court of Arbitration Bulletin, 10-2 (Fall 1999), at 98

¹²³⁹ Barnett, Randy E., *The Sound of Silence: Default Rules and Contractual Consent*, Virginia Law Review, 78-4 (May, 1992), at 880

¹²⁴⁰ *Ibid.*, at 831-855

¹²⁴¹ Goode, Roy, *Usage and its Reception in Transnational Commercial Law*, International and Comparative Law Quarterly, 46-1 (1997), at 12-13

¹²⁴² Craswell, Richard, *Do Trade Customs Exist?*, in Jody S. Kraus & Steven D. Walt, *The Jurisprudential Foundations of Corporate And Commercial Law*, Cambridge University Press, 1999, available at <http://ssrn.com/abstract=184988>, at 2

¹²⁴³ *Ibid.*, at 17-18

beyond their own personal experience.”¹²⁴⁴ Thus, the use of trade usages, even in the narrow sense, often reflects the combination of observation of the contractual practices with estimates or intuitive judgment. As a result, in some transactions, it is possible to note a hostile attitude of the parties towards custom, usages or course of dealing as these may threaten the structure of the transaction and underlying bargain. There are contractual clauses try to exclude trade usages and other similar concepts.¹²⁴⁵ It is argued that this is also possible for contracts subject to the CISG, and the evidence relating to trade usages relevant under Article 9(1) or established practices concerning the implicit background of the transaction can be barred, if the parties so intend.¹²⁴⁶

It is observed that, in international contracting practice, it is really rare to find a contract which has a provision requiring a strict or literal interpretation of the contract.¹²⁴⁷ Particularly, it can be said that the parties to transactions governed through legal uncertainty should not opt for a truly limited approach to contract interpretation with regard to the relevance of extrinsic factors relating to objective considerations, since such considerations enable the decision maker to exercise an abstract reasoning through the reasonableness test in searching for accurate solutions. In such transactions, the parties may even prefer to incorporate such standards that invite the decision maker to look beyond the plain meaning of the contract terms. In this vein, some ICC Model Contracts provide that their terms, as well as any statements made by the parties in connection with their contractual relationships shall be interpreted in accordance with the principles of good faith and fair dealing.¹²⁴⁸ In the commentary to ICC Model Commercial Agency Contract, it is explained that, under that provision, the contract should generally be interpreted in conformity with the general meaning of the language used, but if a different meaning would have been understood by a reasonable person in the same situation as the parties, then the latter should prevail.¹²⁴⁹

4. Interpretative Presumptions

There are interpretative presumptions in the form of established rules, which aid the interpretation of the contract. Their application is mostly subsidiary, namely when there is doubt with regard to the common intentions of the parties and the use of extrinsic factors and reasonableness test does not provide conclusive results about the meaning to be attached to

¹²⁴⁴ Goode, Roy, Usage and its Reception in Transnational Commercial Law, *International and Comparative Law Quarterly*, 46-1 (1997), at 13

¹²⁴⁵ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 179; An example clause reads, “... No understanding, agreement or trade custom not expressly stated in this Agreement shall be binding on the parties in the interpretation or fulfillment of this Agreement unless such understanding, agreement or trade custom is reduced to writing and signed by the parties.” Another reads, “... and this Contract shall not be modified, varied or supplemented by any course of dealing, usage of the trade or otherwise except by a writing signed by the parties hereto.”

¹²⁴⁶ CISG-AC Opinion No. 3, Parol Evidence Rule, Plain Meaning Rule, Contractual Merger Clause and the CISG, Rapporteur: Professor Richard Hyland, Rutgers Law School, Camden, NJ, USA, 2004, para. 4.7

¹²⁴⁷ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 182

¹²⁴⁸ Article 2.2 of ICC Model Mergers & Acquisitions Contract, International Chamber of Commerce, ICC publication, 656, Paris, 2004; Article 2.2 of ICC model contract for the turnkey supply of an industrial plant, ICC publication, 653, Paris, 2003; Article 2.2 of the ICC model commercial agency contract, 2nd ed., ICC publication, 644, Paris, 2002

¹²⁴⁹ Lando, Ole, Commentary to Article 2, in Bortolotti, Fabio, (ed.), *The ICC Agency Model Contract*, A Commentary, ICC Publication No. 512, Paris, 1993, at 17

the terms of contract in dispute. One of those interpretative presumptions is the principle of effectiveness. The principle of effectiveness is an ancient concept expressed in the maxim “*ut res magis valeat pereat*” (“That the thing may rather have effect than be destroyed”). This principle raises the presumption that the draftsmen of a clause intended it to have a meaning and a practical effect.¹²⁵⁰ Accordingly, if the terms of a contract are capable of two contrary interpretations or can convey two different meanings, one should favor the interpretation, which gives a certain effect to the words, rather than the interpretation, which renders them redundant or even absurd.

In national laws, the rule of effectiveness in the interpretation of contracts is widely accepted and can be described as a general principle of law and an established rule of interpretation.¹²⁵¹ It is also included in Article 4.5 of the UNIDROIT Principles and Article 5:106 of the PECL. In the arbitral practice, it is observed that this principle is also applied as a universally acknowledged principle of interpretation without reference to national law.¹²⁵² In ICC Case No 8365, the arbitral tribunal, after deciding to apply *lex mercatoria* to the dispute, stated that the principle of effectiveness is included into the substantive aspect of *lex mercatoria*.¹²⁵³ In ICC Case No 8547 concerning a dispute over the terms of an international sales contract involving successive deliveries, the parties had agreed that the two 1964 Uniform Laws on the International Sale of Goods and on the Formation of Contracts for the International Sale of Goods should govern their contract. With respect to questions not settled by the two instruments, the tribunal decided to apply the UNIDROIT Principles. In rejecting the contention of the defendant that the contract was renegotiated wholly for each delivery, the tribunal held that the contract continued to exist as the legal framework of the parties to which specific alterations or amendments may have been made from time to time and, by referring to Article 4.5 of the UNIDROIT Principles, stated that “if the parties at one point agreed on certain provisions, this needs to be taken into account when trying to resolve a dispute” and any alterations that were put in writing for each and every delivery can be said to have been renegotiated and agreed upon every time within the existing framework of the contract.¹²⁵⁴

In the Ad hoc Award of May 27, 1991, where the parties agreed to Swiss law as governing the substance of the dispute, the arbitrators applied the principle of effectiveness in construing the relationship between the terms of the contract and the applicable law. The disputed issue was the legal validity of the obligation for a member of a Swiss association to pay the compensation for the withdrawal from the association, as provided in the articles and in the supplemental agreements. The tribunal was divided on the question of validity of the requirement to pay compensation under Swiss law, which reflected the division between the two eminent Swiss jurists, whose opinions were submitted to the tribunal. The majority decided to proceed “from the general principle *ut res magis valeat quam pereat*; in other words the point of departure of the majority was that when commercial parties enter into legal arrangements after lengthy negotiations conducted with the help of professional advisers - i.e.,

¹²⁵⁰ In the Matter of the Diverted Cargoes (Greece v. Great Britain), Award by President Cassin, June 10, 1955, International Law Reports, Vol. 22, at 825

¹²⁵¹ Lauterpacht, Hersch, Restrictive Interpretation and the Principle of Effectiveness in the Interpretation of Treaties, British Year Book of International Law, 6 (1949), at 68

¹²⁵² Craig, W. Laurence, William W. Park & Jan Paulsson, International Chamber of Commerce Arbitration, Oceana Publications, 3rd ed., 2000, at 646

¹²⁵³ ICC Award in Case No. 8365, Journal du Droit International, (1997), at 1079-1080

¹²⁵⁴ ICC Award in Case No. 8547, 1999, Yearbook Commercial Arbitration, (2003), at 32-34

there is no suggestion of unfair bargaining or pressure - they should be held to their bargain.” According to the arbitrators, “when there is nothing inherently unlawful or immoral about the arrangement concluded by the parties, and no evidence of intent to evade mandatory restrictions, the law should be construed, if fairly possible, in such a way as to uphold rather than to frustrate the intent of the parties.” The tribunal stated that the principle of effectiveness is “particularly compelling when, as here, the arrangement in question has many parties from different states who chose Switzerland as the home for their association, and when numerous arrangements similar to the one here challenged are in effect among persons in many different industries who are not party to the present controversy.”¹²⁵⁵ Thus, the majority considered the terms of the articles and supplemental agreements and the applicable rules of the national law chosen by the parties as constituting the articulated rules, and interpreted them as a whole. Given the difference of opinion and inconclusive evidence as to the position of the applicable law, the tribunal exercised equity *infra legem* and gave “the benefit of the doubt to the intention of the parties, expressed when they freely subscribed to the Articles and Supplemental Agreements which gave rise to the present controversy” and held that “there is no legal impediment to requiring the member to pay compensation upon withdrawal from the association in accordance with the formula contained in the Articles and Supplemental Agreements”.¹²⁵⁶

The principle of effectiveness can also be found in international law. In the field of international law, this principle requires that a treaty should be interpreted so as to give full effect to its purpose.¹²⁵⁷ The principle of effectiveness in international law is closely related to the teleological approach and has been used as a means to imply specific terms into treaties on the basis of wider terms stated in the treaty.¹²⁵⁸ Thus, there is a tension between this principle and the rule of restrictive interpretation in international law, under which a restrictive interpretation must be put upon the obligations of national states in view of their sovereignty.¹²⁵⁹ However, in practice, the right of entering into international engagements and conclusion of a treaty, by which a state undertakes to perform or refrain from performing a particular act, is considered as an attribute of state sovereignty, and, not as an abandonment of its sovereignty. Therefore, the restrictive interpretation is only allowed if all other methods of

¹²⁵⁵ Ad Hoc-Award of May 27, 1991, Yearbook Commercial Arbitration, (1992), at 16

¹²⁵⁶ Ibid., at 25

¹²⁵⁷ Malanczuk, Peter, Akehurst's Modern Introduction to International Law, Routledge, 7th rev. ed., 1997, at 367; It has been applied by international courts. In the Corfu Channel case, for example, in interpreting a Special Agreement, the Court stated that “It would indeed be incompatible with the generally accepted rules of interpretation to admit that a provision of this sort occurring in a Special Agreement should be devoid of purport or effect.” Corfu Channel case, Judgment of April 9th, 1949: I.C. J. Reports 1949, at 24

¹²⁵⁸ In the Reparation for Injuries case, the Court advised that the United Nations possessed not only power expressly conferred by the Charter, but also such implied powers as were necessary to enable it to achieve the purposes for which it was set up. Reparation for injuries suffered in the service of the United Nations, Advisory Opinion: I.C. J. Reports 1949, at 183: “the Members of the Organization have entered into certain undertakings, some of which are in the Charter and others in complementary agreements. The content of these undertakings need not be described here; but the Court must stress the importance of the duty to render to the Organization “every assistance” which is accepted by the Members in Article 2, paragraph 5, of the Charter. It must be noted that the effective working of the Organization - the accomplishment of its task, and the independence and effectiveness of the work of its agents - require that these undertakings should be strictly observed. For that purpose, it is necessary that, when an infringement occurs, the Organization should be able to call upon the responsible State to remedy its default, and, in particular, to obtain from the State reparation for the damage that the default may have caused to its agent.”

¹²⁵⁹ Lauterpacht, Hersch, Restrictive Interpretation and the Principle of Effectiveness in the Interpretation of Treaties, British Year Book of International Law, 6 (1949), at 58

interpretation, including the principle of effectiveness, have failed.¹²⁶⁰ Nevertheless the International Court of Justice has insisted that there are definite limits to the use which may be made of the principle of effectiveness, and stated that it cannot justify the court in attributing to the treaty a meaning contrary to its letter and spirit.¹²⁶¹

The principle of effectiveness is also adopted by the World Trade Organization Appellate Body as one of the rules of customary international law in the interpretation of treaties.¹²⁶² These rules are generally taken to be expressed in Articles 31 and 32 of the Vienna Convention on the Law of Treaties, and the Appellate Body noted that Vienna Convention represents a codification of customary international law and is therefore binding on all states.¹²⁶³ However, the principle of effectiveness is not explicitly included in Articles 31 and 32 of the Vienna Convention. In the Commentary to the final draft, the International Law Commission stated that “in certain circumstances recourse to the principle may be appropriate and that it has sometimes been invoked by the International Court.” The Commission took the view that, “in so far as the maxim *ut res magis valeat quam pereat* reflects a true general rule of interpretation, it is embodied in [Article 31 (1)] which requires that a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to its terms in the context of the treaty and in the light of its object and purpose.” However, the Commission also noted that “Properly limited and applied the maxim does not call for an ‘extensive’ or ‘liberal’ interpretation in the sense of an interpretation going beyond what is expressed or

¹²⁶⁰ *Ibid.*, at 61 and 67

¹²⁶¹ In the Interpretation of Peace Treaties Advisory Opinion, it said: “the principle of interpretation expressed in the maxim: *ut res magis valeat quam pereat*, often referred to as the rule of effectiveness, cannot justify the Court in attributing to the provision for the settlement of disputes in the Peace Treaties a meaning which... would be contrary to their letter and spirit.” Interpretation of Peace Treaties (second phase), Advisory Opinion: I.C. J. Reports 1950, p. 221, at 229

¹²⁶² Appellate Body Report, United States – Standards for Reformulated and Conventional Gasoline, WT/DS2/AB/R, 1996, at 21; “... One of the corollaries of the “general rule of interpretation” in the Vienna Convention is that interpretation must give meaning and effect to all the terms of the treaty. An interpreter is not free to adopt a reading that would result in reducing whole clauses or paragraphs of a treaty to redundancy or inutility.” Appellate Body Report, Japan – Taxes on Alcoholic Beverages, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, 1996, at 12: “... A fundamental tenet of treaty interpretation flowing from the general rule of interpretation set out in Article 31 is the principle of effectiveness (*ut res magis valeat quam pereat*). ...” Appellate Body Report, Canada – Measures Affecting the Importation of Milk And the Exportation of Dairy Products, WT/DS103/AB/R, WT/DS113/AB/R, WT/DS103/AB/R/Corr.1, WT/DS113/AB/R/Corr.1, 1999, at 36: “... the task of the treaty interpreter is to ascertain and give effect to a legally operative meaning for the terms of the treaty. The applicable fundamental principle of *effet utile* is that a treaty interpreter is not free to adopt a meaning that would reduce parts of a treaty to redundancy or inutility.” United States – Continued Dumping and Subsidy Offset Act of 2000, WT/DS217/AB/R, WT/DS234/AB/R, 2003, para. 271: “As we have stated on many occasions, the internationally recognized interpretive principle of effectiveness should guide the interpretation of the WTO Agreement, and, under this principle, provisions of the WTO Agreement should not be interpreted in such a manner that whole clauses or paragraphs of a treaty would be reduced to redundancy or inutility. ...” United States – Subsidies on Upland Cotton, WT/DS267/AB/R, 2005, para. 549: “... Furthermore, as the Appellate Body has explained, “a treaty interpreter must read all applicable provisions of a treaty in a way that gives meaning to all of them, harmoniously”. We agree with the Panel that “Article 3.1(b) of the SCM Agreement can be read together with the Agreement on Agriculture provisions relating to domestic support in a coherent and consistent manner which gives full and effective meaning to all of their terms”.”

¹²⁶³ Cameron, James, & Kevin R. Gray, Principles of International Law in the WTO Dispute Settlement Body, International and Comparative Law Quarterly, 50-2 (Apr., 2001), at 254

necessarily to be implied in the terms of the treaty.”¹²⁶⁴ The WTO’s Appellate Body also adopted the same approach.¹²⁶⁵

The principle of effectiveness as applied by international courts and tribunals to international treaties indicates the necessity of consideration of limits of the principle when it becomes applicable under *lex mercatoria*. The decision maker applying *lex mercatoria* should take into account the possibility that the parties may not have intended the effectiveness of a certain provision or may have attributed a lower degree of effectiveness to a particular provision. The parties may provide evidence to refute the presumption of the principle of effectiveness, or to prove that the degree of effectiveness attributed by the decision maker to a certain provision do not reflect the parties’ common intentions. The principle of effectiveness cannot justify an interpretation which would have a result obviously contrary to the language of the contract and to the will of both parties. The principle of effectiveness is no more than an indication of common intentions of the parties.¹²⁶⁶ It is the common intention of the authors of the provision in question, which should be the starting-point and the goal of interpretation.

As the consensual principle prevails in arbitration, it is argued that the interpretation of contractual provisions should be favorable to their validity and effectiveness in order to respect the common intentions of the contracting parties.¹²⁶⁷ However, the limits of the principle can be relevant for the characterization of the provisions of an international commercial contract with regard to their degree of effectiveness.¹²⁶⁸ Particularly, in the international contracting practices under the influence of Anglo-American drafting techniques, it is possible to observe “agreements in principle” (also called letters of intent, memorandum of understanding or heads of terms), under which the parties provide a general description of their intentions to enter into certain agreements and intend a lower degree of effectiveness.¹²⁶⁹

An international contract may include both those provisions relating to agreements in principle and other provisions relating to final and binding obligations. In ICC Case No 8331, the parties entered into an agreement titled Memorandum of Understanding (MOU) relating to the sale by the claimant to the respondent of trucks and spare parts and the organization of

¹²⁶⁴ Draft Articles on the Law of Treaties with commentaries, Text adopted by the International Law Commission at its eighteenth session, in 1966, and submitted to the General Assembly as a part of the Commission’s report covering the work of that session, at 219

¹²⁶⁵ “The Vienna Convention principles of interpretation neither require nor condone the imputation into a treaty of words that are not there or the importation into a treaty of concepts that were not intended.” Appellate Body Report, India - Patent Protection for Pharmaceutical and Agricultural Chemical Products, 1997, para. 46

¹²⁶⁶ Lauterpacht, Hersch, *Restrictive Interpretation and the Principle of Effectiveness in the Interpretation of Treaties*, *British Year Book of International Law*, 6 (1949), at 83

¹²⁶⁷ ICC Arbitral Award in Case No. 2321, *Journal du Droit International*, (1975), at 941. Also cited in ICC Award in Case No. 7920, *Yearbook Commercial Arbitration*, (1998), at 82

¹²⁶⁸ For similar concerns, in the comments of UNIDROIT Principles Article 4.5, the subsidiary nature of the principle of effectiveness to the actual intentions of the parties is made explicit through the statement that “The rule however comes into play only if the terms in question remain unclear notwithstanding the application of the basic rules of interpretation laid down in Arts. 4.1 - 4.3.” These concerns were first raised in UNIDROIT 1978 – Study L – Doc. 13, Rome 1978, at 5: where it was pointed out that the principle of effectiveness might run counter to the intention of the parties insofar as they might wish something which would render their contract null and void, and, to that extent, it was considered open to criticism and if it was desired to retain it, then it should be modified so as to give more importance to the actual will of the parties.

¹²⁶⁹ Vandomme, Laurent, *Negotiating International Contracts*, *International Business Law Journal*, (2003), at 498

after-sales service and future co-operation.¹²⁷⁰ The parties agreed that the arbitral tribunal shall apply UNIDROIT Principles. The claimant argued that the MOU is not a binding contract, but has the character of a letter of intent, while the respondent considered the MOU to be a binding basic agreement between the parties who will clarify the secondary matters in further discussions. The arbitral tribunal examined the legal status of the agreement and whether it had binding force on the parties. Considering Article 4.5 of UNIDROIT Principles, the arbitral tribunal distinguished two kinds of provisions: the first of which defines specific conditions and terms that are the result of the parties' agreement and, consequently, to be considered as final obligations between them, and the second one being a general description of the parties' intention to enter into certain agreements. With regard to the second kind of provisions, the arbitral tribunal held that the general description of the parties' intentions to reach agreements on certain issues contained in the MOU obligates the parties to exert their best efforts in order to have such intentions become defined terms of contracts legally binding for each of them.¹²⁷¹

Another interpretative presumption is that the clauses of a contract should be interpreted *contra proferentem*, i.e. against the party that drafted it. This established rule of interpretation has its foundation in the Roman law principle and it is widely accepted by national laws.¹²⁷² It is considered as a principle in public international law¹²⁷³. It is also included in UNIDROIT Principles¹²⁷⁴ and PECL.¹²⁷⁵ The basic premise of the rule is that it is in the interest of the party drafting contractual terms to do so in a clear way and without any ambiguities.¹²⁷⁶ Moreover, there should be no temptation for the party drafting the terms to leave deliberate ambiguities in the hope of exploiting them at a later stage. Therefore, the *contra proferentem* rule usually applies to terms, which were not individually negotiated.¹²⁷⁷

Since this rule is usually, although not exclusively, applied when construing contracts of adhesion, it is observed that there have been fewer opportunities to apply it in arbitration

¹²⁷⁰ ICC Award in Case No. 8331 of 1996, ICC International Court of Arbitration Bulletin, 10-2 (1999), at 65

¹²⁷¹ *Ibid.*, at 66-67

¹²⁷² Canaris, Claus-Wilhelm, & Hans Christoph Grigoleit, Interpretation of Contracts, in A.S. Hartkamp, E.H. Hondius, M.W. Hesselink, E. du Perron & M. Veldman, (eds.), *Towards A European Civil Code*, Kluwer Law International, 2004, at 461

¹²⁷³ Cheng, Bin, *General Principles of Law as Applied by International Courts and Tribunals*, Cambridge: Grotius Publications, 1987, at 108

¹²⁷⁴ Article 4.6 of the UNIDROIT Principles: "If contract terms supplied by one party are unclear, an interpretation against that party is preferred." In the Official Comment, it is stated, "The extent to which this rule applies will depend on the circumstances of the case; the less the contract term in question was the subject of further negotiations between the parties, the greater the justification for interpreting it against the party who included it in the contract."

¹²⁷⁵ The requirement of individual negotiation for the applicability of this rule is made explicit in Article 5:103 of the PECL: "Where there is doubt about the meaning of a contract term not individually negotiated, an interpretation of the term against the party who supplied it is to be preferred."

¹²⁷⁶ Lew, Julian D. M., Loukas Mistelis L. A., & Stefan M. Kröll, *Comparative International Commercial Arbitration*, Kluwer Law International, 2003, at 470

¹²⁷⁷ Canaris, Claus-Wilhelm, & Hans Christoph Grigoleit, Interpretation of Contracts, in A.S. Hartkamp, E.H. Hondius, M.W. Hesselink, E. du Perron & M. Veldman, (eds.), *Towards A European Civil Code*, Kluwer Law International, 2004, at 462

cases.¹²⁷⁸ When applied, it is occasionally considered as a widely accepted principle of interpretation in the arbitral awards.¹²⁷⁹ In many cases where *lex mercatoria* is relevant, however, the contract is negotiated in detail by both parties.¹²⁸⁰ The parties may also make this aspect explicit in their final contract by adding a provision that “this agreement shall be construed as if drafted jointly by the Parties and no presumption or burden of proof shall arise favoring or disfavoring any Party by virtue of the authorship of any of the provisions of this Agreement.”¹²⁸¹ Thus, this rule should be applied in a subsidiary manner to other methods of interpretation aimed at revealing the intentions of the parties.¹²⁸² In the end, the decision maker applying *lex mercatoria* should resort first to text, nature and purpose of the contract, by considering it as a whole, to discover the common intention of the parties; second to any relevant extrinsic factors, which may reveal or render clear the common intentions of the parties, unless the parties effectively set some limitations to the use of extrinsic evidence; and finally to interpretative presumptions, but not as a ready substitute for active search for the common intentions of the parties.

¹²⁷⁸ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 827 For instance; in China 7 January 2000 CIETAC Arbitration proceeding (Cysteine case) [available at <http://cisgw3.law.pace.edu/cases/000107c1.html>], it was held that “Both parties' interpretations of Clause 5 of the Contract make sense to a certain extent. The Tribunal cannot locate a guide from the CISG -- which both parties agreed to have as the governing law -- to solve the problem. However, the Tribunal notes that Clause 5 is from the standard contract drafted by the [Seller]. According to the basic principle of contract interpretation -- *contra proferentem* -- if contract terms supplied by one party are unclear, an interpretation against that party shall be adopted.”

¹²⁷⁹ ICC Award in Case No. 7110, ICC International Court of Arbitration Bulletin, 10-2 (1999), at 44: “It is a general principle of interpretation widely accepted by national legal systems and by the practice of international arbitral tribunals, including ICC arbitral tribunals, that in case of doubt or ambiguity, contractual provisions, terms or clauses should be interpreted against the drafting party (*contra proferentem*)” ICC Award in Case No. 3779, Yearbook Commercial Arbitration, (1984), at 129: “With respect to the interpretation of the contract, the (also in Swiss law) traditional rule can be applied as well: ‘in dubio, *contra proferentem*’.”

¹²⁸⁰ In ICC Case No 2795, the Swiss buyer alleged that the clause concerning the dispute was obscure and should be interpreted against the seller who had drafted the clause. The arbitrators found, however, that the clause was drafted by both parties as it was added in type writing to a printed form in the mother language of the Swiss buyer i.e. French. ICC Award in Case No. 2795, Yearbook Commercial Arbitration, (1979), at 211

¹²⁸¹ Execution version of a Share Purchase Agreement dated 12 June 2006, on file with the author

¹²⁸² For example, English, French and German law treat the *contra proferentem* rule as a rule of last resort which is meant to be subsidiary to the other rules and maxims of interpretation. Vogenauer, Stefan, Interpretation of Contracts: Concluding Comparative Observations, Oxford Legal Studies Research Paper No. 7/2007, available at <http://ssrn.com/abstract=984074>, at 21; The Iran US Claims Tribunal also considered the rule of *contra proferentem* as the subsidiary rule of interpretation which comes into play if, after all the ordinary processes of interpretation are exhausted, doubt still remains as to which meaning should be enforced. Crook, John R., Applicable Law in International Commercial Arbitration: The Iran-US-Claims Tribunal Experience, American Journal of International Law, 83 (1989), at 290

ii. Supplementation of the Contract

It is almost impossible to draw a bright line between the interpretation and supplementation of the contract since they overlap to a significant extent.¹²⁸³ This is mainly because contracts in general contain gaps to varying degrees.¹²⁸⁴ First, it can be said that there is a gap in a contract when it fails to resolve an issue unambiguously: the contractual clauses do not precisely deal with a particular situation that has arisen, or they are in the form of standards, lacking sufficient detail to resolve the situation that has arisen. In these cases, the supplementation of the contract can be framed as an issue of interpretation, requiring an extension of the scope of the clause and leading to the application of such a clause to fact patterns that are not covered clearly by its wording. Secondly, a gap in a contract can be said to exist when the contracting parties completely fail to deal with a particular contingency. For example, the contractual clauses do not determine the remedies in case of breach, they do not elaborate the conditions under which performance is excused, or they do not allocate the risks that may arise from a particular contingency. In such cases, the decision maker focuses on addressing the techniques that can be used to fill the gap in the contract, rather than on ascertaining the intentions of the parties. Under *lex mercatoria*, the decision maker may supplement the contract with implied terms, which are determined through a contextual approach, and which prevail over the default rules that are chosen by the parties or found to be applicable by means of the established rules of conflict.

In many national legal systems, the prevailing view is that interpretation precedes gap filling, and there are various gap filling mechanisms, which employ contractual interpretation and default rules to differing extents.¹²⁸⁵ The national legal systems generally acknowledge the possibility of the extensive interpretation of contracts, according to which the implied intentions of the parties to a particular case may override the default rules provided by the legal systems in order to enable case-specific solutions and achieve justice in a particular case.¹²⁸⁶ The recognition of the significance of an individual case in the supplementation of the contract under national legal systems endows the decision makers with the capacity for controlling legal uncertainty and exercising an abstract reasoning in the *ex post* consolidations instead of applying formal consolidations. However, there are strict requirements under national legal systems for the decision maker's consideration of implied intentions of the parties, since the relevant national legal system retains the control over legal uncertainty through formal consolidations and a general framework of institutions that provides responsible direction and control of the actions of individual judges in the presence of legal uncertainty. The decision makers applying *lex mercatoria* do not have to follow those requirements of extensive interpretation under a particular national law, but may search for established rules that guide them in the supplementation of the contract with individualized terms, unless the national law chosen by the parties imposes such requirements, which the decision makers then have to apply as articulated rules and part of the bargain.

¹²⁸³ This is also acknowledged in the Official Comment to the American Restatement where it is stated that the "supplying of an omitted term is not technically interpretation, but the two are closely interrelated", and that in many situations "the supplying of an omitted term may resemble or overlap interpretation". Restatement (Second) of Contracts, Section 204, Comment a

¹²⁸⁴ Kornet, Nicole, *Contract Interpretation and Gap Filling: Comparative and Theoretical Perspectives*, Intersentia, 2006, at 4

¹²⁸⁵ *Ibid.*

¹²⁸⁶ See Chapter II, b, iv, a

In the supplementation of the contract with individualized terms, the activity of the decision maker shifts from the ascertainment of the meaning of the contract to the ascertainment of the content of contract. Such individualized terms may precede all forms of default rules that address the generality of actions, regardless of whether they are applicable as established rules or on the basis of the choice of law analyses. In supplementing the contract with individualized terms, the decision maker will consider the relevant materials that indicate the reasonable expectations of the parties within the internal and external context of the contract. This exercise can be conceived as extending the contextual approach, which governs the interpretation of the contract, to supplementation of contract on the basis of the same materials that are related to the reasonable expectations of the parties to a particular dispute. Thus, the contextual approach is a characteristic of *lex mercatoria*, as the law of principled adjudication, which is based on the idea of meaningful utilization of the knowledge of particular circumstances of time and place. The ascertainment of the content of contract under *lex mercatoria* has a direct bearing on the allocation of the residual contractual rights, obligations and risks.

The international instruments, to some extent, indicate the established rules that govern the exercise of contextual interpretation for the supplementation of the contract with individualized terms under *lex mercatoria*. Article 8 of the CISG only speaks of interpretation, but it is generally accepted that the provision also covers cases that might be referred to as gap filling.¹²⁸⁷ Under the UNIDROIT Principles, there are two different provisions dealing with gap filling activities of the decision maker, namely Article 4.8 (Supplying an omitted term) placed under Chapter 4 on “Interpretation” and Article 5.1.2 (Implied obligations) placed under Chapter 5 Section 1 on “Content”. Article 4.8 provides that where the parties to a contract have not agreed with respect to a term which is important for a determination of their rights and duties, such a term that is appropriate in the circumstances shall be supplied. The Official Comment distinguishes the interpretation of contract in the strict sense, i.e. with the determination of the meaning which should be given to contract terms, which are unclear, and the supplying of omitted terms which occurs when, after the conclusion of the contract, a question arises which the parties have not regulated in their contract at all, either because they preferred not to deal with it or simply because they did not foresee it. The Official Comment also states that the default rules provided under the Principles may not be applicable in a given case, because they would not provide a solution appropriate in the circumstances in view of the expectations of the parties or the special nature of the contract.¹²⁸⁸ In such cases, Article 4.8 would be applicable, and the contractual gap would be filled by the decision maker by taking into account, among other factors, (a) the intention of the parties, (b) the nature and purpose of the contract, (c) good faith and fair dealing, (d) reasonableness.

Article 5.1.2 merely describes the sources of implied obligations, which may arise from (a) the nature and purpose of the contract, (b) practices established between the parties and usages, (c) good faith and fair dealing, and (d) reasonableness. The relationship between Article 4.8 and 5.1.2 is not clear. It is argued that the first provision seems to follow the notion of constructive interpretation that is familiar to civilian systems, while the latter is phrased in the language of implied terms as understood in common law jurisdictions.¹²⁸⁹

¹²⁸⁷ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 535

¹²⁸⁸ Official Comment 2 to Article 4.8 of the UNIDROIT Principles

¹²⁸⁹ Vogenauer, Stefan & Jan Kleinheisterkamp (eds.), *Commentary on the UNIDROIT Principles of International Commercial Contracts (PICC)*, Oxford University Press, 2009, at 536

However, it is doubtful whether this understanding is really adopted in the drafting process and the final texts. When the Rapporteur submitted the first draft of Article 4.8, he stated his sources of inspiration were American and German notions of interpretation in supplying omitted terms, and suggested an illustration for Article 4.8 that was based on one of the leading English cases on terms implied in fact.¹²⁹⁰ The Official Comments to Article 5.1.2 also refers to the notion of terms implied in fact by stating that “The implied obligations may for example have been so obvious, given the nature or the purpose of the obligation, that the parties felt that the obligations “went without saying”.”¹²⁹¹ Thus, the basis of distinction between these two articles cannot be stated firmly. Moreover, terms implied in fact in common law jurisdictions can be regarded as a form of constructive interpretation under German law, as both techniques provides gap fillers that are tailored to the specific circumstances of the contract and an individualized solution to deal with issues not addressed by the parties in the express terms of their contract. Thus, it is acknowledged that Article 5.1.2 may, to a certain extent, overlap with Article 4.8, but argued that it will, in practice, make no difference whether the missing term is determined by applying one or the other provision.¹²⁹² In this context, the differentiating factor of Article 5.1.2 can arguably be its relatively stronger emphasis on the objective considerations, such as the nature and purpose of the contract in an objective sense, trade usages, good faith and fair dealing, and reasonableness, while Article 4.8 requires the consideration of the intention of the parties “as inferred from, among other factors, the terms expressly stated in the contract, prior negotiations or any conduct subsequent to the conclusion of the contract”.¹²⁹³

A similar distinction is not made in the PECL. The PECL deals with interpretation of the contract in Chapter 5, and Chapter 6 deals with determining the content of the contract. Article 6:102 of the PECL provides that “In addition to the express terms, a contract may contain implied terms which stem from (a) the intention of the parties, (b) the nature and purpose of the contract, and (c) good faith and fair dealing.” The Official Comments to Article 6:102 explain that contracting parties frequently leave matters unsettled in their contract, and usages can be applied to supply the missing terms, while in other cases, gap filling terms can be found in the various rules of the PECL. The Official Comments states that “To determine the content of a contract it is not sufficient to resolve any ambiguities in what the parties have expressly agreed; it may also be necessary to complete it where the parties have not provided some clause which is necessary for the working of the contract, in other words where the contract has a lacuna”.¹²⁹⁴ In these cases, the PECL requires the decision maker to take into account the presumed intention of the parties, in the sense that he “should consider what parties, acting in accordance with good faith and fair dealing, would reasonably have agreed if they had discussed the question.”¹²⁹⁵

¹²⁹⁰ UNIDROIT 1993 – P.C. – Misc. 17, Rome, February 1993, at 142-143: citing *Aerial Advertising v. Bachelors Peas Ltd (Manchester)* [1938] 2 All ER 788, KB.

¹²⁹¹ Official Comment to Article 5.1.2 of the UNIDROIT Principles

¹²⁹² Bonell, Michael Joachim, *An International Restatement of Contract Law: the UNIDROIT Principles of International Commercial Contracts*, Transnational Publishers, 3rd ed., 2005, at 145

¹²⁹³ Official Comment 3 to Article 4.8 of the UNIDROIT Principles

¹²⁹⁴ Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law, Parts I and II*, Kluwer Law International, 2000, at 302

¹²⁹⁵ *Ibid.*, at 303

The international restatements of contract principles do not provide the guidance that would help the decision maker applying *lex mercatoria* to discern any clear distinction among varying degrees of gaps, and among interpretation, supplementation of an omitted term and contractual gap filling on the basis of the default rules. The absence of such a clear distinction has led to variety of approaches in the arbitral awards. ICC Case No 9797 concerned a dispute between member firms of a worldwide business group, namely Andersen Consulting Business Unit member firms (“ACBU”) as claimants, and Arthur Andersen Business Unit member firms (“AABU”) and Andersen Worldwide Société Coopérative (“AWSC”) as respondents.¹²⁹⁶ The arbitral tribunal held that, on account of AWSC's fundamental non-performance, the ACBU member firms were released from all their obligations under the MFIFAs.¹²⁹⁷ In their counterclaim, the respondents requested that if the claimants were to leave the Andersen Worldwide Organization, they should return and cease using “Andersen technology”, including the special technology they had developed in the consulting sector. The tribunal considered whether the Andersen Technology jointly developed by several member firms should be understood, as commonly owned intellectual property of all the member firms; as property of AWSC; or as property of those member firms responsible for developing such technology. Noting that, under the MFIFAs, the member firms control the funds to be allocated to the development of Andersen Technology, and the scope and direction of its development, the tribunal favored the last interpretation.¹²⁹⁸

However, the MFIFAs did not provide any guidance for deciding the case where all the member firms, which jointly developed and collectively owned Andersen Technology, departed the organization. Thus, in view of the contractual gap with regard to the use of Andersen Technology in the case of the separation of all the members of a Business Unit, the tribunal referred to general principles of law, particularly Article 4.1 (1) and (2) of the UNIDORIT Principles as well as to the corresponding provisions of the PECL. On the basis of these principles the tribunal concluded that “It would not be reasonable to hold - and reasonable persons of the same kind as the parties to this arbitration could not possibly claim - that the member firms not paying for or participating in the development of Andersen Technology are common owners of such technology or that the entities which funded and developed it are bound to forfeit their rights to those who have no title thereto.” The tribunal found that the AABU member firms established a broad-based consulting practice that competed with the activities of ACBU member firms. For this reason, the tribunal considered that it would be unfair to compel the ACBU member firms to surrender their technology which would capacitate the competing AABU member firms in the ACBU member firms’ core activities. According to the tribunal, any Andersen Technology that was jointly developed by member firms from both business units must remain within the AABU member firms as provided in the MFIFAs. Thus, the tribunal held that the ACBU member firms shall return and cease using the Andersen Technology jointly owned, controlled and developed by the ACBU and AABU member firms, while the ACBU member firms shall keep the Andersen Technology jointly owned, controlled and developed by the ACBU member firms.

