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The Curious Case of the 15 Professors — Claims Against Russia Under the Energy Charter Treaty



by Markus Esly

On 30 November 2009, an eminent international arbitral tribunal (Yves Fortier QC, Dr Charles Poncet and Judge Stephen Schwebel), sitting at the Permanent Court of Arbitration (“PCA”) in The Hague handed down three connected awards¹ that have generated great interest among arbitration practitioners and energy investors in Russia alike. These awards are of course the interim decisions on jurisdiction and admissibility in Yukos’s claims against the Russian Federation under the Energy Charter Treaty (“ECT”). The amount in dispute is rumoured to be around US\$ 100 billion, with the claims being brought following Yukos’s final liquidation in Russia at the end of 2007.

Until recently, one could only speculate as to why the arbitrators confirmed that the claims could proceed to the merits stage — that is not surprising, since arbitration is meant to be confidential. Starting in 2010, however, the arbitration community was being fed interesting morsels by Counsel for Yukos². In January, a five-page summary of the tribunal’s findings was released, describing the award as a landmark decision against Russia. Then, on 1 February, the main course was served in the form of the publication of the full

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¹ *Hulley Enterprises Limited (Cyprus) v. The Russian Federation* (PCA Case No. AA 226), *Yukos Universal Limited (Isle of Man) v. The Russian Federation* (PCA Case No. AA 227) and *Veteran Petroleum Limited (Cyprus) v. The Russian Federation* (PCA Case No. AA 228).

² Principally Emmanuel Gaillard, of Shearman & Sterling, Paris.

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award³, again (reportedly) through Yukos's Counsel. The awards were made public without agreement of the Russian Federation.

In this article, we explore the substantive issues the tribunal decided — principally, that Russia is still bound by the Energy Charter Treaty despite having rejected it by vote of the Duma (the Russian Parliament) terminating provisional application of the treaty earlier in 2009. The upshot is that Russia must now answer the Yukos claims, though Russia will no doubt deny them on the merits. Before the PCA tribunal, Russia fielded an impressive 13 professors of law as expert witnesses (as against 2 professors for Yukos). Even that combined academic might, however, was not enough to convince the tribunal that it did not have jurisdiction.

But there is also a somewhat wider issue that merits comment. Should investment treaty awards be published because they add to a growing body of jurisprudence, and do they have any value as precedent? Confidentiality is often hailed as one of the hallmarks of arbitration, or even its *raison-d'être*. Does the fact that “public” international law and relations between sovereign states and private investors are at the heart of these disputes require that awards are not only published, but also followed in later cases?

Is there a doctrine of precedent in investor-state arbitrations?

In the aftermath of the Yukos awards, one may ask: does this open the floodgates for ECT claims against Russia? Will the Russian Federation now have to give up all jurisdictional challenges due to terminating provisional applicability of the ECT? Yukos's Counsel commented on the publication of the award as follows:

“As you know, more and more awards are published and, in particular, transparency has become the rule in investment arbitration. Given the fundamental importance of the awards and their precedential value, we thought that they ought to be made available.⁴”

These two points — transparency and precedent — are linked. Without publication of decisions, no doctrine of precedent can develop or operate in practice. There would be no accessible body of law or jurisprudence to follow.

Of course, publication of investment treaty awards is nothing new. Awards under the International Convention for the Settlement of Investment Dispute (“ICSID”) have been

reported for a number of years now⁵, and they are frequently cited, or apparently applied, by tribunals in later decisions. However, in reality no principle of binding precedent, or *stare decisis* as it is known in common law, exists in ICSID or other investment treaty arbitrations. As one ICSID tribunal stated, ‘precedent’ in this context is really a matter of comparison of earlier awards, or perhaps one of “*inspiration*”:

“Each tribunal remains sovereign and may retain, as it is confirmed by ICSID practice, a different solution for resolving the same problem; but decisions on jurisdiction dealing with the same or very similar issues may at least indicate some lines of reasoning of real interest; this Tribunal may consider them in order to compare its own position with those already adopted by its predecessors...”⁶

Tribunals do, undoubtedly, read prior awards on similar issues and will not disregard them lightly. But they do not always follow them, and they certainly do not (or should not) consider that they are automatically bound to do so. There have been instances where tribunals reached differing conclusions on quite similar facts. Awards involving SGS as investor and Pakistan and the Philippines as respective host states illustrate this⁷. The tribunal in the Philippines case interpreted similar key provisions in a different manner, and noted:

“... although different tribunals constituted under the ICSID system should in general seek to act consistently with each other, in the end it must be for each tribunal to exercise its competence in accordance with the applicable law, which will by definition be different for each BIT and each Respondent State. Moreover there is no doctrine of precedent in international law, if by precedent is meant a rule of the binding effect of a single decision. There is no hierarchy of international tribunals, and even if there were, there is no good reason for allowing the first tribunal in time to resolve issues for all later tribunals.”

The ICSID Convention itself provides (in Article 53(1)) that an award is to be “*binding on the parties*.” Some tribunals⁸ and commentators have relied on this as supporting the view that an award made under the auspices of ICSID cannot be a binding precedent. After all, the jurisdiction of arbitral tribu-

⁵ See for instance the ICSID Reports published by Cambridge University Press.

⁶ *AES Corp v Argentine Republic* (Jurisdiction) ICSID Case No ARB/02/17 (2005).

⁷ *SGS Societe de Surveillance SA v Republic of the Philippines* (Jurisdiction) 8 ICSID Rep 515 (2005) and *SGS Societe de Surveillance SA v Islamic Republic of Pakistan* (Jurisdiction) 8 ICSID Rep 383 (2003).

⁸ See *AEA v Argentina*, and further *Amco Asia Corp v Republic v Republic of Indonesia* (Annulment) 1 ICSID Rep 509, 521 (1986).

³ It can be found on the Investment Treaty Arbitration (“ITA”) website, run by the University of Victoria Law Faculty — <http://ita.law.uvic.ca>.