¹²⁹⁶ Bonell, Michael Joachim, A ‘Global’ arbitration decided on the basis of the UNIDROIT Principles: In re Andersen Consulting Business Unit Member Firms v. Arthur Andersen Business Unit Member Firms and Andersen Worldwide Société Coopérative, *Arbitration International* 17 (2001), at 250

¹²⁹⁷ ICC Award in Case No. 9797, July 28, 2000, Andersen Consulting Business Unit Member Firms vs. Arthur Andersen Business Unit Member Firms and Andersen Worldwide Societe Cooperative, *World Trade and Arbitration Materials*, 12-5 (2000), at 210

¹²⁹⁸ *Ibid.*, at 222

¹²⁹⁹ The approach of the tribunal is criticized on the ground that since the issue was not to interpret an ambiguous contract term, but rather to supply an omitted term, it would have been more appropriate to rely directly on Articles 4.8 and 5.1.2 of the UNIDROIT Principles specifically dealing with this matter.¹³⁰⁰

Essentially, as the decision maker applying *lex mercatoria* will be able to consolidate many different materials that can be used in determining reasonable expectations, on the basis of his abstract reasoning, the distinctions made by the international restatements of contract principles, among interpretation and supplementation are not binding for the decision maker adopting a contextual approach under *lex mercatoria*. In ICC Case No. 11295, the sole arbitrator found that the applicable Polish law did not provide any specific solution on the substance of the dispute. He considered that the UNIDROIT Principles may be applied to the dispute subsidiarily to Polish law, but he did not find any specific UNIDROIT rule covering the issue. Therefore, he decided to refer to both Articles 4.1 (1), and 4.8 (2) of the UNIDROIT Principles simultaneously, by consolidating them with the general principles of Polish law for supplementing the contract, in order to resolve the question of whether the claimant's transfer of claims based on the infringement of rights to a subsidiary concerned both rights and obligations, or only rights.¹³⁰¹ In ICC Case No 7365, the arbitral tribunal referred to Article 5.1.1 and 5.1.2 of the UNIDROIT Principles, instead of Article 4.8, in order to determine whether the termination for convenience clause in the contract directly applied to the instant case. The arbitral tribunal stated that "[it] is a widely accepted principle that contractual obligations of the parties may be implicit. Implied obligations may stem from the nature and purpose of the contract, practices established between the parties and usages, good faith and fair dealing and reasonableness (UNIDROIT Principles, Articles 5.1 and 5.2). Pursuant to such criteria as good faith and fair dealing, parties to a contract may reasonably expect that similar situations should have the same or similar consequences to the extent that the applicable law or the contractual terms do not explicitly provide otherwise". The tribunal then took into account the negotiations between the parties and their subsequent conduct as the factual circumstances, and concluded that the termination for convenience clause shall be applied, if not directly, then at least by analogy, to the assessment of the parties' respective claims.¹³⁰²

Trade usages in the narrow sense are another means for the supplementation of the contract under *lex mercatoria* in a manner that precedes the application of the default rules, which are chosen by the parties or found to be applicable by means of the established rules of conflict. Under the national legal systems, trade usages in this sense supplement the contract as a matter of specific intent, such as an explicit reference in the contract to certain trade usages, or by implication, where a usage is not referred to but is applied by the decision maker on the basis of certain objective grounds.¹³⁰³ In the context of international arbitration, the particular

¹²⁹⁹ *Ibid.*, at 223-224

¹³⁰⁰ ICC Award in Case No. 9797, July 28, 2000, Andersen Consulting Business Unit Member Firms vs. Arthur Andersen Business Unit Member Firms and Andersen Worldwide Societe Cooperative, *World Trade and Arbitration Materials*, 12-5 (2000), at 254

¹³⁰¹ ICC Award in Case No. 11295, December 2001, ICC International Court of Arbitration Bulletin, 2005 Special Supplement, at 88-89

¹³⁰² ICC Award in Case No. 7365, May 5, 1997, Islamic Republic of Iran vs. Cubic Defense Systems, Inc., *Uniform Law Review*, (1999-3), at 798; Reference here is made to the original version of the award, available to the author, para. 11.23-11.28

¹³⁰³ See Chapter II, b, ii, a

provisions in the arbitration rules and laws, which require that arbitrators consider trade usages, underline the objective of providing international commercial disputes in a manner which accords with commercial expectations and practices, and release the arbitrators from the requirements for the relevance of trade usages established by the national legal systems even if a national law is chosen by the parties to govern the substance of the dispute.¹³⁰⁴ However, those provisions do not guide the arbitrators as to which practices constitute trade usages that add a layer of contractual relationship and as to their verification to the arbitrators by the parties.

The CISG and the international restatements of contract principles can be considered as reflecting the established rules under *lex mercatoria* for determining the relevance of trade usages in the narrow sense, which supplement the contract and even prevail over the default rules of a national law chosen by the parties as the applicable law. Under the CISG, if the decision maker cannot solve the dispute through the interpretation of the parties' intentions, he will apply the provisions of the Convention as the default rules. Article 9 of the CISG gives superior weight to trade usages over the provisions of the Convention.¹³⁰⁵ Article 9 (1) of the CISG provides that the parties are bound by any usage to which they have agreed and by any practices which they have established between themselves. Thus, under Article 9 (1), "usages" bind the parties to the extent that the parties have agreed to them.¹³⁰⁶ As the provision does not require that an agreement to apply a usage must be express, the agreement may be implied.¹³⁰⁷ In this provision, "practices" are established by a course of conduct that creates an expectation that this conduct will be continued.¹³⁰⁸ Except for the case in which a party expressly excludes their application, such usages and practices are automatically applicable to supplement the terms of the contract, and prevail over the default rules of the CISG.

Article 9 (2) defines the usages which are binding for the parties even though they were not agreed by the parties expressly or impliedly.¹³⁰⁹ It provides that the parties, unless they agree otherwise, are considered to have made certain trade usages applicable to their contract. The usage referred to in Article 9 (2) must be one "of which the parties knew or ought to have known" and "which in international trade is widely known to, and regularly observed by,

¹³⁰⁴ Born, Gary B., *International Commercial Arbitration*, Vol. II, Kluwer Law International, Alphen aan den Rijn, 2009, at 2146

¹³⁰⁵ Audit, Bernard, *The Vienna Sales Convention and the Lex Mercatoria*, in Thomas E. Carbonneau (ed.), *Lex mercatoria and arbitration: a discussion of the new law merchant*, Kluwer Law International, Rev. ed., 1998, at 175; Ferrari, Franco, *What Sources of Law for Contracts for the International Sale of Goods? Why One Has to Look Beyond the CISG*, *International Review of Law and Economics*, 25 (September 2005), at 334; see Oberster Gerichtshof, 15 October 1998, available at <http://cisgw3.law.pace.edu/cases/981015a3.html>: "According to the dispositive character of the CISG, trade usages agreed between the parties, any practices established between the parties, as well as customs generally known and observed in international trade prevail over the provisions of the CISG"

¹³⁰⁶ Ferrari, Franco, *What Sources of Law for Contracts for the International Sale of Goods? Why One Has to Look Beyond the CISG*, *International Review of Law and Economics*, 25 (September 2005), at 332

¹³⁰⁷ Bonell, Michael Joachim, Article 9, in C. Massimo Bianca & Michael Joachim Bonell (eds.), *Commentary on the International Sales Law: the 1980 Vienna Sales Convention*, Milan, Giuffrè, 1987, at 107

¹³⁰⁸ Honnold, John O., *Uniform Law for International Sales under the 1980 United Nations Convention*, Kluwer Law International, 3rd ed., 1999, at 125

¹³⁰⁹ Enderlein, Fritz & Dietrich Maskow, *International Sales Law: United Nations Convention on Contracts for the International Sale of Goods: Convention on the Limitation Period in the International Sale of Goods: Commentary*, Oceana Publications, 1992, at 67

parties to contracts of the type involved in the particular trade concerned". The first requirement provides that there will always be an effective link between the application of a particular usage and the parties' intention.¹³¹⁰ The second requirement for trade usages to be applicable under Article 9(2) is an objective one, in the sense that usages must be regularly observed within the particular trade to which the parties belong and must be widely known in international trade. The usage must be one widely known in international trade, but "trade may be restricted to a certain product, region or set of trading partners."¹³¹¹ Thus, domestic usage is also applicable under Article 9 if it is widely known and observed by international traders.¹³¹² The main issue is whether the parties knew or ought to have known of the usage.¹³¹³ Thus, the usage must constitute part of the reasonable expectations of the contracting parties.¹³¹⁴

Both the UNIDROIT Principles and the PECL reflect the concept of trade usages under *lex mercatoria* that can be used in the supplementation of the contract. Article 1.9 (1) of the UNIDROIT Principles, which is virtually identical to Article 9 (1) of the CISG, provides that "The parties are bound by any usage to which they have agreed and by any practices which they have established between themselves". Under Article 1.9 (2) of the UNIDROIT Principles, it is provided that "The parties are bound by a usage that is widely known to and regularly observed in international trade by parties in the particular trade concerned except where the application of such a usage would be unreasonable." Article 1:105 (1) of the PECL is also the same as Article 9 (1) of the CISG. Article 1:105 (2) provides that "The parties are bound by a usage which would be considered generally applicable by persons in the same situation as the parties, except where the application of such usage would be unreasonable." According to the Official Comments of the PECL, usages and practices will be given precedence by the decision maker over the default rules of law including the PECL, which would otherwise apply.¹³¹⁵ The Official Comments to the Article 1.9 of the UNIDROIT

¹³¹⁰ Bainbridge, Stephen, Trade Usages in International Sales of Goods: An Analysis of the 1964 and 1980 Sales Conventions, *Virginia Journal of International Law*, 24 (1984), at 655

¹³¹¹ Text of Draft Convention on Contracts for the International Sale of Goods Approved by the United Nations Commission on International Trade Law Together With a Commentary Prepared by the Secretariat, U.N. Doc. A/CONF.97/5/1979 available at <http://www.cisg.law.pace.edu/cisg/text/secomm/secomm-09.html>; Honnold, John O., *Uniform Law for International Sales under the 1980 United Nations Convention*, Kluwer Law International, 3rd ed., 1999, at 178

¹³¹² CLOUT Case No. 175 [Oberlandesgericht Graz, Austria, 9 Nov. 1995], available at <http://www.unilex.info/case.cfm?pid=1&do=case&id=370&step=Abstract>: "it is also possible that, in certain circumstances, a local usage may be applicable to the contract. This is particularly the case with respect to usage applied within local commodity exchanges, fairs and warehouses, provided that such usage is regularly observed also with respect to businesses involving foreign dealers."

¹³¹³ Bainbridge, Stephen, Trade Usages in International Sales of Goods: An Analysis of the 1964 and 1980 Sales Conventions, *Virginia Journal of International Law*, 24 (1984), at 658

¹³¹⁴ Pamboukis, Ch., The Concept and Function of Usages in the United Nations, Convention on the International Sale of Goods, *Journal of Law and Commerce*, 25 (2005-2006), at 120; Honnold, John O., *Uniform Law for International Sales under the 1980 United Nations Convention*, Kluwer Law International, 3rd ed., 1999, at 129: "the Convention gives effect to a usage only if, on an objective basis, it constitutes a part of the contractual expectations of the parties." *E.H.T.M. Peters v. Kulmbacher Spinnerei GmbH & Co. Produktions KG*, the Netherlands, Hof 's-Hertogenbosch [District Appeal Court] 456/95, 24 April 1996; It is held that the standard terms of Association of Yarn Traders were binding although not included in contract; both the seller (German) and the buyer (Netherlands) were familiar with the Association practices. UNILEX D. 1996-5.2 available at <http://www.unilex.info/case.cfm?pid=1&do=case&id=224&step=Abstract>

¹³¹⁵ Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law, Parts I and II*, Kluwer Law International, 2000, at 104

Principles also state that the usages are implied terms of the contract, and as such, they are superseded by any express term stipulated by the parties, but they prevail over the Principles, unless they violate mandatory rules of law.¹³¹⁶

A usage is described in the comments to the PECL as “a course of dealing or line of conduct which is and for a certain period of time has been generally adopted by those engaged in trade or in a particular trade”.¹³¹⁷ Although, a general definition of usage is not provided, the Official Comments to the Article 1.9 of the UNIDROIT Principles require that the usage must be widely known and regularly observed and, similar to Article 9 (2) of the CISG, it must be an international usage.¹³¹⁸ It is stated in the Official Comments that only in certain cases are national or local usages applicable without any reference by the parties, for instance, with respect to certain commodity exchanges, trade exhibitions or ports, provided they are also regularly followed by foreign parties. While Article 1:105 of the PECL lacks a reference to international usage, it is stated in the Official Comments that a local or national usage “in the place of business of one of the parties can only bind the other party if it would be reasonable to bind him”, and “a party entering the market of the other party will often be bound by the local usages of that market.”¹³¹⁹

Both the PECL and the UNIDROIT Principles require that the applicable usage must be reasonable. The Official Comments to Article 1:105 of the PECL explain that although “commercial acceptance by regular observance by business people is prima facie evidence that the usage is reasonable, it may be disregarded if the court finds the application unreasonable.”¹³²⁰ The Official Comments to the Article 1.9 of the UNIDROIT Principles provides that the particular conditions in which one or both parties operate and/or the atypical nature of the transaction may render the application of a usage generally observed in a particular trade, unreasonable in a particular case.¹³²¹

The materials indicating the reasonable expectations of the parties, for the purposes of supplementation of the contract with implied terms, include the nature and purpose of the contract, prior negotiations, subsequent conduct of the parties, course of dealing established between the parties, trade usages in the narrow sense, and the abstract reasoning of the decision maker with regard to the test of reasonableness. The parties may prevent the decision maker from using certain materials to supplement the contract in accordance with their freedom of contract, subject to the principle of good faith and fair dealing. The international contracts under the influence of Anglo-American contracting techniques commonly include

¹³¹⁶ Official Comment 6 to Article 1.9 of the UNIDROIT Principles

¹³¹⁷ Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law, Parts I and II*, Kluwer Law International, 2000, at 104

¹³¹⁸ An early draft contained a definition of usage which was based on the language of Art 9(2) of the CISG. See UNIDROIT 1983 – Study L – Doc. 25, Rome, March 1983, at 11, draft Article 21: “For the purposes of these Rules “usage” means any practice or method of dealing which the parties knew or ought to have known and which in international trade is widely known to, and regularly observed by parties to the contracts of the type involved in the particular trade concerned” However, the Working Group decided that a general provision on usages should focus on the circumstances in which a usage is binding on the parties. UNIDROIT 1983 – P.C. – Misc. 4, Rome, June 1983 at 6.

¹³¹⁹ Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law, Parts I and II*, Kluwer Law International, 2000, at 106

¹³²⁰ *Ibid.*

¹³²¹ Official Comment 5 to Article 1.9 of the UNIDROIT Principles

contractual clauses, which reinstate the parol evidence rule of common law, such as “entire agreement clauses” and “no oral modification clauses” discussed above. Under English law, parol evidence rule prevents supplementation of the contract by the decision makers through express terms not recorded in writing by providing that, once the contracting parties enter into a written contract, they cannot adduce extrinsic evidence to add to, vary or contradict the written contract.¹³²² However, parol evidence rule is subject to many exceptions under English law. One of those exceptions is that a party may still prove that the written contract was not intended to contain the whole agreement. Parol evidence is also admissible, among other things, to prove terms which must be implied into the agreement, to prove a custom, to prove that the contract is invalid on the ground of misrepresentation, mistake, fraud and to prove the existence of a collateral agreement.¹³²³ Parol evidence relating to subsequent conduct of the parties may also be relevant to gap filling in cases of estoppel through variation or waiver by conduct.¹³²⁴

In the United States, the parol evidence rule is only relevant to the admission of extrinsic evidence relating to pre-contractual negotiations.¹³²⁵ The main issue is the determination of whether the parties adopted a written contract as a final expression of their agreement. If that is the case, all prior terms are deemed to have been completely integrated into the contract, and the parol evidence rule excludes the evidence of prior negotiations relating to additional or contradicting terms not recorded in the contract. Apart from complete integration, there is also the possibility of partial or incomplete integration, whereby the parol evidence rule excludes only the evidence attempting to establish the existence of contradicting terms but would admit extrinsic evidence of additional terms.¹³²⁶ When there is ambiguity about complete or partial integration in the contract, there are two different views in practice about the admissibility of extrinsic evidence relating to statements prior to the time of the making of the contract. Under an older and restrictive view, adopted in the First Restatement of Contracts and still followed by a minority of courts, such extrinsic evidence can be admitted only if it appears on its face that the contract is partially integrated, where the written contract is incomplete and the written contract has omitted a term.¹³²⁷ Under the prevailing and more liberal view endorsed by Section 210(3) of the Second Restatement of Contracts, by Section 2-202 (b) of the Uniform Commercial Code and by the majority of the courts, the extrinsic evidence may be used to establish prior agreements, and the courts, on the basis of that evidence, will determine whether the parties intended a written contract to be completely or partially integrated.¹³²⁸ On the other hand, the use of extrinsic evidence in US law, relating to a misrepresentation, a term implied in law, such as one imposing an obligation of good faith,

¹³²² McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 184

¹³²³ For all the exceptions to the parol evidence rule: Treitel, G. H, *The Law of Contract*, Thomson/Sweet & Maxwell, 11th ed., 2003, at 192-201

¹³²⁴ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 116

¹³²⁵ Perillo, Joseph M, *Calamari and Perillo on Contracts*, St. Paul, Minn.: Thomson/West, 5th ed., 2003, at 435-436

¹³²⁶ Gordley, James, *An American Perspective on the Unidroit Principles*, Centro di Studi e Ricerche di Diritto Comparato e Straniero, Saggi, conferenze e seminari; 22, Rome, 1996

¹³²⁷ Restatement (First) of Contracts, Section 240(1)(b)

¹³²⁸ The Restatement (Second) of Contracts, Section 210(3) and Comment b provides that in determining, as a "preliminary question," whether an agreement is completely or partially integrated, the court must consider "any relevant evidence" and "wide latitude must be allowed for inquiry into circumstances bearing on the intention of the parties. . . ." Posner, Eric, *The Parol Evidence Rule, the Plain Meaning Rule, and the Principles of Contractual Interpretation*, *University of Pennsylvania Law Review*, 146 (1998), at 535

trade usage, course of performance, course of dealing and statements subsequent to the time the contract is made, will not be barred by the parol evidence rule, and the judge may take into account such evidence in contractual gap filling depending on the circumstances of the case.¹³²⁹

The parties to an international contract may prefer to restrict the evidentiary means that can be used by the decision maker in supplementing the contract, through entire agreement clauses, no oral modification clauses, and other contractual clauses limiting the use of trade usages or course of dealing. In practice, there are also some clauses, which deal with the cases of inconsistent behaviors of the parties, which affect the effectiveness of the clauses that limit the evidentiary means in the ex post supplementation of the contract. It is observed that “a consistent view by international commercial arbitrators that any act, or failure to act, that constitutes a divergence from the strict terms of the contractual stipulations calls for an immediate reaction by the other contracting party, in the absence of which the latter is presumed to have waived any objection.”¹³³⁰ The contracting parties may, thus, want to prevent themselves against this problem by providing a contractual clause rejecting any kind of waiver other than in writing.¹³³¹ These clauses are called “non-waiver clauses” and frequently observed in international contracting practice.¹³³² When used in combination with other clauses limiting the evidentiary background, non-waiver clauses are protective measures against the contingency of the decision maker’s consideration that the parties, who have agreed on the adoption of the written form for a certain act, such as modification or supplementation of the contract, may subsequently waive this formal requirement, and that such waiver may well derive from acts other than in writing, and, in particular, from behavior inconsistent with the will to maintain such a formalism that had previously been agreed by the parties.

The combination of all these clauses can be seen as excluding the application of what is called “relationship-preserving norms”, which the parties choose to follow when they cooperatively resolve disputes among themselves in order to preserve their relationship. Under this understanding, the contractual intentions of the parties can be interpreted as requiring the application of “end-game norms”, i.e. the norms that parties would want a third-party neutral to apply in a situation where they were unable to cooperatively resolve a dispute and viewed their relationship as being at an end-game stage.¹³³³ While relationship-preserving norms can be reflected in the parties’ prior negotiations, subsequent conducts or trade usages, the end game norms are contained in the terms of the written agreement. It is argued that the

¹³²⁹ Farnsworth E. A., *The Interpretation of International Contracts and the Use of Preambles*, *International Business Law Journal*, (2002), at 274; Gordley, James, *An American Perspective on the Unidroit Principles*, *Centro di Studi e Ricerche di Diritto Comparato e Straniero, Saggi, conferenze e seminari*; 22, Rome, 1996

¹³³⁰ Derains, Yves, *Comment to ICC Case No. 3344, 1981, Collection of ICC Arbitral Awards, Vol. I (1974-1985)*, at 447; see e.g. *ICC Award in Case No. 8362, 1995, Yearbook Commercial Arbitration*, 22 (1997), at 171: “As a rule, no-oral modification clauses are not strictly enforced by the courts where the intention of the parties is to amend their agreement by an oral understanding, waiving in effect the requirement of a writing.”

¹³³¹ Fontaine, Marcel & Filip De Ly, *Drafting International Contracts: An Analysis of Contract Clauses*, Brill Academic Publishers, 2009, at 163

¹³³² Article 15.1 of the ICC Model Mergers & Acquisitions Contract provides that “The failure of a party to insist upon strict adherence to any term of this Agreement on any occasion shall not be construed a waiver or deprive that party of the right thereafter to insist upon strict adherence to that term or any other term of this agreement. Any waiver must be in writing.”

¹³³³ Bernstein, Lisa E., *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, *University of Pennsylvania Law Review*, 144-5 (1996), at 1796

merchants recognize the distinction between relationship-preserving and end-game norms, and do not necessarily want relationship-preserving norms to be used to resolve end-game disputes. In this view, the decision maker, who takes into account relationship-preserving norms in deciding cases where the relationship is at an end-game stage, may impose an efficiency loss on the parties.¹³³⁴

Under *lex mercatoria*, the parties may disable a decision maker from using certain extrinsic factors to supplement the contract, through such clauses as entire agreement, no-oral-modification or waiver clauses or the choice of a national law that includes parol evidence rule, in accordance with basic principle of freedom of contract. However, those contractual preferences cannot eliminate entirely the effect of basic principles of *lex mercatoria*, and the contextual approach based on those principles may trump even the most restrictively drafted versions of those contractual clauses in certain cases. The parties cannot oust the process of contextual approach of the decision maker utilizing all sorts of factors and his specialization, which are based on the basic principle of good faith and fair dealing, if the actions of one of the parties at the enforcement stage amounts to an abuse of contractual rights. In view of the fact that the parties' interests diverge at the enforcement stage and the probability that at least one party would prefer not to be governed by relationship-preserving norms and seek to escape from those norms to promote his own self-interest, the decision maker should evaluate the question of abuse before refusing to consider relationship-preserving norms at the end-game stage. In evaluating the question of abuse, the decision maker should focus on whether the application of a relationship preserving norm serves the purpose of the contract and whether it is common to the expectations of both parties in the particular circumstances of the case. The relationship-preserving norms may indicate the established manner of doing things in the particular contractual relationship and, in this sense, their enforcement has a particular significance, as the established rules are the fundamental means of producing and maintaining a spontaneous order.

Essentially, in transactions governed through legal uncertainty, the parties themselves often recognize the utility of the relationship-preserving norms, by incorporating standards in the contractual clauses, which give rise to various residual questions. The existence of such standards requires the decision maker to exercise an abstract reasoning in *ex post* consolidations, which form the basis of the contextual approach under *lex mercatoria* in the interpretation and supplementation of the contract. The incorporation of such standards into the contract should have a greater influence on the final decision, than such clauses as the entire agreement, no-oral-modification or waiver clauses or the choice of a national law that includes parol evidence rule, which allow the invocation of the end-game norms by a party, who was previously cooperative with the other party throughout the process whereby relationship-preserving norms emerged and applied by the parties under those standards, but has later become non-cooperative in contravention of the reasonable expectations of the other party. The clauses, which limit the relevance of extrinsic factors and relationship-preserving norms, may then operate as a presumption which puts the burden of proof on the party attempting to refute.

¹³³⁴ *Ibid.*, at 1802

iii. Intervention in the Contract

The spontaneous order of international commerce requires a balance between its various elements, which is achieved by enabling them to adjust their actions towards each other through abstractions. The deliberate actions of organizations that are taken for the restoration or improvement of their internal orders or the overall order of international commerce should not destroy this balance, but respect the abstract relations constituting the spontaneous order and the possibility of the correspondence of the expectations of the elements of the order without any conflict that may disturb the balance in the order. Thus, the decision maker applying *lex mercatoria* should seek for some correspondence between the interests underlying the actions that are taken by various national legal systems for the purpose of protecting their internal orders or the order of international commerce.

In order for norms of mandatory nature, as actions of the national legal systems, to permeate the knowledge and expectations of the parties and become a source of *lex mercatoria* thereby requiring the decision maker to intervene in the contract, their underlying interests should be considered by the decision maker as being protected by the established rules of policy in the particular case. Due to the necessity of the correspondence of expectations for the order of international commerce, which enables its various elements to make feasible plans for the achievement of their individual purposes, the freedom of contract may not always overlap with the freedom of contract as understood in a particular national legal system. Thus, the peaceful development of international commerce requires the authorities in the national legal systems to have confidence in the ability of the decision maker to determine *ex post* the limits of the basic principle of freedom of contract and to render such judgments that restore the order of international commerce, which has been disturbed by a particular dispute, by resolving that dispute in a manner that maximizes the expectations of the elements of that order.

Lex mercatoria applies where the decision making is final and where the ensuing decisions do not become a part of self-referential structure of a legal system. The policies favoring this form of finality in decision making indicate the confidence of the authorities in the national legal systems in the ability of the decision maker to render correct judgments. In the context of international arbitration, there is an increasing awareness among the authorities in the national legal systems as to the different nature of the freedom of contract in the order of international commerce. Thus, the national courts increasingly rely on the specialization of the arbitral tribunals, which are expected to ensure that the outcome of their decisions does not lead to a violation of the public policy interests that are considered so fundamental to the internal order of a particular national legal system or to the overall order of international commerce that their violation cannot be tolerated in the context of peaceful development of international commerce.

However, in essence, the arbitral tribunals have no obligation to uphold the public policy of any national legal system given that international arbitral tribunals owe no allegiance to any national legal system and have no *lex fori* in the conventional sense.¹³³⁵ The arbitrator is not the guardian of the interests of states, which, as it is argued, may sometimes show a kind of arrogance in seeking to impose their national laws arising from their isolated interests on

¹³³⁵ Lew, Julian D. M., *Applicable Law in International Commercial Arbitration: A Study in Commercial Arbitration Awards*, Oceana, 1978, at 535

others. However, the arbitrator is not simply the “obedient servant” of the parties either.¹³³⁶ The arbitrator has a responsibility to the parties and their reasonable expectations of having an enforceable award.¹³³⁷ He also carries the burden to ensure that the confidence of national legal systems in his specialization remains intact. Due to such confidence, the arbitrators have become substitutes for judges, but this substitution would appear indefensible, at least in the eyes of states, if it were to result in the sacrifice of public interests held by a state to be essential and which a national judge would have protected. The arbitrators should accept from the outset that a state may have legitimate jurisdiction to promulgate mandatory rules to further those interests. The arbitrators’ refusal to take into account those interests imperils the arbitrability of disputes implicating such interests. Thus, although arbitrators are not guardians of the internal order of any national legal system and they are not particularly motivated by any desire to contribute to jurisprudence, they should nevertheless have an incentive to do so out of a sense of duty to the survival of international arbitration as an institution.¹³³⁸

The arbitral tribunals should apply *lex mercatoria* as the law of principled adjudication to determine whether a mandatory norm or public policy value of a national legal system, which claims to override the ascertainable content of the contract, reflects an interest protected by the established rules of policy, and requires the decision maker to intervene in the contract, as interpreted and supplemented by means of the articulated and established rules. The arbitrators applying *lex mercatoria* will seek a balance between the expectations of the parties and the other elements of the order of international commerce, particularly the national legal systems relevant to the dispute, by means of specialized consolidations on the basis of his abstract reasoning. In this balancing exercise, the reasonableness of expectations that are worthy of protection under *lex mercatoria* will depend on the maximization of the possibility of expectations of the elements of the order as a whole being fulfilled and matched. The intervention in the ascertainable content of the contract under *lex mercatoria* can be attributed to the functioning of the principle of good faith and fair dealing under *lex mercatoria* as the law of principled adjudication. The principle of good faith, as the substantive framework for principled adjudication requires the decision maker to determine the limits of the basic principle of freedom of contract due to its qualifying function. Thus, the arbitrator applying *lex mercatoria* will be guided by the principle of good faith and fair dealing to intervene in the contract on the basis of a balancing exercise between the interests of the parties and relevant national legal systems in order to determine which expectations are reasonable for the parties to rely on.

1. Different Concepts of Public Policy

The national courts apply public policy as the minimum standard acceptable to the national legal system to which they owe allegiance, i.e. their *lex fori*. The refusal to recognize an arbitral award because it infringes the forum’s public policy is a direct application of the *lex fori*. However, each national legal system contains its own concept of “public policy” and

¹³³⁶ Marc Blessing, *Mandatory Rules of Law versus Party Autonomy in International Arbitration*, 14(4) *Journal of International Arbitration* 23 (1997), at 40

¹³³⁷ For example, Article 35 of the ICC Rules states that the arbitral tribunal “shall make every effort to make sure that the award is enforceable at law.” Similar provisions are contained in Article 32.2 of the LCIA Rules and Article 47 of the SCC Rules.

¹³³⁸ Mayer, Pierre, *Mandatory Rules of Law in International Arbitration*, *Arbitration International*, 2 (1986), at 285-286

other mandatory rules as a protection against the detrimental results that may arise from the basic principles of freedom of contract and *pacta sunt servanda*. Every legal system reserves the right to declare a contract unenforceable if it is legally and morally offensive and violating its public policy and mandatory rules.¹³³⁹ Particularly, the contents of the public policy are usually not clearly defined. In most legal systems, the task of determining the content and limits of public policy is left to the court, which considers the circumstances of the case on the basis of the current standards of public policy.

The effect of public policy on enforceability of arbitral awards requires the arbitrator to determine the relevant public policy considerations on the basis of the circumstances of the case, and to render an award which can be expected to stand both in setting aside and in enforcement procedures before national courts. In this context, it is aptly argued that the arbitrator is pulled in different directions: he should seek to respect the contract and the intent of the parties, but at the same time be concerned with the efficacy of his award and the avoidance of annulment.¹³⁴⁰ *Lex mercatoria* as the law of principled adjudication essentially provides a method of reasoning for giving effect to the interests of the parties and the national legal systems concerned. Striking a balance between those interests is fundamental to the determination of the reasonable expectations of the parties to a particular contract and to the peaceful development of the order of international commerce.

There are different concepts of substantive public policy that are taken into consideration by the national courts, where the enforcement or annulment of an arbitral award is sought. These concepts consist of external public policy related to fundamental principles and values of a particular national legal system, European public policy arising from European Union law, and transnational (or truly international) public policy representing the international consensus on accepted values and principles.

a. External Public Policy

The national contract laws prohibit contractual arrangements infringing mandatory rules and standards under national legal systems, which restrict the freedom of contract of individuals and prevents derogation by private agreements. Under Article 6 of the French Civil Code, the parties to a contract are forbidden to derogate by way of an agreement from laws concerning *ordre public* or good morals. A contract is contrary to *ordre public* if it violates statutory or judge-made rules protecting the political, social or economic order of the state, while the term “good morals” is given a more restrictive meaning, whereby the issues relating to good morals are usually dealt with by specific statutes.¹³⁴¹ The French Civil Code links the *ordre public* with the concept of “cause”. Article 1131 of the French Civil Code provides that an obligation based on an illicit cause is void, and Article 1133 of the French Civil Code declares the cause to be illicit when it is prohibited by law, or when it is contrary to good morals or *ordre public*. Thus, the concept of cause provides a mechanism for annulment of contracts, whose subject matter may be valid, but the motivation and purpose of the parties renders the contract

¹³³⁹ Zweigert, Konrad & Hein Koetz, *An Introduction to Comparative Law*, translated by Tony Weir, Oxford University Press, 3rd rev. ed., 1998, at 380

¹³⁴⁰ Mayer, Pierre, *Mandatory Rules of Law in International Arbitration*, *Arbitration International*, 2 (1986), at 293

¹³⁴¹ Beale, Hugh, Denis Tallon, Stefan Vogenauer, Jacobien W. Rutgers & Bénédicte Fauvarque-Cosson, *Contract Law (Ius Commune Casebooks for the Common Law of Europe)*: 5, Hart Publishing; 2nd Revised edition, 2010, at 609

illicit.¹³⁴² It has been accepted that the cause is illicit when it is contrary to *ordre public* without any need for it to be forbidden by law, and consideration of good morals is commonly subsumed under the broader heading of *ordre public*.¹³⁴³ Pursuant to Section 134 of the German Civil Code, a legal transaction is void if it violates a statutory prohibition, and under Section 138 (1) of the German Civil Code, a legal transaction is void if it offends good morals, which has been construed as encompassing notions of public policy as well. By denying legal effects to contracts which are contrary to public policy, German law grants the judges with considerable discretion in policing the enforcement of contracts which would be considered offensive to the public interest.¹³⁴⁴

In England, a contract is against public policy only if its harmful tendency is clear, in the sense that if injury to the public is contract's probable and, not solely possible, consequence.¹³⁴⁵ The concept of public policy under common law is very wide and often stated in general terms. Burroughs J once described public policy as "a very unruly horse and when you get astride it you never know where it will carry you".¹³⁴⁶ On the other hand, Lord Denning argued that "With a good man in the saddle, the unruly horse can be kept under control. It can jump over obstacles. It can leap fences put up by fictions and come down on the side of justice."¹³⁴⁷ The English courts have generally been cautious and conservative in their formulation of public policy under common law.¹³⁴⁸ It is only when a contract falls under one of the well established categories of precedents as being contrary to public policy that a judge can interfere, while changes in public values through time are also taken into consideration.¹³⁴⁹ A contract is also illegal and in violation of public policy if its formation is expressly or impliedly prohibited by statute. In the alleged cases of implied prohibition by statute, the courts seek to discern the intention of Parliament and the effect of the violation of the statute upon the contract, but the courts are generally reluctant to conclude that a statute impliedly prohibits a contractual arrangement.¹³⁵⁰

In the United States, Restatement (Second) of Contracts provides in Section 178 that a contractual term may become unenforceable on grounds of public policy. The question of unenforceability depends, under Section 178(1), on what is provided in the relevant legislation. Pursuant to Section 178(2) and (3), in the absence of an express provision in the legislation, the court's decision as to unenforceability depends on a careful balancing of a number of factors, such as the strength of the policy involved, the parties' expectations, any special public interest in the enforcement of the contractual term, any forfeiture that would result if enforcement were denied, the likelihood that a refusal to enforce will further the policy, the seriousness of any misconduct involved and the extent to which it was deliberate, and the directness of the connection between that misconduct and the contractual term.

¹³⁴² *Ibid.*, at 610

¹³⁴³ Nicholas, Barry, *The French law of contract*, Oxford University Press, 1992, at 129

¹³⁴⁴ Markesinis, B.S., W. Lorenz & G. Dannemann, *The German Law of Obligations*, Vol. I, *The Law of Contracts and Restitution: a Comparative Introduction*, Clarendon Press (Oxford), 1997 (2001 reprinted), at 175

¹³⁴⁵ Treitel, G. H, *The Law of Contract*, Thomson/Sweet & Maxwell, 11th ed., 2003, at 439

¹³⁴⁶ *Richardson v Mellish* (1824) 2 Bing 229 at 252

¹³⁴⁷ *Enderby Town Football Club Ltd. v. Football Association Ltd.*, (1971) Ch D 591, at 606

¹³⁴⁸ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 332

¹³⁴⁹ Atiyah, P. S., *An Introduction to the Law of Contract*, Clarendon Express (Oxford), 5th ed., 1995, at 345

¹³⁵⁰ McKendrick, Ewan, *Contract law*, Palgrave Macmillan, 2007, at 330

This fairly wide understanding of public policy under the national contract laws has been limited by the concepts and distinctions devised under the private international law as far as the international contracts are concerned. To designate the concept of public policy as understood in national contract laws, the expression "ordre public interne" is suggested, whereas the ordre public as a concept of private international law is called "ordre public international" which comprises solely the relevant norms to the international contracts, namely the set of rules, a breach of which could not be tolerated even in international cases.¹³⁵¹ Thus, the international public policy has a more limited impact than national public policy, and the former has been relevant to the enforcement and recognition of international arbitral awards. Accordingly, some national courts have enforced international contracts providing for arbitration that would have been unenforceable in a domestic context.¹³⁵²

However, the use of the word "international" seems to be inappropriate since the specific aim of the operation of ordre public in the field of private international law is again to assert the fundamental principles of the national law of the forum.¹³⁵³ Therefore, another terminology is suggested in the sense that national public policy is made up of internal or domestic public policy (ordre public interne) and external public policy (ordre public externe, instead of ordre public international).¹³⁵⁴ Internal public policy comprises the national policies recognized in customary law and legislation enacted to regulate certain situations, which cannot be circumvented by the parties to a contract, whereas external public policy contains certain external elements, and it is essentially a national policy, though concerned with international relations. External public policy comprises legislation either of an imperative character or giving effect to fundamental policies and standards of a state. It also comprises certain laws and standards from the public international law and, where appropriate, the laws and policies

¹³⁵¹ Husserl, G., *Public Policy and Ordre Public*, Virginia Law Review, 25-1 (Nov. 1938), at 38

¹³⁵² Jarvin, Sigvard, *The Sources and Limits of the Arbitrator's Powers*, Arbitration International, 2 (1986), at 155; For instance, in the case of *Westacre Investments v. Jugoimport* before the Court of Appeals in England explained the distinction. *Westacre Investments* entered into a contract with *Jugoimport* for the sale of military equipment in Kuwait. Under the contract, disputes were to be determined by arbitration and the seat of arbitration was Geneva. *Jugoimport* cancelled the contract and the Swiss arbitral tribunal awarded *Westacre Investments* with damages. In the arbitration, *Jugoimport* alleged that *Westacre* had bribed Kuwaiti officials to persuade them to exercise their influence favorably in awarding contracts. The arbitral tribunal rejected these allegations and rendered an award in favor of *Westacre Investments*. After Swiss Federal Court refused to set aside the award, *Westacre Investments* sought enforcement of the award in England. *Jugoimport* challenged the enforcement of the award, among others, on the ground that the contract was for the purchase of personal influence and, therefore, contrary to public policy in England. The Court of Appeal decided "that there were some rules of public policy that, if infringed, would lead to non-enforcement by the English court whatever the proper law of the parties' agreement and wherever the place of performance, but others that were based on considerations that were purely domestic. Contracts for the purchase of influence were not in the former category. Thus a contract for the purchase of personal influence, if to be performed in England, would not be enforced as contrary to English domestic public policy. But where such a contract was to be performed abroad, it was only if performance was also contrary to the domestic public policy of that country, that the English court would not enforce it. Furthermore, if all that could be said for a contract was that performance in a foreign country would be contrary to the domestic public policy of that state, enforcement would only be refused if performance was also contrary to domestic public policy in England." Accordingly, the Court held that the award should be enforced. *Westacre Investments v. Jugoimport* [1999] 3 All E.R. 864 (Q.B.); [1999] 3 W.L.R. 811 (C.A.)

¹³⁵³ Husserl, G., *Public Policy and Ordre Public*, Virginia Law Review, 25-1 (Nov. 1938), at 38

¹³⁵⁴ *Ibid.*

of a community of states.¹³⁵⁵ Thus, the concept of external public policy contains the interests that will seek protection from the established rules of policy in the order of international commerce. The protected interests should be so fundamental to the internal order of a certain national legal system that their violation cannot be tolerated in the context of peaceful development of international commerce, provided that the particular international contract has sufficient connection with the jurisdiction of that legal system.

Under the New York Convention, it is generally accepted that the review of arbitral awards by the national courts on public policy issues is limited with external public policy of the *lex fori*. On the basis of the legislative history of the New York Convention, it is argued that, the term “public policy” used in the second paragraph of Article V refers to “external public policy” as distinct from “internal public policy”, since the Geneva Convention of 1927¹³⁵⁶ provided the wording “contrary to the public policy or the principles of law of the country” in which the enforcement of the award was sought, whereas the Conference of the New York Convention accepted the suggestion to limit the reference to “public policy” of the country where recognition and enforcement is sought, and it is argued that “the provision should not be given a broad scope of interpretation”.¹³⁵⁷ Although Article V (2) of the New York Convention is not explicit on this point, the distinction between domestic and external public policy is made either expressly or implicitly in a great number of court decisions reported under the Convention, which support the argument that the reference in that provision to public policy is in fact a reference to the external public policy of the forum.¹³⁵⁸ The concept of external public policy have also appeared in the decisions of some national courts in the enforcement or recognition of foreign arbitral awards, which have traditionally been perceived as hostile jurisdictions to the international arbitration.¹³⁵⁹

¹³⁵⁵ Lew, Julian D. M., *Applicable Law in International Commercial Arbitration: A Study in Commercial Arbitration Awards*, Oceana, 1978, at 533

¹³⁵⁶ Geneva Convention on the Execution of Foreign Arbitral Awards of 1927. The Geneva Convention ceased to have effect between Contracting States on their becoming bound and to the extent that they become bound, by the New York Convention, pursuant to Article VII of the New York Convention.