⁴ See Global Arbitration Review, “*Yukos decisions published*,” Alison Ross, 1 February 2010.

nals in investment treaty arbitrations still derives from an offer by the host state, made to the investor, to arbitrate disputes — whether that is a standing offer made in an applicable Bilateral Investment Treaty (“BIT”) that is accepted by an investor once a dispute has arisen, or in a specific contractual arbitration agreement. It is a matter of privity between the parties, and nobody else.

The absence of a doctrine of precedent is consistent with the position of the most well-known tribunal in public international law. The Statute of the International Court of Justice (“ICJ”), Article 59, notes that “*The decision of the Court has no binding force except between the parties and in respect of that particular case.*”

Of course, where claims raise (virtually) identical issues — such as closely related investments giving rise to disputes against a host state — it often makes sense for both parties to have the claims heard together. The Yukos awards were handed down in three parallel arbitrations, all against the Russian Federation, by three technically separate tribunals consisting of the same arbitrators. The tribunal in the awards specifically noted that it was (paragraph 2 of the Yukos award):

“Mindful of the fact that each of the three Claimants maintains separate claims in separate arbitration proceedings that necessitate separate awards...”

Therefore, while there is no *de jure* doctrine of precedent in investment treaty arbitration, in the writer’s view in practice it will take quite a lot to get a tribunal to depart from prior decisions that are on point. A review of the Yukos award shows that it reads much like a judgment of a common law court, with citations from previous awards, and conclusions said to be ‘in harmony’ with other tribunals. Of course, one may comment that this is only a reflection of both the Yukos tribunal, and the earlier tribunals, deciding a particular point correctly. Nonetheless, anyone trying to convince a tribunal in an investment treaty arbitration to depart from a strand of received jurisprudence that is reflected in a number of awards will face an uphill struggle — though they may not be fighting an altogether lost cause.

The Yukos awards — relevant provisions of the Energy Charter Treaty

The Yukos proceedings are unrelated to ICSID: they concern claims under the ECT, governed by the UNCITRAL procedural rules. The claims arose out of the collapse of the Russian Yukos energy conglomerate. Yukos entered into final liquidation in November 2007, following what the claimants describe as a series of coordinated attacks on the business by the Russian Federation. Russia denies this.

The tribunal’s two key findings that we address in this article

relate to what constitutes an investor under the ECT, and how the ‘provisional application regime’ of the ECT operates and relates to a State’s sovereign immunity and its constitution.

But first a brief summary of the ECT and its most important provisions. The ECT is a multi-lateral treaty aimed at establishing a legal framework for co-operation between States in the energy sector, and for the promotion and protection of foreign investments in that field (made by nationals of contracting states in other contracting states). At this time, around 50 states have signed up to it. A crucial part of the scheme for the protection of investments is the mandatory arbitration provision found in Article 26 of the ECT in Part V (“*Dispute Settlement*”).

Under the ECT, an investment made by a qualifying investor in a host state that has accepted application of the relevant part of the ECT is entitled to protection under Part III of the ECT (“*Investment Promotion and Protection*”).

Unlike the ICSID Convention, the ECT contains definitions of both “*investment*” and “*investor*.” An “*investment*” is widely defined as including “*every kind of asset*” that is controlled, either directly or indirectly, by an “*investor*” — specifically including a company or business enterprise, and also any shares therein (Article 1(6)(b)). The ECT also tells us that an “*investor*” is someone who either has the nationality / citizenship of a signatory state, or is permanently resident in such a state (Article 1(7)(a)(ii)).

Article 45 of the ECT concerns provisional application of the ECT:

“(1) Each signatory agrees to apply this Treaty provisionally pending its entry into force for such signatory in accordance with Article 44, to the extent that such provisional application is not inconsistent with its constitution, laws or regulations. (emphasis added)”

Article 45(3)(a) of the ECT concerns the termination of provisional application of the Treaty:

“Any signatory may terminate its provisional application of this Treaty by written notification to the Depository of its intention not to become a Contracting Party to the Treaty. Termination of provisional application for any signatory shall take effect upon the expiration of 60 days from the date on which such signatory’s written notification is received by the Depository.”

Investor and investment — The “widest possible” definition and ‘treaty shopping?’

The Russian Federation argued that the Yukos corporate vehicles were not qualifying investors within the meaning, or at least the spirit, of the ECT since the capital behind the entire

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group was Russian, and not foreign. To use one of the three claimants as an example, Yukos Universal Limited was incorporated in the Isle of Man in 1997 and was a Manx company of good standing at the time the notice of arbitration was served. The other two claimants were in similar positions, their standing being attacked on essentially the same grounds by Russia — they were mere shell companies created to gain the protection of the ECT. Returning to the question of precedent touched on earlier, Yukos cited five prior arbitral awards in support of its position.

The tribunal found in favour of Yukos (from paragraph 411). On its face, the relevant provisions of the ECT contained no further requirements other than that the investor had to be a company incorporated under laws of a contracting state (in our example, the United Kingdom). The arbitrators noted that Article 31 of the Vienna Convention on the Law of Treaties (1969) required that treaties be construed based on the plain language used — rather than seeking to go behind the provisions of such an instrument to discover some other provision of public international law (perhaps customary and unwritten) that could have parallel application.

We noted at the outset that Russia relied on a number of eminent Professors. Some of them gave opinions on principles of international law that, it was said, should supplement the ECT. The tribunal, however, preferred the opinion of Professor Crawford SC, for the Yukos claimants, who emphasized that the ECT imposed no further requirements on an investor as regards its shareholding, management, business activities or anything else relating to a particular location. Neither was there, in his opinion, any principle of international law that circumscribed who could qualify as a foreign investor under a bilateral investment treaty⁹.

The tribunal accepted Professor Crawford's opinion, and cited a decision of a previous PCA tribunal sitting under UNCITRAL Rules — in *Saluka Investments BV (The Netherlands) v The Czech Republic* (17 March 2006):

“240. The Tribunal has some sympathy for the argument that a company which has no real connection with a State party to a BIT, and which is in reality a mere shell company controlled by another company which is not constituted under the laws of that State, should not be entitled to invoke the provisions of that treaty. Such a possibility lends itself to abuses of the arbitral procedure, and to practices of ‘treaty-shopping’ which can share many of the disadvantages of the widely criticized practice of ‘forum shopping’.