¹³⁵⁷ Van Den Berg, Albert Jan, *The New York Arbitration Convention of 1958, Towards a Uniform Judicial Interpretation*, Kluwer Law and Taxation Publishers, 1981, at 362

¹³⁵⁸ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 996

¹³⁵⁹ According to a study conducted by the School of International Arbitration at the Centre for Commercial Law Studies, Queen Mary University of London, where the in-house lawyers of various corporations were the respondents, the respondents perceived China, India and Russia as the countries that are most hostile to enforcement. *International Arbitration: Corporate Attitudes and Practices 2008*, PricewaterhouseCoopers and Queen Mary College, 2008, at 11; In India, the Delhi High Court in *Penn Racquet Sports v Mayor International Ltd*, delivered in January 2011, held that a more restrictive approach to the definition of public policy should be applied to the enforcement of foreign arbitral awards. The Delhi High Court relied upon judgments of the Supreme Court of India and held that enforcement of a foreign award could not be denied merely because the award was in contravention of the law of India. The Delhi High Court reiterated that for an Indian court to deny recognition and enforcement of an award, it would need to be shown that a foreign award was contrary to (i) the fundamental policy of India; or (ii) interests of India, or justice or morality. Desai, Vyapak & Sahil Kanuga, *Delhi High Court Upholds Enforcement of ICC Arbitration Award*, *India Law Journal*, 4-2 (April-June, 2011). In China, the Supreme People’s Court has always maintained that violating domestic law, even the domestic mandatory law, does not necessarily pertain to public policy in international relations. The Court has confirmed that inconsistency with a mandatory rule, such as export and import control laws, exchange control regulations, price laws, and antitrust laws, would not necessarily be contrary to public policy, only those violations contrary to the fundamental principles of Chinese law, the judicial sovereignty or the fundamental economic interests of the state constitute the violation of public policy. Fei, Lanfang, *Public Policy as a Bar to Enforcement of International Arbitral Awards: A Review of the Chinese Approach*, *Arbitration International*, 26-2 (2010), at

The external public policy is also widely accepted in connection with actions for setting aside of arbitral awards. This is the position adopted explicitly by the French Code of Civil Procedure in Article 1502(5), which ensures the compliance with the requirements of international public policy.¹³⁶⁰ The French courts draw a clear distinction between domestic public policy and international public policy, pointing out that for the purposes of Article 1502(5) no account should be taken of the domestic public policy rules of a foreign jurisdiction, or of the rules of French domestic public policy.¹³⁶¹ The case law refers to “the French conception of international public policy” and, thus, the concept is not a transnational public policy limited to the rules recognized by all of the states or a large majority thereof, but national, ensuring the respect of the fundamental rules and values of the French legal system in international matters.¹³⁶² In Switzerland, Article 190(2)(e) of the Federal Code on Private International Law simply enables the national courts to set aside an award which is “incompatible with public policy”, and this imprecision has led to doctrinal controversies and hesitations on the part of case law. While generally agreeing that this reference can only mean international or external public policy, the doctrine has debated on the questions of whether it is specific to Switzerland, or whether it also includes the public policy of certain foreign laws or finally, whether it should be understood as a transnational public policy with a universal scope.¹³⁶³ The Swiss Federal Tribunal refers to the Swiss conception of public policy, not in the sense of domestic public policy, but public policy in international matters, i.e. fundamental rules and principles of Swiss law, the respect of which must be ensured also in international relations.¹³⁶⁴ This is also reportedly the approach of the UNCITRAL Model Law on International Commercial Arbitration and the majority of arbitration laws.¹³⁶⁵

306, 310; In Russia, it is observed that the public policy defense to enforcement has received a more restrictive interpretation. Although the concept of public policy is not yet settled, the Russian courts do not automatically treat a violation of substantive law as a contradiction of public policy. In Russia, the concept of public policy relates to the basic fundamental provisions of justice, ethics and the legal order, the fundamental rules underlying the law, and fundamental principles of state structure and public life. The Russian courts have repeatedly rejected the public policy defense in cases involving Russian currency exchange laws, failure of arbitrators to take into account the principle of “proportionality” in determining the scope of liability and failure of arbitrators to apply mandatory provisions of Russian civil legislation. Nikiforov, Ilya, Interpretation of Article V of the New York Convention by Russian Courts: Due Process, Arbitrability and Public Policy Grounds for Non-Enforcement, *Journal of International Arbitration*, 25-6 (2008), at 794; However, in Russia, the public policy exception may result in the refusal to enforcement of the arbitral award, if the enforcement is against the Russian state or state subsidiary organization and can lead to a negative influence on the social and economic stability of the Russian Federation. Nacimiento, Patricia and Alexey Barnashov Recognition and Enforcement of Arbitral Awards in Russia, *Journal of International Arbitration*, 27-3 (2010), at 297; In general, in these countries, the concept of external public policy still includes not only the fundamental principles of their legal systems relating to justice or morality but also tradition, custom, societal or national sentiment or even local protectionism, and it is hoped that the highest courts in these countries will make further efforts to reduce uncertainty concerning the interpretation and application of public policy in the future.

¹³⁶⁰ While in domestic matters, Article 1487 (6) provides for the setting aside “if the arbitrator has violated a public policy rule”, Article 1502 (5) only considers the violation of “international public policy”.

¹³⁶¹ Gaillard, Emmanuel & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration, Kluwer Law International, 1999, at 954

¹³⁶² Poudret, Jean-Francois & Sebastien Besson, *Comparative Law of International Arbitration*, London: Sweet & Maxwell, 2nd ed., 2007, at para.822

¹³⁶³ *Ibid.*, at para. 824

¹³⁶⁴ *Ibid.*, at para. 825

¹³⁶⁵ Lew, Julian D. M., Loukas Mistelis L. A., & Stefan M. Kröll, *Comparative International Commercial Arbitration*, Kluwer Law International, 2003, at 667; Article 34 of the UNCITRAL Model Law is in line with

Due to the distinction between internal and external public policy, the number of matters considered as falling under public policy in international cases is smaller than in domestic ones. This reflects the recognition of the national legal systems, as elements of the spontaneous order of international commerce, that the law making capacity of contracting parties on the basis of the principle of freedom of contract in the order of international commerce can be greater than that of parties contracting within the internal orders of the national legal systems. Thus, it is observed that public policy defense rarely leads to a refusal of recognition or enforcement or an annulment of the arbitral awards.¹³⁶⁶ However, the general approach of the regulation of international arbitration under the national laws and international instruments rules out the exclusive consideration by the national courts of the established rules of policy in the order of international commerce by referring to such concepts as transnational or truly international public policy. The national court is generally required to consider only the set of values, a breach of which could not be tolerated by its legal system, even in international cases, since the mission of the court is mainly to ensure the compliance with the national legal system, as its organ. It is the concept of external public policy from the perspective of the national legal system of the seat of the arbitration, or of the national legal system where the enforcement of the award is sought, which is decisive. This concept may contain values which are essential from the perspective of the relevant state, even if they are not universally recognized.

b. European Public Policy

The influence of European Union and the importance of Community law have also become apparent in the field of arbitration. The arbitral tribunals and national courts of the Member States reviewing the arbitral awards have to deal increasingly with rules and notions of Community law.¹³⁶⁷ It is argued in the doctrine, the laws and regulations of the European Union, which have a public policy character, cannot be avoided by the private parties since, equally and automatically, they form part of the national public policy of the Member States.¹³⁶⁸ This understanding of public policy is usually called as “European public policy”.

Article V (2) (b) of the New York Convention with regard to public policy barrier. Therefore, the test of public policy compliance will also be a national test in light of external public policy at the place of arbitration.

¹³⁶⁶ Van Den Berg, Albert Jan, *Why Are Some Awards Not Enforceable?*, in Albert Jan van den Berg (ed.), *New Horizons in International Commercial Arbitration and Beyond*, ICCA Congress Series No. 12, Kluwer Law International, 2005, at 309

¹³⁶⁷ The European Court of Justice, in the *Nordsee* case, pronounced the obligation of arbitral tribunals to apply the relevant provisions of Community law if the law applicable to the contract is the law of a Member State. *Nordsee Deutsche Hochseefischerei GmbH v Reederei Mond Hochseefischerei Nordstern AG & Co. KG and Reederei Friedrich Busse Hochseefischerei Nordstern AG & Co. KG.* - Case 102/81. para. 14: “...Community law must be observed in its entirety throughout the territory of all the member states; parties to a contract are not, therefore, free to create exceptions to it. In that context attention must be drawn to the fact that if questions of Community law are raised in an arbitration resorted to by agreement the ordinary courts may be called upon to examine them either in the context of their collaboration with arbitration tribunals, in particular in order to assist them in certain procedural matters or to interpret the law applicable, or in the course of a review of an arbitration award - which may be more or less extensive depending on the circumstances - and which they may be required to effect in case of an appeal or objection, in proceedings for leave to issue execution or by any other method of recourse available under the relevant national legislation.”

¹³⁶⁸ Lew, Julian D. M., *Applicable Law in International Commercial Arbitration: A Study in Commercial Arbitration Awards*, Oceana, 1978, at 534

The first decision of the European Court of Justice relating to the concept of European public policy was the *Eco Swiss* case.¹³⁶⁹ In the *Eco Swiss* case, the arbitrators issued an award without considering Article 81 of the European Community Treaty, which prohibits all agreements, decisions of associations and concerted practices that have as their object or effect the prevention, restriction or distortion of competition within the common market.¹³⁷⁰ The parties did not raise this issue and the arbitrators did not pay any attention to this provision during the arbitral proceedings. However, when the award was being reviewed by the Dutch courts in setting aside proceedings, the unsuccessful party argued that the award was contrary to public policy on the ground that the disputed license agreement was void under Article 81. The Dutch court (the Hoge Raad der Nederlanden) decided to stay proceedings and to refer to the Court of Justice for a preliminary ruling, among others, the questions of whether Article 81 allows a claim for annulment of that award notwithstanding the rules of Dutch law, according to which, a party may claim annulment of an arbitration award only on a limited number of grounds, one ground being that an award is contrary to public policy, which generally does not cover the mere fact that no effect is given to a prohibition laid down by competition law through the enforcement of an arbitration award, and whether the court is also required to allow such a claim despite the fact that the question of the applicability of Article 81 remained outside the ambit of the dispute in the arbitration proceedings and the arbitrators therefore made no determination in that regard.¹³⁷¹

The European Court of Justice acknowledged that the efficient arbitration proceedings require that review of arbitration awards should be limited in scope and that annulment of or refusal to recognize an award should be possible only in exceptional circumstances.¹³⁷² However, the Court indicated that, Article 81 of the EC Treaty constitutes 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, and the importance of such a provision is expressed by its sanction that any agreements or decisions prohibited pursuant to that article are to be automatically void.¹³⁷³ Thus, the Court held that Article 81 is a mandatory provision of public policy character and its provisions may be regarded as a matter of public policy within the meaning of the New York Convention.¹³⁷⁴ The Court also noted that arbitrators, unlike national courts and tribunals, are not in a position to request a preliminary ruling on questions of interpretation of Community law, while it is manifestly in the interest of the Community legal order that every Community provision should be given a uniform interpretation. The Court concluded that Community law requires that questions concerning the interpretation of the prohibition laid down in Article 81 should be open to examination by national courts when asked to determine the validity of an arbitration award and that it should be possible for those questions to be referred, if necessary, to the Court of Justice for a preliminary ruling.¹³⁷⁵

¹³⁶⁹ *Eco Swiss China Time Ltd v Benetton International NV*. - Case C-126/97. European Court reports 1999 Page I-03055

¹³⁷⁰ Article 81 of the European Community Treaty is now referred to as Article 101 of the Treaty on the Functioning of the European Union, as amended by the Treaty of Lisbon, which entered into force on 1 December 2009

¹³⁷¹ *Eco Swiss China Time Ltd v Benetton International NV*. - Case C-126/97. European Court reports 1999 Page I-03055, para. 29

¹³⁷² *Ibid.*, para. 35

¹³⁷³ *Ibid.*, para. 36

¹³⁷⁴ *Ibid.*, para. 39

¹³⁷⁵ *Ibid.*, para. 40

Thus, this decision held that violation of Article 81 as part of European public policy justifies setting aside of the award under the national laws as well as a refusal of enforcement under the New York Convention regardless of the fact that, in the particular Member State, the violation of competition law is not considered to be an infringement of its external public policy.

In *Ingmar* case, the European Court of Justice dealt with the question whether the provisions of the Directive relating to self-employed commercial agents¹³⁷⁶, which guarantee certain rights to commercial agents after termination of agency contracts, must be applied where the commercial agent carried on his activity in a Member State, although the principal is established in a non-member country, and the parties agree that the contract is to be governed by the law of that country.¹³⁷⁷ In the case, *Ingmar and Eaton* concluded a contract under which *Ingmar* was appointed as *Eaton's* commercial agent in the United Kingdom, and the parties agreed that the contract was governed by the law of the State of California. The contract was terminated, and *Ingmar* instituted proceedings before the High Court of Justice of England and Wales, Queen's Bench Division, seeking payment of commission and, pursuant to the Directive, compensation for damage suffered as a result of the termination of its relations with *Eaton*. The High Court held that the Directive did not apply, since the contract was governed by the law of the State of California. When *Ingmar* appealed against that judgment, the Court of Appeal decided to stay proceedings and to refer to the Court for a preliminary ruling, asking whether the provisions of the Directive relating to the payment of compensation to agents on termination of their agreements with their principals is applicable as an overriding provision of public policy.¹³⁷⁸

The European Court of Justice noted that the regime established by the Directive for the purpose of protecting the commercial agent after termination of the contract is mandatory in nature, which is confirmed by the fact that, under the Directive, the parties may not derogate from them to the detriment of the commercial agent before the contract expires.¹³⁷⁹ Moreover, the Court stressed the underlying purpose of the Directive, namely the intention to eliminate restrictions on the carrying-on of the activities of commercial agents, to make the conditions of competition within the Community uniform and to increase the security of commercial transactions. Thus, the Court concluded that the purpose of the regime established in the Directive is to protect, for all commercial agents, freedom of establishment and the operation of undistorted competition in the internal market.¹³⁸⁰ Accordingly, the Court held that it is essential for the Community legal order that parties cannot evade such provisions by the simple expedient of a choice-of-law clause, irrespective of the law by which the parties intended the contract to be governed.¹³⁸¹

The extent of possible influence of these cases on the application of provisions based on other fundamental Community freedoms or other comparable directives or regulations by

¹³⁷⁶ Council Directive 86/653/EEC of 18 December 1986 on the coordination of the laws of the Member States relating to self-employed commercial agents (OJ 1986 L 382, p. 17)

¹³⁷⁷ *Ingmar GB Ltd v Eaton Leonard Technologies Inc.*, Case C-381/98., European Court reports 2000 Page I-09305

¹³⁷⁸ *Ibid.*, para. 13

¹³⁷⁹ *Ibid.*, para. 22

¹³⁸⁰ *Ibid.*, para. 24

¹³⁸¹ *Ibid.*, para. 25

arbitration tribunals is not yet clear.¹³⁸² In addition to the Community competition rules and rules of self-employed commercial agents, it can be argued that the fundamental Community freedoms and the basic ideas of European Directives, particularly if their objectives are to increase economic freedoms and to develop the internal market, may become the elements of the concept of European public policy.¹³⁸³ Thus, the violation of mandatory rules or public policy of European Community may result in an arbitral award being set aside, when the award is rendered by a arbitral tribunal having its seat in a Member State, or the refusal of its enforcement, when the enforcement is sought in a Member State, if the courts consider that those rules are part of the external public policy of their national legal systems, on the basis of the public policy exception contained in the arbitration laws or the New York Convention.¹³⁸⁴

Moreover, the European Court of Justice also decided whether a rule that a Member State considers to be mandatory and covered by the public policy exception does indeed qualify to be characterized as such. In *Arblade* case with regard to the question concerning the classification of certain provisions as public-order legislation under Belgian law, the Court stated that the term public-order legislation must be understood as applying to national provisions, compliance with which has been deemed to be so crucial for the protection of the political, social or economic order in the Member State concerned as to require compliance therewith by all persons present on the national territory of that Member State and all legal relationships within that State.¹³⁸⁵

It is argued that, as a consequence of *Arblade* judgement, the freedom of the Member States to define what they consider to be their international mandatory rules has considerably diminished.¹³⁸⁶ In the private international law, the mandatory rules are generally distinguished from the contents of public policy, on the basis that the former imposes a positive obligation on the decision maker to replace the contrary terms of the contract or the rules of applicable law with the mandatory rules of the forum, while the latter works as a negative imposition on the decision maker's reasoning to displace the contractual term or the rules of applicable law. However, it is observed that the difference between the concepts of mandatory norms and public policy relates more to the method than to the content itself and

¹³⁸² The cases *Eco Swiss* and *Ingmar*, were cited by the Final Report of the International Law Association, Committee on International Commercial Arbitration on public policy as a bar to enforcement of international arbitral awards, in which the Committee notes that "EC law is increasingly regarded as part of the international public policy of EU Member States, and an arbitral award that violates that law will not be enforced." Mayer, Pierre & Audley Sheppard, Final ILA Report on Public Policy as a Bar to Enforcement of International Arbitral Awards, *Arbitration International*, 19-2 (2003), at 261

¹³⁸³ Prechal, S. & N. Shelkopyas, National Procedures, Public Policy and EC Law, From Van Schijndel to *Eco Swiss* and Beyond, *European Review of Private Law*, 5 (2004), at 602, Liebscher, Christoph, European Public Policy, A Black Box?, *Journal of International Arbitration* 17-3 (2000), at 78; More recently, in *Asturcom* case, the European Court of Justice held that Directive 93/13 on unfair terms in consumer contracts as a whole constitutes, in accordance with Article 3(1)(t) of the EC Treaty, a measure which is essential to the accomplishment of the tasks entrusted to the European Community and, in particular, to raising the standard of living and the quality of life throughout the Community. The Court concluded that "in view of the nature and importance of the public interest underlying the protection which Directive 93/13 confers on consumers, Article 6 of the directive must be regarded as a provision of equal standing to national rules which rank, within the domestic legal system, as rules of public policy." *Asturcom Telecomunicaciones SL v Cristina Rodríguez Nogueira*, Case C-40/08, 6 October 2009, para. 51-52

¹³⁸⁴ Lew, Julian D. M., Loukas Mistelis L. A., & Stefan M. Kröll, *Comparative International Commercial Arbitration*, Kluwer Law International, 2003, at 492

¹³⁸⁵ *Arblade* (Case C-369/96) and *Leloup* (Case C-376/96) [1999] ECR I-8453, para 30.

¹³⁸⁶ Kessedjian, Catherine, Public Order in European Law, *Erasmus Law Review*, 1-1 (2007), at 31

becomes unnecessary in practice, as both concepts reveal fundamental values of the national legal system in which it has developed.¹³⁸⁷ In such a context, the *Arblade* judgment of the Court of Justice can be construed as providing an insight into the contents of the external public policy of the Member States. The definition provided in the *Arblade* judgment was adopted by Article 9 (1) of the Rome I Regulation on the law applicable to contractual obligations with regard to overriding mandatory provisions.¹³⁸⁸

c. Transnational Public Policy

In contrast to the external public policy, which is based on the fundamental rules and standards of a certain legal system, the violations of which cannot be tolerated even in international cases, “transnational public policy” (or “truly international public policy”) represents the international consensus on accepted norms of conduct and the established rules of policy in the order of international commerce. The concept of transnational public policy is of more restricted scope, solely comprising fundamental rules of natural law, principles of universal justice, *jus cogens* in public international law, and the general principles of morality accepted by international community. The concept of transnational public policy includes the prohibition of bribery, slavery, racial, religious and sexual discrimination, kidnapping, murder, piracy, terrorism, and subversion of the imperative laws of a sovereign state, fundamental human rights and basic standards of honesty and *bona fides*, and other imperative rules contained in the major and widely accepted international instruments.

The national courts generally refer to their own external public policy. There are a few court decisions in which reference has been made, in one way or another, to a universal conception of public policy.¹³⁸⁹ The Paris Court of Appeal, in the case of *European Gas Turbines SA v. Westman International Ltd*, noted that a contract having influence-peddling or bribery as its motives or object is contrary to French international public policy as well as to the ethics of international business as conceived by the largest part of the members of the international community.¹³⁹⁰ In England, the Court of Appeal in *Soleimany v Soleimany* case refused to

¹³⁸⁷ *Ibid.*, at 152

¹³⁸⁸ The definition of the European Court of Justice formed the inspiration for the European Commission’s definition of international mandatory provisions in Article 8(1) of the proposed Rome I Regulation: COM (2005) 650 final. As from 17 December 2009, the adopted Regulation (Reg. 593/2008, Rome I) supersedes the Rome Convention on the same subject matter, and apply to contracts concluded after the same date. Article 9 (1) of the Rome I Regulation defines overriding mandatory provisions as “provisions the respect for which is regarded as crucial by a country for safeguarding its public interests, such as its political, social or economic organisation, to such an extent that they are applicable to any situation falling within their scope, irrespective of the law otherwise applicable to the contract under this Regulation.”

¹³⁸⁹ The Swiss Federal Tribunal, in *W. v. F. and V* case, referred to a “universal conception of public policy, under which an award will be incompatible with public policy if it is contrary to the fundamental moral or legal principles recognized in all civilized countries”. Decision dated 30 December 1994, *ASA Bulletin*, (1995), at 217; The Milan Court of Appeal described transnational public policy as a “body of universal principles shared by nations of similar civilization, aiming at the protection of fundamental human rights, often embodied in international declarations or conventions.” Decision dated 4 December 1992, *Yearbook Commercial Arbitration*, 22 (1997), at 725.

¹³⁹⁰ Court of Appeal of Paris (1st Ch C), 30 September 1993, *Revue de l'Arbitrage* (1994), at 366; In the case, *Alsthom*, the predecessor of *European Gas Turbines*, was attempting to sell gas turbines to the National Petrochemical Company (NPC) for a petrochemical project in Iran. *Alsthom* entered into a contract with *Westman*, under which it was to provide *Alsthom* with information and advice during the negotiations to obtain a contract for the gas turbine project and its pre-qualification process. After being pre-qualified and signed with NPC a contract to furnish gas turbines, *Alsthom* refused to pay the commissions to *Westman*, and *Westman* initiated the ICC arbitration. In ICC Case No 6662, *Alsthom* stated that the consulting contract was null and void

enforce an award made in London under Jewish law giving effect to a contract between a father and son that involved the smuggling of carpets out of Iran in breach of Iranian revenue laws and export controls. The court held that it would not enforce “a contract governed by the law of a foreign and friendly state, or which requires performance in such a country, if performance is illegal by the law of that country.”¹³⁹¹

Some commentators argued that, in the context of globalized and market oriented society, the principles of competition law should be safeguarded by the concept of transnational public policy when it is put in jeopardy. In the great majority of the national legal systems, sophisticated competition rules and mechanisms of competition safeguards are adopted, as required by the market economy. It is argued that the fundamental nature of those rules and safeguards entails that it is almost unanimously acknowledged to be part of public policy.¹³⁹² In this view, the ideas of free competition has now become a universal policy, even if there are some differences between the competition rules of national laws.¹³⁹³ On the other hand, since most competition laws do not purport to apply universally and their application is

since it was illicit or amoral in its objects and motives. Westman produced a detailed accounting of its expenses that it certified having expended in accomplishing its tasks under the agreement. The arbitral tribunal held the consulting agreement to be valid and that Westman had proven that it had fulfilled its obligations. The tribunal noted that Westman’s role consisted only of promotion of Alstom’s gas turbines. The tribunal stated it did not emerge from the contract as it was written that Westman had to exercise influence upon NPC to obtain the pre-qualification. ICC Award in Case No. 6662, Mealey’s International Arbitration Report, 8-11, p. 5 and B-1. European Gas Turbines filed an appeal to the Paris Court of Appeal for annulment of the arbitral award. It argued that the enforcement of the award was contrary to the public policy because it supported a contract “having as its motive and goal the exercise of influence peddling or the payment of bribes”. Moreover, European Gas Turbines argued that the award was based on a fraudulent report of expenses submitted by Westman in the arbitration. The Court of Appeal dismissed the first ground for annulment, finding that there was no proof that the contract was an illicit contract for traffic in influence. However, the Court found that the second ground for annulment was partially well-founded, and that some parts of the arbitral award were affected by the fraud committed by Westman in the arbitration. The court therefore annulled the award in so far as it was based on Westman's fraudulent accounts, applying the general principle of law *fraus omnia corrumpit*, with the exception of the arbitrators' finding that a valid *sui generis* contract (combining a brokerage contract and a contract for work) had been concluded by the parties.

¹³⁹¹ *Soleimany v. Soleimany*, [1999] Q.B. 785 (C.A. 1998); Lord Steyn explicitly endorsed the concept of transnational public policy in the decision of House of Lords in *Kuwait Airways Corporation v. Iraqi Airways Company*, [2002] UKHL 19, at 115: “Our domestic public policy on the status of Resolution 369 [which was passed by the Revolutionary Command Council of Iraq in 1990, dissolving Kuwaiti Airways Corporation, purporting to transfer all of the company’s property, wherever situated, to Iraqi Airways Company] does not stand alone. In recent years, particularly as a result of French scholarship, principles of international public policy (*l'ordre public veritablement international*) have been developed in relation to subjects such as traffic in drugs, traffic in weapons, terrorism, and so forth: see a magisterial paper by Professor Pierre Lalive, “Transnational (or Truly International) Public Policy and International Arbitration, ICCA,” in *Comparative Arbitration Practice and Public Policy in Arbitration*, ed Sanders, (1986), p 257, at pp 284-286; Fouchard, Gaillard and Goldman on *International Commercial Arbitration*, (1999), p 953, et seq.; Redfern and Hunter, *Law and Practice of International Commercial Arbitration*, 3rd ed (1999), p 152, para 3-27; Craig, Park and Paulsson, *International Chamber of Commerce Arbitration*, 3rd ed (2000), pp 338-346, para 17.04. Similarly, there may be an international public policy requiring states to respect fundamental human rights: *Restatement*, vol 2, pp 152 et seq, para 701. The public policy condemning Iraq's flagrant breaches of public international law is yet another illustration of such a truly international public policy in action. This international dimension reinforces the view of the Court of the Appeal.”

¹³⁹² Radicati Di Brozolo, Luca G., *Arbitration and Competition Law: The Position of the Courts and of Arbitrators*, *Arbitration International*, 27-1 (2011), at 4

¹³⁹³ Kessedjian, Catherine, *Transnational Public Policy*, in Albert Jan van den Berg (ed.), *International Arbitration 2006: Back To Basics?*, ICCA Congress Series No. 13, Kluwer Law International, 2007, at 868

limited to the conducts within the relevant jurisdiction, it is also argued that this is entirely inconsistent with the status as transnational public policy.¹³⁹⁴

The Swiss Federal Tribunal adopted the latter view in dealing with the annulment proceedings of an ICC Arbitration case, where the arbitral tribunal sitting in Switzerland rejected the allegation that the contract, which was governed by Italian law, was inconsistent with EU competition law. The award was challenged before the Swiss courts on the grounds of violation of public policy. It was argued that the award disregarded fundamental provisions of European and Italian competition laws. The Swiss Federal Tribunal held that competition law is not part of a universal concept of public policy and stated that “it would be presumptuous to take the view that European or Swiss concepts in the field of competition law should evidently be imposed to all the states of the planet as a panacea, because such concepts are tied to a certain type of economy and to a certain regime... Swiss law itself acknowledges that not all restrictions to competition are damaging ... and it excludes certain goods or services from free competition. Other models, based on a more planned economy emphasizing the intervention of the State in the economy, existed in the past and still exist. No one would hold them out as immoral or contrary to the fundamental principles of law for the simple reason that they depart from the Swiss model. Actually, it appears that despite the efforts made to emphasize a convergence of the various solutions adopted in the field of competition law, it is an area which hardly lends itself to an analysis in terms of universal morals and the thesis of a substantial public policy of *lex mercatoria* in competition law appears, for the time being, to remain utopia... Indeed, this is a technical field in which the results sought may be reached or enhanced in various ways. As to finding a common denominator to the existing state laws with a view to deriving from them a principle which could be tied to public policy, this is an endeavour which would not necessarily meet success whilst most probably not leading to a definition derived from art. 81 EC ... In reality, the differences between the various laws on competition are too acute – specially between Switzerland and the European Union – to allow a finding that a transnational or international rule public policy would have to be found there”¹³⁹⁵ Therefore, this highly technical subject with its policy implications seems to be more easily analyzed by national courts in terms of external (or European) public policy, rather than in terms of universal conception of public policy.¹³⁹⁶

In essence, the conception of external public policy under each national legal system comprises certain genuinely international concepts or rules since these truly international criteria are drawn from the fundamental rules of natural law and the general principles of morality and public policy based on *opinio iuris*.¹³⁹⁷ For example, according to the repeated formula of the Swiss courts, Swiss external public policy includes, in particular, the observation of contractual obligations (*pacta sunt servanda*), the rules of good faith, and the

¹³⁹⁴ Redfern, Alan, Comments on Commercial Arbitration and Transnational Public Policy, in Albert Jan van den Berg (ed.), *International Arbitration 2006: Back To Basics?*, ICCA Congress Series No. 13, Kluwer Law International, 2007, at 874

¹³⁹⁵ English translation of the Decision of the Swiss Supreme Court (‘Federal Tribunal’) of March 8, 2006, 4P.278/2005, *ASA Bulletin*, 24-3 (September 2006), at 556-557

¹³⁹⁶ Gaillard, Emmanuel & John Savage (eds.), *Fouchard, Gaillard, Goldman on International Commercial Arbitration*, Kluwer Law International, 1999, at 855

¹³⁹⁷ Lew, Julian D. M., *Applicable Law in International Commercial Arbitration: A Study in Commercial Arbitration Awards*, Oceana, 1978, at 535

prohibition of abuse of rights.¹³⁹⁸ These are the established rules of policy in the order of international commerce and constitute part of the external public policy of almost all national legal systems.

It is also argued that, on the basis of such rules that positivize private property, contractual freedom and human rights as transnational public policy, the communities of merchants may also develop public policy contents entirely outside national legal systems, such as the principles of “corporate social responsibility,” and codes of conducts relating to the environment, labor, corruption and free competition.¹³⁹⁹ Essentially, in addition to the international merchants developing such codes voluntarily, the states are also involved in establishing voluntary codes of conduct for transnational corporations through the norms of international organizations, which provide general guidelines concerning labor conditions, product quality, environmental policies, consumer protection, and human rights.¹⁴⁰⁰ Moreover, the states convene private actors to encourage the creation of code of conducts, thereby influencing their norms, structure, and procedures through their terms for collaboration with the private actors.¹⁴⁰¹ Transnational public policy in this view would be composed of codes of conduct indicating mandatory norms, which may be imposed by the national courts and international arbitral tribunals on merchants either because they have been created by those merchants themselves or by relevant civil society at large, or because they have been widely accepted by the different states around the world.¹⁴⁰²

However, in many cases, the codes of conduct provided by the states remain as mere recommendations with no binding effects. Similarly, the self-commitments in those codes adopted by transnational corporations are often only strategic attempts to preempt state regulation through a nonbinding declaration of intent, or they are arguably mere public relations strategies without any effective change of behavior. Even so, it is observed that in

¹³⁹⁸ Tribunal Federal, May 5 1976, concerning an award made in ICC Case No 1803, *Yearbook Commercial Arbitration*, 5 (1980), at 219; Poudret, Jean-Francois & Sebastien Besson, *Comparative Law of International Arbitration*, London: Sweet & Maxwell, 2nd ed., 2007, at para. 826

¹³⁹⁹ Kessedjian, Catherine, *Transnational Public Policy*, in Albert Jan van den Berg (ed.), *International Arbitration 2006: Back To Basics?*, ICCA Congress Series No. 13, Kluwer Law International, 2007, at 868; These code of conducts also include more or less extensive procedures for implementation and monitoring. For instance, Labor rights scheme of Gap, Inc., 1992; The Body Shop, "Trade Not Aid" initiative, 1991; International Chamber of Commerce Business Charter for Sustainable Development, 1991; Responsible Care, 1987; Global GAP, agricultural products standard on safety, environment, labor, 1997 (as EUREPGAP); SQF 1000, 2000 food safety standards, optional social, environmental standards, 1994; World Diamond Council warranty system for conflict diamonds, 2004; International Council on Mining and Metals sustainable development principles, 2003; Worldwide Responsible Apparel Production, industry labor code, 2000; Sustainable Forestry Initiative, 1994; Programme for the Endorsement of Forest Certification, 1999 (as Pan-European Forest Certification); World Business Council for Sustainable Development, 1992; Business Social Compliance Initiative, European supplier labor standard, 2004. Abbott, Kenneth W., & Duncan Snidal, *Strengthening International Regulation Through Transnational New Governance: Overcoming the Orchestration Deficit*, *Vanderbilt Journal of Transnational Law*, 42 (2009), at 514 (Zone 2 in the Table 1)

¹⁴⁰⁰ For instance, United Nations Draft Code of Conduct on Transnational Corporations, the United Nations Draft Norms on Business and Human Rights, the Organization for Economic Co-operation and Development's Voluntary (OECD) Guidelines for Multinational Enterprises, and the International Labour Organization's (ILO) Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy.

¹⁴⁰¹ Abbott, Kenneth W., & Duncan Snidal, *Strengthening International Regulation Through Transnational New Governance: Overcoming the Orchestration Deficit*, *Vanderbilt Journal of Transnational Law*, 42 (2009), at 574

¹⁴⁰² Kessedjian, Catherine, *Transnational Public Policy*, in Albert Jan van den Berg (ed.), *International Arbitration 2006: Back To Basics?*, ICCA Congress Series No. 13, Kluwer Law International, 2007, at 861

some cases the codes have improved labor conditions, increased environmental protection, and pushed through human rights standards, but the success in changing the behavior mainly depends on the permanent monitoring of the non-governmental organizations or binding contracts with civil societal certification bodies.¹⁴⁰³ Thus, the norms included in those codes are “voluntary” in the sense that they are not legally required, but the corporations often adhere “because of pressure from NGOs, customer requirements, industry association rules, and other forces that render them mandatory in practice.”¹⁴⁰⁴ These codes attempt at restricting corporate activities in the name of public responsibility by realizing self-restraint in the areas of labor, product quality, environment, and human rights.¹⁴⁰⁵ However, when the parties to an international contract have not expressed their consent to be bound by such self-restraint mechanisms,¹⁴⁰⁶ the intervention of any decision maker at the stage of legal enforcement on the basis of those codes of conduct potentially introduce wider policy considerations, which could result in overstating the contents of transnational public policy thereby granting the decision makers with a potentially arbitrary power to override contract between the parties through his personal, moral or political views, and to alter, on the basis of considerably vague criteria, the nature of the contractual obligations assumed by the parties.¹⁴⁰⁷

Furthermore, the formulation of mandatory norms that override the parties’ freedom of contract through such instruments at the stage of legal enforcement contradicts their very nature. Those codes are more in the form of trade usages or practices from the perspective of an ex post decision maker at the stage of legal enforcement, since the terms of contract prevail over them and their effective enforcement mainly depends on the consent of the parties or the mechanisms of self-regulation to the extent they have become an autonomous, privately ordered, coercive inner law of corporations, whereas the mandatory norms relating to the environment, labor and other matters will naturally be relevant and may render a contract unenforceable or illegal if they are part of the relevant national legal systems and, thus, relevant to the public policy considerations. Although the interests that are protected by such codes of conduct may become influential on the abstract reasoning of the decision maker and, thus, on the manner of application of the vague standard of public policy by assisting the ex post decision maker in utilizing the tacit knowledge of the parties to a particular dispute, it will not be appropriate to refer to the specific rules of such codes as elements of the transnational public policy that bind the parties even in the absence of consent. Such voluntary rules are provided by diverse and multiple sources, and they operate in parallel in

¹⁴⁰³ Teubner, Gunther, Self-Constitutionalizing TNCs? On the Linkage of 'Private' and 'Public' Corporate Codes of Conduct, *Indiana Journal of Global Legal Studies*, 18 (2011), at 619-620

¹⁴⁰⁴ Abbott, Kenneth W., & Duncan Snidal, Strengthening International Regulation Through Transnational New Governance: Overcoming the Orchestration Deficit, *Vanderbilt Journal of Transnational Law*, 42 (2009), at 506 fn 25

¹⁴⁰⁵ Teubner, Gunther, Self-Constitutionalizing TNCs? On the Linkage of 'Private' and 'Public' Corporate Codes of Conduct, *Indiana Journal of Global Legal Studies*, 18 (2011), at 623

¹⁴⁰⁶ For example, the Voluntary Principles on Security and Human Rights have been incorporated into binding agreements between multinational investors and host governments in several countries. Ruggie, Gerard, *Business and Human Rights: The Evolving International Agenda*, *American Journal of International Law*, 101 (2007), at 835; Voluntary Principles on Security and Human Rights are the result of the engagement between the Governments of the United States and the United Kingdom, companies in the extractive sectors, and non-governmental organizations and aim to promote corporate human rights risk assessments and the training of security providers in the extractive sector. Available at <http://www.voluntaryprinciples.org>

¹⁴⁰⁷ Pryles, Michael, Reflections on Transnational Public Policy, *Journal of International Arbitration*, 24-1 (2007), at 5

pursuit of shared objectives, albeit with significant variations in norms and procedures, so that they often compete with each other.¹⁴⁰⁸ Whether such voluntary rules transform into mandatory norms in practice is not to be decided by the ex post decision makers at the stage of legal enforcement, but in the inner processes of corporations and private organizations.

Besides, the purpose of this form of regulation differs from that of the traditional mechanisms adopted and enforced by the national legal systems through “hard law”. It is observed that, prior to 1985, the regulation of labor, environment, and human rights was almost exclusively the province of the states and intergovernmental organizations, where mandatory “hard law” predominated.¹⁴⁰⁹ After 1985, by adopting those codes of conducts to complement or substitute for mandatory “hard law”, the states have intended to engage companies in the promotion of certain values and goals, but not to force them towards certain behaviors by means of hard law and its legal enforcement. In this “Transnational New Governance model of regulation”, the states should incorporate a decentralized range of actors and institutions, both public and private, into the regulatory system, such as by negotiating standards with firms, encouraging and supervising self-regulation, or sponsoring voluntary management systems. They should rely on this range of actors for regulatory expertise rather than the bureaucratic expertise. In this model of regulation, the regulatory responsibilities of the states should emphasize orchestration of public and private actors and institutions, rather than direct promulgation and enforcement of rules. For instance, the states should initiate voluntary and cooperative programs, convene and facilitate private collaborations, persuade and provide incentives for firms to self-regulate, build the capacities of private actors, negotiate regulatory targets with firms, provide incentives to exceed mandated performance levels, and ratify or scale up successful approaches.¹⁴¹⁰ In this context, the states should be ready to step in with mandatory action to steer the conduct in desired directions where softer methods fail, even if the coordinated state action seems problematic on the international plane.

The wider considerations of transnational public policy on the basis of those voluntary codes at the stage of legal enforcement would contradict the purpose of the Transnational New Governance model of regulation, which is to encourage the merchants to regulate themselves and civil society actors to participate in regulating the conduct of merchants through varied forms of private ordering and relationships with state agencies, by erroneously turning it, at the discretion of the ex post decision maker, who does not have the necessary regulatory expertise, into “hard law”, i.e. the traditional model of regulation. Only the authorities in the national legal systems, which have obtained sufficient expertise as a result of their utilization of knowledge of the relevant stakeholders and brought the dispersed expertise, resources, and capacities of private actors into the regulatory system by means of direct contact, may decide to step in with mandatory regulation and to incorporate the soft private commitments directly into the binding law. In the absence of such action of the authorities, the intervention of the ex post decision maker in the contract on the basis of those soft commitments at the stage of legal enforcement would increase the likelihood of the arbitrary decision making and outcomes that are incompatible with the concepts of freedom of contract, *pacta sunt servanda* and mandatory norms, which are the foundations of the traditional model of regulation. The potential of arbitrariness in ex post decision making that relies on such “soft law” in limiting the freedom of contract mainly arises from the different assumptions that distinguish the

¹⁴⁰⁸ Abbott, Kenneth W., & Duncan Snidal, *Strengthening International Regulation Through Transnational New Governance: Overcoming the Orchestration Deficit*, *Vanderbilt Journal of Transnational Law*, 42 (2009), at 542

¹⁴⁰⁹ *Ibid.*, at 519

¹⁴¹⁰ *Ibid.*, at 521

traditional model of regulation from the Transnational New Governance model of regulation: the former assumes effective representative democracy for making choices in the public interest, while the latter assumes effective stakeholder representation, participation, and deliberation. Thus, the intervention of the national court in the contract through such soft law would have a questionable legitimacy for the lack of the assumption of representative democracy and in view of its inferior position to utilize the knowledge of the stakeholders.

Above all, the national courts are generally hesitant to resort to the concept of transnational public policy rather than to the external public policy of the forum, since it seems more legitimate for the national courts to fill in the vague concept of public policy with the mandatory rules of the national legal system in determining the limits of the freedom of contract of the parties and overriding their contract. The introduction of wider considerations in determining the scope of public policy exception can potentially produce incompatible results with the generally desired restrictive approach of the national courts to the issue of enforcement of arbitral awards. Nevertheless, while the voluntary codes of conduct may sometimes be technically complex, the social consequences of certain conducts of merchants can be relatively simple and evident in relation to the interests and stakeholders that should be protected and, thus, may guide the abstract reasoning of the ex post decision maker in intervening in the contract by means of the concept of transnational public policy.

2. Lex Mercatoria in Public Policy Considerations

The judicial authority and jurisdictional power of arbitrators find its origin in the will of the parties and, as a result, the arbitrators should conform to the parties' stipulations, since any deviation would imply acting beyond the scope of their authority.¹⁴¹¹ Even so, the arbitrators tend to consider the possibility of rendering their decisions while applying or taking into account public policy considerations. However, the arbitration laws and rules do not provide guidance for the arbitrator in identifying a rule or value as protecting one of the substantive public policy concepts described above, the violation of which would be a ground for refusal of enforcement or setting aside of the award.¹⁴¹² The issue is apparently left to the specialization of the arbitrator, who should ensure that an arbitration clause does not become an instrument used by the parties to fraudulently evade the public policy considerations.

It can be said that public policy considerations by arbitrators is even promoted by many national legal systems, which have considerably expanded the outreach of the international arbitration by reducing the number or scope of non-arbitrable matters. The modern laws of arbitration gradually depart from the traditional solution of simply refusing enforcement due to lack of arbitrability. In such a context that arbitral determinations may affect the vital state and community interests to a greater extent, the arbitrators are required to carefully consider legal norms or values protecting such interests. The authorities in the national legal systems increasingly rely on the specialization of international arbitrators in applying the different concepts of public policy, rooted in national jurisdictions or of transnational nature, and only sanction their infringement, while considering the policy in the finality of arbitral awards, which ensures an effective dispute settlement mechanism. Thus, the arbitrators have a clear duty to address the issues of illegality whenever they arise in the arbitration and whatever the

¹⁴¹¹ Grigera Naón, Horacio A., *Choice of Law Problems in International Commercial Arbitration*, *Recueil des Cours*, 289 (2001), at 296

¹⁴¹² Poudret, Jean-Francois & Sebastien Besson, *Comparative Law of International Arbitration*, London: Sweet & Maxwell, 2nd ed., 2007, at para. 705

wishes of the parties, and to record their legal and factual conclusions in their awards. These circumstances invite or prompt the arbitrators to take into account and to apply both national and transnational mandatory rules and principles.

The international restatements of contract principles contain some guidance in their provisions, which deal with the issue of application of the public policy rules. Article 1:103 of the PECL and Article 1.4 of the UNIDROIT Principles provide that effect should be given to those mandatory rules of national, supranational and international law which, according to the relevant rules of private international law, are applicable irrespective of the law governing the contract. In the revised Official Comments to UNIDROIT Principles 2010, it is explained that “Given the particular nature of the Principles as a non-legislative instrument, neither the Principles nor individual contracts concluded in accordance with the Principles, can be expected to prevail over mandatory rules of domestic law, whether of national, international or supranational origin, that are applicable in accordance with the relevant rules of private international law.” The Official Comments define “mandatory rules of national origin” as those enacted by states autonomously (e.g. particular form requirements for specific types of contracts; invalidity of penalty clauses; licensing requirements; environmental regulations; etc.), while mandatory rules of international or supranational origin as those derived from international conventions or general public international law (e.g. Hague-Visby Rules; UNIDROIT Convention on Stolen or Illegally Exported Cultural Objects; United Nations Convention against Corruption; United Nations Universal Declaration of Human Rights, etc.) or adopted by supranational organisations (e.g. European Union competition law, etc.).¹⁴¹³

Although, under private international law, public policy and mandatory rules traditionally form two different concepts, it is generally accepted that there is a fair amount of overlap between them.¹⁴¹⁴ Even so, it is argued that for dogmatic clarity the issue of mandatory rules should not be used interchangeably with the issue of public policy, because the rules of public policy imply a highly ethical or moral standard, which can be, but are not necessarily, embodied in explicit provisions, while mandatory rules are always explicit rules which seek application in a dispute at stake, and mandatory rules may contain issues which would be classified as issues of public policy, but they can also have a broader content.¹⁴¹⁵ However, even if the mandatory norms may vary in their content and be formulated in terms of rules or standards, the same considerations can be at play in the determination of their applicability. In the context of an international contract, the main differentiating factor in such a determination is whether the relevant norm aims at and capable of limiting the principle of freedom of contract in the order of international commerce. Thus, the conceptual distinction between public policy and mandatory rules becomes mostly irrelevant in the context of *lex mercatoria* as far as the question of illegality is concerned.

Accordingly, the revised Official Comments to UNIDROIT Principles 2010 make it clear that, for the purpose of Article 1.4, the notion of “mandatory rules” is to be understood in a broad sense, so as to cover both specific statutory provisions and general principles of public policy. Moreover, the Official Comments to Article 1.4 explicitly refer to Article 35 of the

¹⁴¹³ Official Comment 1 of Article 1.4 of the UNIDROIT Principles

¹⁴¹⁴ Chong, Adeline, *The Public Policy and Mandatory Rules of Third Countries in International Contracts*, *Journal of Private International Law*, 44 (April 2006), at 32; Lando, Ole, *The Lex Mercatoria in International Commercial Arbitration*, *International and Comparative Law Quarterly*, 34 (1985), at 764

¹⁴¹⁵ Voser, Nathalie, *Mandatory Rules of Law as a Limitation on the Law Applicable in International Commercial Arbitration*, *American Review of International Arbitration*, 7 (1996), at 322

1998 ICC Arbitration Rules, which obliges the arbitrator to “make every effort to make sure that the Award is enforceable at law”, in order to draw attention to the international mandatory rules or public policies of those countries where enforcement of the award is likely to be sought.¹⁴¹⁶ Thus, the internal and external public policy concepts can be understood respectively as the “domestic mandatory rules or standards” from which the parties cannot escape in domestic settings, but in international situations can be excluded by party autonomy and, as “international mandatory rules or standards” from which the parties cannot escape in international circumstances. It can be said that, under *lex mercatoria*, a mandatory rule is a matter of public policy and reflects a public policy interest so commanding that it may be applied even if the contract provides otherwise and the general body of law to which such a rule belongs is not competent by application pursuant to the parties’ choice or the conflict of laws rules in the absence of choice.

Although the international restatements of contract principles recognize a distinction between those mandatory rules, which may be rendered inapplicable by the parties’ choice of law and others, which are applicable regardless of the law governing the contract, they deliberately refrain from stating which mandatory rules should apply, and refer instead to the relevant rules of private international law for the solution in each given case in view of the considerable differences in the ways in which the national courts and arbitral tribunals determine the mandatory rules applicable to international contracts. As observed from their official comments, their distinction is basically inspired by Article 7 of the Rome Convention on the Law Applicable to Contractual Obligations 1980 (or Article 9 of the Rome I Regulation, which replaces the Convention), which provides that effect may be given to the overriding mandatory rules of a country other than the forum with which the situation has a close connection (under Article 9(3) of the Rome I Regulation, the overriding mandatory provisions of the law of the country where the obligations arising out of the contract have to be or have been performed, in so far as those overriding mandatory provisions render the performance of the contract unlawful), and nothing shall restrict the application of the overriding mandatory rules of the law of the forum.¹⁴¹⁷ This provision requires courts to have regard to the nature and purpose of mandatory rules and to the consequences of their application or non-application in considering whether to give effect to those overriding mandatory rules.¹⁴¹⁸ It is expressly intended to give a power of discretion to judges or arbitrators to choose between the rules of different states that purport simultaneously to be applicable to one and the same situation.¹⁴¹⁹

The international restatements of contract principles deal more specifically with the consequences of the violation of an applicable mandatory rule or public policy standard. In the Chapter 15 on the issue of illegality, Article 15:101 of the PECL provides that “a contract is of no effect to the extent that it is contrary to principles recognized as fundamental in the

¹⁴¹⁶ Official Comment 4 of Article 1.4 of the UNIDROIT Principles; UNIDROIT 2010 - Study L - Doc. 115, Rome, 24-28 May 2010. Article 1.4 (Mandatory Rules) Revised Comments by Professor Michael Joachim Bonell, Consultant, UNIDROIT - February 2010, Comments 3 and 4; UNIDROIT 2009 - Study L - Misc. 29, Rome, 25 – 28 May 2009, at para. 489

¹⁴¹⁷ Official Comment 5 of Article 1.4 of the UNIDROIT Principles; Lando, Ole & Hugh Beale (eds.), *Principles of European Contract Law, Parts I and II*, Kluwer Law International, 2000, at 100-103

¹⁴¹⁸ Lando, Ole & Peter Arnt Nielsen, *The Rome I Regulation*, *Common Market Law Review*, 45 (2008), at 1719-1723

¹⁴¹⁹ Shore, Laurence, *Applying Mandatory Rules of Law in International Commercial Arbitration*, *American Review of International Arbitration*, 18 (2007), at 99

laws of the Member States of the European Union.” The wording of this provision is intended to avoid the varying national concepts of immorality, illegality, public policy, ordre public and bonos mores, and to invoke the broader idea of fundamental principles found in the laws of the Member States and Community law.¹⁴²⁰ It is also suggested that the concept of fundamental principles of law under this provision should be distinguished from good faith as a control device in contract law. It is argued that while the principle of good faith applies directly to the specifics of the relationship between the parties, the public policy concept of fundamental principles of law deals with more abstract questions of moral and social standards apart from the relationship of the parties.¹⁴²¹ According to the Official Comments to the PECL, the guidance in the search for such fundamental principles can be obtained from the European Community Treaty, particularly from the rules regarding fundamental Community freedoms and the protection of market competition. The European Convention on Human Rights and the European Union Charter on Fundamental Rights are also indicated as the possible sources of reference to such fundamental principles.¹⁴²²

Article 15:102 (1) provides that where a contract infringes a mandatory rule of law applicable under Article 1:103 of the PECL, the effects of that infringement upon the contract are the effects, if any, expressly prescribed by that mandatory rule. Article 15:102 (2) of the PECL reflects the approach of Section 178 of the US Restatement (Second) of Contracts.¹⁴²³ It provides that, in the absence of express provision under the relevant mandatory rule as to its effects, the decision maker may declare, in its discretion, the contract to have full effect, to have some effect, to have no effect, or to be subject to modification, having regard to all relevant circumstances, including: (a) the purpose of the rule which has been infringed; (b) the category of persons for whose protection the rule exists; (c) any sanction that may be imposed under the rule infringed; (d) the seriousness of the infringement; (e) whether the infringement was intentional; and (f) the closeness of the relationship between the infringement and the contract. The main difference between Article 15:101 and Article 15:102 is that the latter provision deals with less important violations of the law and, thus, allows for more flexibility in the effects of illegality on the contract than the former provision, which applies to all cases where the violation of a statute also involves a violation of a fundamental principle of law and provides for absolute ineffectiveness.¹⁴²⁴

Illegality was one of the matters, which had been expressly excluded from the scope of the UNIDROIT Principles 2004 pursuant to Article 3.1. The Working Group, which was set up with the task of preparing a third edition of the UNIDROIT Principles, prepared provisions on the issue of illegality.¹⁴²⁵ In the discussions, the Working Group considered the relevant

¹⁴²⁰ MacQueen, H. L., *Illegality and Immorality in Contracts: Towards European Principles*, in A.S. Hartkamp, E.H. Hondius, M.W. Hesselink, E. du Perron & M. Veldman, (eds.), *Towards A European Civil Code*, Kluwer Law International, 2004, at 418

¹⁴²¹ *Ibid.*, at 419

¹⁴²² Lando, Ole, Eric Clive, Andre Priim & Reinhard Zimmermann (eds.), *Principles of European contract law. Part III*, Kluwer Law International, 2003, at 211

¹⁴²³ In fact, it is stated that this provision of the PECL was inspired by the Law Commission of England and Wales Consultation Paper No. 154, *Illegal Transactions: The effect of Illegality on Contracts and Trusts* (1998). MacQueen, H. L., *Illegality and Immorality in Contracts: Towards European Principles*, in A.S. Hartkamp, E.H. Hondius, M.W. Hesselink, E. du Perron & M. Veldman, (eds.), *Towards A European Civil Code*, Kluwer Law International, 2004, at 421

¹⁴²⁴ *Ibid.*, at 420

¹⁴²⁵ UNIDROIT 2006 - Study L - Doc. 99, March 2006, at paras. 16-19

provisions of the PECL, Restatement (Second) of Contracts, and “Recommendations on the Application of Public Policy as a Ground for Refusing Recognition or Enforcement of International Arbitral Awards” adopted by the International Law Association in New Delhi in 2002.¹⁴²⁶ The new section on illegality under the UNIDROIT Principles 2010 does not provide a provision similar to Articles 15:101 of the PECL, but contains Article 3.3.1, which corresponds to Article 15:102 of the PECL.¹⁴²⁷

The first paragraph of Article 3.3.1 of the UNIDROIT Principles provides that where a contract infringes a mandatory rule, whether of national, international or supranational origin, applicable under Article 1.4, the effects of that infringement upon the contract are the effects, if any, expressly prescribed by that mandatory rule. Pursuant to the second paragraph, where the mandatory rule does not expressly prescribe the effects of an infringement upon a contract, the parties have the right to exercise such remedies under the contract as in the circumstances are reasonable. The Official Comments to Article 3.3.1 explains that the formula “such remedies under the contract as in the circumstances are reasonable” is sufficiently broad to permit a maximum of flexibility and, notwithstanding the infringement of the mandatory rule, one or both of the parties may, depending on the circumstances of the case, be granted the ordinary remedies available under a valid contract (including the right to performance), or other remedies such as the right to treat the contract as being of no effect, the adaptation of the contract or its termination on terms to be fixed.¹⁴²⁸ Finally, the third paragraph provides that, in determining what is reasonable, regard is to be had in particular to: (a) the purpose of the rule which has been infringed; (b) the category of persons for whose protection the rule exists; (c) any sanction that may be imposed under the rule infringed; (d) the seriousness of the infringement; (e) whether one or both parties knew or ought to have

¹⁴²⁶ UNIDROIT 2006 - Study L - Misc. 26, October 2006, at paras. 84-153

¹⁴²⁷ An earlier draft of the section on illegality contained the following provision: “Article 1 - Contracts contrary to fundamental principles: (1) A contract is illegal if, whether by its terms, performance or otherwise, it is contrary to principles widely accepted as fundamental in legal systems throughout the world.” The comments to this article explained that the Principles distinguished between “contracts contrary to fundamental principles” and “contracts infringing mandatory rules” according to the seriousness of the infringement. The former case was related only to those that are “widely accepted as fundamental in legal systems throughout the world”, and did not cover all principles of good morals and public policy considered fundamental at domestic level, given the universal sphere of application of the Principles. The latter case was reserved for the contracts which, though not violating principles widely accepted as fundamental in legal systems throughout the world, may nevertheless be illegal because they infringe mandatory rules enacted by national, supranational or international legislatures for a variety of reasons of public policy. UNIDROIT 2009 - Study L - Doc. 111 (rev.), Rome, 25-29 May 2009. This distinction is not preserved in the black letter rules of the UNIDROIT Principles 2010. The main objection was that the notion of “principles widely accepted as fundamental in legal systems throughout the world” was too vague and would inevitably give rise to divergent interpretations in the different parts of the world, thereby undermining one of the main objectives of the UNIDROIT Principles, which was to promote legal certainty in international contract practice. It was suggested that the Principles should address only one kind of illegality, i.e., the infringement of mandatory rules of national, international or supranational origin applicable under Article 1.4. Bonell, Michael Joachim, *The New Provisions on Illegality in the UNIDROIT Principles 2010*, *Uniform Law Review*, (2011), at 521-522. During the drafting process, the Working Group discussed the necessity to rewrite the Comments to Article 1.4 so as to explain that the reference to “mandatory rules” was to cover also principles of public policy. Particularly, the Working Group intended to make it clear that the reference was not only to statutory rules but also to unwritten principles of domestic and international public policy, such as prohibition of commission or inducement of crimes, prohibition of corruption, protection of human dignity, prohibition of discrimination on the basis of gender, race or religion, prohibition of undue restraint of trade, and etc. UNIDROIT 2010 - Study L - Doc. 115, Rome, 24-28 May 2010. Article 1.4 (Mandatory Rules) Revised Comments by Professor Michael Joachim Bonell, Consultant, UNIDROIT - February 2010, Comment 2; UNIDROIT 2009 - Study L - Misc. 29, Rome, 25 – 28 May 2009, at paras. 431 and 441

¹⁴²⁸ Official Comment 5 of Article 3.3.1 of the UNIDROIT Principles

known of the infringement; (f) whether the performance of the contract necessitates the infringement; and (g) the parties' reasonable expectations. Unlike the PECL, this provision of the UNIDROIT Principles expressly refers to the reasonable expectations of the parties, and may be considered as linking the appropriate remedies of illegality to the principle of good faith thereby requiring the decision maker to take into account also the specifics of the relationship between the parties through a balancing exercise of the relevant interests of the parties and the states.

However, while assisting the decision makers in determining the appropriate remedies for the infringement of a mandatory rule that is silent as to the effects of its infringement, the provisions of the international restatements of contract principles do not completely reflect the potential of the approach of Section 178 of the Restatement (Second) of Contracts, which can also be extended to the determination of the applicable mandatory rules or standards in the order of international commerce. The Restatement provides that, in cases where the legislation is not clear as to the enforceability of a particular contractual term, a decision as to enforceability is to be reached only after a careful balancing, in the light of all the circumstances, of the interests of the parties in the enforcement of the particular terms and of the public interests against the enforcement of such terms, by taking into account such factors as the parties' justified expectations, the strength of public policy as manifested by legislation or judicial decisions, the likelihood that a refusal to enforce the term will further that policy, and the directness of the connection between the misconduct involved and the term. As the Restatements exist in the US legal system, the Comments to Section 178 of the Restatement (Second) of Contracts make it clear that, legislation, which establish formal consolidations, binds the courts, as an organ of the legal system, and where legislation provides that specified kinds of promises or other terms are unenforceable, whether such legislation is valid and applicable to the particular term in dispute is beyond the scope of the Restatement, and the court is bound to carry out the legislative mandate with respect to the enforceability of the term. According to the Restatement, in the context of the US legal system, the capacity of the courts for abstract reasoning in the ex post consolidations in the form of a balancing exercise is limited to those cases where the legislation is unclear about the enforceability of a contractual term or where there are such matters as the enforceability of the rest of the agreement and the possibility of restitution, absent contrary provision in the legislation itself.¹⁴²⁹

As the order of international commerce lacks such a legal system and the international arbitral tribunal lacks a *lex fori*, there are no directly and effectively applicable legal structures, such as clear provisions of a legislation except for the limited and uncertain contents of the transnational public policy, that limit the freedom of contract of the parties to an international contract, and become immanently binding for the arbitrators to carry out a mandate, as an organ of a legal system, with regard to the enforceability of a contractual term. In such a context, the factors relating to an exercise of balancing interests, as listed by Section 178 of the Restatement (Second) of Contracts, should not only be relevant to such cases as in the US legal order, but conceivably also to the determination of whether a norm or value of a national legal system, which is claimed to be overriding the ascertainable content of the contract, effectively limits the freedom of contract in the order of international commerce at the stage of legal enforcement. However, both the UNIDROIT Principles and the PECL limit the relevance of those factors to the determination of the effects of a mandatory norm or public policy value, but do not deal with the question of which mandatory rules or public policy

¹⁴²⁹ Restatement (Second) of Contracts, Section 178, comment (a)

standards will be applicable in a given case and enable a decision maker to intervene in the ascertainable content of the contract. International restatements of contract principles, while able to assist the decision makers dealing with the consequences of illegality, do not provide sufficient guidance for dealing with the problems associated with the question of illegality, i.e. which mandatory rules or public policy standards are applicable in a particular case, given that the issue of determination of the applicable mandatory rules are referred to the private international law under those international restatements.

In the cases of judicial intervention, *lex mercatoria* in public policy considerations first enable the decision maker to achieve accuracy in determining the conditions of illegality in the international contracts through the application of the relevant mandatory rules and public policy standards in a given case, by means of the established rules of private international law, under which the decision maker should engage in a balancing exercise of the relevant expectations of the parties and national legal systems concerned. Secondly, *lex mercatoria* may assist the decision maker in dealing with the consequences of the illegality, particularly in the context of transactions governed through legal uncertainty, which are characterized by their complexity or long duration.

a. Conditions of Illegality

In international arbitration, the decision makers are required to consider three potentially problematic issues in the determination of the conditions of illegality arising from the applicable mandatory rules or public policy standards of the national legal systems relevant to the dispute. First, it is conceivable that in the cases where the parties determined the applicable law, the application of mandatory rules from other legal sources by the arbitrator may raise the issue of whether the resulting award exceeds the arbitrator's authority.¹⁴³⁰ A situation similar to this problem can be found in the *Hilmarton* case, i.e. ICC Case No. 5622.¹⁴³¹ The French corporation OTV had entered into a contract with *Hilmarton*, an English company, for provision of legal and tax advice and “to coordinate administrative matters” with a view to obtaining and performing a public works contract in Algeria. The contract was governed by Swiss law. When a dispute arose concerning payment of the agreed commissions, the sole arbitrator sitting in Geneva held that the commission was not due, considering that Algerian law absolutely prohibited payments to intermediaries in such circumstances. He declared the contract void on the ground that it contravened an Algerian mandatory rule prohibiting the activity of intermediaries for the conclusion or award of state contracts, irrespective of whether such payments have been actually applied or not to pay bribes to Algerian officers. *Hilmarton* instituted proceedings in Switzerland to have the award set aside. The Court of Justice of the Canton of Geneva, the decision of which was later affirmed by the Swiss Federal Tribunal, set aside the award on the ground that the award was “arbitrary” pursuant to Article 36(f) of the Intercantonal Concordat on Arbitration. The Swiss courts considered that, unlike corruption, the use of intermediaries did not offend Swiss law which was applicable to the merits of the case.¹⁴³²

¹⁴³⁰ Park, William W., *Control Mechanisms in the Development of a Modern Lex Mercatoria*, in Thomas E. Carbonneau (ed.), *Lex mercatoria and arbitration: a discussion of the new law merchant*, Kluwer Law International, Rev. ed., 1998, at 163

¹⁴³¹ ICC Award in Case No. 5622, 1988, *Yearbook Commercial Arbitration*, 29 (1994), at 105 et seq.

¹⁴³² *Cour de Justice [Court of Appeal]*, Geneva, 17 November 1989 and *Tribunal Fédéral [Supreme Court]*, 17 April 1990, *Yearbook Commercial Arbitration*, 29 (1994), at 214

Secondly, in international arbitration, the arbitrator should consider external public policies of the national legal systems, where enforcement will be sought. However, only the result of the award allows the arbitrator to know who will be the party against whom enforcement may be sought.¹⁴³³ Moreover, in many cases, it may be impossible for the arbitrators to predict with accuracy which jurisdictions may later be called on to enforce an award, since the assets are often distributed among many countries. Even so, Article 35 of the 1998 ICC Rules establish the “general rule” that “[i]n all matters not expressly provided for in these Rules, the Court and the Arbitral Tribunal shall act in the spirit of these Rules and shall make every effort to make sure that the Award is enforceable at law”, but one still may question whether such a duty extends or should extend to the arbitrator's having to determine the state(s) where the parties may wish to enforce the award, and then applying mandatory rules and public policy values of those states.¹⁴³⁴

Thirdly, the arbitrator should also consider the public policy considerations of the country where the arbitration takes place not only to avoid the risk of the setting aside of the award, but also to minimize the chances of the refusal of its enforcement by other countries. Article V (1) (e) of the New York Convention provides that enforcement may be denied if the award has been set aside “by a competent authority of the country in which, or under the law of which, that award was made.”¹⁴³⁵ This ground for refusal to enforcement has been subject to limitations by means of Article VII (1), which provides that the provisions of the Convention shall not affect the validity of multilateral or bilateral agreements concerning the recognition and enforcement of arbitral awards entered into by the contracting states nor deprive any interested party of any right he may have to avail himself of an arbitral award in the manner and to the extent allowed by the law or the treaties of the country where such award is sought to be relied upon.

For instance, the effect of Article V (1) (e) of the New York Convention is limited with regard to the jurisdictions of the signatories of the European Convention on International Commercial Arbitration of 1961 done at Geneva. Pursuant to Article IX (1) of the European Convention, an award that has been set aside in a contracting state shall only constitute a ground for the refusal of recognition or enforcement in another contracting state, when such setting aside took place for one of the following reasons: incapacity of the parties or the invalidity of the arbitration agreement; violation of the right to due process; excess of arbitrator's mission; or composition of the tribunal or conduct of the proceedings contrary to the will of the parties or the law of the state of the seat of arbitration. Only when the award is set aside based on any of these grounds, such a decision leads to the refusal of recognition or enforcement by another contracting state. Thus, the European Convention excludes certain of the grounds listed in the New York Convention, namely those included in Article V (2) concerning the arbitrability of the dispute and violation of public policy. Article IX (2) of the European Convention explicitly states that in relations between contracting states that are also

¹⁴³³ Derains, Yves, Public Policy and the Law Applicable to the Dispute in International Arbitration, in Albert Jan van den Berg (ed.), *Comparative Arbitration Practice and Public Policy in Arbitration*, ICCA Congress Series No. 3, Kluwer Law International, 1987, at 255

¹⁴³⁴ Shore, Laurence, *Applying Mandatory Rules of Law in International Commercial Arbitration*, *American Review of International Arbitration*, 18 (2007), at 92; This rule is retained as Article 41 of the new ICC Rules of Arbitration in force as from 1 January 2012.

¹⁴³⁵ While the law under which the award was made is a reference to the arbitral law, and not the substantive law, almost in all cases, the country in which the award was made and the country under whose law the award was made are the same.

parties to the New York Convention, paragraph 1 of this Article limits the application of Article V (1) (e) of the New York Convention solely to the cases of setting aside set out under paragraph Article IX (1) of the European Convention.

Article VII of the New York Convention has also been invoked by the French courts as ground for their approach that an arbitral award that has been set aside in its state of origin may nonetheless be recognized in France.¹⁴³⁶ In the *Hilmarton* case, although the award was set aside in Switzerland, it was recognized in France when its enforcement was requested. The Paris Court of Appeal noted that, in applying Article VII of the New York Convention, the judge may not refuse to enforce unless the national law so authorizes. The Court observed that Article 1502 of the French Code of Civil Procedure does not include, as one of the grounds for refusal to enforce an award, the fact that it has been set aside in its country of origin. This approach was confirmed by the decision of Cour de Cassation holding that the award in question was “an international award which was not integrated into the Swiss . . . legal order, such that its existence continued in spite of its being set aside and that its recognition in France was not contrary to international public policy.”¹⁴³⁷ However, it has been observed that this approach has not been followed by the vast majority of the courts in the other states, which do not enforce arbitral awards that have been set aside in the country of origin, either under the New York Convention or otherwise.¹⁴³⁸

These problematic issues can be resolved on the basis of *lex mercatoria* as the law of principled adjudication, according to which the arbitrators may intervene in the ascertainable contents of the contract without impairing the confidence of the parties and the relevant states in their specialization in dealing with the uncertainty arising from public policy considerations. The resolution of these issues under *lex mercatoria* clarifies the conditions for the illegality on the basis of public policy considerations in the order of international commerce. The application of *lex mercatoria* in the public policy considerations aims at demonstrating the correspondence of the expectations of the contracting parties with those of other elements of the order of international commerce and, thus, maximizes the possibility of

¹⁴³⁶ Gaillard, Emmanuel, *The Enforcement of Awards Set Aside in the Country of Origin*, *ICSID Review—Foreign Investment Law Journal*, 14 (1999), at 19

¹⁴³⁷ *Ibid.*, at 22

¹⁴³⁸ Van Den Berg, Albert Jan, *An Overview of the New York Convention of 1958*, (2008), available at <http://www.arbitration-icca.org/articles.html>; In *Chromalloy* case, the United States District of Columbia granted enforcement of an award made in Cairo, even though it had been set aside by the court of appeal in Cairo on the grounds that the arbitral tribunal had failed to apply the law agreed by the parties to the subject-matter of the dispute. The court pointed out that, while Article V gave it a discretion to decline to enforce an award that had been set aside by the courts or the place of arbitration, Article VII required it not to deprive *Chromalloy* of more favorable provisions in the law of the enforcement state. *Chromalloy Aeroservices v Arab Republic of Egypt*, 939 F. Supp. 907 (D.D.C. 1996), at 910; It should also be noted that, more recently, the Court of Appeal in Amsterdam enforced four arbitral awards annulled by the Russian courts under the New York Convention. The Court of Appeal’s principal reason was: “[S]ince it is very likely that the judgments by the Russian civil judge setting aside the arbitration decisions are the result of a dispensing of justice that must be qualified as partial and dependent, said judgments cannot be recognized in the Netherlands. This means that in considering the application by Yukos Capital for enforcement of the arbitration decisions, the setting aside of that decision [sic] by the Russian court must be disregarded.” The Court also opined that “the Dutch court is, in any event, not obliged to refuse enforcement of an arbitral award that has been set aside if the foreign judgment setting aside the arbitral award cannot be recognized in the Netherlands.” This reasoning has been criticized as being at odds with the New York Convention. Van Den Berg, Albert Jan, *Enforcement of Arbitral Awards Annulled in Russia – Case Comment on Court of Appeal of Amsterdam*, April 28, 2009, *Journal of International Arbitration*, 27-2 (2010), p. 179; Nacimiento, Patricia and Alexey Barnashov *Recognition and Enforcement of Arbitral Awards in Russia*, *Journal of International Arbitration*, 27-3 (2010), at 303-305

fulfillment of expectations as a whole. According to the basic principle of good faith and fair dealing under *lex mercatoria*, the arbitrator should find a balance between giving effect to the will of the parties and respecting the public policies of those states that have a vital interest in the dispute. The arbitrators applying *lex mercatoria* can incorporate into the final award a reasoning, which effectively demonstrates that the matching of relevant expectations is possible.

As far as the issues of excess of mandate are concerned, it is argued that the arbitrators, in such cases as *Hilmarton*, should pursue their line of reasoning to its logical conclusion by examining whether the activities or the contract in dispute in fact constituted acts prohibited by the concept of transnational public policy, such as corruption, bribery, commission or inducement of crimes, smuggling, discrimination on the basis of gender, race or religion or undue restraint of trade.¹⁴³⁹ After the annulment of the first award in *Hilmarton* case in Switzerland, a second award was rendered by another arbitrator, who granted *Hilmarton's* claim. The second arbitrator considered himself bound by the decision of the Swiss Federal Tribunal, and found that, absent any evidence of bribery, the agreement was not unlawful under Swiss law. OTV sought to resist enforcement of the second award in England. Timothy Walker J of the Queen's Bench Division, Commercial Court, emphasizing that he was adjudicating upon the award not the underlying contract, held that there were no public policy grounds on which the enforcement of the award could be refused since, unlike the *Soleimany* case, which involved "quite simply a smuggling contract", there was no finding of fact of corrupt practices which would give rise to obvious public policy considerations on the basis of the arbitrator's unchallengeable findings of fact.¹⁴⁴⁰

Essentially, the excess of authority due to the application of different mandatory rules and public policy standards should not be treated as a critical issue under the modern arbitration laws of the national legal systems, to the extent that the national courts' scope of reviewing arbitral awards is limited. As acknowledged by the Swiss Federal Tribunal in a decision in 2006, the public policy aimed at by Article 190 (2) (e) of the Swiss Private International Law Act is merely a reservation clause, meant to protect fundamental and broadly recognized values and it is a narrower concept than "arbitrariness", which was set out as a ground for annulment of the awards under the Intercantonal Concordat on Arbitration of 1969 and led to the annulment of the first award in *Hilmarton* case.¹⁴⁴¹ The ground of "arbitrariness" was essentially invoked by the Swiss courts as a means to control the proper application of Swiss law by the arbitral tribunals.¹⁴⁴² In the 2006 decision, the Swiss Federal Tribunal stated that

¹⁴³⁹ Gaillard, Emmanuel & John Savage (eds.), *Fouchard, Gaillard, Goldman on International Commercial Arbitration*, Kluwer Law International, 1999, at 854

¹⁴⁴⁰ *Omnium De Traitement et de Valorisation S.A. v. Hilmarton Limited* [1999] 2 *Lloyds Rep* 222

¹⁴⁴¹ English translation of the Decision of the Swiss Supreme Court ('Federal Tribunal') of March 8, 2006, 4P.278/2005, *ASA Bulletin*, 24-3 (September 2006), at 553-554

¹⁴⁴² In *Hilmarton* case, the Swiss Federal Tribunal considered that the use of intermediaries did not offend Swiss law which was applicable to the merits of the case and implied that the arbitral tribunal did not apply Swiss law properly. Similar considerations were relevant in the annulment of the award in *ICC Case No 2114*. The case concerned a licensing contract whereby the claimant granted the defendant the exclusive right, license and privilege to manufacture certain specified plastics machines and to sell those products in Europe. Upon request of the claimant, the arbitrator ordered the defendant, as of the date of the award, to cease the manufacture and sale of the claimant's products listed in the contract, and not to use, disclose or sell the claimant's know-how, which has not fallen in the public domain, since the arbitrator considered that those activities would constitute a case of unfair competition contrary to the Swiss Federal Law on Unfair Competition. However, this part of the award was set aside by the Swiss Federal Tribunal, which held that the arbitrator misconstrued Swiss law and acted arbitrarily in applying Federal Law on Unfair Competition without indicating which were the legal

the arbitrator's public policy is not the public policy of the appeal judge. According to the Swiss Federal Tribunal, the arbitral tribunal would violate Article 190 (2) (b) of the Swiss Private International Law Act (in connection with Article 187 (1)) by denying jurisdiction to examine the application of a foreign mandatory law, when asked to do so by a party, and the Swiss courts would refuse to review the way in which an arbitral tribunal applied the same law because "public policy as to how the Arbitral Tribunal applied the law" does not belong to the realm of public policy as defined in Article 190 (2) (e) of the Swiss Private International Law Act.¹⁴⁴³ In this context, it can be argued that had the first award in the Hilmarton case been subject to annulment proceedings in Switzerland under the Swiss Private International Law Act, which entered into force in 1985, the application of Algerian mandatory law by the arbitrator would not have resulted in the annulment of the first award since the Swiss courts would have refused to examine the way in which the first arbitrator applied that law, and, moreover, the arbitrator would have been under an obligation to examine its applicability, given that a party had invoked that law in the proceedings.