241. However that may be, the predominant factor which must guide the Tribunal’s exercise of its functions is the terms in which the parties to the Treaty now in question have agreed to establish the Tribunal’s jurisdiction. In the present context, that means the terms in which they have agreed upon who is an investor who may become a claimant entitled to invoke the Treaty’s arbitration procedures. The parties had complete freedom of choice in this matter, and they chose to limit entitled ‘investors’ to those satisfying the definition set out in [the relevant treaty]”

The tribunal further noted that other decisions, such as that in *Plama Consortium Limited v. Republic of Bulgaria*, 8 February 2005¹⁰, showed that it was simply sufficient to have a company incorporated under the law of a contracting state for the purpose of the bilateral investment treaty in question — “irrespective of who might own or control the investor.”

In the same vein, the tribunal went on to hold that legal ownership of shares, irrespective of beneficial entitlement or anything further, of an investment satisfied the requirements. So since the Manx company owned shares in the Yukos enterprise that was subject to liquidation in Russia, the requirements of Article 1.6 of the ECT were satisfied. Again, reading the ECT as it was written and not as it might have been written, the tribunal could find nothing that would allow it to investigate who was ultimately behind the off-shore investment vehicles. The arbitrators were alive to the point that Russia's signature of the ECT (at least as far as provisional application was concerned) would have been motivated by a desire to encourage Western investment, rather than giving Russian businessmen and new avenue of redress for Russian capital invested by them in local energy resources:

“434. If the States that took part in the drafting of the ECT had been asked in the course of that process whether the ECT was designed to protect — and should be interpreted and applied to protect — investments in a Contracting State by nationals of that same Contracting State whose capital derived from the energy resources of that State, it may well be that the answer would have been in the negative, not only from the representatives of the Russian Federation but from the generality of the delegates. The ultimate source of the investments at issue in the instant cases may be Russian. The fortunes of the “oligarchs” — a term constantly employed in the pleadings of Respondent which the Tribunal for its part repeats without pejorative intent — may derive from investments by Russians in Russian resources.

⁹ Yukos award, paragraph 408.

¹⁰ ICSID Case No. ARB/03/24, Decision on Jurisdiction, 20:1 ICSID Review 262.

435. *But, as the Tribunal noted earlier, the Tribunal is bound to interpret the terms of the ECT not as they might have been written so as exclusively to apply to foreign investment but as they were actually written.*"

The conclusion, therefore, is that an 'investor' has a good chance of taking advantage of treaty protection by incorporating a vehicle in a jurisdiction that is a contacting state vis-à-vis the host state for the desired investment — no matter who is pulling the strings in the background. The Yukos arbitrators were not willing to investigate beneficial ownership or any trust arrangement.

Provisional application of the ECT to the Russian Federation

Russia had signed the ECT on 17 December 1994, but had never ratified it by vote of the Duma, the Russian Parliament. The result of that was that Russia was not a full 'Contracting Party', and the ECT only had provisional application, in line with Article 45 set out above. On 20 August 2009 the Respondent terminated the provisional application of the ECT, by making a formal notification under Article 45(3)(a).

The first point on Article 45(1) — provisional application might be inconsistent with a state's constitution — was decided in Russia's favour. The tribunal found that Russia could, even after years of "stalwart and unqualified support," rely on the limitation that provisional application was, in fact, inconsistent with the Russian constitution. The arbitrators cited the test for estoppel set out in the ICJ's *North Sea Continental Shelf Cases*¹¹, which was then directly applied by the arbitrators to the facts:

"Applying the standard thus established by the ICJ, the Tribunal concludes that the present case does not satisfy the conditions for the existence of a situation of estoppel."

No estoppel could be raised against the Russian Federation, since Russia had never acted 'sufficiently clearly' to give up its right to rely on Article 45(1). Here, we find perhaps the tribunal's strongest expression of its view that there is precedent in international law.

Finally, the tribunal went on to hold that Article 45(1) required provisional application of the whole ECT, and not just certain limited provisions, including the arbitration provisions found in

¹¹ "[I]t appears to the court that only the existence of a situation of estoppel could suffice to lend substance to [the contention that the Federal Republic was bound by the Geneva Convention on the Continental Shelf] [...], — that is to say if the Federal Republic were now precluded from denying the applicability of the conventional régime, by reason of past conduct, declarations, etc., which not only clearly and consistently evidence acceptance of that régime, but also had caused Denmark or the Netherlands, in reliance on such conduct, detrimentally to change position or suffer some prejudice"

Article 26. That finding was again said to be "entirely consistent with" an earlier ICSID award in *Kardassopoulos v Georgia* (2006)¹² concerning the ECT: the ECT prevents a state from circumventing the principle of provisional application by using that State's domestic laws if the *principle of provisional application of treaties* itself is consistent with that State's legal system. Having reviewed all the evidence on Russian law that was submitted to the tribunal, the arbitrators were satisfied that there was nothing in Russian domestic law, or in its constitution, that would prohibit provisional application of the ECT.

Conclusion

Though Russia terminated provisional application of the ECT on 19 October 2009, the PCA awards suggest that all existing investments covered by the ECT might be protected by the ECT until 19 October 2029. That is important news for all investors. While there is no binding doctrine of precedent in international arbitration, it will take quite a lot of persuasive argument to get other tribunals, in other ECT claims against Russia, to depart from the decision in the Yukos awards, imposing a narrower view of who can be an investor. Investors filing claims should, however, expect that Russia will mount a jurisdictional challenge, which can be costly and can delay the merits stage of claims by a few years.

The claims currently awaiting substantive determination by the PCA arbitrators are not, of course, the only legal proceedings arising out of the Yukos insolvency. A final award in The Hague by Messrs Fortier, Poncet and Schwebel may not, in the event, be the first substantive decision on the merits of Yukos's claims. In April 2004, the Yukos interests lodged a reference with the European Court of Human Rights in Strasbourg, alleging that Russia's conduct amounted to an infringement of principles enshrined in the European Convention of Human Rights. After what appears to have been something of a procedural hiatus (perhaps due to the backlog of cases in Strasbourg), in January 2009 the European Court found that Yukos's claims could proceed and were (procedurally) admissible under the Convention. The hearing on the merits has now taken place, on 4 March 2010¹³, reportedly in less than half a day. It appears that at the March hearing, Yukos advanced claims for all the alleged losses — around US\$ 98 billion. It is not known when the Strasbourg judges might be expected to hand down their verdict. The existence of parallel proceedings brought under two different international treaties but concerning what seem to be the same alleged losses raises interesting questions of *res judicata*, jurisdiction or issue estoppel — something for a future edition of this newsletter. ☺

¹² ICSID Case No. ARB/05/18, Decision on Jurisdiction, 6 July 2007.

¹³ See for instance <http://news.bbc.co.uk/1/hi/8549226.stm>.

Contractual Interpretation — A Fresh Perspective?



By Melanie Willems

Contractual interpretation is often a vexed question. Contracts generate disputes. Part of the reason for this may simply be human nature. When things go wrong and money is on the line, positions can easily become entrenched.

Even the best drafters are not clairvoyant, and it is impossible to provide for every eventuality in commercial agreements. Agreements are usually the result of compromise. A party may sign on the dotted line when negotiations have produced wording they can live with, even though it may not be quite what they wanted, or be quite as clear as had been hoped for.

In this article, we look at how judges interpret commercial contracts. We go ‘back to basics’ to the fundamental principles of English law, with particular focus on how far English law goes in re-writing a commercial agreement, and the concept of ‘business common sense’.

Possible approaches to contracts in jurisprudence: a sliding scale

Of course ‘*pacta sunt servanda*’ (agreements must be kept) in virtually all legal systems, but how they are construed varies. The different possible approaches to interpretation can be illustrated on a sliding scale.

At the top end of the scale, one might place a strict, literal approach. A written contract means what it says. The meaning of words is a matter of language, which one can look up in a dictionary. Such an approach is purely objective. The subjective intention of the parties does not matter, if it was not recorded in writing. Grown-up commercial parties are held to their bargain, no matter if it seems unreasonable or even irrational.

At the bottom end of the scale is a purposive, or teleological, approach. The will of the parties, or to use the French term “*volonte des parties*,” is king. An agreement is the result of a meeting of their minds. The parties promised to each other to do certain things. A written contract is just an expression of the will of the parties. It may well be an imperfect expression. On this approach, the law investigates the actual state of mind of the parties — subjectively — to ascertain their common intention.

Where would English law sit on this sliding scale? The immediate reaction of many might be to place it quite near the top, since ‘the contract means what it says’ is a familiar sounding

phrase to someone with a common law background. But as we shall see, sticking strictly to the words on the page may not always give you the result that English law eventually reaches.

English law adopts an objective approach and stays close to the words in the contract

Lord Bingham’s famously succinct summary of the English law of contractual interpretation conveniently sums up the approach in our jurisdiction¹:

“To ascertain the intention of the parties the court reads the terms of the contract as a whole, giving the words their natural and ordinary meaning in the context of the agreement, the parties’ relationship and all the relevant facts surrounding the transaction so far as known to the parties. To ascertain the parties’ intentions the court does not of course inquire into the parties’ subjective states of mind but makes an objective judgment on the materials already identified.”

English law undoubtedly attaches a great deal of importance to the written contract. If the meaning of the words, then the parties are bound. The common law also sticks by its objective approach to determining what the parties intended. Calls for reform by the advocates of a move to a subjective test, aimed at finding out what the parties actually, in fact, intended were rejected by the House of Lords. In a recent decision, their Lordships confirmed that negotiations between the parties, prior to contract signature remain inadmissible as evidence under what is called the ‘exclusionary rule’. The court will not look at anything the parties said to each other about their contract before actually agreeing or signing it.

In *Chartbrook v Persimmon* [2009] UKHL 38, their Lordships rejected an appeal that the law should not turn such a blind eye. Their Lordships considered that in many cases, exchanges between the parties preceding the contract would be irrelevant and would not throw any light on what the contract meant, since the parties had not yet come to an agreement and might be at issue on any number of things. They might be trying to persuade each other. However, it cannot be denied that in some cases, excluding pre-contractual negotiations will mean that the court could not take something into account that was, in fact, known to both parties. Ultimately, excluding the negotiations was however justified on a practical basis². Lord Hoffmann’s conclusion meant that certainty carried the day:

“The rule may well mean, as Lord Nicholls has argued, that parties are sometimes held bound by a contract in terms

¹ *BCCI v Ali* [2001] 1 AC 251.

² Lord Hoffmann, mainly paragraphs 28 to 42.

which, upon a full 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.”

As their Lordships noted, the exclusionary rule is one area where English common law continues to differ from French civil law, which always looks for the actual, common intention of the parties and allows evidence of negotiations³. As Lord Hoffmann observed:

*“French law regards the intentions of the parties as a pure question of subjective fact, their *volonté psychologique*, uninfluenced by any rules of law. It follows 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...”*

The meaning of words, and what happens when the wrong word has been used

So we are left with the words in the contract. What do they mean? Lord Hoffmann’s seminal speech in *ICS v West Bromwich* [1997] UKHL 28 set out the principles of contractual interpretation. Like Lord Bingham reiterated four years later, Lord Hoffmann stressed that the meaning of words had to be construed in light of the factual background to the contract — or ‘factual matrix’. That background, or matrix, is always ascertained objectively. Subject to the exclusionary rule, it can include anything that could reasonably have been known to both parties. This idea of the factual matrix is fairly well known. What may not be so well known, however, is the notion that the factual matrix can require that words in the contract are not just to be given another, alternative meaning that they can bear, but are actually replaced by other words altogether. When that is appreciated, one might be tempted to take English law down a notch on the sliding scale.