It is reasonable to expect that the question of excess of authority in this regard will only arise under the modern arbitration laws, in the cases where none of the parties raises the issue, but the arbitral tribunal *ex officio* decides to consider or apply the mandatory rules not belonging to the applicable law chosen by the parties. In cases where the parties did not determine the law applicable to the contract, the arbitrator will be free to apply any rule of law which he deems appropriate, and these rules may also include the mandatory rules or public policy values from various legal sources.¹⁴⁴⁴ In other cases, it is argued that the more the public policy behind the mandatory rules represents a transnational or at least a commonly recognized value and not an idiosyncratic interest of a state, the more an *ex officio* application is justified in such cases.¹⁴⁴⁵ More importantly, in cases of *ex officio* application, the

principles or particular circumstances which authorized to prohibit absolutely the defendant to manufacture and sell the products in question, as long as they contain certain characteristics, without any limitation. Switzerland, Tribunal Federal, March 17, 1976, *Bucher-Guyer S.A. (Switzerland) vs. Meiki Co. Ltd. (Japan)*, *Yearbook Commercial Arbitration*, 5 (1980), at 224

¹⁴⁴³ English translation of the Decision of the Swiss Supreme Court ('Federal Tribunal') of March 8, 2006, 4P.278/2005, *ASA Bulletin*, 24-3 (September 2006), at 559; The view that the national court's limited review of arbitral awards on public policy grounds should not be expanded is also adopted by the US courts. The US Supreme Court, which laid the cornerstones of the standard of review of arbitral awards in antitrust matters in *Mitsubishi* case, stated that "while the efficacy of the arbitral process requires that substantive review at the award enforcement stage remain minimal, it would not require intrusive inquiry to ascertain that the tribunal took cognizance of the antitrust claims and actually decided them." *Mitsubishi Motors Co. v. Soler Chrysler-Plymouth*, 473 U.S. 614, 638 (1985) Another US court reasoned that "Mitsubishi did not contemplate that, once arbitration was over, the federal courts would throw the result in the waste basket and litigate antitrust issues anew. This would just be another way of saying that antitrust matters are not arbitrable." *Baxter Int'l v. Abbott Laboratories*, 315 F.3d 716 (7th Cir. 2003); A restrictive approach to court review is followed also by the other national courts. *Radicati Di Brozolo, Luca G.*, *Arbitration and Competition Law: The Position of the Courts and of Arbitrators*, *Arbitration International*, 27-1 (2011), at 10-11

¹⁴⁴⁴ Bermann, George A., *Mandatory Rules of Law in International Arbitration*, in Franco Ferrari & Stefan Kröll (eds.), *Conflict of Laws in International Arbitration*, Sellier, European Law Publishers, 2011, at 339; Voser, Nathalie, *Mandatory Rules of Law as a Limitation on the Law Applicable in International Commercial Arbitration*, *American Review of International Arbitration*, 7 (1996), at 339

¹⁴⁴⁵ Voser, Nathalie, *Mandatory Rules of Law as a Limitation on the Law Applicable in International Commercial Arbitration*, *American Review of International Arbitration*, 7 (1996), at 356; Berger, Klaus Peter, *Arbitration and Act of State: Exchange Control Regulations*, in Karl-Heinz Böckstiegel (ed.), *Arbitration and Act of State*, *DIS/CEPANI/NAI*, 1997, at 124: ("It cannot be argued that parties to an international arbitration may legitimately mandate their arbitrators to ignore legal rules and principles which are part of transnational public policy.") In ICC Case No. 1110, the arbitration involved a claim for commissions by an Argentinean

arbitrators should observe their duty to give the parties a reasonable opportunity to set out their positions on the applicability of the mandatory substantive rule, and such action should aim at ruling on an existing claim in order not to fall outside the specific ambit of his mission.¹⁴⁴⁶ The clearest affirmation in practice that a tribunal may deem itself authorized to raise issues of the application of mandatory rules *ex officio* has been made by many arbitral awards in the area of competition laws.¹⁴⁴⁷

In the arbitral practice, there is a variety of approaches whereby the tribunals found themselves competent to apply or consider the mandatory rules or public policy standards of the national laws other than the one governing the substance of the dispute. In some cases, the mandatory rules of a foreign law has been invoked by the parties as simple facts, which made performance impossible, such as exchange control restrictions or embargo decrees; in other words, as events of force majeure or impossibility. In Case No 1491 of the Chamber of National and International Arbitration of Milan, the sole arbitrator had to deal with the effects of the declarations of embargo by European Community and Italy against Iraq in 1990 on the contract concluded between Italian parties in 1989, whereby the subcontractor agreed to supply a main contractor with parts for a plant to be built in Iraq. The arbitration clause provided that the arbitrator decide the dispute according to Italian law. The sole arbitrator noted that the EC and Italian embargo legislations were aimed at the sale and supply of products to Iraq and at any activities which have as their object or effect the production of such sales or supplies.¹⁴⁴⁸ The arbitrator stressed that these legislations must necessarily be applied in the EC, whichever law applies to the contract, as it appears from their purpose and public law character. The arbitrator considered that the very broad wording of the pertinent provisions called for a non-restrictive interpretation, which may contribute towards attaining the goals set on the international level by the UN Security Council decisions and later on the EC level.¹⁴⁴⁹ According to the arbitrator, the embargo was not only extended to the main

agent in respect of public works contracts awarded by the Perón regime in Argentina to the defendant. The General Manager of the defendant stated that “One could not get business of any scale in the Argentine, save by using an intermediary who required large commissions to enable him to obtain influence in the Government's Departments. Anybody who had any dealing in the Argentine, one way or the other, had to face this condition.” In the General Manager’s opinion, the bulk of the commissions would be required for bribing Government officials, President Peron was the chief shareholder in these big commissions that were going to the party, and it was pretty certain the money was not needed for anything else than bribery. Both parties confirmed that they considered the agency contract binding and effective and asked the tribunal to decide their case in accordance with the terms of reference. The sole arbitrator, Judge Lagergren, stated that although the documents drawn up seem on their face to be legal and bear the semblance of ordinary commercial documents, it was, in his judgment, plainly established from the evidence that the agreement between the parties contemplated the bribing of Argentine officials for the purpose of obtaining the hoped-for business. Thus, he decided that he could not just ignore the issue of bribery and so examined it on his own motion. Wetter, J. Gillis, *Issues of Corruption Before International Arbitral Tribunal: the Authentic Text and True Meaning of Judge Gunnar Lagergren's 1963 Award in ICC Case No.1110*, *Arbitration International*, 10-3 (1994), at 277-294

¹⁴⁴⁶ Waincymer, Jeff, *International Arbitration and the Duty to Know the Law*, *Journal of International Arbitration*, 28-3 (2011), at 237; Cremades, Bernardo M., & David J.A. Cairns, *Trans-national Public Policy in International Arbitral Decision-Making: The Cases of Bribery, Money Laundering and Fraud*, in *Dossier of the ICC Institute of World Business Law: Arbitration - Money Laundering, Corruption and Fraud*, ICC Publication No. 651, 2003, at 82

¹⁴⁴⁷ Radicati Di Brozolo, Luca G., *Arbitration and Competition Law: The Position of the Courts and of Arbitrators*, *Arbitration International*, 27-1 (2011), at 23

¹⁴⁴⁸ Chamber of National and International Arbitration of Milan, *Final Award in Case No. 1491*, July 20, 1992, *Yearbook Commercial Arbitration*, 18 (1993), at 85

¹⁴⁴⁹ *Ibid.*, at 86

contract between the contractor and the Iraqi Ministry, but also to the subcontract, because the ultimate object of this contract was the supply of special parts intended for the plant in Iraq, and thus was aimed at the execution of the main contract's works. The arbitrator stated that the impossibility to perform under contracts promoting forbidden activities towards Iraq, which originally could be considered temporary, must be considered definitive after two years and it was still impossible to foresee if and when full normalization shall be reached in the relationship with the Iraqi State.¹⁴⁵⁰

The arbitrator held that the EC and Italian embargo legislations led to an objective, absolute and definitive impossibility under Article 1463 of the Italian Civil Code. In the arbitrator's opinion, since the subcontractor negotiated with the main contractor, well knowing that the final destination of the supply was Iraq, accepting the specifications made by the final customer and undertaking to carry out activities on the building site, the subcontractor participated in the whole operation and shared, though in a limited manner, in its risk. In particular, the arbitrator considered that the economic and functional connection between the subcontract and the main contract justified that part of the risk be shifted onto the subcontractor.¹⁴⁵¹ The arbitrator concluded that the contract at issue was suspended and later terminated according to Article 1463 of the Italian Civil Code, as of date when the Italian embargo legislation entered into force. According to the arbitrator, since the performance was suspended before the first delivery, the main contractor did not owe subcontractor compensation, and the subcontractor's claim for indemnification for developing and manufacturing of the products could not be granted because it did not seem that part of the works already done by the subcontractor could be of any use to the main contractor, nor was the main contractor unjustifiedly enriched.¹⁴⁵²

Thus, in these cases, it becomes sufficient for the arbitrator to determine the criteria of force majeure or impossibility under the contract, the default law that governs the contract or the established rules, and to rule whether the mandatory rule as a matter of fact satisfies those criteria or not.¹⁴⁵³ Such force majeure or impossibility will, as a rule, have an ex nunc effect only.¹⁴⁵⁴ However, the mandatory rule of a foreign law may lead to the questions of direct application to the contract and cease to constitute a default issue, if at least one of the parties intended to violate the rule when entering into the contract.

¹⁴⁵⁰ Ibid., at 87

¹⁴⁵¹ Ibid., at 89-90

¹⁴⁵² Ibid., at 91

¹⁴⁵³ Mayer, Pierre, *Mandatory Rules of Law in International Arbitration*, *Arbitration International*, 2 (1986), at 281; ICC awards in Case No. 2216, *Journal du droit international*, (1975), at 917; Case No. 2139, *Journal du droit international*, (1975), at 929; and Case No. 2138, *Journal du droit international*, (1975), at 934; Section 2-615(a) of the Uniform Commercial Code also recognizes this point: "Except so far as a seller may have assumed a greater obligation and subject to the preceding section on substituted performance: (a) Delay in delivery or non-delivery in whole or in part by a seller ... is not a breach of his duty under a contract for sale if performance as agreed has been made impracticable by ... compliance in good faith with any applicable foreign or domestic governmental regulation or order whether or not it later proves to be invalid." However, when the contract underlying the dispute is a state contract, other considerations may also be relevant. Grigera Naón, Horacio A., *Choice of Law Problems in International Commercial Arbitration*, *Recueil des Cours*, 289 (2001), at 323-325 fn. 358

¹⁴⁵⁴ Blessing, Marc, *Mandatory Rules of Law versus Party Autonomy in International Arbitration*, *Journal of International Arbitration*, 14-4 (1997), at 34-35

In order to directly apply mandatory rules or public policy values, some arbitrators have referred to such rules of the law of the arbitral seat that allows them to apply the mandatory rules of a national law other than the law applicable to the substance of the dispute, although such practice is controversial to some extent.¹⁴⁵⁵ In ICC Case No 10246, the arbitral tribunal, sitting in Switzerland, considered the existence of an implied obligation not to compete in an exclusive licensing agreement by taking into account its compatibility with EC antitrust law. The applicable law of the contract was Swiss law. The arbitral tribunal decided that Article 187 (1) of the Swiss Private International Law Act, which requires the tribunal to apply the rules of law chosen by the parties to settle contractual disputes, does not prevent the application of Article 19 of the Swiss Private International Law Act, which provides that a mandatory provision of a law other than the one designated by the Act may be taken into account, if the case is closely connected to that law, and if, according to Swiss legal views, the legitimate and clearly overriding interests of a party so require. The arbitral tribunal noted that the dispute showed close connection with the European Community since, inter alia, one of the parties to the arbitration had its seat in France and the contract targeted the common market. The tribunal therefore concluded that there was a strong connection with European Community law, within the meaning of Article 19. According to the tribunal, the divergent regimes of non-competition clauses under Swiss law and Community law should not lead to prevent the application of Community law, and there was a legitimate and manifestly prevailing interest under Swiss legal notions to take European law into account in the case, since the contract giving rise to the dispute was to a large extent to have effects in the market regulated by the European Community. The tribunal maintained that if the consideration of European law would be totally excluded in the course of arbitrations held in Switzerland, the organization of the internal market would be disrupted and unbalanced. The tribunal also pointed out that, in the case, the application of European antitrust law largely responded to the interests of one of the parties to see respected protective provisions regarding market competition prevailing in the state where such party is based.¹⁴⁵⁶

In ICC Case No. 9333, the dispute concerned the validity of an agreement pursuant to which the claimant, a Moroccan broker, promised to provide services to help the defendant, a French company, to win and perform a building contract, and the defendant undertook to pay commission. The defendant withheld further payment on the ground that it had become part of an American group under a policy, which was alleged to have been introduced in connection with US Foreign Corrupt Practice Act, and which prohibited it from paying in a country other than that where the agent was located or the services rendered. The defendant argued that the reason why the claimant demanded payment be made in Switzerland was due to bribery,

¹⁴⁵⁵ In Switzerland, the question is whether Article 19 of the Swiss Private International Law Act, which provides that a provision of a law other than the one designated by the Act that is meant to be applied mandatorily may be taken into account if interests of a party that are, according to Swiss views, legitimate and clearly overriding so require and the case is closely connected to that law, applies in any way to arbitration and, if it does, what is its relation to Article 187(1), which provides that the arbitral tribunal shall decide the case according to the rules of law chosen by the parties or, in the absence of such a choice, according to the rules of law with which the case has the closest connection. Few authors argue for a binding effect of Article 19 on arbitrators, while others clearly stating that there is no room for Article 19 in international arbitration since Article 187 is as *lex specialis* for arbitration and independent from the general provisions in Articles 13 to 19. Some authors, although holding that Article 19 is not directly and mandatorily applicable in arbitration, suggest that the ideas of such a provision may be taken into account by an arbitrator in deciding applicability of a mandatory rule. Hochstrasser Daniel, Choice of Law and 'Foreign' Mandatory Rules in International Arbitration, *Journal of International Arbitration*, 11-1 (1994), at 60-64

¹⁴⁵⁶ ICC Final Award in Case No 10246, 2000, *Chronique de jurisprudence arbitrale de la CCI*, in *Cahiers de l'arbitrage*, *Gazette du Palais*, (2003), at 7-8

which in its view was an illicit purpose under Swiss law that was the applicable law pursuant to the agreement of the parties. The sole arbitrator first held that the allegation of bribery was not established by documentary evidence. The arbitrator stated that the question whether Article 19 of the Swiss Code on Private International Law is applicable to an international arbitration and the requirements for application of that provision are controversial. Nevertheless, according to the arbitrator, this question can be left open if the arbitrator is of the opinion that (i) the application of the Foreign Corrupt Practices Act of the United States under the title of foreign law of the quality of police regulations is not justified; and (ii) hypothetically, the requirements of the application of the FCPA are not met. However, in determining the applicability of the FCPA, the arbitrator still examined whether the connection between the FCPA and the transaction was sufficient under the title of Article 19 of the Swiss Code on Private International Law.¹⁴⁵⁷

In ICC Case No. 7047, the tribunal declined to refer to the rule of private international law of the arbitral seat, which allowed the tribunal to apply mandatory provisions of a foreign law that rule, and decided to discuss the relevant matter under the applicable substantive law and the concept of *ordre public international*. The dispute arose from an agreement under which the claimant, Westacre, a company incorporated in Panama, undertook, as an exclusive “consultant”, to consult with, advise and otherwise assist the defendant, Yugoimport, a state-owned entity of Yugoslavia, in promoting and selling the defendant’s military products and services to Kuwait. The contract was governed by Swiss law pursuant to the parties’ choice of law clause. The defendant argued that the agreement was void under the mandatory laws of Kuwait regulating commercial agencies and declined to pay the consultant’s fee. The tribunal noted that it is disputed in arbitration whether Article 19, belonging to Chapter 1 of the Swiss Code on Private International law, is applicable if the parties have agreed on a specific law, and only the arbitration procedure is governed by Chapter 12 due to the fact that Switzerland is the venue of arbitration. According to the tribunal, it is generally accepted that the arbitral tribunal has to apply the mandatory rules of the private law governing the agreement. The tribunal held that, in the case, the mandatory rules of the *lex contractus* included Articles 19 and 20 of the Swiss Code of Obligations on illegality and immorality, and any rules of Kuwaiti law, concerning details of agency cannot come under Articles 19 and 20 of the Swiss Code of Obligations.¹⁴⁵⁸ The tribunal held that the freedom of the parties to choose the applicable law was a generally recognized principle enabling the parties to exclude the

¹⁴⁵⁷ ICC Award in Case No 9333, 1998, The ICC International Court of Arbitration Bulletin, 10-2 (1999), at 102-103: The sole arbitrator noted that the only factor connecting the dispute with US law was that, after the execution of the agreement for the payment of the commission, the defendant had become a subsidiary of an American corporation. According to the arbitrator, such connection was insufficient to justify the application of the FCPA as international mandatory rules. The arbitrator also noted that the FCPA did not extend its application to subsidiaries of US companies located outside of the United States, but was only aimed at rendering US-based mother companies responsible for illicit action of their subsidiaries under the FCPA, so that many US-based multinational corporations have introduced programs in all of their subsidiaries and affiliates to assure respect for the FCPA. The arbitrator further maintained that even if the conditions for application of the FCPA had been fulfilled, this did not automatically warrant that such application could be extended to international cases for the absence of powerful and legitimate interests of the United States in the application of such law. According to the arbitrator, the existence of such interests was “doubtful” in the case of the FCPA since it was not primarily aimed at protecting fundamental interests of the United States, but to restore public trust in US companies, whose reputation had been tarnished as a consequence of a series of scandalous events. Thus, the arbitrator held that it was not appropriate to apply in that manner the FCPA on enterprises outside the United States. According to the arbitrator, the battle against corruption, certainly a worthy objective, does not necessarily justify the exportation of methods or the code of conduct unique to the FCPA in order to reach that objective.

¹⁴⁵⁸ ICC (Final) Award in Case No. 7047, 1994, Yearbook Commercial Arbitration, 21 (1996), at 89

national law which would otherwise apply. The tribunal stated that “Therefore, provisions of the law which is excluded can only be recognized within the chosen law to the extent they are a part of the *ordre public international*. Examples of this are provisions to fight corruption and bribery.”¹⁴⁵⁹ Thus, the tribunal determined that Swiss law chosen by the parties treats illegality as a defense to a contract claim under Articles 19 and 20 of the Swiss Code of Obligations, and then examined whether the violation of the rules of the law of a different jurisdiction, where the contract was to be performed, could be considered as an instance of illegality under those provisions of Swiss law. The tribunal concluded that those rules of the law of the place of performance concerning details of agency cannot come under Articles 19 and 20 of the Swiss Code of Obligations and examined whether the facts of the case indicate a violation of the transnational public policy.

It seems that the arbitral tribunals may find the authority to give effect to the mandatory rules of law of third countries, without applying them directly, but merely by taking into account those rules for purposes of applying legal principles of the applicable law governing the illegality or immorality.¹⁴⁶⁰ However, this approach is criticized on the ground that it cannot be immoral or illicit to fail to respect a law which is inapplicable, and if one wishes to annul a contract, it is not sufficient to take account of a foreign mandatory rule, but one must take the further steps of acknowledging the authority of a mandatory rule of a law which has not been chosen by the parties, and applying it directly.¹⁴⁶¹ In arbitral cases, due to the controversy as to the reference to the rule of the arbitral seat that allows them to apply the mandatory rules of a national law other than the law applicable to the substance of the dispute, the genuine application of a mandatory rule seems to have required at least an evaluation of the foreign mandatory rules in light of the transnational public policy, which underlines the view that an arbitral tribunal does not have a traditional *lex fori* in the form of a national legal system.

Essentially, the direct and genuine application of foreign mandatory norms, even in cases where the parties stipulated the applicable law, require some capacity of the arbitrator to engage in an exercise of balancing interests that should finally determine if the arbitrator should apply a foreign mandatory norm or not. Under *lex mercatoria*, the arbitral tribunal’s authority, but no obligation, to apply, even *ex officio*, mandatory rules, not belonging to the applicable law chosen by the parties, can be based on the established rule of private international law that certain mandatory national laws may qualify as overriding or international mandatory rules and apply notwithstanding the parties’ choice of law under certain conditions. An established rule in this regard can be derived from the cumulative application of such rules under the private international laws of the countries relevant to the dispute, or a general principle of law relating to the overriding applicability of international mandatory rules, or based on abuse of rights to prevent the parties from fraudulently evading the public policy considerations.¹⁴⁶² It should also be mentioned that there are several

¹⁴⁵⁹ *Ibid.*, at 89-90

¹⁴⁶⁰ Bermann, George A., *Mandatory Rules of Law in International Arbitration*, in Franco Ferrari & Stefan Kröll (eds.), *Conflict of Laws in International Arbitration*, Sellier, European Law Publishers, 2011, at 334

¹⁴⁶¹ Mayer, Pierre, *Mandatory Rules of Law in International Arbitration*, *Arbitration International*, 2 (1986), at 282

¹⁴⁶² This established rule also inspires the understanding that a decision maker may give effect to such mandatory rules *ex officio*: Article 7 of the Rome Convention of 19 June 1980 on the Law Applicable to Contractual Obligations (now Article 9 of the Rome I Regulation), Article 19 of the Swiss Private International Law Act, Article 11 of the Inter-American Convention of 17 March 1994 on the Law Applicable to International Contracts, and Section 187(2) of the US Restatement (Second) of the Conflict of Laws do not necessarily require a plea by one of the parties.

international treaties, which contain provisions that provide the decision makers with the power of discretion and capacity to consider the applicability of mandatory rules of law of the legal systems with which the situation has a close or significant connection.¹⁴⁶³ The articulation of an established rule for the applicability of such mandatory norms may give effect to the reasonable expectations of the parties in relation to the conditions of illegality in a more accurate manner through balancing the weight of certain factors relevant to the case, than the direct reference to the relevant rules of the law of the arbitral seat, the applicable substantive law or the concept of transnational public policy.¹⁴⁶⁴

However, in ICC Case No. 6379, the arbitrator expressly rejected to adopt such an approach in determining the applicability of the mandatory rules of a foreign state. The dispute arose from the alleged invalidity of notification period under the termination clause of an exclusive distributorship contract between a Belgian distributor and an Italian principal. The parties agreed on Italian law as the governing law in the contract. The principal gave three months' prior notice of termination of the contract in accordance with the terms of the contract, but the distributor contested the validity of contractual termination clause on the basis of the Belgian mandatory rules of law. The Belgian statute of 1961 applied to the termination of distributorship contracts producing their effects in all or in part of Belgium, notwithstanding any agreement to the contrary stipulated before the end of the distributorship contract. The Belgian statute required a substantially long notice period. The distributor invoked Article 7 of the Rome Convention of 1980 on the law applicable to contractual obligations. The arbitrator noted that the Rome Convention was not yet in force, and stated that the norm according to which a foreign mandatory law is to be respected is "a very interesting concept, but it is not a universally accepted norm of Italian law, which should be applied by the arbitrator in the present case." The arbitrator also stated that "The Geneva Convention of 1961, which has become part of the Italian legal system and which prevails over internal provisions, allows the parties to agree on the law applicable to their contract (Article VII). It provides that the validity of the arbitral clause must be ascertained according to the law chosen by the parties (Article 6(2)), i.e. in the present case, according to Italian law. The Geneva Convention makes no exception for foreign provisions of mandatory application." The arbitrator held that he should disregard the mandatory rules contained in the Belgian statute and the contractually agreed upon period should be respected, as there was no mandatory provision or public policy provision in Italian law that imposes a longer notification period between the producer and the distributor.¹⁴⁶⁵

¹⁴⁶³ Article 7 of the Rome Convention of 19 June 1980 on the Law Applicable to Contractual Obligations; Article 11 of the Inter-American Convention of 17 March 1994 on the Law Applicable to International Contracts; Article 16 of the Hague Convention of 14 March 1978 on the Law Applicable to Agency; Article 16 of the Hague Convention of 1 July 1985 on the Law Applicable to Trusts and on their Recognition. However, in the discussion of the new treaty on the sale of goods, this question was taken up at The Hague in 1985, but the issue met much resistance, and in the end the proposal to reproduce a provision analogous to those contained in the earlier treaties was rejected by 22 votes to 20. Mayer, Pierre, *Mandatory Rules of Law in International Arbitration*, *Arbitration International*, 2 (1986), at 283

¹⁴⁶⁴ This approach has also been advocated by other commentators, who suggest that that the arbitral tribunal should be free to create its own rule with an independent determination as to whether a particular mandatory rule of a given state should be applied to the case at hand, under the non-binding guidance of the already existing provisions designed for the solution of this problem by the courts, national legislators, or international conventions. Voser, Nathalie, *Mandatory Rules of Law as a Limitation on the Law Applicable in International Commercial Arbitration*, *American Review of International Arbitration*, 7 (1996), at 344

¹⁴⁶⁵ ICC Award in Case No. 6379, 1990, *Yearbook Commercial Arbitration*, 17 (1992), at 219

In contrast, the sole arbitrator in ICC Case No 6572, which involved almost identical facts, reached the same conclusion through a different reasoning. The contract in dispute was an exclusive distributorship agreement between the claimant, an Italian principal, and the defendant, a Belgian distributor, and governed by Italian law pursuant to the parties' choice. The arbitrator was asked to examine the applicability of the Belgian mandatory rules of law on the termination of the distributorship agreement. The arbitrator held that the relevant Belgian statute of 1961 did not touch upon Belgian public policy, nor, a fortiori, upon international public policy, on the basis of a legal opinion as to the Belgian case law on the issue, submitted during the proceedings. The arbitrator also stated that "Nor do its provisions qualify as mandatory rules within the meaning of the Rome Convention on the Law Applicable to Contractual Obligations of 19 June 1980 which, by the way, is not applicable to the contract at issue which was made before the Convention entered into force..." Thus, the arbitrator considered the choice of law clause in favor of Italian law as perfectly valid. According to the arbitrator, as the claimant respected the notice period of six months provided for in the contract, the termination was not untimely, nor did such a termination seem to have been inspired by bad faith: even if the claimant had not had good reasons to justify the termination, it would have had the right to end the contract while respecting the notice period. Therefore, the arbitrator decided that the contract was validly terminated at the initiative of the claimant.¹⁴⁶⁶

The arbitral tribunal, sitting in Switzerland, in ICC Case No. 8404, expressly stated that "Similarly to a provision applicable to state courts (article 19, Swiss Code on Private International Law), Arbitral Tribunals have the authority, or even the duty, to take into account mandatory provisions of a law different from the one chosen by the parties." According to the tribunal, the prerequisites to be met for such mandatory rules to be applied would be the following: "(a) In the first place, the foreign provisions must be of the category of rules which claim to be applied irrespective of which law is applicable to the merits. (b) Further, there must be a close connection between the subject matter of the parties' contractual relationship and the territory for which the foreign rule has been promulgated. (c) Finally, the application of the foreign rule must be justified under criteria reasonably balancing on the one side the values which the foreign rule aims to protect, and on the other side the legitimate interests of the parties in the particular contractual relationship. The more universally recognized the values to be protected by the foreign rule are, the more will the Arbitral Tribunal not only have the authority, but the obligation to determine *motu proprio* whether legitimate interests require the foreign provision to be taken into account." The tribunal found the basis for these considerations in "internationally accepted fundamental rules as reflected e.g., by article 7.1 of the Rome Convention on the Law Applicable to Contractual Obligations and similar provisions."¹⁴⁶⁷

¹⁴⁶⁶ ICC (Final) Award in Case No. 6752, 1991, *Yearbook Commercial Arbitration*, 18 (1993), at 56

¹⁴⁶⁷ ICC Award in Case No 8404, 1998, (unpublished), cited by Grigera Naón, Horacio A., *Choice of Law Problems in International Commercial Arbitration*, *Recueil des Cours*, 289 (2001), at 326; This last point was also made by another arbitral tribunal, sitting in Switzerland, in ICC Case No. 8528, which indicated that Article 19 of the Swiss Code on Private International Law was in harmony with international conventions, national legislation and court decisions denoting an international trend regarding the taking into account or application of *lois de police* even when they do not belong to the *lex causae*. ICC Award in Case No 8528, *Yearbook Commercial Arbitration*, (2000), at 341; Similarly, in ICC Case No. 6500, the arbitral tribunal deciding a dispute between a Lebanese Claimant and a Swiss Respondent and sitting in France, referred to Article 7 of the 1980 Rome Convention on applicable law to contractual obligations as a general private international law principle, even if the countries of none of the parties had ratified the Convention, which had been ratified, however, by France, country of the place of the arbitration. ICC Award in Case No 6500, *Collection of ICC Arbitral Awards*, Vol. III (1991-1995), at 454

The tribunal's articulation of the established rule of private international law in ICC Case No 8404 provides guidance as to the resolution of the problems regarding the observation of the public policies of jurisdictions, where the enforcement may be sought and where the award is made. This established rule enables a balancing exercise, which can be made in a particular case on the basis of the consideration of the fundamental and corresponding principles of the legal systems of the countries, where the award is made, where the contract is performed, of which the parties are citizens and alike. Under this balancing exercise, the decision maker, applying *lex mercatoria*, should initially consider whether the relevant mandatory norm is within the expectations of the parties as to its applicability thereby taking into account the interests of the parties in the enforcement of their contract. The decision maker should consider the extent of the transaction's connection with the national legal systems containing mandatory rules or public policy standards relevant to the case. It can be presumed that parties as reasonable merchants have to, and in most cases instinctively will, look at the laws at the places where the contract is to unfold its effect, since mandatory rules, in most cases, are concerned with obtaining specific results within a given territory.¹⁴⁶⁸ As stated in ICC Case No. 1859, "Any merchant of a country who attempts to sell his products in another country is bound to respect the mandatory rules of the country of reception and cannot be claim to be unaware of or not to respect mandatory laws on the regulation governing the importations of his goods, particularly when this law or regulation existed at the time of the performance of the contract."¹⁴⁶⁹

Subsequently, the decision maker should consider the expectations within the state having enacted the relevant norm thereby taking into account the interest of the internal order of the relevant legal system against the enforcement of the contract.¹⁴⁷⁰ The decision maker should

¹⁴⁶⁸The close connection of the transaction with the mandatory rules of a particular national legal system may also have significance in the determination of the applicable law at the stage of conflict of laws when the parties have not agreed on the applicable law governing the substance of the dispute. In ICC Case No 2930, which was about a dispute between two Yugoslav enterprises and a Swiss company arising out of a complex compensation transaction, the arbitral tribunal considered the close connection of the contract with a particular national legal system as well as its public policy considerations in determining the law applicable to the substance of the dispute. Having referred to the Hague Convention on the law applicable to the international sale of goods, and the Rome Convention on Law Applicable to Contractual Obligations as well as Swiss, French and Yugoslav conflict of laws, all of which "refer to similar criteria in looking for the law applicable to the contractual obligations", the arbitral tribunal concluded that Yugoslav law should apply because it was "very closely connected" with the contract. The tribunal also considered the issue of applicable law in the light of the purposes of the relevant substantive rules and of circumstances of the case, and stated that: "The Arbitral Tribunal is even more convinced with this choice in that the claimants, being under Yugoslav jurisdiction, are subject to the Yugoslav law controlling import and export . . . This law contains provisions of public law including punitive sanctions . . . Consequently, any contract concerning import into Yugoslavia or export from Yugoslavia is subject to the mandatory provisions of this law." According to the arbitrators, the contract was fictitious and violated foreign exchange regulations. The tribunal stated that, according to Yugoslavian law, all agreements contrary to mandatory provisions of law or public policy, to morality and *bonos mores* are null and void. The tribunal added that "this principle is recognized in all countries and in all legal systems" and "it is an element of generally accepted contract law in the international field". ICC Award in Case No. 2930, 1982, *Yearbook Commercial Arbitration*, (1984), at 105 et seq.

¹⁴⁶⁹ ICC Award in Case No. 1859, (unpublished), cited by Derains, Yves, *Public Policy and the Law Applicable to the Dispute in International Arbitration*, in Albert Jan van den Berg (ed.), *Comparative Arbitration Practice and Public Policy in Arbitration*, ICCA Congress Series No. 3, Kluwer Law International, 1987, at 252

¹⁴⁷⁰ In an ad hoc award between Banque Arabe et Internationale d'Investissements (BAII) and Inter-Arab Investment Guarantee Corporation (IAIGC), the tribunal was confronted with issue of validity of termination by IAIGC, as the guarantor, its loan guarantee contract (also referred to as an insurance contract) with BAII, as the guarantee, on the ground that BAII no longer fulfilled the nationality condition, which required the majority of

determine whether the expectations within the state are reasonable in the order of international commerce. For that purpose, the decision maker should take into account both whether the mandatory rule or public policy value being considered is an international one from the perspective of the state enacting it, and whether the application of the international mandatory rule or public policy value, in respect of the issue at stake, is consistent with the established rules of policy, including generally accepted legal principles or transnational or “truly international” public policy exogenous to the law of the forum enacting the mandatory rule or containing public policy standard.¹⁴⁷¹

After determining the relevant interests, the decision maker, applying *lex mercatoria*, should focus on the central problem of which expectations must be protected and which ones must be allowed to be disappointed in order to maximize the possibility of expectations in general being fulfilled in the order of international commerce. Thus, he will attempt to strike a balance between the interests of the parties and states connected to the dispute, as elements of the order of international commerce, in the enforcement or non-enforcement of a particular contract on the basis of two scales. First, the closer the contact to the national legal system enacting the rule or claiming a public policy value, the more relevant will be the protected interest to the decision maker’s consideration for intervention in the ascertainable content of the contract. This is because such an interest will be influential on the considerations of what a reasonable merchant can expect from its contract, and because the violation of that rule or value will more likely have serious consequences in the internal order of the legal system, which cannot be tolerated in the context of peaceful development of international commerce. In this regard, the mandatory rules of the state where the arbitration takes place do not, *per se*, have the necessary close connection, given that the arbitrator has no *lex fori*, and the mandatory rules of the law chosen by the parties should not be assumed to have the required close connection, particularly where the goal of the parties was to choose a neutral law without any connection to the case.¹⁴⁷² Secondly, as the interests to be protected by the mandatory rule or public policy value claiming application are more uniformly recognized as worthy of protection by the national legal systems relevant to the dispute, the arbitrator will

party’s owners to be of Arab nationality, pursuant to Article 17(2) of the International Convention establishing IAIGC, which was also included in the guarantee contract as one of the annexes. Although the agreement was governed by the common legal principles prevailing in the Arab world and international law at large, BAII argued that Kuwaiti law should be declared as the governing law and, consequently, the termination of the contract on that ground should be considered arbitrary and illegal pursuant to a mandatory rule of the Kuwaiti Civil Code under which an arbitrary condition in an insurance contract that terminates the insurance coverage for reasons unconnected with the risk is void, a rule also common to the other Codes of the Arab countries. The tribunal took into consideration that the investment insurance coverage under the Convention covered such risks that might not be obtained in the commercial insurance market and the scheme of Convention was intended to protect Arab investments. The tribunal also noted that the adoption of the Convention by Arab countries having the same applicable mandatory rule supported the view that these countries did not consider Article 17(2) of the Convention to be an arbitrary provision, or at least, did not subscribe to it with the intent of arbitrariness. Accordingly, the tribunal held that Article 17(2) of the Convention had to be treated as validly enforceable and legally binding. *Ad Hoc UNCITRAL Award of 17 November 1994, Banque Arabe et Internationale d’Investissements et al v Inter-Arab Investment Guarantee Corporation, Yearbook Commercial Arbitration*, 21 (1996), at 24-25

¹⁴⁷¹ Grigera Naón, Horacio A., *Choice of Law Problems in International Commercial Arbitration*, *Recueil des Cours*, 289 (2001), at 334

¹⁴⁷² Voser, Nathalie, *Mandatory Rules of Law as a Limitation on the Law Applicable in International Commercial Arbitration*, *American Review of International Arbitration*, 7 (1996), at 346-347

more readily intervene in the ascertainable contents of the contracts by applying such rule and giving precedence to that rule over the contract and its applicable substantive law.¹⁴⁷³

Such an application of *lex mercatoria* in public policy considerations can be found in ICC Case No 6320. The dispute concerned a construction contract, where the claimant, a Brazilian party, claimed that the defendant, a US contractor, had infringed the US “Racketeering Influenced and Corrupt Organizations Act”, (RICO) by committing a “pattern of racketeering activities” and thus had to pay treble damages indemnity to the claimant in compensation for the defendant’s illicit activity. The parties had agreed on Brazilian law as the proper law of the contract, yet the defendant admitted that the arbitral tribunal had jurisdiction over the claimant’s RICO claim.¹⁴⁷⁴ The arbitral tribunal, sitting in Paris, noted that “the prime purpose of the RICO statute is to protect the United States economy and society against the negative effects of organized ‘racketeering activities’, and this reflects a fundamental policy of the United States which is protected by the statute’s mandatory application.” According to the tribunal, the specific question in the case was limited to whether the application of the RICO statute is mandated in a case before an international arbitral tribunal where a non-US party seeks treble damages from a US party pursuant to that statute, and the contractual relations between the parties were governed by the national law of the non-US party.

The tribunal observed that while the application of mandatory laws initially concerned only those of the *lex fori*, “foreign mandatory rules were later placed on an equal footing, for instance in a number of multilateral conventions, for cases where the relevant situation had a close or significant connection with the state having enacted such a rule.”¹⁴⁷⁵ The tribunal accepted the premise that there may be situations in which an international arbitral tribunal should admit the application of mandatory rules different from the law that the parties have chosen to govern their claims or relationships, but emphasized that the application of a mandatory rule not belonging to the *lex contractus* required the fulfillment of stringent conditions as to whether such rule is actually an international mandatory rule or not. The tribunal stated that the thrust of such conditions for extraterritorial application of mandatory law is the existence of a “strong” and “legitimate” interest of the state having enacted such a law to justify its application in international arbitration. The tribunal examined whether there was sufficiently strong and legitimate interest of the United States so as to mandate the application of the RICO statute, by focusing on the type of interest and the connection factor.

As to the legitimate interests of the United States, the tribunal first stated that, “even if a particular state does claim the mandatory extraterritorial application of its laws, that – by itself – is not sufficient to lead to the mandatory application of such laws in international arbitration. Otherwise, those states that make extensive use of such claims and thereby show less recognition of the sovereignty of other states embedded in the principle of territoriality could attain a privileged position in relation to other states.”¹⁴⁷⁶ The tribunal indicated that for extraterritorial claims, one has to distinguish between the aim and the method of the national

¹⁴⁷³Kreindler, Richard H., *Approaches to the Application of Transnational Public Policy by Arbitrators*, *Journal of World Investment*, 4-2 (April 2003), at 242: arguing that, unless the illegality under a relevant national legal system rises to the level of a violation of notions of external public policy, which likewise offend notions of external public policy in other national legal systems connected with the dispute, the illegality at a single national legal system need not concern the arbitral tribunal and should not bind it.

¹⁴⁷⁴ ICC Final Award in Case No. 6320, 1992, *Yearbook Commercial Arbitration*, 20 (1995), at 94

¹⁴⁷⁵ *Ibid.*, at 98

¹⁴⁷⁶ *Ibid.*, at 99

law rules at stake, and not only the aim but also the method applied would have to meet the particular stringent conditions for the exceptional mandatory application of a national law rule. The tribunal observed that the treble damages remedy or compensation method advanced by the RICO statute is a specific feature of United States law and not used by other national law or international treaties, although the international community of states share the aims pursued by the RICO statute. Thus, according to the tribunal, the states of international community seem to have not considered the United States interest that may claim extraterritorial application of this method as a mandatory interest in their own jurisdiction. Thus, the tribunal stated that it “cannot find that this is an interest that should be protected in an international arbitration which rests on the agreement of private parties, concerns the tripling of damages allegedly suffered in a private business relationship and is otherwise governed, pursuant to the choice of the parties, by a law of another country.”¹⁴⁷⁷

With respect to the connecting factor, the tribunal found that the substantial part of the fraudulent conduct giving rise to the RICO claims did not take place in the United States as the center of relations between the parties was in Brazil, and neither the United States market nor the social and economic organization of the United States were affected by the transaction giving rise to the dispute. The tribunal noted that the conclusion might be different if the national mandatory law would have to be considered as reflecting a principle of international public policy, but such a qualification cannot be made for the treble damages rule of the RICO statute. Thus, the tribunal concluded that the application of RICO was not mandatory in the case.¹⁴⁷⁸ The tribunal also determined that the claimant’s claim for treble damages pursuant to the RICO statute was not admissible on the basis of the contract by finding that the contract and the intentions of the parties must be interpreted as intending to exclude claims such as RICO claims on the basis of the choice of law clause in favor of Brazilian law, the provision on limitation of liability, which was extended to responsibility in tort, and the provision on exclusivity of warranties and remedies, which limited the warranties and remedies to those provided in the contract.¹⁴⁷⁹

These considerations under the circumstances that the non-US party was invoking a US statute against a US defendant to access a level of protection not afforded in the applicable law chosen by the parties led to the conclusion of the tribunal balancing the interests of the parties and the US that it was not within the expectations of the parties to see the RICO statute apply against a US party to the benefit and at the instigation of a non-US party, nor within the expectations of the authorities in the US legal system to claim an extraterritorial application of the RICO statute. In effect, after the award in ICC Case No 6320 was rendered, in a series of cases arising out of the Lloyd's of London bankruptcy, the US Federal Courts of Appeals enforced arbitration and judicial forum selection agreements, even on the assumption that English courts and arbitrators would not enforce applicable US securities law and the RICO statute invoked by the plaintiffs.¹⁴⁸⁰ In *Roby v. Corp. of Lloyd's*, the fundamental question, in the court's view, was not whether the specific content of US mandatory law would apply, but instead whether the available remedies were sufficient to vindicate the statutory policies underlying that mandatory law. Although English law allowed neither the “controlling

¹⁴⁷⁷ *Ibid.*, at 100

¹⁴⁷⁸ *Ibid.*, at 101

¹⁴⁷⁹ *Ibid.*, at 102-103

¹⁴⁸⁰ 996 F.2d 1353, 1361-66 (2d Cir. 1993) See also *Haynsworth v. The Corp.*, 121 F.3d 956, 969-70 (5th Cir. 1997); *Allen v. Lloyd's of London*, 94 F.3d 923, 928-30 (4th Cir. 1996); *Bonny v. Soc'y of Lloyd's*, 3 F.3d 156, 161-62 (7th Cir. 1993)

person” liability of US securities law nor the treble damages offered by the RICO statute, the court reasoned that English law was nevertheless sufficient “to deter British issuers from exploiting American investors through fraud, misrepresentation or inadequate disclosure.”¹⁴⁸¹ Thus, the reasoning in the Roby case suggested that the arbitrators should focus on protecting the core interests behind the mandatory rule rather than on honoring every aspect of the rule as codified in a particular national law and may select and apply such protections that are sufficient to advance the various policies of those states claiming an interest in the dispute.¹⁴⁸²

The tribunal in ICC Case No 6320, in line with this suggestion, examined the relevant provisions of the RICO statutes for the admissibility of the claims without discussing whether the claimant’s allegations were proven, which would have been a discussion on the merits, but by merely discussing “whether or not the claimant alleged all the categories of facts constituting a RICO activity that would entitle it to treble damages”, given that RICO activities are particularly serious and blame-worthy frauds. Taking into account the absence of any fraud committed by the defendant, the tribunal concluded that the claimant did not state a valid RICO claim, and consequently it was not admissible.¹⁴⁸³ Thus, even if the mandatory rule or public policy value of the relevant national legal systems does not qualify for the intervention of the decision maker engaging in a balancing exercise, the arbitrators should weigh the facts of the case in the light of the concept of transnational public policy before finally deciding whether or not to intervene in the ascertainable content of the contract. The weight given to the transnational public policy in the order of international commerce is also a direct result of the absence of a traditional *lex fori* in the context of international arbitration, which suggests the arbitrators to consider the protection and satisfaction of transnational and public international law considerations and concerns regarding the role of international arbitration in the peaceful development of the order of international commerce.