A word in a contract may be capable of having two meanings, in the sense that both meanings appear in a dictionary. That word will be given the meaning that best fits with the background to the contract. But English law can go further than looking up meanings in dictionary. The fourth ‘Hoffmannian principle’ in *ICS v West Bromwich* emphasises that the law is not just concerned with the meaning of words

in isolation or found in a dictionary, but how they would have been understood by the audience of the speaker (or writer) — the other party to the contract, living in the same common factual matrix⁴ (our emphasis):

*“(4) The meaning which a document (or any other utterance) would convey to a reasonable man is not the same thing as the meaning of its words. The meaning of words is a matter of dictionaries and grammars; the meaning of the document is what the parties using those words against the relevant background would reasonably have been understood to mean. The background may not merely enable the reasonable man to choose between the possible meanings of words which are ambiguous but even (as occasionally happens in ordinary life) to conclude that the parties must, for whatever reason, have used the wrong words or syntax. (see *Mannai Investments Co. Ltd. v Eagle Star Life Assurance Co. Ltd.* [1997] 2 WLR 945)”*

So you *can* depart from the words actually written in the contract and substitute them for other words, if it is obvious that those other words were what the parties meant. Taking the liberty to borrow Lord Hoffmann’s example used at a recent seminar on the topic, assume someone is preparing to do the washing up after dinner, having returned from the office and still wearing a suit. That person’s partner says: ‘Why don’t you put on your umbrella?’ Of course, they meant to say ‘apron’, but still they are understood. The context, or the factual background or matrix, of the exchange provides the answer.

An illustration in the commercial context: choosing the right meaning

But how does this work in the commercial context? What if the contract in question has been drafted by lawyers (albeit perhaps imperfectly)? One would not expect the parties to have used blatantly the wrong word, as in the example given above. Yet even in the commercial arena, the judge can take out his red pen and alter the clause in question. That was emphatically affirmed by Lord Hoffmann in his swan song in *Chartbrook Ltd v Persimmon Homes* (his last speech before stepping down from the House of Lords).

Before turning to *Chartbrook* and the red pen of the judge, it is important to bear in mind the ‘fifth Hoffmannian principle’, that of business common sense, as explained by Lord Diplock in

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³ See for instance, French Civil Code, Book III, Title III, Chapter III, Section V: “Of the interpretation of agreements”: Art. 1156: “In interpreting agreements, one must seek what the common intention of the contracting parties was, rather than stopping at the literal meaning of the terms.”

⁴ *Mannai Investments Co. Ltd. v Eagle Star Life Assurance Co. Ltd.* [1997] 2 WLR 945, Lord Hoffmann had made the same point: “... another part is our knowledge of the background which enables us, not only to choose the intended meaning when a word has more than one dictionary meaning but also, in the ways I have explained to understand a speaker’s meaning, often without ambiguity, when he has used the wrong word.....”

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a well-known judgment some 25 years ago:

*“(5) On the other hand, if one would nevertheless conclude from the background that something must have gone wrong with the language, the law does not require judges to attribute to the parties an intention which they plainly could not have had. Lord Diplock made this point more vigorously when he said in *The Antaios Compania Neviera S.A. v. Salen Rederierna A.B.* 1985 1 A.C. 191, 201:*

“... if detailed semantic and syntactical analysis of words in a commercial contract is going to lead to a conclusion that flouts business commonsense, it must be made to yield to business commonsense.”

The Chartbrook case illustrates how this is applied in practice. Chartbrook entered into a deal with Persimmon, the house-builders. Chartbrook owned land in Wandsworth, South London. It wanted Persimmon to develop the site, by (after acquiring planning permission) constructing a mostly residential development on it. After construction, Chartbrook would grant long leases over units in the development, selling them as directed by Persimmon. Persimmon would get the bulk of the proceeds of sale, but Chartbrook would be entitled to a certain amount for the land. Everything went according to plan, the development was built, and units were being sold. Then the parties fell out over the price and what Chartbrook should get.

The contract contained a formula that was supposed to give you the price, but that formula was anything but clear. The ‘Price’ was to be the sum of the ‘Total Land Value’ and a ‘Balancing Payment’ payable to Chartbrook, all defined. It was that Balancing Payment, also known as the ‘Additional Residential Payment’ (“ARP”), that led to the falling out. The ARP was defined as⁵:

“ARP = 23.4% of the price achieved for each Residential Unit (“PRU”) in excess of the Minimum Guaranteed Residential Unit Value (“MGRUV”) less the Costs and Incentives (“CRI”).”

On closer inspection, one asks: ARP should be 23.4% of something, but 23.4% of what precisely? The words could be transcribed into mathematical formulae as follows:

$$ARP = 23.4\% \times (PRU - MGRUV) - C\&I \quad [\textit{Chartbrook's contention}]$$

Or, was ARP supposed to mean this:

$$ARP = ((23.4\% \times PRU) - MGRUV) - C\&I \quad [\textit{Persimmon's contention}]$$

Lord Hoffmann disagreed with most of the judges below him that the syntax of the words in the contract could offer any assistance. In commenting on the quality of the drafting, he “totally” disagreed with Court of Appeal who had thought that the formula was, in fact, unambiguous:

“84. In his brief judgment Rimer LJ quoted the definition of the ARP and observed in para 183: “There is nothing unclear, uncertain or ambiguous about that. It is clear, certain and unambiguous and its arithmetic is straightforward.” Tuckey LJ agreed. With profound respect to both of them, I totally disagree. The definition is obviously defective as a piece of drafting. ...

86. Treated acontextually, the formula “x per cent of A in excess of B” is undoubtedly ambiguous. It can mean $(x/100 \times A) - B$ or $x/100(A - B)$. If required to guess I would opt for the latter meaning, because the expression “in excess of” has been used rather than “less,” and to my mind “in excess of” suggests a focus on B as an integer and distances it from the percentage. But I readily accept that this would be little more than guesswork.”

Since the words in the contract could not help, Lord Hoffmann worked through a set of examples. Chartbrook’s contention, perhaps unsurprisingly, consistently gave a high ARP and so increased the price Persimmon would have to pay. Crucially, that was so even if the actual sale prices achieved for the properties were disastrously low. Persimmon’s construction, on the other hand, was based on the assumption that there was a trigger point at which the ARP would become a positive figure. That trigger came when the actual sale price for each unit multiplied by 23.4% gave a figure higher than MGRUV (the C&I that needed to be deducted was a relatively small sum).

On Persimmon’s construction, if the sale price for the units was exceptionally high, the ARP would give Chartbrook a modest additional payment. On Chartbrook’s case, however, even if the sale price was horrendously low (based on Lord Hoffmann’s review of a realistic or likely range of prices), it would be due £3 million ‘on top’ as a balancing payment. That, Lord Hoffmann found, was commercial nonsense and did not reflect the underlying structure of the bargain. His approach to interpreting the contract is instructive: comparing the contentions of the parties to see what the (hypothetical) results would be is a useful technique often employed by judges.

In *Chartbrook*, Lord Hoffmann was not dismissing one construction because there was a *reductio ad absurdum* and it

⁵ Additional abbreviations have been inserted into the definition for the reader’s convenience.

made no sense at all or was unworkable. He looked at the bottom line, and the purpose of the clause, and — one could say — applied his own commercial judgment to the clause. In reaching the conclusion that he did, he was evidently not concerned by the possibility that Persimmon might simply have agreed a very bad bargain. He could do so because the words in the contract were ambiguous, and business common sense became the deciding factor.

“Business common sense” — How far can you go in re-writing the contract?

One may ask why it needed the House of Lords to uphold Persimmon’s construction, and why many of the four judges below apparently remained oblivious to the commercial nonsense that Lord Hoffmann pointed out. It may be because, by their own admission, judges may not always be commercially astute⁶, and there is always room for error when faced with submissions from both parties that their construction makes perfect commercial sense while the rival meaning is plainly ludicrous. In *Torvald Klaveness A/S v Arni Maritime Corp (The Gregos)* [1994] 1 W.L.R 1465 Lord Mustill made that point (page 1473):

“Naturally no judge will favour an interpretation which produces an obviously absurd result unless the words drive him to it, since it is unlikely that this is what the parties intended. But where there is no obvious absurdity, and simply assertions by either side that its own interpretation yields the more sensible result, there is room for error.”

Whether or not commercial absurdity is readily apparent or only emerges out of the fog of legal argument after one or two appeals, it is clear that English law allows the judges or arbitrators to not only to choose between alternative meanings of wording in a contract, but also to change the wording. In the hey-day of the *lex mercatoria*, the law of merchants, Lord Halsbury L.C. was quite emphatic that the purpose of the document was the overriding consideration. More than a century ago, in *Glynn v Margetson* [1893] AC 351, the Lord Chancellor said that one can reject “words, indeed whole provisions” if

these are inconsistent with the main purpose of the document.

In modern times, one would perhaps be surprised if a judge threw out an entire clause so to make the contract fit with the aim of the underlying transaction. But it is worth bearing in mind that at least in principle, even today there is no limit to the amount of re-writing judges can do as a matter of construction (rather than claiming rectification of a written document). In *Chartbrook*, Lord Hoffmann reviewed the authorities dealing with correcting or altering the language in the contract, and said (paragraph 25):

“What is clear from these cases is that there is not, so to speak, a limit to the amount of red ink or verbal rearrangement or correction which the court is allowed. All that is required is that it should be clear that something has gone wrong with the language and that it should be clear what a reasonable person would have understood the parties to have meant. In my opinion, both of these requirements are satisfied.”

Calls for restraint — when “a little” is “a lot”

Of course, that does not mean that *Chartbrook* is a call to arms for the judges to start re-writing commercial agreements to get a fairer result. Lord Hoffmann himself, when he was in the Court of Appeal, sounded a note of caution⁷ that was echoed by Neuberger LJ more recently⁸ (our emphasis):

“the surrounding circumstances and commercial common sense do not represent a licence to the court to re-write a contract merely because its terms seem somewhat unexpected, a little unreasonable, or not commercially very wise. The contract will contain the words the parties have chosen to use in order to identify their contractual rights and obligations. At least between them, they have control over the words they use and what they agree, and in that respect the words of the written contract are different from the surrounding circumstances or commercial common sense which the parties cannot control, at least to the same extent.”

Later on in the same judgment, Neuberger LJ however goes on to say that words can be given a strained meaning to avoid

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⁶ As Neuberger LJ noted in *Skanska Rashleigh Weatherfoil Ltd v Somerfield Stores Ltd* [2006] EWCA Civ 1732 “Judges are not always the most commercially-minded, let alone the most commercially experienced, of people, and should, I think, avoid arrogating to themselves overconfidently the role of arbiter of commercial reasonableness or likelihood. Of course, in many cases, the commercial common sense of a particular interpretation, either because of the peculiar circumstances of the case or because of more general considerations, is clear. Furthermore, sometimes it is plainly justified to depart from the primary meaning of words and given them what might, on the face of it, appear to be a strained meaning, for instance where the primary meaning of the words leads to a plainly ridiculous or unreasonable result.”

⁷ *Co-operative Wholesale Society Ltd v National Westminster Bank plc* [1995] 1 EGLR 97. Lord Hoffmann (referring to Lord Diplock’s famous quote in *The Antaios*): “This robust declaration does not, however, mean that one can rewrite the language which the parties have used in order to make the contract conform to business commonsense. But language is a very flexible instrument and, if it is capable of more than one construction, one chooses that which seems most likely to give effect to the commercial purpose of the agreement.”

⁸ *Skanska Rashleigh Weatherfoil Ltd v Somerfield Stores Ltd* [2006] EWCA Civ 1732

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a “plainly ridiculous or unreasonable result.” So a little unreasonableness means the judge should stay his hand, where a plainly unreasonable result should be avoided. While the sentiment expressed by Neuberger LJ may be sound, the passage is perhaps not as clear as it could be. It is difficult to think of any other legal test or concept that relies on different ‘grades’ of unreasonableness, where only unreasonableness of the “plain” variety satisfies it.