Under these considerations, a distinction has apparently been made by the arbitral tribunals in terms of admissibility of the mandatory rules on the basis of the methods adopted by the authorities of national legal systems, even if the underlying interests seem legitimate under the transnational public policy considerations. For instance, while the prohibition of hard corruption is considered as a valid method in giving effect to the transnational public policy, the banning of the activities of foreign intermediaries or contracts for influence peddling in government transactions is not considered to be part of transnational public policy, but rather an idiosyncratic method of the legal systems of investment-importing countries, which is based on the idea that the work of intermediaries is a typical risk for disguised corrupt activities and serves primarily the domestic social or economic interests. In relation to influence peddling, it is even argued in the doctrine that “influence is the main stock in trade of any agent. Only a foolish principal would retain an agent without influence. Agents may have acquired influence as a result of longstanding professional experience, through the force of their personality, by their standing in society or through their respected expertise.”¹⁴⁸⁴

In ICC Case No. 8113 concerning a dispute arising from the failure of a German contractor to pay remuneration to a Syrian consultant, the arbitral tribunal sitting in Switzerland determined

¹⁴⁸¹ Roby, 996 F.2d at 1364-65

¹⁴⁸² Greenawalt, Alexander K.A., Does International Arbitration Need a Mandatory Rules Method?, *American Review of International Arbitration*, 18 (2007), at 118

¹⁴⁸³ ICC Final Award in Case No. 6320, 1992, *Yearbook Commercial Arbitration*, 20 (1995), at 104-106

¹⁴⁸⁴ Scherer, Matthias, Circumstantial Evidence in Corruption before International Tribunals, *International Arbitration Law Review*, 5-2 (2002), at 30

the applicable law as German law, and discussed the applicability of Syrian law prohibiting intermediation in public procurement. The contractor pointed out that according to Syrian law, government departments and public sector entities were prevented from accepting to deal with intermediaries or brokers under all kinds of foreign contracts. Given that the arbitral tribunal determined the applicable law as German law, the contractor relied on Article 7(1) of the Rome Convention on the applicable law to contractual obligations, which constituted part of German law, for the application of the Syrian mandatory rules. The consultant contended that the facts clearly suggested that there was no violation of Syrian mandatory rules, since the consultant's activity was confined to providing consultancy services, and did not involve active intermediation with state organs. The tribunal stated that "If the application of German law leads to the violation of any Syrian rule of public policy, such violation would not affect the award as long as the award respects the international, or rather the universal and 'transnational', public policy. Any possible inconsistency with the local Syrian public policy would conceivably be raised only at the stage of enforcement of the award, and only for its enforcement in Syria. The international arbitrator has no 'lex fori' and is the guardian of international or universal public policy. He is not the guardian of any municipal system of law, while a national judge is the guardian of his country's legal system and local public policy. Awards of international arbitrators may be enforced in any country signatory of the New York Convention, while the decisions of State Courts are enforceable abroad, only subject to certain conditions . . ."¹⁴⁸⁵

In ICC Case No 9886, the arbitral tribunal sitting in France refused to apply Algerian statute prohibiting operations of intermediation in connection with the award of state contracts, in view of the fact that the parties had expressly submitted the substance of the dispute, concerning the payment of commissions, to French law. Under the Algerian statute, all commission payments to facilitate the award of Algerian state contracts, irrespective of whether such payments have been actually applied or not to pay bribes to Algerian officers, were illicit. The arbitral tribunal held that in case of international transactions, the parties are free to choose the applicable law and thus exclude the application of state laws that would apply "in absence of such choice", with the only reservation of national laws which could be considered as an expression of truly international public policy or "ordre public vraiment international". According to the tribunal, the Algerian statute did not belong to "ordre public vraiment international" to the extent that it has not "as objective to determine fundamental principles corresponding to the organization of an international community".¹⁴⁸⁶

The effect of this approach is to exclude the application of a mandatory rule not belonging to the applicable law expressly stipulated by the parties unless such rules are part of the transnational public policy or contribute to its formation. However, those arbitral tribunals do not give much weight to the question of whether the relevant statute contains such mandatory rules that should apply even if not belonging to the applicable law or whatever the will of the parties might have been in that respect, from the perspective of the national legal system promulgating those rules. Similarly, in ICC Case No 7047, the tribunal rejected the applicability of rules of Kuwaiti law regulating commercial agencies on the ground that they are not a part of the ordre public international, and sought for the activities of "hard" corruption, which in its view, was recognized within the chosen Swiss law and constituted a part of the ordre public international. The tribunal held that the agreement would be void if

¹⁴⁸⁵ ICC Award in Case No 8113, 1996, Yearbook Commercial Arbitration, (2000), at 324

¹⁴⁸⁶ ICC Award in Case No 9886, 1999, (unpublished), cited by Grigera Naón, Horacio A., Choice of Law Problems in International Commercial Arbitration, Recueil des Cours, 289 (2001), at 318-319

the parties, when closing the agreement, had intended that the claimant was to effect the conclusion of the contract between Kuwait and the defendant by illicit means, such as bribery. The tribunal was convinced that neither the agreement infringed the *ordre public international*, nor the claimant's activity as performed in the particular circumstances violated *bona mores*.¹⁴⁸⁷

In contrast, the arbitral tribunals have chosen to apply the mandatory rules of competition laws as international mandatory rules, without questioning whether the underlying interests or particular methods adopted by such rules are part of the transnational public policy. However, it is controversial whether the rules of competition laws belong to the essential and broadly recognized interests that are protected by the concept of the transnational public policy, which could be found in any national legal system.¹⁴⁸⁸ Those rules rather reflect the domestic social or economic interests aiming at protecting the free trade and the functioning of an effective market. Arguably, those arbitral tribunals considered that the rules of competition law of a particular national legal system are so closely connected to the transaction that the factor of close connection tips the balancing scales in favor of their applicability even if their underlying interests may not be considered as being protected by the established rules of policy in the order of international commerce. The relevant interests represent basic political decisions of the authorities in a national legal system, and the laws that attempt to pursue these basic decisions are governed by a "strong" or "fundamental" public interest, which are connected to one specific state and cannot be regarded as universally recognized or commonly shared.¹⁴⁸⁹ Even so, this approach of the arbitral tribunals to the competition cases seems appropriate because the peaceful development of the spontaneous order of international commerce requires respect for the knowledge and capacity of the authorities in national legal systems for regulating their internal orders, and it can be considered as an interest protected by the established rules of policy that *ex post* judicial processes should not become a means for disturbing such orders that are directly and clearly affected by a particular transaction. Thus, as far as the rules of competition laws are concerned, the arbitral tribunals seem to admit this recognized interest for the general protection of the public in a state. Indeed, the contractual obligations at stake in the cases of competition law before arbitral tribunals were to be performed in the relevant state enacting those rules or produced effects in the relevant market or a part of it, or had an effect in that state.

In ICC Case No 8626, the arbitral tribunal sitting in Geneva decided to apply EC antitrust law, although the contract was governed by New York law and the claimant was a US party. The dispute arose from a licensing agreement between the claimant, and the defendant, a

¹⁴⁸⁷ ICC (Final) Award in Case No. 7047, 1994, Yearbook Commercial Arbitration Volume, 21 (1996), at 94; This award was enforced in England, although it was alleged that the agreement with Westacre was for the purpose of procuring sales through bribery or other corrupt influence and, therefore, contrary to public policy, an argument raised before but rejected by the arbitrators. See *Westacre Investments v. Jugoinport* [1999] 3 All E.R. 864 (Q.B.); [1999] 3 W.L.R. 811 (C.A.) After becoming public through the enforcement proceedings, it has become apparent that the claimant, "a State Y corporation" was "Westacre", a company incorporated in Panama, the defendant, "an agency of State Z" was "Yugoinport", a state-owned entity of Yugoslavia, now based in Serbia, and State X was Kuwait.

¹⁴⁸⁸ It is even argued that European antitrust law is not a part of transnational public policy. Derains, Yves, *Application of European Law by Arbitrators — Analysis of Case Law*, in CEPANI (ed.) *Arbitration and European Law*, Brussels, Bruylant, 1997, at 67-78; ICC Final Award No. 6503, 1990, *Journal du Droit International*, (1995), at 1024-1025

¹⁴⁸⁹ Voser, Nathalie, *Mandatory Rules of Law as a Limitation on the Law Applicable in International Commercial Arbitration*, *American Review of International Arbitration*, 7 (1996), at 352

German company. The defendant maintained that the agreement was void under the applicable New York law and under Article 81 of the EC Treaty. The tribunal decided to take into account Article 81 for three main reasons. First, the tribunal referred to the doctrine embodied in the United States Supreme Court judgment in *Mitsubishi Motors Corp. v. Soler Chrysler Plymouth*, which held that an arbitral tribunal in considering a contract expressly governed by Swiss law had to take into account, on the grounds of international public policy, the anti-trust law of the United States. In the opinion of the arbitral tribunal, “the law of New York requires that an arbitral tribunal wherever situated should take into account the anti-competition provisions of the Treaty of Rome and the relevant Regulations made thereunder.”¹⁴⁹⁰ Secondly, according to the tribunal, *lex arbitri* also allowed for the same result to be reached by reference to a Swiss Federal Tribunal decision which held that an arbitral tribunal is competent to examine whether a contract is valid within the meaning of Article 81, notwithstanding that arbitral tribunals do not have powers of state authorities of the Member States of the European Union. Thirdly, the tribunal maintained that an arbitral tribunal should always be concerned with the effectiveness of its decisions, as expressly provided in Article 35 of the ICC Rules. The tribunal noted that the enforcement of any award in the claimant’s favor would in all probability be sought by the claimant in Germany and would be refused by all German courts if this resulted in giving effect to a contract which was in breach of Article 81 of the EC Treaty.¹⁴⁹¹ For these reasons, the tribunal deemed itself bound to consider the applicability of Article 81, and found that the relevant contractual clause had a direct effect in the European Union and it was potentially capable of restricting trade between Member States and prohibited by Article 81. Thus, the tribunal held that a particular clause of the agreement to be void. The tribunal did not find it necessary to express a concluded view on the effect of the law of New York in view of what it held concerning the application of Article 81 of the EC Treaty.¹⁴⁹²

Apparently, the arbitral tribunal in ICC Case No 8626 considered that its capacity to deal with the issues of antitrust laws, on the basis of the Swiss and US court decisions, exempted it from examining whether the interests and methods advanced by the European antitrust law are compatible with the transnational public policy considerations.¹⁴⁹³ In deciding to apply those rules, the arbitral tribunal also relied on Article 35 of the ICC Rules and took into account as a factor that the courts of the claimant’s country would deny the enforcement of the award if the latter gave effect to the contractual clauses the validity of which had been challenged. This

¹⁴⁹⁰ ICC Award in Case No 8626, 1996, ICC International Court of Arbitration Bulletin, 14-2 (2003), at 56; In contrast, in ICC Case No 7893, the arbitral tribunal reached a different conclusion with regard to the arbitrability of anti-trust issues in the context of an agreement governed by the laws of New York. In the case, the US licensor argued that the Japanese licensee continued to use its licensed technology after the termination of the license and technical assistance agreement unlawfully and in breach of the contract. The Japanese licensee argued that the agreement was contrary to anti-trust rules of the State of New York and to the Treaty of Rome, citing among others the *Mitsubishi* case. Although admitting that there was a body of precedent that favored resolving disputes under the arbitration clauses, the tribunal considered that such presumption was overcome when the language of the arbitration clause did not appear to cover the arbitration of disputes under the anti-trust laws and, in addition, the parties specifically provided that the agreement be construed under New York law, which contained court decisions that it was against the public policy of New York for arbitrators to adjudicate anti-trust claims. ICC (Interim) Award in Case no. 7893, 1994, Yearbook Commercial Arbitration Volume, (2002), at 139 et seq.

¹⁴⁹¹ ICC Award in Case No 8626, 1996, ICC International Court of Arbitration Bulletin, 14-2 (2003), at 56

¹⁴⁹² *Ibid.*, at 57

¹⁴⁹³ Grigera Naón, Horacio A., Choice of Law Problems in International Commercial Arbitration, *Recueil des Cours*, 289 (2001), at 331

decision clearly contrasts with the reasoning of the arbitral tribunal in ICC Case No 8113, examined above, where it was considered, as factors for the inapplicability of Syrian mandatory rules, that they were not part of the transnational public policy, and any possible inconsistency with the local Syrian public policy would conceivably be raised only at the stage of enforcement of the award in Syria, but the award could be enforced in any country signatory of the New York Convention.¹⁴⁹⁴

In ICC Case No 10704, the dispute arose over a contract by which the claimants agreed to purchase businesses belonging to the defendants. The contract was governed by French law, and the parties on both sides were companies from various European countries. The claimants allege that the defendants violated clause 11 of the contract, by agreeing upon a merger with a third party. Amongst other things, this clause forbade the seller to engage in competitive acts for a period of seven years. The defendants contended that if clause 11 was read as the claimants proposed, the clause would fall foul of Article 81 of the EC Treaty. It was agreed by the defendants that the tribunal was only concerned with EU competition law and they were not disposed to argue that any different result would be reached by the application of either French competition law or French civil law. The tribunal acted on this assumption, to which the claimants did not object.¹⁴⁹⁵ In the tribunal's opinion, which was not contested by the parties, an appreciable effect on trade between Member States existed, given the pan-European nature of the business purchased by the claimants and the geographic scope of the "Territory" as defined in contract.¹⁴⁹⁶ The tribunal also stated that "one should have no hesitation in considering when, taking the global size of the undertakings into consideration and the established nature of their trademarks, that there is a sufficiently appreciable effect on competition capable of hindering the attainment of the objectives of the single market thereby justifying the application of EU law to the terms of the [contract]."¹⁴⁹⁷ Having accepted the applicability of EU law, the tribunal examined the validity of clause 11 of the contract in terms of its duration, geographic scope and subject in light of the European Court of Justice case law and the Commission's Notice on ancillary restrictions. The tribunal stated that "where the clause fails under any one of these grounds, it is considered null and void and as having no effect." The tribunal was of the opinion that the duration of seven years set out in the non-compete clause was excessive and that the clause should fall on this account.¹⁴⁹⁸

Even in cases where the arbitral tribunals decided not to apply competition law, they did so after finding that its conditions for application were not present, without denying their mandatory nature and potential applicability to international contracts.¹⁴⁹⁹ ICC Case No 9240 concerned a licensing agreement between US, Belgian and UK companies, which was governed by the laws of the State of Ohio. The tribunal based its competence to apply EC competition law on the fact that the parties agreed in their respective submissions that, notwithstanding the choice of law provision, EC Competition law should apply to the competition law aspects of the agreement, and on the plausible arguments of the claimant that

¹⁴⁹⁴ ICC Award in Case No 8113, 1996, Yearbook Commercial Arbitration, (2000), at 324

¹⁴⁹⁵ ICC First Partial Award in Case No 10704, 2000, ICC International Court of Arbitration Bulletin, 14-2 (2003), at 67

¹⁴⁹⁶ *Ibid.*, at 69

¹⁴⁹⁷ *Ibid.*, at 72

¹⁴⁹⁸ *Ibid.*, at 73

¹⁴⁹⁹ Grigera Naón, Horacio A., Choice of Law Problems in International Commercial Arbitration, *Recueil des Cours*, 289 (2001), at 331, at 325-326

during the negotiations which led to the signing of the agreement, EU competition law matters were carefully examined by both parties with a view to ensuring that the agreement would be enforceable, and that the resulting agreement was regarded by both parties not only as fair and balanced but also enforceable. However, according to the tribunal, the defendants failed to establish that the agreement violated Article 81 of the EC Treaty and, even if it were to be held to violate Article 81, the claimant demonstrated that the agreement could benefit from the application of the Know-How Block Exemption of 1988. Accordingly, the tribunal rejected the defendants' argument that the agreement was null and void because it violated EU competition law and held that the agreement was not in violation of the EC Treaty or other applicable antitrust laws.¹⁵⁰⁰

In ICC Case No 12127, the claimant, French licensor, and the defendant, US licensee, entered into an exclusive license agreement covering the procedures, know-how and techniques to manufacture the product under the US patents, as well as the right to sell the product in the United States and Canada. The agreement provided that it was governed by the laws of France. The defendant argued that the territorial sales limitation was prohibited by French law and European competition law, as an “absolute territorial protection” whereby the consumers located in a given territory are forced to purchase a product only from a single exclusive supplier in such territory. The arbitral tribunal underlined that the French and European anti-trust rules prohibiting such absolute territorial protections were applicable only insofar as a contract directly or indirectly restricted the freedom of competition in all or part of the European territory, and the fact that the contract was governed by French law did not necessarily imply the application of mandatory rules of French competition law where such rules would in any event not be materially or territorially applicable. Thus, the tribunal considered that the defendant failed to demonstrate that how a license agreement related to two US patents, to be exclusively performed in the territory of the United States and Canada by an American company based in the United States, could in any manner restrict competition in the French or in the European territories, or create an absolute territorial protection to the prejudice of consumers located in such territories. The tribunal also noted that the defendant did not make any submission based on the US anti-trust regulations, and considered that a distribution agreement covering the whole US territory could hardly be restrictive of the competition within the American market. Thus, the tribunal held that the contractual clauses preventing the defendant to sell outside the territory were valid in the context in which the contract was to be performed.¹⁵⁰¹

Moreover, in some cases, the arbitrators did not even hesitate to check, *ex officio*, whether an agreement is compatible with the antitrust rules. In ICC Case No 4132 where the dispute arose out of a supply and purchase agreement entered into between Italian and South Korean parties, the sole arbitrator considered himself obliged to determine whether Korean anti-trust law as invoked by the defendant was applicable to the agreement, even if it did not govern it, since the agreement was for an important part to be performed in Korea. The arbitrator noted that he is empowered to apply this law insofar as he was satisfied that, in the circumstances of the case and pursuant to the published case-law of the competent national courts and/or the published and stated policy of the competent national authorities, the acts under consideration of the arbitrator were deemed null and void, and unenforceable, as prohibited by any relevant national public law. According to the arbitrator, a party appealing to any national public law had the duty to prove that this law, indeed, was applicable to the case, and to what extent.

¹⁵⁰⁰ ICC Award in Case No. 9240, April 1998, ICC International Court of Arbitration Bulletin, 14-2 (2003), at 60

¹⁵⁰¹ ICC Award in Case No. 12127, 2003, Yearbook Commercial Arbitration Volume, 33 (2008), at 89-90

Since the defendant did not provide sufficient evidence as to the structure of the relevant market and the position of the claimant thereupon, the arbitrator was not satisfied that certain clauses of the agreement were prohibited by Korean law. On the other hand, the arbitrator on its own initiative investigated whether the agreement came under the prohibition of Article 81 of the EC Treaty, which, in his view, is “of public order and part of the public policy of the Community”. Since the agreement was a contract between an Italian and a Korean undertaking, and was for larger part performed in Korea, the arbitrator was not satisfied that the agreement could affect trade between Member States or had, as its object or effect, a prevention, restriction or distortion of competition within the common market of the Community, to any appreciable extent.¹⁵⁰²

In ICC Case No. 7181 which concerned a joint venture agreement for the development of software packages governed by Belgian law, the arbitral tribunal stated that “in view of the public policy character of Art. [81 of the EC Treaty], the Arbitral Tribunal does have to examine ex officio whether Art. X of the Agreement is not caught by the prohibition of restrictive agreements”, and after examination, the tribunal concluded that there was no possible violation of Article 81 as well as Article 82 of the EC Treaty.¹⁵⁰³ In ICC Case No. 7539, the arbitral tribunal stated that it is the responsibility of the arbitrators to raise even ex officio, but with all the prudence required, the incompatibility of an agreement which is submitted to them with Article 81 of the EC Treaty. Although the tribunal was unclear as to the requirement of prudence, it should be understood as the procedural prudence to be exercised by it in raising, of its own motion, competition law issues by submitting those issues for comments to the parties to ensure a fair hearing. The tribunal then found that the exclusive licensing agreement concerned in this case was block-exempted and did therefore not infringe EC competition law.¹⁵⁰⁴

In the arbitral awards, it appears that the rules of competition law are consistently considered as international mandatory rules without questioning whether there are idiosyncrasies in the interests or methods of such rules. The modern competition laws define their scope of application by localizing the anti-competitive effects on the territory or the markets of their country, regardless of the nationality, the domicile or the seat of the enterprises in question. Their applicability seems to have been justified in such cases by the fact that they are not discriminative and the consideration that the parties assumed the risk of illegality under those laws when entering into the contract. In ICC Case No 8626, the tribunal expressed its view that “since the Agreement, jointly negotiated by the parties, was entered into in 1989, four years after the decision of the United States Supreme Court in *Mitsubishi Motor Corporation*, ..., the implications of that decision for anti-competitive clauses in contracts entered into between parties established, respectively, in the United States and in a member state of the European Community, and which required performance within the European Community, should have been taken into account by the negotiators on both sides.”¹⁵⁰⁵ In ICC Case No 10704, the tribunal stated that “[Claimants] are deemed to know the effect of European competition law in just the same way as the Respondents or any other company incorporated and doing business in the EU. [Claimants] must have been aware that they were taking a risk

¹⁵⁰² ICC Award in Case No. 4132, *Yearbook Commercial Arbitration*, (1985), at 50-51

¹⁵⁰³ ICC Award in Case No 7181, 1992, *Yearbook Commercial Arbitration*, (1996), at 105-106

¹⁵⁰⁴ ICC Award in Case No 7539, *Journal du Droit International*, (1996), at 1030-1034

¹⁵⁰⁵ ICC Award in Case No 8626, 1996, *ICC International Court of Arbitration Bulletin*, 14-2 (2003), at 59

in agreeing to a clause the duration of which was seven years and unfortunately for them this risk turned into reality.”¹⁵⁰⁶

In contrast, the rules prohibiting intermediaries or purchase of influence in government transactions, although justified in the interests protected by them as issues of transnational public policy, as far as the issue of corruption is concerned, are not considered as adopting appropriate methods in protecting those interests absent evidence of hard corruption, and they are disregarded by the arbitral tribunals. Even so, both the rules prohibiting anti-competitive practices and certain forms of intermediary contracts in government transactions serve primarily the domestic social or economic interests, and the various methods adopted by the national legal systems to protect those interests can be justified in view of the specific needs of their internal orders. The practice, in which the former rules qualify as international mandatory rules solely on the basis of the connection between the transaction and the relevant national legal system, while the latter ones may not, reflects a contradiction. Such a practice would probably result from the perception that while all modern national legal systems provide some form of mandatory rules ensuring free competition within their internal orders, the prohibition of foreign intermediaries or purchase of influence in government transaction remains limited to the national legal systems whose internal orders run a higher risk of corruption in public officials and its aim is considered to establish a monopoly of foreign trade, thereby contradicting the values of free trade that are protected in the modern national legal systems.

The considerations of transnational public policy are not issues of moral or political choice of the arbitrators.¹⁵⁰⁷ Moreover, the transnational public policy considerations may not be in contradiction with, nor supersede, public international law principles, including state sovereignty, which requires the respect for the sovereign rights of a state to exercise its legislative jurisdiction or jurisdiction to prescribe within the limits accorded by public international law. States’ exercise of such jurisdictional powers is of course not unlimited.

¹⁵⁰⁶ ICC First Partial Award in Case No 10704, 2000, ICC International Court of Arbitration Bulletin, 14-2 (2003), at 74

¹⁵⁰⁷ The award in ICC Case No 9298 is an example where the arbitrators declared their personal convictions as reflecting transnational public policy considerations in an obiter dictum. In the award, the tribunal declined to apply foreign exchange regulations of the law chosen by the parties as applicable to a contract for the sale of shares on the basis that such regulations affect money transfers out of the state having enacted them but do not have the effect of rendering invalid contracts for the sale of shares for a price in foreign currency. The tribunal stated that “it need not analyze further the policies pursued by these provisions in order to assess them against international standards in order to determine whether they should be applied or taken into consideration by the Arbitral Tribunal”. Nevertheless, the tribunal was of the view, obiter dictum, that (i) it should be understood that the people of the country having enacted the foreign exchange regulations had an interest in protecting and encouraging foreign investment, and also an interest in maintaining the stability of its currency, such latter interest being embodied, obviously, in such regulation ; and (ii) from an international point of view, an international Arbitral Tribunal “must favor the law protecting and encouraging foreign investment over the law protecting the currency”. ICC Award in Case No 9298, 1998, (unpublished), cited by Grigera Naón, Horacio A., Choice of Law Problems in International Commercial Arbitration, *Recueil des Cours*, 289 (2001), at 314 It is rightly pointed out that this obiter dictum was questionable since the arbitral tribunal was not explicit as to the legal basis for the assertions in the obiter dictum. It seems difficult to understand the national or public international law source providing some degree of principled justification for such assertions, in the absence of any indication in the law of the relevant state, including court decisions, or international treaties to which it is a party, to systematically privilege foreign investment protection over its laws aimed at protecting its currency and given that each country, within the scope of its sovereign powers, has the right to decide to which extent it wishes to advance foreign investment protection and under which circumstances its interests to protect its economy and the stability of its currency should be privileged or not over the interests of foreign investors. *Ibid.*, at 314-315

However, the arbitral tribunals should find such limits in public international law to the extent the relevant mandatory rules do not reflect limitations rooted in public international law or well-received notions of morality, justice and good faith enjoying at least quasi-universal acceptance or recognition, but not in a supposed correspondence or lack of correspondence of the methods adopted by the mandatory rules being considered with some presumably objective substantive standards traced by a concept of transnational public policy which, in practice, may be largely influenced by subjective judgments as to its contents.

Once it is accepted that there is a universally recognized interest for the general protection of the public in a state, that the authorities in national legal systems are in a better position to regulate the actions of the elements of their internal orders, and that the interests protected and methods adopted by those regulations should be respected when an international contract is closely connected to the jurisdiction enacting the relevant rules, there should be no difference between the evaluation of the applicability of the competition law rules and the mandatory rules of representation in government transactions. It is also argued in the doctrine that the concerned state itself has to decide which means are necessary to prevent bribery and corruption, and if the state decides that it is also necessary to prohibit commission agreements with third parties because such agreements are likely to lead to bribery, this should be respected.¹⁵⁰⁸ These considerations ultimately imply that absolute and unlimited freedom for the parties to regulate their transactions is not a part of transnational public policy in the order of international commerce.

Moreover, in both cases relating to competition law or intermediary contracts in government transactions, the parties cannot argue that the application of those rules is not within their reasonable expectations. In particular, in the cases of the intermediary contracts for obtaining government transactions, the parties are apparently aware of the mandatory rules in the place of performance, since they attempt to avoid their applicability by agreeing on arbitration and submitting their contract to a foreign law, under which such contracts are not illegal. At the stage of determining the applicability of mandatory rules, it should be accepted, as a general principle, that “[a]s long as a State or a supranational organization has enacted rules which do not violate the (international) public policy notions of the arbitrators, and the facts of the case call for an application of these rules, a tribunal should not grant protection to the will of the parties to circumvent the rules.”¹⁵⁰⁹

In these cases, the issue of illegality is usually raised as a defense by the defendant against the claimant’s demands for performance of the contract, or claims for damages for non-performance. It is true that the application of those rules at the stage of legal enforcement may lead to the impression of favoring the defendant, who may have enjoyed the benefits of the transaction until the dispute has arisen and revealed the relevant mandatory rule in order to avoid sharing its benefits from the transaction with the other party or otherwise to escape the consequences of its own contractual nonperformance.¹⁵¹⁰ However, this kind of consideration

¹⁵⁰⁸ Voser, Nathalie, Mandatory Rules of Law as a Limitation on the Law Applicable in International Commercial Arbitration, *American Review of International Arbitration*, 7 (1996), at 351

¹⁵⁰⁹ Hochstrasser Daniel, Choice of Law and 'Foreign' Mandatory Rules in International Arbitration, *Journal of International Arbitration*, 11-1 (1994), at 86

¹⁵¹⁰ In the *Hilmarton* case, the Swiss courts, in annulling the arbitral award, considered the fact that the claimant had performed its obligations under the contract and that the defendant, which had paid the commission amounts regularly, discontinued such payments once the contract with the Algerian state had been awarded to it. *Cour de Justice [Court of Appeal]*, Geneva, 17 November 1989 and *Tribunal Fédéral [Supreme Court]*, 17 April 1990, *Yearbook Commercial Arbitration*, (1994), at 214-222; In *Paris Chamber of Arbitration Award in Case No.*

should not be the decisive factor to conclude on the non-application of a mandatory rule, to the extent the relevant rule aims at furthering the interests protected by the established rules of policy going beyond the interests or conduct of the parties to the dispute.¹⁵¹¹

The decision maker applying *lex mercatoria* should consider the issue of illegality as an issue of risk allocation, if both parties can be considered as aware of it when entering into the transaction. In such cases, the terms of contract that is affected by illegality may determine in a residual manner the allocation of the risk of illegality between the parties. The consistent

9246, the claimant, Austrian agent, initiated arbitral proceedings against the defendant, Egyptian principal, who failed to pay the commission fee arising from a contract which the defendant concluded with one of the states covered by the exclusive agency agreement, State X. The arbitral tribunal determined the applicable law as *lex mercatoria*. The defendant argued that under the public policy provisions of State X, a foreign company could not act as a representative in State X and, consequently, the claimant could not seek commission fees. The tribunal considered that the law of State X, even its public policy provisions, should not be applied to a representation which did not concern State X specifically, but, rather, several countries. However, the tribunal did not consider the partial nullity of the agreement and held that the defendant may not at the same time entrust the Austrian claimant with the task of representing him in State X, and later argue that that task was null and void, simply in order to escape his obligations towards his agent and refuse to pay him for his efforts, whose existence he recognized. Thus, the tribunal denied the objection aiming at having the agency contract declared null and void. Paris Chamber of Arbitration Award in Case No. 9246, March 8, 1996, *Yearbook Commercial Arbitration*, 22 (1997), at 31-32; In ICC Case No 6294, the sole arbitrator took into account whether one of the parties would obtain an undue benefit or advantage through the application of the mandatory rules. Under the contract in dispute, the claimant, a Hungarian company, was hired as a subcontractor to perform construction on a site located in Germany on behalf of the defendant, a German company. The defendant argued that the contract between the parties was invalid under German law relating to immigration and social policy since it aimed at circumventing the prohibition on transfer of employees without authorization from the public authorities. The arbitrator noted that the parties' business relationship on the basis of the contract lasted for several years, but the contract was challenged by the defendant in these proceedings. According to the arbitrator, the contract was executed in fact and in law, without either of the parties raising the possible invalidity of the legal basis of their business relations, and the interest of either party to invalidate the contract today could only indicate an attempt to free themselves of unfulfilled obligations with respect to the other party. Thus, the arbitrator rejected the application of mandatory rules of German public law since the party's refusal to perform appeared abusive in view of the principle of the prohibition of *venire contra factum proprium*. ICC Award in Case No 6294, 1991, *Journal Du Droit International*, (1991), at 1050-1052; In ICC Case No 6503, the tribunal found that, in light of the prevailing circumstances, it would be 'inequitable and shocking' to admit the competition law claim coupled with a claim for damages given that the defendant now invoking that claim had been relying on the very validity or the underlying exclusive licence agreement and its compliance with the relevant competition law rules throughout its commercial relationship with the claimant. ICC Final Award in Case No. 6503, 1990, *Journal Du Droit International*, (1995), at 1024

¹⁵¹¹ For instance in ICC Case No 6475, the defendant argued that the invalidity of the agreement under Article 81 of the EC Treaty. The arbitrator noted that "all contentions concerning the invalidity of the 1981 contract were raised a long time after the expiry date of the agreement itself and after the final breaking of the contractual relationship existing between the parties." According to the arbitrator, this was an important consideration "since at the time the argument based on Article [81] was put forward, it had become impossible for either party-and especially for Claimant- to protect its position by confirming the validity of the agreement through a notification to the European Commission in order to obtain either a confirmation of its validity by a negative attestation, or an exemption under Article [81].3." The arbitrator also considered that the defendant supported the exactly opposite view during the lifetime of the agreement, namely that the contract was valid and binding on the claimant. The arbitrator stated that "Under these circumstances it would be contrary to the fundamental principles of justice to allow a Defendant who began by claiming that the contract was valid, who obtained from the other party the carrying out of its obligations and drew considerable commercial privileges from this performance, to claim, once the contract ended, that it had been null and void from the start." However, the arbitrator added that "The conclusion I have reached on this question is however not based on this principle only." The arbitrator examined the contract in light of the relevant mandatory rules and concluded that the contract was valid and binding on the parties, since it did not violate Community competition regulations, either on its own or in conjunction with the claimant's other licence agreements. ICC Award in Case No 6475, 1994, *International Court of Arbitration Bulletin*, 6-1 (1995), at 53-54

application of this approach may even deter the parties from entering into the illegal contracts. For instance, in the intermediation contract for obtaining government procurement, the risk of illegality can be considered as having assumed by the agent, where the full amount of its commission fee depends on the success of its services. If the risk materializes and the arbitrator holds that the contract between the agent and the principal is invalid, the arbitrator may decline the agent's claim for the payment of the remainder of its fees, following the traditional legal consequence of illegality, which denies restitution and leaves the parties in whatever position had been achieved at the time the illegality was recognized. In the event that this reasoning prevails in arbitral practice, as the agents would not be able to obtain full amount of its fees, when it depends on the success of their services, they may insist on upfront full payment by the principal at the stage of negotiations in subsequent intermediation agreements. The principal will not be willing to assume the risk of illegality and to enter into such a transaction where the success of the services of the principal may not be guaranteed or if the principal suspects that the agent may raise the issue of illegality after obtaining such upfront payment without performing any services.

The decisive factors in determining the applicability of mandatory rules should be whether the interests advanced by those rules are protected by the established rules of policy and whether the method adopted by those rules leads to a violation of established rules of policy even if the underlying interests of such rules seem justified in the order of international commerce. In the end, the arbitral tribunal, endowed with the capacity of rendering final and binding decisions, the substantive content of which is mostly outside the control of the national legal systems, should not become instrumental in enforcing a transaction that attempts to evade such mandatory rules that may deserve protection in the order of international commerce.