With all this talk of business common sense, one may ask: is there a test that governs when the contractual language can be altered? There, as the Court of Appeal recently noted. In *Lediaev (aka Vadim Ledyayev) v Vallen* [2009] EWCA Civ 156, the Court of Appeal described the following as a principle of construction that can allow introduction of new words into a contract⁹:

“It is not for a party who relies upon the words actually used to establish that those words effect a sensible commercial purpose. It should be assumed, as a starting point, that the parties understood the purpose which was effected by the words they used; and that they used those words because, to them, that was a sensible commercial purpose. Before the Court can introduce words which the parties have not used, it is necessary to be satisfied (i) that the words actually used produce a result which is so commercially nonsensical that the parties could not have intended it and (ii) that they did intend some other commercial purpose which can be identified with confidence. If, and only if, those two conditions are satisfied, is it open to the court to introduce words which the parties have not used in order to construe the agreement. It is then permissible to do so because, if those conditions are satisfied, the additional words give to the agreement or clause the meaning which the parties must have intended.”

That is not the same as the test of implying a term to ensure the contract has business efficacy (to prevent the contract from being unworkable). As a principle of *construction*, it stands beside the old *Moorcock* test¹⁰ which allows the *implication* of a term to give efficacy to a transaction — in other words, to make the deal work, and prevent “*such a failure of consideration as cannot have been within the contemplation of the parties.*” We all know that sufficient consideration can be found even in a small payment, and nobody would question the validity of a contract that is a “bad bargain” for one side on grounds of failure of consideration.

The Court of Appeal’s principle of implication is, it is sug-

gested, brought into play more easily than any term implied to give the contract business efficacy. It is still a potentially powerful tool, since it can introduce new words into the contract.

The last word from the Supreme Court

Having reviewed the law, it is important to take a step back. There are very few reported cases where the courts have in fact gone ahead and inserted new words into a contract to make business common sense. Generally, English law retains the certainty of written agreements between grown-up commercial parties being upheld. One recent example that has given some insolvency practitioners a headache is *In re Sigma Finance* case, decided by Supreme Court in October 2009¹¹. Lord Mance was construing a complex security trustee deed, and he had this to say about how to approach the interpretation exercise:

“... the resolution of an issue of interpretation in a case like the present is an iterative process, involving “checking each of the rival meanings against other provisions of the document and investigating its commercial consequences” ... I also think that caution is appropriate about the weight capable of being placed on the consideration that this was a long and carefully drafted document, containing sentences or phrases which it can, with hindsight, be seen could have been made clearer, had the meaning now sought to be attached to them been specifically in mind. Even the most skilled drafters sometimes fail to see the wood for the trees...”

Unless the words in the contract are crystal clear, the parties need to be prepared for the judge embarking on a review of the commercial consequences of “rival meanings,” and testing them against each other — even in a complex agreement drafted by experienced solicitors. In practical terms, it may therefore be advisable to explain the commercial aim of the contract in the recitals, since even if there is dispute about the precise meaning of the words, at least there will be a contemporaneous record of the commercial purpose. That is one way of reducing the element of uncertainty that will exist in all these types of disputes. ☺

⁹ First expounded in *City Alliance Ltd v Oxford Forecasting Services Ltd* [2001] 1 All ER (Comm) 233 by Chadwick LJ.

¹⁰ *The Moorcock* (1889) 14 PD 64

¹¹ *In re Sigma Finance Corporation* [2009] UKSC 2

A Tale of Faith, Powers and Sanctions — Reflections on *ReliaStar*



by Phoebe A. Wilkinson and
Thomas N. Pieper¹

In *ReliaStar Life Insurance Co. of New York v. EMC National Life Co.* (“*ReliaStar*”), 564 F.3d 81 (2d Cir. 2009), a U.S. appellate court in New York affirmed an award for attorneys’ fees, arbitrator’s fees and costs as a “sanction” for failing to arbitrate in good faith, despite a provision in the underlying contract that each party would bear its own expenses.



The Court held that the contract provision at issue – a version of the “American Rule” under which each party pays its own fees and costs – applied only as long as the parties had conducted the arbitra-

tion in good faith. Once the arbitrators found that a party had failed to do so, they were free to assess fees and costs against that party in order to “sanction” it, as the contract provision did not explicitly proscribe such powers in the context of such a finding of bad faith. While the decision involved a domestic U.S. arbitration seated in New York, it raises important issues for the international practitioner involved in New York arbitrations and potentially for disputes governed by New York law.

Factual and Procedural Background

At issue in *ReliaStar* were two identical coinsurance agreements between ReliaStar Life Insurance Company (“*ReliaStar*”) and EMC National Life Company, also known as National Travelers Life Company (“*National Travelers*”). Each contract specified that any disputes between the parties would be resolved by arbitration and that “[e]ach party shall bear the expenses of its own arbitrator . . . and related outside attorneys’ fees, and shall jointly and equally bear with the other party the expenses of the third arbitrator.”² The parties had agreed that any dispute would be resolved by New York law and, where applicable, the Federal Arbitration Act (“*FAA*”).

National Travelers initiated arbitration proceedings in connection with its desire to terminate the agreements. *ReliaStar*

opposed termination. In August 2006, following discovery and a two-week hearing, the arbitration panel entered an interim decision directing National Travelers to pay *ReliaStar* more than \$21 million past due under the coinsurance agreements. The majority of the panel, without explanation, also awarded *ReliaStar* its attorneys’ fees, arbitrators’ fees and costs. Following further briefing by the parties, the panel issued a final decision in October 2006, awarding *ReliaStar* \$3.2 million in fees and nearly \$700,000 in costs. The panel explained that it viewed National Travelers’ conduct in the arbitration “as lacking good faith.”³

The parties complied with all aspects of the award, except for the part that awarded *ReliaStar* fees and costs. *ReliaStar* petitioned a federal district court to confirm the final arbitration award, and in response, National Travelers moved to vacate the portion of the award regarding fees and costs, arguing that the award exceeded the arbitral panel’s authority in light of the contractual provision in which each party had agreed to bear its own expenses. The lower court, the United States District Court for the Southern District of New York, agreed with National Travelers and vacated the part of the arbitration award that had directed National Travelers to pay *ReliaStar*’s fees and costs. *ReliaStar* appealed.