Thus, all forms of mandatory rules, whether enacted by an investment-importing or capital-exporting country, that have a claim for application in a particular case deserve a careful examination of the interests and expectations of the states enacting them by the decision maker, who should determine whether those rules are international mandatory rules from the perspective of the state enacting it, and whether their interests are protected by the established rules of policy and their methods are not violating the established rules of policy. Otherwise, the international arbitral tribunals may be perceived as failing to play a positive role in the peaceful and harmonious development of the order of international commerce and endangering the present prevalingly positive attitude of the authorities in the national legal systems towards the international arbitration, due to the lack of a sense of cultural equidistance and the respect for cultural diversity in the arbitrators' determination of the applicability of the relevant mandatory rules or public policy standards of the national legal systems.¹⁵¹² Accordingly, the application of national mandatory rules that have sufficient connection to a particular contract should only be rejected when the relevant interests are not protected by the established rules of policy, or the methods adopted by such rules are so idiosyncratic that their justified interests would not be served in an international case, and the enforcement of those methods offends the basic tenets of transnational public policy: for instance, the rule aims to discriminate on the basis of race or religion, or it is enacted by a state, which wish to avoid its obligations or responsibility in a state contract in violation of generally accepted principles of international law.¹⁵¹³

¹⁵¹² Grigera Naón, Horacio A., Choice of Law Problems in International Commercial Arbitration, *Recueil des Cours*, 289 (2001), at 337

¹⁵¹³ ICC Case No 6474 concerned a dispute arising from several contracts for the supply of agricultural products by the claimant, a European supplier, to the defendant, the Republic of X. The defendant argued that the arbitral tribunal had no jurisdiction over the claim due to overriding transnational public policy interests because

However, such a detailed examination of the mandatory rules is generally lacking in the cases of the intermediary contracts for obtaining government transactions. In ICC Case No. 7047, adopting a restrictive approach, which excludes the application of an international mandatory rule not belonging to the applicable law expressly stipulated by the parties unless such application is commanded by truly international or transnational public policy, the arbitral tribunal considered to some extent the nature of the relevant rules of Kuwaiti law regulating commercial agencies, under which the relevant agreement was allegedly void. In fact, the tribunal solely expressed its view that it was inclined to believe the claimant's allegation that the relevant provisions of Kuwaiti law were not compulsory.¹⁵¹⁴ Moreover, the arbitral tribunal stated that "In the permanent practice of international arbitration, national provisions governing the law of agency are not considered to belong to the *ordre public international*."¹⁵¹⁵

In contrast, in ICC Case No. 6500, which concerned a commercial agency contract between a Lebanese agent and a Swiss principal, the arbitral tribunal held that insofar as Lebanese law was mandatory and is aimed at protecting the commercial agent, its application cannot be ignored even if *lex mercatoria* were found to generally apply to the case at hand.¹⁵¹⁶ There are also many arbitral awards dealing with the cases of commercial agency contracts, which implicitly recognize the overriding applicability of mandatory rules of the chosen national laws, which aim at protecting commercial agent from unfair consequences of termination through the goodwill indemnity or notification procedures, in view of the external public policy values behind those rules.¹⁵¹⁷ In these cases, the arbitral tribunals should still examine whether the mandatory rules of the law chosen by the parties can be derogated by the agreement, or considered as international mandatory rules and overriding the contrary provisions of the contract agreed by the parties, given the distinct nature of the basic principle of freedom of contract in the order of international commerce. In such cases, the decision maker applying *lex mercatoria* should give effect to such considerations that are similar to those with regard to the application of international mandatory rules of foreign countries.

international public policy prohibited recognition of the Republic of X, which was not recognized as a state by the international community. The defendant alleged that the source of the relevant principle of international law regarding the issue is the principles of *jus cogens*, which apply to international arbitrators who must apply international public policy to the extent that they are the organs of the international community. However, according to the tribunal, the defendant failed to establish the existence of a general principle of either *jus cogens* or transnational public policy, which could justify an international arbitral tribunal to decline jurisdiction in this case. The tribunal noted the paradoxical situation arising from the defendant's claims insofar as it amounted to a party attempting to benefit from its own non-recognition by the international community. The tribunal considered the principle of good faith, in particular the international concept of estoppel, as prohibiting the defendant from relying on its own non-recognition by the international community in order to avoid or annul its previous undertaking to arbitrate under the contracts. In the tribunal's view, "such a denial of jurisdiction in the circumstances would be contrary to that clear principle of transnational public policy which is the principle of good faith; it would defeat the legitimate expectations of the parties to the agreements and finally compel the claimant to go before the courts of the territory, as suggested by the defendant — all results which do not seem, to say the least, to be in keeping with the requirements of international public policy and of natural justice." ICC Partial Award in Case No. 6474, 1992, *Yearbook Commercial Arbitration* (2000), at 285

¹⁵¹⁴ ICC (Final) Award in Case No. 7047, 1994, *Yearbook Commercial Arbitration Volume* (1996), at 90

¹⁵¹⁵ *Ibid.*, at 89-90

¹⁵¹⁶ ICC Award in Case No 6500, 1992, *Collection of ICC Arbitral Awards, Vol. III (1991-1995)*, at 454

¹⁵¹⁷ Bortolotti, Fabio, *International Commercial Agency Agreements and ICC Arbitration*, *ICC International Court of Arbitration Bulletin*, 12-1 (2001), at 59

The arbitrators usually do not engage in a balancing exercise of the relevant interests and expectations of the parties and the national legal systems involved in the dispute in determining the applicability of mandatory rules of the national law chosen by the parties, in the cases of commercial agency. In ICC Case No. 9301, although the defendant entered into a service agreement with the claimant, as an independent contractor, the arbitrator characterized their agreement, in his discretion, as an agency contract by interpreting the contract and determining the parties' intention in the light of the manner in which the agreement was performed, beyond the terms of the contract and the classification given to it by the parties.¹⁵¹⁸ The agreement was governed by Belgian law. The defendant terminated the agreement, and the claimant sought compensation, invoking the Belgian agency statute of 1995 in support of its claims. The arbitrator held that "where what is involved are mandatory provisions of public policy in the Agency Act 1995, the Arbitrator, as the case may be, will dispense with the application of or rule on the ex officio nullity of any clause in the contract that might be in contravention of such statutory provisions."¹⁵¹⁹ Thus, the arbitrator set aside the contractual clause, which prevented the claimant from claiming compensation upon termination of the contract in any manner and for any reason, and instead, applied the relevant indemnification rules of Belgian law for the period of notice and the loss of goodwill.¹⁵²⁰

In ICC Case No. 8161, the defendant, a British company, appointed the claimant, of German origin, as its exclusive agent. The parties decided that German law would be applicable to their agreement. The agreement included a provision to the effect that no compensation would be due in the event of termination. The claimant terminated the agreement due to his having reached retirement age and for health reasons. He claimed compensation under German law, which grants fair and equitable compensation, in the event of termination by the agent, provided that the termination was caused by the principal's behavior or the agent could not be expected to carry on due to age or illness. Under German law, these rules cannot be excluded by the agreement between the parties. The arbitrator noted that either party could have engaged professional advisors in reviewing the provisions of the agreement, yet neither party obtained any legal advice. However, the arbitrator assumed that both parties entered into agreement in full awareness of the clauses contained therein and accepted the overriding rule of German law by selecting that law as the governing law. Accordingly, the arbitrator held that the defendant accepted the claimant's right, as agent, to compensation on the valid termination of the agreement.¹⁵²¹

In ICC case No. 8251, the tribunal applied mandatory provisions of Austrian law, which granted compensation to the agent in the event of termination, even if the parties chose Austrian law as the governing law to the exclusion of its mandatory provisions for domestic agents and replaced those provisions with a contractual clause entitling the agent to a different amount of compensation. The tribunal reasoned that the parties could not, at one and the same time, choose a national law and exclude certain mandatory provisions it contained, since that would be an abuse of law by making possible to bypass the mandatory rules of any legal system. Moreover, the tribunal noted that Austrian law makes no distinction between the rules applicable to domestic agents and those applicable to foreign agents. As the text of the agreement was a model contract provided by the principal, the arbitrators interpreted this

¹⁵¹⁸ ICC Award in Case No. 9301, May 1998, International Court of Arbitration Bulletin, 12-1 (2001), at 138

¹⁵¹⁹ *Ibid.*, at 141

¹⁵²⁰ *Ibid.*, at 143

¹⁵²¹ ICC Award in Case No. 8161, March 1995, International Court of Arbitration Bulletin, 12-1 (2001), at 59

unclear expression to the disadvantage of that party. According to the tribunal, the choice of Austrian law implied the application of all Austrian rules on agency, including mandatory rules, particularly those relating to indemnification upon termination.¹⁵²²

In ICC Cases No. 9301, 8161 and 8711, the arbitrators apparently did not engage in a balancing exercise in determining the applicability of mandatory rules of the national law chosen by the parties, even if the relevant contracts contradicted those rules of the chosen national law. In ICC Case No. 8711, concerning a similar situation, the arbitral tribunal did not follow the line of reasoning adopted by the tribunals in the cases above. The parties to the dispute in ICC Case No 8711 agreed on Austrian law while excluding the mandatory provisions applicable to Austrian domestic agents. The tribunal started to examine the clause by noting that, “contrary to the situation under German law for example, Austrian law contains no provisions which apply specifically to domestic agents.” The tribunal stated that “since the notion is not found in Austrian law, one could assume that the restriction is meaningless and that Austrian law applies without restriction.”¹⁵²³ The tribunal also considered the other possibility where the mandatory provisions of Austrian law relating to commercial agents have been excluded by the choice of law clause. In that case, the tribunal opined that the law applicable to the related issues should be ascertained pursuant to private international law since there has been no choice of law for this area, and there was no indication that the parties did not intend to apply any legal system at all to specific areas of their relationship. The tribunal determined Italian law as applicable to the issue. However, the tribunal added that, as the rules relating to compensation claim under Italian and Austrian law were identical and there was no fact which justified a connection with a third legal system, it was irrelevant, with respect to the question of the compensation claim, whether it applied Austrian or Italian law. Neither of those allowed the exclusion of the compensation claim to the disadvantage of the commercial agent.¹⁵²⁴ In the end, all of the arbitral tribunals in the cases cited above applied the mandatory rules that protect the commercial agents and awarded the indemnity on the basis of those rules, but the tribunal in ICC Case No 8711 showed greater ability in dealing with the uncertainty created by the conflict between the contract and the mandatory rules of the chosen national law by taking into account the context of the agreement and reasonable expectations of the parties in deciding as to the applicability of the relevant mandatory norms.

In ICC Case No. 7314, the arbitral tribunal rejected the invalidity of the termination clause of a license agreement under the applicable national law, upon a consideration of reasonable expectations of the parties on the basis of an analysis of the nature of contract and wide spread use of such clauses in the practice of international license agreements. The parties concluded a license agreement governed by Greek law under which the defendant granted to the claimant the exclusive license to manufacture, distribute and sell certain products in Greece, using the defendant's methods, techniques, styles, knowhow and trademarks. The agreement provided for a five-year exclusive license. The duration was extended by various extension letters and agreements for a total of fifteen years. In the fifteenth year, the defendant informed the claimant of its decision to terminate the license relationship. The parties concluded a transition period agreement, which provided for the final termination of the license in the seventeenth year. The dispute arose regarding the exclusion of any claims by the claimant

¹⁵²² ICC Award in Case No. 8251, August 1995, International Court of Arbitration Bulletin 12-1 (2001), at 94

¹⁵²³ ICC Award in Case No. 8711, March 1998, International Court of Arbitration Bulletin 12-1 (2001), at 120

¹⁵²⁴ *Ibid.*, at 121

against the defendant due to termination of the license. The arbitral tribunal interpreted the transition period agreement in the broader context of contractual relationship between the parties, which consisted of license agreement and various extension and amendment agreements, in order to determine the parties' intentions with regard to the termination of the contract and waivers. The tribunal found that the wording of relevant provisions indicated that the license would automatically come to an end without any right of the claimant for an extension and that no compensation of any kind was due to the claimant in connection with this termination. The tribunal did not consider that these provisions violated any mandatory rules of Greek law, and stated that "the automatic termination and the waiver of any claims can also not be considered as being *contra bonos mores* ... because provisions of that kind are found regularly in international agreements and in particular in license agreements."¹⁵²⁵ The tribunal took into account the nature of license agreement, where a normal distribution of benefits from a license and all activities and investments are covered by the fees and compensation expressly agreed in the contract. Thus, the tribunal distinguished the contract in question from a commercial agency contract as the claimant was not acting as a commercial agent for the defendant, and rejected the application of mandatory Greek rules with regard to the indemnification of agents in view of the exceptional character of those rules, which prevents their application to other commercial relationships by analogy.¹⁵²⁶

The approach of balancing exercise under *lex mercatoria* may avoid the application of national rules, which have no claim of mandatory application to international contracts, where the parties' intentions indicate that they wished to avoid such rules, despite the existence of a choice of law clause in favor of that national law. In this sense, the arbitrators may disregard the mandatory rules of the applicable law, which do not address the issue in dispute, or which are redundant or irrelevant with regard to international contracts, although mandatory in an entirely domestic setting.¹⁵²⁷

In ICC Case No. 7528, the arbitral tribunal avoided the application of a French mandatory rule, which was contradicting the intention of the parties, although both parties were French, and they chose the French law as the applicable law. French Law no. 75-1334 of 31 December 1975 provided that a subcontract would be void if certain conditions were not met, including the contractor's obligations to introduce the subcontractor to the employer and to place a guarantee in favor of the subcontractor. The claimant subcontractor argued that those conditions were not satisfied by the defendant contractor as the parties agreed that the claimant subcontractor would remain undisclosed to the owner and would thus operate as a division of the defendant. The arbitral tribunal found it difficult to accept that the parties meant to refer to French law while concluding a contract which would be void under that same law. The tribunal also considered that "Even in international arbitration, the parties' agreement should not be allowed to prevail over all mandatory rules of national laws in all circumstances: some rules are so important to the economic or social welfare of the country whose legislature enacted them that international arbitrators must be prepared to enforce them irrespective of the contrary intent of private parties." Although acknowledging that the French Law of 1975 has a mandatory character in domestic transactions, the arbitral tribunal discussed whether that character extends to international contracts such as the disputed one, which was to be substantially performed in Pakistan. The tribunal noted the importance of the

¹⁵²⁵ ICC Award in Case No. 7314, 1995, *Yearbook Commercial Arbitration*, 23 (1998), at 58

¹⁵²⁶ *Ibid.*, at 60

¹⁵²⁷ Grigera Naón, Horacio A., *Choice of Law Problems in International Commercial Arbitration*, *Recueil des Cours*, 289 (2001), at 271

place of performance of the sub-contract as the relevant factor in order to determine the applicable law in sub-contracts, absent any choice by the parties. After determining the expectations of the parties, the tribunal turned to those of the state enacting mandatory law and considered the interests protected and methods adopted by that law. The tribunal found that the relevant interest, which was to protect the sub-contractor against the consequences of the contractor's bankruptcy, did not have any scope of application to the case in question. Moreover, the arbitral tribunal considered the contradiction, which would entail the avoidance of the contract at the request of a party which knowingly and consciously agreed to its terms. Thus, the tribunal held that the parties clearly intended to avoid the provisions of Law no. 75-1334 relating to the formation of the subcontract, and that, given the international character of their contract and its place of performance, their intention must be upheld.¹⁵²⁸

The conditions of illegality under *lex mercatoria* depends on the determination of the applicability of mandatory rules and public policy standards in a given case by means of the established rule of private international law, which enables a balancing exercise between the interests and expectations of the parties and national legal systems concerned. This balancing exercise provides a solution to the problematic issues for the arbitral tribunals determining the relevance of the public policies of jurisdictions, where the enforcement may be sought and where the award is made. The doctrine also favors the arbitrators, who engage in a balancing exercise that considers all relevant factors including the nature of the rule, the connection to the parties' transaction, the strength of a particular state's interest in having its mandatory rules enforced, the mandatory rule's "application-worthiness," and the appropriateness of the result.¹⁵²⁹ This position is closely related to the understanding that arbitral tribunals do not

¹⁵²⁸ ICC Award in Case No. 7528, 1994, *Yearbook Commercial Arbitration*, (1997), at 125, 130

¹⁵²⁹ Mayer, Pierre, *Mandatory Rules of Law in International Arbitration*, *Arbitration International*, 2 (1986), p. 274: (Mayer urged the adoption of a special "mandatory rules method" to govern arbitration of mandatory rules. In his view, first, the arbitrator should take it upon himself to evaluate the authority that should be acknowledged to the law being invoked, under criteria, which heavily rely on Article 7 of the Rome Convention; secondly, the arbitrator may reject the very tenor of that law, if that offends the public policy in his conscience or the fundamental tenets of a transnational *lex mercatoria*; finally, in the particular case of contracts involving states, the arbitrator may disregard such law when the state party to invoke its own law to extinguish or alter its obligations.) Hochstrasser Daniel, *Choice of Law and 'Foreign' Mandatory Rules in International Arbitration*, *Journal of International Arbitration*, 11-1 (1994), p. 57 (Hochstrasser formulated some principles as a guideline for arbitral tribunals. According to Hochstrasser, the arbitrators should apply to take into account mandatory rules from outside the *lex contractus* in the following circumstances: (i) where the parties chose a special law with the sole purpose of circumventing or escaping mandatory rules of a legal system that would have applied to their agreement in the absence of this choice of law; (ii) where the performance of the contract is affected by the invoked mandatory rules, and there is a close connection between the performance and the rules in question; (iii) where enforcement of the award would be doubtful or unlikely if the award does not take into consideration mandatory rules of the country where enforcement will be sought by the winning party. Hochstrasser argued that the decisive factor is the closeness of the connection between the underlying facts and the rules seeking to be applied, yet the arbitrator must check the compatibility of such rules with international public policy and his own notions of equity, as applied to the dispute at hand.) Voser, Nathalie, *Mandatory Rules of Law as a Limitation on the Law Applicable in International Commercial Arbitration*, *American Review of International Arbitration*, 7 (1996), p. 319: (Voser suggests a method for the determination of the application of mandatory rules, which is based on the theory of Special Connection (*Sonderanknüpfung*): the case at hand has to have a "close" connection to the enacting state; furthermore, an arbitrator cannot apply a mandatory rule when the concerned state itself would not apply it if it had jurisdiction over the case; finally, the arbitrator has to make an independent evaluation of the content of the mandatory rules, whereby purely sectional and parochial interests of one state should not be supported by applying the relevant mandatory rules of that state, while mandatory rules that belong to transnational public policy must be applied *ex officio*, in spite of having no relevant connection to a specific state. According to Voser, in distinguishing between purely selfish or parochial interests of a state from transnational public policy, the arbitral tribunal can rely on the question whether the mandatory rules protect interests which are universally, or at least commonly recognized, but, especially in new areas, the arbitral

have a *lex fori* and should view all laws as being of “equal dignity”.¹⁵³⁰ Although the precise factors that should be taken into account by the arbitrators vary, the authors generally draw inspiration from conflict of laws doctrines applied in the national courts, in particular Article 7 of the Rome Convention on the Law Applicable to Contractual Obligations.¹⁵³¹ These considerations should not only relate to the determination of the applicability of the “foreign” mandatory rules but also to that of the mandatory rules of the national law chosen by the parties to the extent they contradict with the terms or purpose of the contract, since all mandatory rules of concerned national legal systems have the same value and rank on the same level for the arbitral tribunal, which is not an organ of a legal system.¹⁵³²

The decision maker applying *lex mercatoria* should seek for some correspondence of the interests underlying the mandatory rules or public policy standards of a national legal system that claims to override the freedom of contract of the parties in the order of international commerce, with those of the other national legal systems connected to the particular contract. Such correspondence will influence the characterization of the reasonable expectations of the parties to a particular dispute. As long as the relevant interest is protected by the established rules of policy and there is sufficient connection between the contract and the national legal system, the particular method adopted by the authorities in that national legal system should be presumed to further such interests and enforced by the decision maker, given that those authorities are in a better position to obtain the necessary knowledge for the regulation of their internal orders. The particular method adopted by a national legal system for furthering the interests protected by the established rules of policy may be disregarded by the decision maker applying *lex mercatoria*, if its enforcement results in a violation of the contents of transnational public policy.

Under *lex mercatoria*, the concept of transnational public policy, rather than operating in a positive way to determine what should be the substance of mandatory rules of national origin, whether or not belonging to the applicable law chosen by the parties, should primarily act in a negative sense to determine whether the application of relevant mandatory rules, although

tribunal must make its own and inventive reflections.) Blessing, Marc, *Mandatory Rules of Law versus Party Autonomy in International Arbitration*, *Journal of International Arbitration*, 14-4 (1997), p. 23: (Blessing proposed six leading criteria: (i) the rule in question must be a norm of mandatory character; (ii) the rule must be such as to impose itself irrespective of the applicable law; (iii) the preconditions regarding the application must be given; (iv) there must be a close connection between the subject matter of the parties' contract and the jurisdiction area or state that had promulgated the mandatory rule or norm; (v) the rule must appear to be "application-worthy" under a functional analysis test, e.g., does the rule "protect a fundamental principle or a universally recognized legal right?"; (vi) the result must qualify as an "appropriate result.") Barraclough, Andrew & Jeff Waincymmer, *Mandatory Rules of Law in International Commercial Arbitration*, *Melbourne Journal of International Law* (2005), p. 205: (The authors advocated taking eight factors in account, which should give some structure to arbitrators' discretion. The list include the following: parties' hostilities towards mandatory rules, rendering an enforceable award, closeness of the connection between the dispute and the law, degree of universal protection the subject matter of a law receives, importance of the mandatory rule to the enacting state, appropriateness and applicability of the law to protecting its subject matter, volume of mandatory rules in the sense that arbitrators' hostility to mandatory rules increases according to the number of mandatory rules each country enacted, and bona fide enactment of mandatory rules.)

¹⁵³⁰ Mayer, Pierre, *Mandatory Rules of Law in International Arbitration*, *Arbitration International*, 2 (1986), p. 274, at 283

¹⁵³¹ Shore, Laurence, *Applying Mandatory Rules of Law in International Commercial Arbitration*, *American Review of International Arbitration*, 18 (2007), p. 91

¹⁵³² For the same view see: Voser, Nathalie, *Mandatory Rules of Law as a Limitation on the Law Applicable in International Commercial Arbitration*, *American Review of International Arbitration*, 7 (1996), at 339-340

sufficiently connected to the contract, would violate fundamental moral or ethical principles or universally recognized human rights, or universally accepted public international law principles.¹⁵³³ The arbitrators should be inspired by the idea that such principles may negatively affect the states by preventing them from exercising their legislative jurisdiction in an overreaching manner and in the pursuit of isolated interests, which could even stimulate retaliation from other states, and from harming the collective interest of having a reliable and balanced order of international commerce. In the end, the deliberate actions of authorities in the national legal systems that are taken for the restoration or improvement of their internal orders should not destroy the balance in the order of international commerce, but respect the abstract relations constituting that order and the possibility of the correspondence of the expectations of the elements of the order without any conflict. The considerations of transnational public policy or public international law may also have a positive effect, thereby affirmatively and directly imposing the application of certain principles prohibiting certain activities, such as bribery or money laundering,¹⁵³⁴ or commanding specific solutions, such as where a state relies on its own law to evade from its contractual obligations towards a private party. However, the decision maker applying *lex mercatoria* should not resort to the considerations of transnational public policy to suggest that there is only one method of fighting corruption, combating restrictive business practices, or protecting commercial agents, and that any national mandatory rule on those topics, which is not modeled accordingly, would be disregarded.

The contents of “corporate social responsibility” have not played a role in the arbitral tribunals’ considerations of transnational public policy in the sense of invalidating a contract, as suggested by some doctrinal writings. However, some arbitral tribunals in investment cases do take into account investor’s conduct in the form of duties to refrain from unconscionable conduct, to engage in the investment in the light of an adequate knowledge of its risks, and to conduct business in a reasonable manner, in determining the standards of protection of the investment in the host country, which points to the need for an investor to take care in how they act if they are to benefit from the full protection and security of their investment under an international investment agreement.¹⁵³⁵ In so doing, investment tribunals have displayed an ability to balance investor and host country interests. Particularly, it is pointed out that the reference to equity in the “fair and equitable treatment standard” leaves open the possibility of looking not only at the conduct of the person who must act fairly but also the conduct of the

¹⁵³³ Grigera Naón, Horacio A., Choice of Law Problems in International Commercial Arbitration, *Recueil des Cours*, 289 (2001), at 321-323

¹⁵³⁴ The bribery of a foreign public official and money laundering are serious crimes in international law, and there is no doubt today that the suppression of corruption and money laundering is an established part of transnational public policy and must be respected by international arbitrators. Cremades, Bernardo M., & David J.A. Cairns, Trans-national Public Policy in International Arbitral Decision-Making: The Cases of Bribery, Money Laundering and Fraud, in *Dossier of the ICC Institute of World Business Law: Arbitration - Money Laundering, Corruption and Fraud*, ICC Publication No. 651, 2003, at 77

¹⁵³⁵ Muchlinski, Peter, ‘Caveat Investor’? The Relevance of the Conduct of the Investor under the Fair and Equitable Treatment Standard, *International and Comparative Law Quarterly*, 55 (2006), at 527 et seq. Some commentators consider this arbitral practice as giving effect to the transnational public policy in investment cases. Hunter, Martin & Gui Conde e Silva, Transnational Public Policy and its Application in Investment Arbitrations, *Journal of World Investment*, 3 (2003), at 374: “public policy is a flexible and dynamic concept, to be used as ... a tool to balance complex and often conflicting goals, such as protection of the environment while assuring the rights of foreign investors.”

person who is acted upon, as the equity suggests a balancing process and weighing up of what is right in all the circumstances.¹⁵³⁶

Thus, the basic tenets of international corporate social responsibility, such as duties to obey the law, to pay taxes, to act in accordance with fundamental labor standards, to observe human rights principles, to refrain from corruption, to provide full disclosure of their activities as required by national law, and to act in accordance with general standards of market fairness, may allow a tribunal to assess more accurately whether the regulatory action in question was proportionate and whether the nature of the investor's conduct entitled the regulator to interfere with the investor's rights.¹⁵³⁷ Thus, the arbitral tribunals will not transform voluntary codes of conducts into mandatory rules and invalidate a contract on the basis of those rules, which is essentially the task for the authorities in the national legal systems due to their better position to obtain sufficient knowledge for taking such decisions, but still be able to give effect to the basic premises of such codes in determining the nature of the host state's actions, the actual causes of the loss to the investor and the amount of compensation for breach of the protection of investment.¹⁵³⁸ This approach utilizes the concept of corporate social responsibility not in intervening the contract but in interpreting and supplementing it with such rights and obligations that would require the investor to take responsibility for the normal commercial risk associated with the investment rather than to find a source of insurance in the host country's obligations under the applicable investment agreement. This may encourage prudent investment in the local community in consistency with the concept of corporate social responsibility, and ensure the management of the investment not only in the best interests of its shareholders, but also with a corporate responsibility, in the interests of the wider stakeholders in the host country.

b. Consequences of Illegality

The consequences of illegality are, in principle, governed by the method prescribed under the mandatory rule or public policy standard, which has been found to be applicable under *lex mercatoria*. For instance, in cases of commercial agency, the decision maker is required to set aside the contractual clause, which violates the applicable mandatory law, and to apply the relevant rules of the applicable mandatory rule, such as provisions protecting commercial agent from unfair consequences of termination through the goodwill indemnity or notification procedures.

In competition law cases, the decision maker may also replace an invalid non-compete clause with a valid one, if the parties have expressed their intention to modify such clauses in case of their invalidity and authorized the decision maker to adapt the contract in case of their failure to reach an agreement, and the applicable mandatory law sets out some specific requirements for the validity of such clauses. In ICC Case No 10704, the non-compete clause with a duration of seven years was found to be invalid under EU competition law. The tribunal stated that, under EU competition law, the clause was null and void and had no effect. However, the

¹⁵³⁶ Muchlinski, Peter, 'Caveat Investor'? The Relevance of the Conduct of the Investor under the Fair and Equitable Treatment Standard, *International and Comparative Law Quarterly*, 55 (2006), at 531; On the obligations of investors see: Sornarajah, M., *The International Law on Foreign Investment*, Cambridge University Press; 3rd ed., 2010, at 145-155

¹⁵³⁷ Muchlinski, Peter, 'Caveat Investor'? The Relevance of the Conduct of the Investor under the Fair and Equitable Treatment Standard, *International and Comparative Law Quarterly*, 55 (2006), at 536

¹⁵³⁸ Also see below Chapter IV, c, vi, 2, c

agreement provided that the parties “shall endeavour through good faith negotiations to replace the invalid . . . provisions by valid provisions, the economic effect of which comes as close as legally possible to that of the invalid . . . provisions” and “If the Parties fail to reach agreement concerning the replacement of such provisions the matter shall be referred to arbitration.”¹⁵³⁹ The tribunal advised the parties to take into account the provisions of EU law and French law concerning duration, geographic scope and subject matter, and to re-negotiate the contract along these lines in order to render the non-compete clause enforceable under EU competition law. The parties failed to agree on a revised clause, and the matter was referred back to the tribunal. In a second partial award, the tribunal took into account the substantive requirements of EU law regarding the validity of non-compete covenants. The tribunal examined the Commission Notice 90/C203/05 dated August 14, 1990 entitled "Commission notice regarding restrictions ancillary to concentrations", which was in force at the date of the contract. The Notice recognized a period of five years as acceptable duration of a prohibition on competition when the transfer of the undertaking includes the goodwill and know-how. The tribunal then referred to a Draft Notice, which was circulated in 1999 by the Commission, amending the relevant period up to three years with goodwill and know-how. The tribunal stated that “The 1999 Notice is not a legislative or judicial text, rather it is a statement of the Commission's policy in relation to these matters which is not binding on a court. However the Tribunal has had regard to the Commission decisions and ECJ case law cited by the parties and their experts.” The tribunal added that “It is clear that if [Claimants] could establish that know-how was involved it would have been able to justify a five year non-compete as the Commission's practice stood at the date of the [contract]. However the Commission's view has changed and under French and EU law the new guidelines would be enforced notwithstanding that they were not in force at the date of the [contract]. This is because this is a matter of "ordre public".” Thus, the tribunal considered itself bound to have regard to the Draft Notice, which sets out the Commission's current position pertaining to non-competition clauses on the sale of an enterprise. In the light of these considerations, the tribunal held that the duration of the non-compete clause was reduced to three years, its subject matter had to be limited to end products, and the geographic scope of the non-compete clause should remain as drafted.¹⁵⁴⁰

The applicable mandatory rule or public policy value may simply invalidate a particular term of the contract, without replacing it with a positive right or obligation for the parties. In such cases, the decision maker may recognize that illegality have its effect only on a certain part of the agreement, and the remainder of the agreement should remain valid, thereby enabling the parties to claim compensation for the violation of the valid parts of the contract. In ICC Case No 8626, the tribunal held that the relevant clause of the agreement to be void since it was potentially capable of restricting trade between Member States and prohibited by Article 81 of the EC Treaty. The tribunal rejected the claimant's claims, so far as based on the relevant contractual clause. Although attracted by the defendant's argument that the relevant contractual clause was so fundamental that the entire agreement must fall, the tribunal decided to deal with the claimant's claim for compensation arising out of the defendant's activities during the currency of the agreement, and assumed that such a claim could be separated from

¹⁵³⁹ ICC First Partial Award in Case No 10704, 2000, ICC International Court of Arbitration Bulletin, 14-2 (2003), at 73

¹⁵⁴⁰ ICC Second Partial Award in Case No. 10704, 2000, ICC International Court of Arbitration Bulletin, 14-2 (2003), at 76-77

the void provisions of the agreement and that the pleadings in the arbitration were wide enough to cover such a claim.¹⁵⁴¹

In ICC Case No 10660, the dispute concerned a cooperation agreement between the claimant, a French company, and the defendant, a Dutch company, whereby they undertook to purchase from each other the complementary machines they produced and to sell them as complete lines under their joint names. They also agreed to make available to each other the know-how needed for marketing, installing and servicing the machines. The arbitral tribunal held that a four-year post-termination non-compete clause and a ban on passive sales of third-party equipment in the agreement were void under the EC competition law. The tribunal concluded that these contractual clauses could be severed from the remainder of the cooperation agreement between the parties on the basis of the following grounds: firstly, under EU law, only those aspects of the agreement which are prohibited by Article 81 of the EC Treaty were void, and the agreement as a whole is void only if those parts of the agreement are not severable from the agreement itself; secondly, it is well established that severance is a matter for national law, and under the applicable French law, it is not disputed that in principle severance is possible; and thirdly, the agreement itself expressly provided that if any provision of the agreement is found to be invalid, it shall be deemed void, but this shall not affect any other provision of the agreement. The arbitral tribunal found that the remainder of the agreement was breached and awarded damages to the claimant for such infringements.¹⁵⁴²

However, the decision maker's reasoning may show the indications of arbitrariness, when he attempts to formulate and impose a positive right or obligation on a party on the basis of the applicable mandatory rule or public policy standard, which only directs him to disregard a contractual term or a provision of the applicable law. In ICC Case No. 1803, the sole arbitrator, sitting in Switzerland, applied the Swiss public policy exception in order to disregard applicable rules of the host state, which dissolved the state entity that was party to an agreement with a foreign investor without accepting responsibility for its liabilities. The arbitrator considered this as a flagrant abuse of right and irreconcilable with Swiss public policy. However, the arbitrator not only exclude the application of those rules, but also considered the host state as a successor to the state entity and ordered the host state to be joined as second respondent to the arbitral proceedings on the basis of Swiss public policy, as the arbitrator understood it.¹⁵⁴³ The award was annulled by the Swiss Federal Tribunal on the ground that, because of the negative function of the Swiss public policy exception, the arbitrator could not take it as a basis for compelling the host state to submit itself to the arbitral procedure against its will and failing a universal succession or specific provisions of law in terms of Swiss private international law referring to the law of the state in which the legal entity has its seat. The Federal Tribunal rejected the appellant's argument that international public policy precluded the application of the relevant rules of the host state, since the appellant did not give any indication as to how to ascertain international public policy. The Federal Tribunal also stressed that this decision did not imply either recognition or approval by the Swiss authorities of the means the host state aimed at withdrawing itself from the liabilities of the state entity.¹⁵⁴⁴

¹⁵⁴¹ ICC Award in Case No 8626, 1996, ICC International Court of Arbitration Bulletin, 14-2 (2003), at 58

¹⁵⁴² ICC Award in Case No. 10660, 2000, ICC International Court of Arbitration Bulletin, 14-2 (2003), at 66

¹⁵⁴³ ICC Award in Case No. 1803, 1972, Yearbook Commercial Arbitration, 5 (1980), at 177 et seq.

¹⁵⁴⁴ Tribunal Federal, May 5 1976, concerning an award made in ICC Case No 1803, Yearbook Commercial Arbitration, 5 (1980), at 219-220

When the relevant mandatory rule or public policy value prescribes the invalidity of the contract or its certain provisions, the traditional approach of the national legal systems denies restitution and leaves the parties in whatever position had been achieved at the time the invalidity was recognized even though this will result in a benefit to one of them.¹⁵⁴⁵ In ICC Case No 10704, the tribunal was of the opinion that the duration of seven years set out in the non-compete clause was excessive and that the clause should fall under EU law. The tribunal rejected the claimants' claim for compensation, which was based on the argument that any re-negotiation of the non-compete clause will have the effect of reducing the value of their purchase. The tribunal put forward two reasons for this rejection. Firstly, according to the tribunal, the competition clause was the fruit of both parties' labors, so that "[Claimants]' 'hands' are also tainted by the illegality of the non-compete clause and consequently they may not now seek to claim compensation under this heading." Secondly, the tribunal maintained that the illegality of the non-compete clause was based on the rules of Community and French public order, and compensation was not available as a result of their application.¹⁵⁴⁶

The traditional approach of the legal systems to the consequences of illegality has also been accepted by the arbitral tribunals where the contracts violated the contents of transnational public policy. In ICC Award No. 1110 of 1963, Judge Lagergren, as the sole arbitrator sitting in France, declined jurisdiction with regard to the dispute arising from an agreement whereby a British company was to pay an Argentine engineer commissions as a percentage of the price of the electrical equipment contract to be concluded between the company and the Argentine authorities. The arbitrator found that the major part of the commissions to be paid to the engineer were to be used for bribes. The arbitrator accepted the witness statement that, during the relevant period, everyone wishing to do business in Argentine was faced with the question of bribes, and the practice of giving commissions to persons in a position to influence or decide upon public awards of contracts seemed to have been more or less accepted or at least tolerated in the Argentine at that time. However, the arbitrator referred to the destructive effect of the violation of the prohibition of bribery and stated that: "... it cannot be contested that there exist a general principle of law recognized by civilized nations that contracts which seriously violate bonos mores or international public policy are invalid or at least unenforceable and that they cannot be sanctioned by courts or arbitrators. This principle is especially apt for use before international arbitration tribunals that lack a 'law of the forum' in the ordinary sense of the term.... such corruption is an international evil; it is contrary to good morals and to an international public policy common to community of nations." The arbitrator concluded that "a case like this, involving such gross violations of good morals and international public policy, can have no countenance in any court either in the Argentine or in France or, for that matter, in any other civilised country, nor in any arbitral tribunal. Thus, jurisdiction must be declined in this case... in concluding that I have no jurisdiction, guidance has been sought from general principles denying arbitrators to entertain disputes of this nature rather than from any national rules on arbitrability."¹⁵⁴⁷

¹⁵⁴⁵ Bonell, Michael Joachim, *The New Provisions on Illegality in the UNIDROIT Principles 2010*, Uniform Law Review, (2011), at 532

¹⁵⁴⁶ ICC First Partial Award in Case No 10704, 2000, ICC International Court of Arbitration Bulletin, 14-2 (2003), at 74

¹⁵⁴⁷ ICC Award in Case No. 1110, 1963, *Yearbook Commercial Arbitration*, (1996), at 47-53

Thus, Judge Lagergren held that the arbitrator should deny his jurisdiction from the beginning, since a contract that violated morality and transnational public policy should not be subject to an arbitral award that could be enforced under the New York Convention. Since the 1980s, however, there has been consensus in the arbitral practice that the severability doctrine applies also in the considerations of transnational public policy, and this practice reflects a growing confidence in international arbitration as an instrument to protect transnational public policy.¹⁵⁴⁸ Thus, since ICC Case No 1110, the contracts tainted by bribery have been held to be invalid, following the traditional solution of the national legal systems, providing that no party may reclaim what it has rendered to the other party if aware that its performance was illegal. In ICC Case No 3916, the claimant was to assist the defendant through his information, advice and actions in obtaining orders from various Iranian authorities. The claimant successfully obtained several contracts from the Iranian Government for the defendant. However, the defendant paid only a portion of the promised commissions to the claimant. After finding that French law applied, the arbitrator concluded that corruption was contrary to both French and Iranian law as well as morality in international business. The arbitrator referred to ICC Case No. 1110 and stated that civilized nations recognize the legal principle that agreements that seriously breach acceptable standards of behavior or international public order are void and cannot be enforced, even if in certain countries corruption of public officials is generally accepted as a way to conduct business affairs. After admitting the evidence of bribery,¹⁵⁴⁹ the arbitrator dismissed the claimant's claim for the unpaid amount of his commissions.

In the first Hilmaron award in ICC Case No 5622, which involved an agreement under which the claimant was to give legal and fiscal advice to the defendant and coordinate its subcontractors, thereby helping defendant obtain the contract with the Algerian authorities, the arbitrator reviewed ICC Case No.1110 and ICC Case No. 3916, and stated: "In the first case, having found that the contract, and consequently the arbitral clause, was null and void, Lagergren held that he had no jurisdiction, finding that the dispute was not arbitrable. In the second case, the arbitrator held that he had jurisdiction by applying the principle, now universally accepted, that the nullity of the main contract does not imply ipso iure the nullity of the arbitral clause... In the present case, this second solution has consequently been followed by the arbitral tribunal. Also, its jurisdiction is not invalidated by the Protocol of Agreement being declared null and void." Although the agreement provided that Swiss law was the applicable substantive law, the arbitrator held that the law of Algeria had been violated since it was proven that the claimant had engaged in trading in influence, which was prohibited by Algerian law to guarantee fairness in the allocation of government contracts and to ensure that contractual partners with the government were chosen on the basis of objective criteria. The arbitrator concluded that the "Law of Algeria lays down a general principle which must be respected by all legal systems wishing to fight corruption. This is why the violation of this Law, which concerns international public policy, is contrary to the notion of morality based onSwiss public policy. Hence the brokerage contract is null and void in its entirety." Accordingly, the arbitrator denied both claimant's claim and defendant's request for compensation.¹⁵⁵⁰

¹⁵⁴⁸ Raeschke-Kessler, Hilmar, & Dorothee Gottwald, Corruption in Foreign Investment - Contracts and Dispute Settlement between Investors, States, and Agents, *Journal of World Investment & Trade*, 9-1 (February 2008), at 26

¹⁵⁴⁹ ICC Award in Case No 3916, *Collection of ICC Arbitral Awards*, Vol. I (1974-1985), at 507-511

¹⁵⁵⁰ ICC Award in Case No. 5622, 1988, *Yearbook Commercial Arbitration*, (1994), at 105 et seq.

In ICC Case No 6248, according to the contract underlying the dispute, the claimant, acting as consultant for defendant, was to assist the defendant in trying to secure saving on costs of a construction project and in acquiring extensions of the total value of the project in the form of additional works such as variations and change orders. The claimant's compensation was fixed at a certain sum, being the "gross maximum compensation". The claimant claimed the amount of the gross maximum compensation as well as additional sums from the defendant in the arbitral proceedings. The defendant alleged that the claimant was nothing other than a post office box address providing cover for the improper activities of Mr. Z, the principal of the architectural firm. The defendant had contracted with a "Group" to construct the project, and the Group had entered into a Supervision Contract with another architectural firm, where Mr. Z was a partner, as its engineering consultant on the project to supervise defendant's performance. Mr. Z was personally involved in the performance of the Supervision Contract whenever important matters were discussed with the Group. According to the defendant, Mr. Z, under the cover of claimant, abused his position as consultant to the Group, to extort payments from the defendant for his private gain instead of acting exclusively in the interest of the Group and, thus, the Agreements were null and void as being contrary to bonos mores. Since arbitrability had been previously denied in ICC Case No. 1110 in similar circumstances, the arbitral tribunal decided to analyze its jurisdiction. The tribunal referred to Article 8(3) of the ICC Rules and Article 178(3) of the Swiss Private International Law Act and stated that "the validity of an arbitration agreement cannot be contested on the ground that the main contract may not be valid. This principle of severability has long been recognized not only generally, but also specifically with respect to main contracts which were found void on the ground of a violation of good morals and public policy." Thus, the arbitral tribunal decided that it had jurisdiction over the case and eventually found the contract null and void. The tribunal stated that "Although defendant participated in the conclusion of the immoral contract and took advantage of claimant's activities, it is - contrary to claimant's opinion - not estopped from invoking the nullity by the general provisions in Art. 2(2) [the Swiss Civil Code] (abuse of a person's rights)." Consequently, the tribunal rejected the claimant's claim in its entirety.¹⁵⁵¹

Thus, rather than rejecting jurisdiction to hear the dispute, the arbitral practice generally follows the traditional solution in cases of illegality, by denying any claims for restitution, performance or compensation and leaving the parties in whatever position had been achieved at the time the illegality was recognized (*ex turpi causa melior est conditio possidentis*). This solution is based on the idea that corruption is illegal and/or immoral, so that the courts or arbitral tribunals should not lend their jurisdictional power to enforce contracts infected by it.¹⁵⁵² In ICC Case No. 3913, the arbitral tribunal found that the parties had a common illicit intention for bribery. The arbitral tribunal pointed out that the international business community and the majority of governments oppose all such corrupt practices. This led to the conclusion that the consultancy agreement between them was null and void, and that no party should have the right to claim back what it paid. According to the tribunal, the parties cannot claim the enforcement of contract or compensation for damages resulting from its non-enforcement, or the restitution or the funds paid or any advance payments made as part of its performance.¹⁵⁵³ In ICC Case No 5943, the arbitrator held that if the agreement constituted a

¹⁵⁵¹ ICC Final Award in Case No. 6248, 1990, Yearbook Commercial Arbitration, (1994), at 124 et seq.

¹⁵⁵² Raeschke-Kessler, Hilmar, & Dorothee Gottwald, Corruption in Foreign Investment - Contracts and Dispute Settlement between Investors, States, and Agents, Journal of World Investment & Trade, 9-1 (February 2008), at 10

¹⁵⁵³ ICC Award in Case No 3913, Collection of ICC Arbitral Awards, Vol. I (1974-1985), at 497-498

breach of anti-corruption laws, as appeared to be the case, the claimant could not seek reimbursement under its contract. According to the arbitrator, it is a fundamental legal principle of all civilized nations that a payment made in breach of a criminal law cannot be reimbursed to anyone who has broken that law. The arbitrator determined that the agreement was void and dismissed the claim for payment or reimbursement under the contract.¹⁵⁵⁴ In ICC Case No 8891, the arbitral tribunal stated that the nullity of a contract of bribery has the result that the party who had benefited from the services of the other contracting party would be dispensed from the payment of the agreed price. According to the tribunal, although, this is undoubtedly an unpleasant result, it seemed unsatisfactory to legitimate the contract, by imposing a declaration of validity despite its illegal object and consideration.¹⁵⁵⁵ The ICSID case between World Duty Free Co Limited and Republic of Kenya involved corruption in high government offices as well as in the private sector. The tribunal stated that “In light of domestic laws and international conventions relating to corruption, and in light of the decisions taken in this matter by courts and arbitral tribunals, this Tribunal is convinced that bribery is contrary to the international public policy of most, if not all, states or, to use another formula, to transnational public policy. Thus, claims based on contracts of corruption or on contracts obtained by corruption cannot be upheld by this Arbitral Tribunal.” The tribunal concluded that “as regards public policy both under English law and Kenyan law (being materially identical) and on the specific facts of this case, the Tribunal concludes that the Claimant is not legally entitled to maintain any of its pleaded claims in these proceedings on the ground of *ex turpi causa non oritur actio*.”¹⁵⁵⁶

It has been questioned whether the traditional solution in cases of illegality arising from corruption is suited to complex international commercial transactions in the context of a foreign investment project. For instance, in a BOT (Build, Operate, and Transfer) project, a joint venture, or turnkey contract involving a state party, during or after realization of the investment, a dispute may arise between the parties about some conditions of the agreement. In such a scenario, typically, the host state has not honored its contractual obligations, and an important reason for the dispute has resulted from internal politics of the host state: a new government has recently come to power and is reviewing critically the acts of its predecessor government. For example, in a BOT project for supply of electricity, where a construction is completed, the plant is in operation, and the electricity produced is being sold to the state's utility company, the new government invokes the fact that the contract with the investor had not been concluded in a correct procedure but due to bribery of previous government members, and therefore contests the obligation of the host state to fulfill the contract. In such a scenario, it is suggested that the utility company or the state should not receive electricity for free, and the private investor should be entitled to a fair price, allowing it to refinance the project, even if bribery occurred when the project was put together.¹⁵⁵⁷ The basic premise of this suggestion is that the state should not profit from its own violation of international law through acts of bribery by avoiding any obligation resulting from a contract tainted by

¹⁵⁵⁴ ICC Award in Case No 5943, *Journal du droit international*, (1996), at 1014

¹⁵⁵⁵ ICC Award in Case No 8891, *Journal du droit international*, (2000), at 1076, 1083

¹⁵⁵⁶ *World Duty Free Co Limited v Republic of Kenya*, ICSID case No. ARB/00/7, Award of 25 September 2006, para. 157, 179

¹⁵⁵⁷ Raeschke-Kessler, Hilmar, *The UNIDROIT Principles in Contemporary Contract Practice*, Special Supplement, ICC International Court of Arbitration Bulletin: UNIDROIT Principles of International Commercial Contracts: Reflections on their Use in International Arbitration, 2002, at 104

corruption.¹⁵⁵⁸ Thus, it is argued that in such cases, an adaptation of the contract could be a preferable sanction, given that the illegal activities are normally sanctioned under penal law and there may be a public interest for the contract to remain valid; such as, the produced electricity in the BOT project example is needed by the state population. In this view, the general interest of the public in fighting the illegal activity and the interest of the parties involved in the contracts have to be balanced by the ex post decision maker considering the concrete circumstances of each situation, rather than the legislatures, opting for a rigid solution ex ante in declaring the contract generally void or valid.¹⁵⁵⁹ This view suggests that, the arbitral tribunal should divide the legal consequences of corruption reasonably between the parties and, in a way, split the difference between the parties.¹⁵⁶⁰

A situation of this kind arose in the dispute between the Hub Power Company (HUBCO) and Water and Power Development Authority (WAPDA) in Pakistan. The main agreement in the dispute was the Power Purchase Agreement (PPA) between HUBCO and WAPDA for the supply of electricity produced by a power plant at a water dam constructed by HUBCO. HUBCO sold the electricity to recoup its costs of construction and operation and to make a profit on the project within a specific time period. Amendments to the tariffs were made under the PPA, and executed under Bhutto's government. WAPDA's decision to enter into the amendments was challenged in a public interest litigation, which raised the accusation that HUBCO colluded with WAPDA in fixing an exorbitant tariff and requested that the some of the amendments be declared invalid and not binding on WAPDA. During the course of these proceedings, WAPDA notified HUBCO that the amendments were indeed void as they had been procured illegally without authorization and therefore were not binding on the grounds of fraud and corruption.¹⁵⁶¹ Particularly, the new government under Sharif alleged that the part of the tariffs raised by the amendments was used as kickbacks to the Bhutto family.¹⁵⁶²

HUBCO initiated arbitration proceedings pursuant the ICC arbitration clause in the PPA. However, the Supreme Court of Pakistan, in a majority decision, refused to enforce the arbitration agreement on the ground that the amendments were prima facie obtained by HUBCO in collusion with the concerned authorities of WAPDA and the high officials of the government who were in a position to exert influence on the WAPDA authorities through the payment of bribe and kickbacks. The majority held that the prima facie evidence in support of the allegations of fraud, illegality and corruption sufficed to preclude arbitration and the allegations constituted matters of public policy to be determined by the appropriate courts in Pakistan since, if proved, they would render the relevant documents as void. The majority

¹⁵⁵⁸ Raeschke-Kessler, Hilmar, & Dorothee Gottwald, Corruption in Foreign Investment - Contracts and Dispute Settlement between Investors, States, and Agents, *Journal of World Investment & Trade*, 9-1 (February 2008), at 12

¹⁵⁵⁹ Raeschke-Kessler, Hilmar, *Corrupt Practices in the Foreign Investment Context: Contractual and Procedural Aspects*, in Norbert Horn & Stefan Kröll (eds.), *Arbitrating Foreign Investment Disputes*, Kluwer Law International, 2004, at 489

¹⁵⁶⁰ Raeschke-Kessler, Hilmar, & Dorothee Gottwald, Corruption in Foreign Investment - Contracts and Dispute Settlement between Investors, States, and Agents, *Journal of World Investment & Trade*, 9-1 (February 2008), at 13

¹⁵⁶¹ Majeed, Nudrat B., *Commentary on the Hubco Judgment*, *Arbitration International*, 16-4 (2000), at 431 et seq.

¹⁵⁶² Raeschke-Kessler, Hilmar, *Corrupt Practices in the Foreign Investment Context: Contractual and Procedural Aspects*, in Norbert Horn & Stefan Kröll (eds.), *Arbitrating Foreign Investment Disputes*, Kluwer Law International, 2004, at 474

reasoned that the disputes between the parties were not of commercial nature arising from an undisputedly valid contract, the disputed documents did not bring into existence any legally binding contract between the parties, and the dispute primarily related to very existence of a valid contract and not a dispute under such a contract.¹⁵⁶³

The dissenting opinion of the minority on the other hand pointed out that the arrangement was the provision of electricity to WAPDA, and the PPA was a valid and entirely legal contract and its arbitration clause was not contrary to public policy.¹⁵⁶⁴ The minority was of the opinion that a subsequent amendment which was alleged to have been procured by fraud cannot, on any analysis, taint the PPA itself.¹⁵⁶⁵ According to the minority, allegations of invalidity, even serious allegations of ab initio invalidity, were perfectly capable of being referred to arbitration.¹⁵⁶⁶ The minority reminded that any award favorable to one party or another would obviously be brought to Pakistan for its execution and it would then be open for any one of the parties to raise a challenge as to its validity on any ground permissible under Pakistani law including public policy.¹⁵⁶⁷ In the end, the parties reached to a settlement outside judicial proceedings, pursuant to which, the purchase price for electricity produced by the HUBCO power plant to be paid by the Pakistani state agency was reduced and, in all other aspects, the main contract was confirmed as valid.

Essentially, the HUBCO case concerned an issue of partial illegality since the allegations of bribery were only related to the amendments made to the PPA, while the main agreement was generally considered to be valid. The issue of partial illegality is recognized by many national legal systems. Article 15:103 of the PECL provides that, if only part of a contract is rendered ineffective under Articles 15:101 or 15:102, the remaining part continues in effect unless, giving due consideration to all the circumstances of the case, it is unreasonable to uphold it. The issue of partial illegality is sometimes considered as leading to the questions of the adaptation of the contract in cases of illegality. The UNIDROIT Principles 2010 do not contain an explicit provision regarding the partial illegality. The earlier draft section on illegality contained a black letter rule on this issue. In the discussions of the Working Group, there were members in favor of providing maximum flexibility as to remedies in case of partial illegality, supporting a provision, which stated that “Where it is held that a contract is partially illegal... the Court may adapt the contract in such a manner as is reasonable in the circumstances of the case.” Some members of the Working Group even suggested extending this provision also to cases where the contract was illegal in its entirety. However, there was insufficient support for the provision and it was discarded.¹⁵⁶⁸ Moreover, the majority of the Working Group favored the view that there was no need of a special black letter rule on the partial illegality, but a reference in the Official Comments would be sufficient.¹⁵⁶⁹ Thus, the UNIDROIT Principles 2010 only mention this possibility in the Official Comments to Article 3.3.1 (2) covering the cases where the mandatory rule does not expressly provide for the

¹⁵⁶³ Hubco Judgment Transcript in the Supreme Court of Pakistan, *Arbitration International*, 16-4 (2000), at 458

¹⁵⁶⁴ *Ibid.*, at 452

¹⁵⁶⁵ Hubco Judgment Transcript in the Supreme Court of Pakistan, *Arbitration International*, Vol. 16, No. 4, 2000, at 452

¹⁵⁶⁶ *Ibid.*, at 455

¹⁵⁶⁷ *Ibid.*, at 456

¹⁵⁶⁸ Working Group see UNIDROIT 2008 - Study L - Misc.28, October 2008, paras. 197-214

¹⁵⁶⁹ UNIDROIT 2009 - Study L - Doc. 111 (rev.), 25-29 May 2009; For the discussion of the Working Group see UNIDROIT 2008 - Study L - Misc.28, October 2008, paras. 114-250

effects of its infringement upon the contract. The Official Comments provide that in such cases, notwithstanding the infringement of the mandatory rule, one or both of the parties may, depending on the circumstances of the case, be granted the ordinary remedies available under a valid contract (including the right to performance), or other remedies such as the right to treat the contract as being of no effect, the adaptation of the contract or its termination on terms to be fixed, and the latter kind of remedies may be particularly appropriate where as a consequence of the infringement only part of the contract becomes ineffective.¹⁵⁷⁰

Under *lex mercatoria*, the decision maker should consider the possibility of partial illegality and exercise his abstract reasoning as to the applicability of mandatory rules or public policy standards, to ascertain the specific aspects of the contract he considers to be contrary to relevant public policy considerations. However, there is much uncertainty, as to under which conditions, the decision maker should extend the exercise of balancing the relevant interests to the determination of the consequences of the found instances of illegality. It is argued that it would greatly facilitate the work of many arbitrators if the international restatements of contract principles were to include a set of transnational law rules.¹⁵⁷¹ The PECL and the UNIDROIT Principles 2010 contain rules that adopt a restitutionary flexibility with regard to the consequences of illegality.

Article 15:104 (1) of the PECL provides that when a contract is rendered ineffective under Articles 15:101 or 15:102, either party may claim restitution of whatever that party has supplied under the contract, provided that, where appropriate, concurrent restitution is made of whatever has been received. In the Official Comments to Article 15:104 of the PECL, it is stated that “In general, for reasons ranging from deterrence, punishment or protection of the dignity of the courts to a notion that parties to an illegal or immoral transaction have placed themselves outside the legal order, the national systems of Europe have commenced their analysis of this problem from the traditional basis of Roman law, which denied restitution and left the parties in whatever position had been achieved at the time the invalidity was recognised (*ex turpi causa melior est conditio possidentis*). But restitution, or unwinding the performances rendered under the illegal contract, appears to be a more appropriate response to the invalidity... Article 15:104 therefore provides a flexible regime for restitution of performances rendered under the ineffective contract.... Nevertheless the rule or principle rendering the contract ineffective is to be examined to see whether or not it requires denial of restitution.”¹⁵⁷² Article 15:104 (2) of the PECL provides that when considering whether to grant restitution under paragraph (1), and what concurrent restitution, if any, would be appropriate, regard must be had to the factors referred to in Article 15:102(3). Thus, the same considerations as those used under Article 15:102 to judge whether or not a contract should be invalidated, where the applicable mandatory rule does not expressly regulate that question, are to be applied to the questions whether there should be restitution and whether any concurrent restitution by the claimant is to be required.

Article 3.3.2 of the UNIDROIT Principles provides that where there has been performance under a contract infringing a mandatory rule under Article 3.3.1, restitution may be granted

¹⁵⁷⁰ Official Comment 5 to Article 3.3.1 of the UNIDROIT Principles

¹⁵⁷¹ Raeschke-Kessler, Hilmar, *The UNIDROIT Principles in Contemporary Contract Practice*, Special Supplement, ICC International Court of Arbitration Bulletin: UNIDROIT Principles of International Commercial Contracts: Reflections on their Use in International Arbitration, 2002, at 104

¹⁵⁷² Lando, Ole, Eric Clive, Andre Priim & Reinhard Zimmermann (eds.), *Principles of European contract law*. Part III, Kluwer Law International, 2003, at 223

where this would be reasonable in the circumstances, and in determining what is reasonable, regard is to be had, with the appropriate adaptations, to the criteria referred to in Article 3.3.1(3), which lists the factors that determine the reasonableness of the remedies where the mandatory rule does not expressly prescribe the effects of an infringement upon a contract.¹⁵⁷³ The Official Comment to Article 3.3.2 makes it clear that the availability of restitution first of all depends on the mandatory rule itself. It is explained in that, where the mandatory rule is silent on the issue, Article 3.3.2 adopts a flexible approach in line with the modern trend and, “contrary to the traditional view that, at least where both parties were aware or ought to have been aware of the infringement of the mandatory rule, they should be left where they stand, i.e. should not even be entitled to recover the benefits conferred, under the Principles restitution may or may not be granted depending on whether it is more appropriate to allow the recipient to keep what it has received or to allow the performer to reclaim it.”¹⁵⁷⁴ Under the UNIDROIT Principles, if restitution is granted under Article 3.3.2, it is governed with appropriate adaptations by the rules set out in Article 3.2.15 on restitution in the context of avoidance. Particularly, Article 3.2.15 (2) provides that if restitution in kind is not possible or appropriate, an allowance has to be made in money whenever reasonable.

Both the PECL and UNIDROIT Principles suggest the decision maker to consider the balancing factors contained in their respective provisions in deciding whether or not restitution should be allowed, where the effects of infringement are not expressly prescribed by the mandatory rule or public policy standard infringed. Thus, they limit the relevance of both adaptation and restitution as remedial options in deciding on the effects of infringement to those cases where the infringed mandatory rule or public policy standard is not clear about its consequences. The adaptation and restitution in cases of illegality reflect a concern for justice in the concrete circumstances of the case. However, the adaptation implies a very broad capacity for the allocation of residual contractual rights, obligations and risks, and the possibility of rewriting the contract between the parties. In such cases, in order to be able to adapt the contract, the decision maker should be authorized either by the terms of the contract, where the parties have expressed their intention to modify the contract in case of its invalidity and authorized the decision maker to adapt the contract in case of their failure to reach an agreement, or by the applicable mandatory rule or public policy standard. Despite the efforts of the doctrine, there is no established rule in the order of international commerce that grants such an authority to the decision maker, where the applicable rule or standard is unclear as to the consequences of illegality. Thus, in the absence of an authorization, the decision maker’s exercise of adaptation can be considered as an instance of equity *contra legem*, which may not serve the aim of accuracy in reflecting the reasonable expectations of the parties. To account for the particularities of the case, the decision maker should resort to his abstract reasoning in the considerations of partial illegality, which can be considered as an instance of equity *infra legem*, and restitutionary remedies, as equity *praeter legem*. Thus, restitution in cases of

¹⁵⁷³ The first illustration in the Official Comments to Article 3.3.2 describes a case where the contractor A of country X enters into an agreement with agent B under which B, for a fee of USD 1,000,000, would pay USD 10,000,000 to C, a high-ranking procurement advisor of D, the Minister of Economics and Development of country Y, in order to induce D to award A the contract for the construction of a new power plant in country Y. It is stated that if A, having been awarded the Contract, had almost completed the construction of the power plant when in country Y and a new Government comes to power which claims that the Contract is invalid because of corruption and refuses to pay the outstanding 50% of the price, it would not be fair to let D have the almost completed power plant for half the agreed price. In such circumstances, the Official Comments suggest that A may be granted an allowance in money for the work done corresponding to the value that the almost completed power plant has for D and D may be granted restitution of any payment it has made exceeding this amount.

¹⁵⁷⁴ Official Comment 1 to Article 3.3.2 of the UNIDROIT Principles

illegality should be available to the extent the applicable mandatory rule or public policy standard does not deny it. Accordingly, only where the denial of restitution is not explicit or implicit, the decision maker applying *lex mercatoria* can extend his abstract reasoning in the determination of the conditions of illegality to the determination of the restitutionary consequences of the found instances of illegality.

It is argued that there is no transnational consensus on the legal consequences of corruption as far as the invalidity of the contract is concerned.¹⁵⁷⁵ However, the international community has achieved a far-reaching anti-bribery consensus, which has become part of not only external, but also transnational public policy, given the “large costs” of corruption for economic development as including less competition, less foreign direct investment, lower tax revenues, lower public spending on health and education and a loss of legitimacy of the state with a consequent loss of capacity to provide institutions that support markets.¹⁵⁷⁶ Thus, the international community focuses on the detrimental effects of the corruption on the society in which it takes place. Even if some consider that the mandatory rules in the order of international commerce are unclear as to the consequences of illegality on the ground of corruption, the position of international community clearly indicates that the corrupt business practices must be deterred in order to avoid the costs of corruption for economic development of the host states. Accordingly, the arbitral practice has consistently favored the traditional solution of the national legal systems by rejecting any contractual claim for compensation or restitution in cases of bribery. In ICC Case No 6497, the tribunal even stated that “If the bribery nature of the agreements would be demonstrated, such agreements would be null and void ... the result of such nullity is not necessarily equitable. The enterprise having benefited from the bribes (i.e., having obtained substantial contracts thanks to the bribes) has not a better moral position than the enterprise having organised the payment of the bribes. The nullity of the agreement is generally only beneficial to the former, and thus possibly inequitable. But this is legally irrelevant.”¹⁵⁷⁷

However, adaptation of the contract between the host state and the foreign investor, or restitution of the benefit obtained by the host state to the investor by the *ex post* decision maker in cases of illegality where the investor has performed the major part of its obligations, may weaken the effect of such deterrence on the part of the foreign investors from engaging in such practices in countries where the corruption is high if they believed that they would be able to obtain some form of compensation despite the corrupt activities. In contrast, it is argued that the host states would be encouraged to accept bribes if they know that by invoking the bribery at a later stage they are able to shift the entire loss resulting from the illegal transaction to the foreign company due to the denial of restitution.¹⁵⁷⁸ Essentially, the consistency of arbitral practice in denying any form of compensation or restitution in cases of bribery implies a clear risk allocation that may curtail such corrupt business practices, by

¹⁵⁷⁵ Raeschke-Kessler, Hilmar, & Dorothee Gottwald, Corruption in Foreign Investment - Contracts and Dispute Settlement between Investors, States, and Agents, *Journal of World Investment & Trade*, 9-1 (February 2008), at 11

¹⁵⁷⁶ Cremades, Bernardo M., & David J.A. Cairns, Trans-national Public Policy in International Arbitral Decision-Making: The Cases of Bribery, Money Laundering and Fraud, in *Dossier of the ICC Institute of World Business Law: Arbitration - Money Laundering, Corruption and Fraud*, ICC Publication No. 651, 2003, at 67-69, 76

¹⁵⁷⁷ ICC Award in Case No. 6497, *Yearbook Commercial Arbitration*, (1999), at 72

¹⁵⁷⁸ Bonell, Michael Joachim, The New Provisions on Illegality in the UNIDROIT Principles 2010, *Uniform Law Review*, (2011), at 534-535

detering the investors, who are inclined to engage in such practices, in line with the aims of international community and, thus, prevail over the uncertainties to be created by the adoption of the mechanisms of adaptation and restitutionary flexibility in those cases. According to this risk allocation, when the investor engages in such corrupt activities to obtain a contract and, then, substantially performs under that contract, it assumes the risk of non-compensation for its investment, when it is invalidated on the ground of corruption, even if the host state raises this issue later and wishes to retain the benefits of that performance without any reasonable compensation by declaring the contract to be null and void at such late and advanced stage of the relationship between the parties.

On the other hand, in state party disputes, the decision maker may demand a higher standard of proof for the evidence of illegal activity, rather than relying on the usual standard of proof.¹⁵⁷⁹ The arbitral tribunal in *Himpurna v. PLN* case stated that “When a country’s reputation as a contractual partner suffers, the terms on which it is able to attract foreign investment and financing are impaired. ... an over-readiness by international arbitrators to

¹⁵⁷⁹ In corruption cases, some tribunals required a higher standard of proof. It is even argued that “there is no uniform standard of proof regarding allegations of corruption in international arbitration, even though it is fair to say that the standard is rather high.” Wilske, Stephan, & Todd J. Fox, *Corruption in International Arbitration and Problems with Standard of Proof: Baseless Allegations or Prima Facie Evidence?*, in Stefan Kroll, Loukas A. Mistelis, Viscasillas P. Perales, and V. Rogers (eds.) *International Arbitration and International Commercial Law: Synergy Convergence and Evolution - Liber Amicorum Eric Bergsten*, Kluwer Law International, 2011, at 496; In ICC Case No 6401, the arbitral tribunal held that the principle of “preponderance of the evidence” would apply for substantive claims. However, with respect to the allegation of corruption, the tribunal argued that pursuant to the laws of the Philippines and the United States (which were the relevant jurisdictions) a higher standard would apply: “[f]raud in civil cases must be proven to exist by clear and convincing evidence amounting to more than a mere preponderance, and cannot be justified by a mere speculation. This is because fraud is never to be taken lightly.” ICC Award in Case No. 6401, *Mealey’s International Arbitration Report*, 7-1 (1992), at 31, 34; In ICC Case No. 5622, i.e. *Hilmarton case*, the first tribunal demanded proof “beyond doubt”. The tribunal stated that “It is true that it is possible to prove something through indirect evidence... However, it is necessary that a sufficient ensemble of indirect evidence be collected to allow the judge to base his decision on something more than likely facts, i.e., facts which have not been proven ... Thus, evidence of bribery has not been given and the indirect evidence is not sufficiently relevant.” ICC Award in Case No. 5622, 1988, *Yearbook Commercial Arbitration*, (1994), at 111; In ICC Case No 7047, the tribunal stated that “If a claimant asserts claims arising from a contract, and the defendant objects that the claimant’s rights arising from the contract are null due to bribery, it is up to the defendant to present the fact of bribery and the pertaining evidence within the time limits allowed to him for presenting facts. The statement of facts and the burden of proof are therefore upon the defendant. The word “bribery” is clear and unmistakable. If the defendant does not use it in his presentation of facts an Arbitral Tribunal does not have to investigate. It is exclusively the parties’ presentation of facts that decides in what direction the arbitral tribunal has to investigate. If the claimant’s claim based on the contract is to be voided by the defence of bribery, the arbitral tribunal, as any state court, must be convinced that there is indeed a case of bribery. A mere “suspicion” by any member of the arbitral tribunal, communicated neither to the parties nor to the witnesses during the phase to establish the facts of the case, is entirely insufficient to form such a conviction of the Arbitral Tribunal.” Although sought to be “convinced” of the alleged fact, bribery, the tribunal also stated, earlier in the award, that “the language of the pertinent section of the Agreement exonerates the Claimant from any proof of its services... Combined with other circumstances, this provision might imply joint illicit intentions of the parties. However, the copies of the Claimant’s telefax letters to Defendant establish that Claimant did indeed render services...” ICC (Final) Award in Case No. 7047, 1994, *Yearbook Commercial Arbitration*, (1996), at 91, 93-94; In *EDF (Services) Ltd. v. Romania*, the ICSID tribunal stated that “corruption must be proven and is notoriously difficult to prove since, typically, there is little or no physical evidence. The seriousness of the accusation of corruption in the present case, considering that it involves officials at the highest level of the Romanian Government at the time, demands clear and convincing evidence. There is general consensus among international tribunals and commentators regarding the need for a high standard of proof of corruption The evidence before the Tribunal in the instant case concerning the alleged solicitation of a bribe is far from being clear and convincing.” *EDF (Services) Limited v. Romania* (ICSID Case No. ARB/05/13), Award (October 08, 2009), at para. 221

accept illegality defences may harm an international mechanism which benefits numerous countries that rely on access to international funding, technology, and trade”. The tribunal held that “The point is simply that there is a presumption in favor of the validity of contracts; that this presumption is healthy; that it is strengthened when contracts have provided the basis upon which many persons have acted over time: and that a finding of illegality or other invalidity must not be made lightly, but must be supported by clear and convincing proof.”¹⁵⁸⁰

It is argued that, in corruption cases, the usual standard and burden of proof should still be applied, for the equal treatment of the parties, since a higher standard of proof may give the claimant an unjust advantage given that the issue of illegality is normally invoked by the defendant that bears the burden of proof.¹⁵⁸¹ Some arbitral tribunals, dealing with corruption cases, applied the usual standard and burden of proof, according to which arbitrators consider a fact as proven if there is “preponderance of evidence”.¹⁵⁸² In those cases, given that straightforward evidence is rarely available, the arbitral practice developed some indications that are useful as circumstantial evidence for determining the “real” objective and content of the contract.¹⁵⁸³ There are some cases where the circumstantial evidence of bribery led to the illegality of the disputed contract between private parties.¹⁵⁸⁴ Even so, in the context of a

¹⁵⁸⁰ Ad hoc (UNCITRAL) Case, *Himpurna California Energy Ltd (Bermuda) v. PT. (Persero) Perusahaan Listrik Negara (Indonesia)*, Final Award, 4 May 1999, para. 169-171

¹⁵⁸¹ Raeschke-Kessler, Hilmar, & Dorothee Gottwald, *Corruption in Foreign Investment - Contracts and Dispute Settlement between Investors, States, and Agents*, *Journal of World Investment & Trade*, 9-1 (February 2008), at 20

¹⁵⁸² ICC Case No 4145 concerned an agreement between the claimant an entity from Middle East Country X and the defendant, a South Asian construction company, under which the defendant appointed the claimant as representative for the promotion and contracting of a project to construct a group of buildings in Country X. The defendant argued that the agreement was unenforceable under the law of Country X as well as under Swiss Law or under applicable principles of international public order, because the main purpose of the agreement was to influence the price of a government construction project by illegal means. The tribunal held that “The defendant’s accusation is not supported by direct evidence or even circumstantial evidence to be retained as convincing.” The tribunal stated that “In this respect, it must be stressed that, following general principles of interpretation (also recognized in Swiss Law...) a fact can be considered as proven even by the way of circumstantial evidence. However, such circumstantial evidence must lead to a very high probability. This is not the case in the present litigation.” ICC Award in Case No. 4145, *Yearbook Commercial Arbitration*, (1987), at 102

¹⁵⁸³ Scherer, Matthias, *Circumstantial Evidence in Corruption before International Tribunals*, *International Arbitration Law Review*, 5-2 (2002), at 29 et seq.

¹⁵⁸⁴ In ICC Case No 3916, the claimant was a former administrator of an Iranian Government department and, prior to his resigning from government service, the claimant had entered into the private sector and established a consulting firm. The claimant entered into a contract with the Greek defendant under which, the claimant was to assist the defendant through his information, advice and actions in obtaining orders from various Iranian authorities. The claimant was successful in obtaining several contracts from the Iranian Government for the defendant, but the defendant paid only a portion of the promised commissions to its Iranian partner. The arbitrator considered the widespread nature of corruption in Iran, the rapidity of the award of the contract, and the agent’s refusal to disclose information about its group structure and details about his activities as circumstantial evidence for the existence of a corrupt practice in the case. The arbitrator dismissed the claimant’s claim for the remainder of his commissions. ICC Award in Case No 3916, *Collection of ICC Arbitral Awards*, Vol. I (1974-1985), at 507-510; In ICC Case No 6497, the claimant was a consultant from Liechtenstein and the defendant was a German construction firm. The parties had entered into a number of consultancy agreements (“Basic Agreements”) over a ten year period in which the claimant provided services to the respondent to successfully obtain construction contracts in a number of countries including a certain Middle Eastern country X. Under the Basic Agreements, the claimant received 1.5% of the amounts received by the defendant under its construction contracts. In addition, the parties had a great number of specific “Product Agreements” providing additional obligations and remuneration to the claimant. As a result of both sets of agreements, the claimant’s remuneration over this period amounted to approximately 5.5% of the amounts received by the defendant. One

foreign investment project, a high standard of proof can be considered as a factor that not only protects the reputation of the host state in the international markets, given that the awards are widely publicized, but also reflects the interests of the investor, who performed its obligations substantially, by ensuring that the host state may not be able to rely on the usual standard and burden of proof to retain the benefits of that performance without paying any compensation to the investor. Accordingly, the host state will have to exceptionally document or evidence its corrupt practices with the foreign investor to be able to invoke the illegality at a later stage, at the expense of its international reputation.

particular agreement, Product Agreement Q, provided a commission of 33.33%. It did not describe the services to be rendered by the claimant. It simply stated that the commission was to be paid “for the performance of extraordinary services received in full” by the defendant. The claimant sought payment of the amounts due, while the respondent argued that no payments were due because the real objective of the agreements was to bribe officials in Country X. The tribunal considered the question of the standard of proof required to sustain the bribery allegation. The tribunal stated that “The ‘alleging Party’ may bring some relevant evidence for its allegations, without these elements being really conclusive. In such cases, the arbitral Tribunal may exceptionally request the other party to bring some counterevidence, if such task is possible and not too burdensome. If the other party does not bring such counter-evidence, the arbitral Tribunal may conclude that the facts alleged are proven (Article 8 of the Swiss Civil Code). However, such change in the burden of the proof is only to be made in special circumstances and for very good reasons.” The tribunal ruled that if the adversary failed to offer evidence in rebuttal, only “some relevant evidence” brought by the party alleging bribery could lead to a conclusion that the real object of the contract was bribery, although such evidence was not conclusive. After considering all of the evidence, the tribunal decided that it was not appropriate to shift the burden of proof onto the claimant with regards to the Basic Agreements and the majority of the Product Agreements since 5.5% of the global amount awarded to the defendant was not perceived as being abnormal for a consultancy agreement, without any bribery nature. However, the tribunal considered the commission of 33.33% under Product Agreement Q extraordinary and extremely unusual. The defendant requested from the claimant the production of banking documents relating to payments under several agreements, in particular for Product Agreement Q, to determine the destination of the payments. The claimant strongly objected on the basis that it would jeopardize its legitimate business secrets, but eventually agreed to produce the relevant documents, which showed that the payments made by respondent to claimant went into a transit account. The claimant’s and its witnesses’ further statements as to the details on these banking transactions were not satisfactory. The tribunal concluded that “Taking into account all circumstances, the arbitral tribunal considers (contrary to its decisions on all other agreements...) that there is a high degree of probability that the real object of Product Agreement Q was to channel bribes to officials in Country X who had the power to decide that both amounts mentioned in the Agreement were to be paid to respondent. Such probability is high enough for the arbitral tribunal to consider that such allegation presented by respondent is to be admitted.” The tribunal thus held that Product Agreement Q was null and void and the claim for this agreement was rejected. ICC Award in Case No. 6497, Yearbook Commercial Arbitration (1999), at 71 et seq.

iv. Concluding Remarks

Under *lex mercatoria*, the interpretation of the contract implies a contextual approach under the guidance of the basic principles for the ascertainment of the meaning of contract and the enforcement of the specific contractual rights, obligations and risk allocations of the parties in accordance with their common intentions. The understanding of common intentions of the parties under *lex mercatoria* is neither entirely subjective in the sense of the parties' inner intent, nor strictly objective in the sense of what the parties should have intended in reference to what a reasonable person would have intended. The decision maker should consider that, the circumstances pointing towards a common actual intention that deviates from the plain or reasonable meaning of the contract must be compelling to justify a deviation. Thus, the interpretation of contract under *lex mercatoria* should start with the text of the contract, requiring the decision maker to consider the contract as a whole together with its nature and purpose, i.e. the internal context of the contract. If the meaning may not be ascertained solely on the basis of internal context of the contract, the recognition of the significance of the individual case under *lex mercatoria* should require the priority of the extrinsic evidence relating to the subjective considerations. Where the decision maker cannot determine the common intentions of the parties solely on the basis of the subjective considerations, he should resort to the objective considerations, which will mostly be characterized by the reasonableness test of the decision maker. The materials that can be used by the decision maker resorting to the external context for the purposes of interpretation may be limited by the rules of interpretation of a particular national law, which is chosen by the parties as the applicable law, or by the rules of interpretation contained in the contract, but such limitations may be subject to the qualifying function of the basic principle of good faith and fair dealing under *lex mercatoria*. Where there is still doubt with regard to the common intentions of the parties despite the considerations of the internal and external context, the decision maker may resort to the interpretative presumptions in the form of established rules, which aid the interpretation of the contract.

The supplementation of contract under *lex mercatoria* primarily denotes the decision maker's application of implied terms through the contextual approach, which governs the interpretation of the contract. The decision makers applying *lex mercatoria* do not have to follow the requirements set by the national legal systems for the supplementation of the contract on the basis of the implied intentions of the parties, but may search for established rules that guide them in the supplementation of the contract with individualized terms, unless the national law chosen by the parties imposes such requirements, which the decision makers then have to apply as articulated rules and part of the bargain. In the supplementation of the contract with individualized terms, the activity of the decision maker shifts from the ascertainment of the meaning of the contract to the ascertainment of the content of contract. Such terms may precede all forms of default rules that address the generality of actions, regardless of whether they are applicable as established rules or on the basis of the choice of law analyses. Another means for the supplementation of the contract under *lex mercatoria* in a manner that precedes the application of the default rules are trade usages in the narrow sense. The particular provisions in the arbitration rules and laws, which require that arbitrators consider trade usages, release the arbitrators from the requirements for the relevance of trade usages established by the national legal systems, even if a national law is chosen by the parties to govern the substance of the dispute. Since those provisions do not guide the arbitrators as to which practices constitute trade usages in the narrow sense, the decision maker applying *lex mercatoria* may consider the CISG and the international restatements of contract principles as reflecting the established rules of *lex mercatoria* for determining the

relevance of such trade usages, which supplement the contract and prevail over the default rules of the applicable national laws.

Under *lex mercatoria*, the decision maker intervenes in the contract and determines the limits of the principle of freedom of contract in the order of international commerce on the basis of the established rules. *Lex mercatoria* enables such an intervention without impairing the confidence of the elements of the order of international commerce in the specialization of the decision maker in dealing with the legal uncertainty. The decision maker applying *lex mercatoria* should search for some form of correspondence between the actions that are taken by various national legal systems for the purpose of protecting their internal orders or the order of international commerce, which can be considered as having permeated the knowledge and expectations of the parties and become a source of *lex mercatoria* under the basic principle of good faith and fair dealing. The capacity of the decision maker in searching for such a correspondence can be based on an established rule of private international law that certain mandatory national laws may qualify as overriding or international mandatory rules and apply notwithstanding the parties' choice of law. Under *lex mercatoria*, this established rule is not only relevant to the determination of the applicability of the "foreign" mandatory rules, but also to that of the mandatory rules of the national law chosen by the parties to the extent they contradict with the terms or purpose of the contract. This rule enables a balancing exercise, which can be made in a particular case on the basis of an abstract consideration of the mandatory rules and public policy standards of the legal systems of the countries, where the award is made, where the contract is performed, of which the parties are citizens and alike. In this balancing exercise, the decision maker should initially consider the extent of the transaction's connection with the national legal systems containing mandatory rules or public policy standards relevant to the case. Subsequently, he should take into account both whether the mandatory rule or public policy standard being considered is an international one from the perspective of the state enacting it, and whether the application of the international mandatory rule or public policy standard, in respect of the issue at stake, is consistent with the established rules of policy.

The consequences of intervention of the decision maker in the contract should, in principle, be governed by the mandatory rule or public policy standard, which has been found to be applicable under *lex mercatoria*. In this regard, the decision maker should consider the possibility of partial illegality, and ascertain the specific aspects of the contract he considers to be contrary to relevant public policy considerations. Where the consequences of illegality are not expressly prescribed by the applicable mandatory rule or public policy standard, such as the contents of transnational public policy, the decision maker may extend the exercise of balancing the relevant interests to the determination of the consequences of the found instances of illegality. In such cases, to account for the particularities, the decision maker may resort to the restitutionary remedies, but should refrain from the adaptation of contract, which implies a very broad capacity for the allocation of residual contractual rights, obligations and risks, without an express authorization of the parties. The restitutionary remedies in cases of illegality should be available to the extent the applicable mandatory rule or public policy standard does not deny restitution. Thus, only where the denial of restitution is not explicit or implicit in the sense of a necessity to discourage certain activities in the order of international commerce, the decision maker applying *lex mercatoria* can extend his abstract reasoning in the determination of the conditions of illegality to the determination of the restitutionary consequences of the found instances of illegality.

The application of *lex mercatoria* to the substance of the dispute leads to the enforcement of the articulated and established rules in a particular case, both of which should contain the element of the parties' reasonable expectations in a particular case and their consent to be legally bound. The disturbance in the order of international commerce can only be avoided or remedied through the correspondence of the expectations of the contracting parties with those of other elements of the order. Thus, when interpreting or supplementing the contract through a contextual approach or intervening in the contract on the basis of public policy considerations, the decision maker applying *lex mercatoria* interprets, supplements and corrects not only the terms of the contract, but also the national laws applicable to the contract, in the process, not for the purpose of the development of the particular national legal systems, but for maximizing the possibility of expectations of the elements of the order being fulfilled, matched and not conflicting, in accordance with the basic principles of *lex mercatoria*.