The Appellate Decision

In a 2-1 decision the United States Court of Appeals for the Second Circuit reversed the lower court and remanded with the direction that the lower court enter a new judgment confirming the arbitration award in all respects. The Court reviewed whether the panel’s award of fees and costs exceeded the authority granted to it under the agreement, and determined it had not, for a number of reasons.

First, the Court found that the parties’ arbitration agreement was sufficiently broad to confer equitable authority on the arbitrators, who have discretion to “order such remedies as they deem appropriate,”⁴ including to sanction bad faith. The Court reasoned that such authority “inheres in the comprehensive arbitral authority,”⁵ even though the contract did not specifically integrate Rule 43 of the Commercial Rules of the American Arbitration Association (“[t]he arbitrator may grant any remedy or relief which the Arbitrator deems just and equitable within the scope of the agreement of the parties”), or otherwise explicitly confer such authority.⁶

Next, the Court analyzed the contract provision in which each party had agreed to bear its own expenses to determine

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¹ An abbreviated version of this article has been published in International Bar Association’s *Arbitration News*, Vol. 15 No 1, March 2010, pages 200-202.

² *ReliaStar*, 564 F.3d at 84.

³ *Id.* at 85.

⁴ *Id.* at 86.

⁵ *Id.* at 87 n. 2.

⁶ *Id.* at 87.

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if the parties had intended to limit the panel's authority to award fees and costs in the event the panel made a finding that a party had failed to conduct the arbitration in good faith. The Court acknowledged that arbitrators may not "exceed the power granted to them by the contract itself," but explained that the provision at issue restated the "American Rule" that each party would bear its own costs and fees, and pointed out that under New York law bad faith is a well-recognized exception to that rule.⁷ In addition, the Court noted that under New York law there is a "covenant of good faith and fair dealing" implicit in every contract, and hence, the provision prohibiting fee-shifting applied only so long as the parties arbitrated in good faith. Despite the absence of any mention of "good faith" in the contract, or any other evidence of the parties' intentions, the Court held that the section at issue "is fairly understood to reflect the parties' agreement as to how fees are to be borne . . . in the expected context of *good faith* dealings."⁸ In conclusion the Court held that a "more explicit statement would be necessary to manifest any intent to override the bad-faith exception to the American Rule and to preclude the arbitrators from awarding attorneys' and arbitrator's fees as a sanction for bad faith conduct."⁹

The Court rejected National Travelers' argument that the contract provision at issue would be superfluous if it were merely a restatement of the "American Rule." Instead, the Court countered that parties might choose to reference the "American Rule" for many reasons that have nothing to do with the arbitrator's sanction authority – for example, as a clarification for arbitrators who come from jurisdictions employing the "English Rule," under which a losing party can be directed to pay the arbitration fees and related costs.¹⁰ The Court emphasized that as sophisticated commercial entities, the parties could have clearly stated their intention to exclude an award of fees and costs from the broad range of sanctions generally available to arbitrators upon an identification of bad faith. Having failed to do so, the parties were bound by the arbitrator's award.

In dissent, Judge Pooler argued that the arbitral award "plainly contradicts an express and unambiguous term of the contract." Specifically objecting to the majority's reference to

an arbitrator's "inherent authority" to sanction bad faith, the dissent noted that the majority was disregarding and contradicting a basic governing principle of arbitration law – "an arbitrator's authority is circumscribed by the agreement of the parties . . . a consensual arrangement meant to reflect a mutual agreement to resolve disputes outside of the courtroom."¹¹ The dissent concluded that the contract provision stating that each party would bear its own costs and fees fully divested the panel of the authority to award such fees and costs as a sanction for bad faith.¹²

The Decision In Context

The Second Circuit's decision concerned a domestic case: This was a New York seated arbitration between two U.S. companies; New York law applied.¹³ This may explain why the Court readily declared the American Rule "generally applicable."¹⁴ In international arbitration this is not true. To the contrary, it is generally accepted that, as a default rule, the arbitrators are free to assess costs according to the circumstances of the case. The rules of the International Chamber of Commerce ("ICC"), International Centre for Dispute Resolution ("ICDR"), the London Court of International Arbitration ("LCIA") all provide that an arbitral tribunal has the authority to apportion costs and fees between the parties.¹⁵ So do the UNCITRAL rules.¹⁶ Article 28(5) of the ICDR Rules even specifically addresses the issue of awarding costs for bad faith conduct, noting that the normal waiver of punitive damages "does not

¹¹ *Id.* at 94 (citing *InterChem Asia 2000 Pte. Ltd. v. Oceana Petrochemicals AG.*, 373 F. Supp. 2d 340, 358 (SDNY 2005)).

¹² *Id.* at 90.

¹³ New York "follows the prevailing American Rule on fee-shifting, permitting an award of fees only where "specifically provided for by statute or contract." *Asturiana de Zinc Marketing, Inc v LaSalle Rolling Mills, Inc*, 20 F Supp 2d 670, 674 (SDNY 1998) (citation omitted). The New York state arbitral statute (modeled after section 10 of the 1955 Uniform Arbitration Act) provides that "[u]nless otherwise provided in the agreement to arbitrate, the arbitrators' expenses and fees, together with other expenses, not including attorneys' fees, incurred in the conduct of the arbitration, shall be paid as provided in the award." NY CPLR section 7513.

¹⁴ At 14.

¹⁵ See ICC Rule 31; ICDR Art. 31; LCIA Art. 23. — A federal court in New York has held that by using the ICC arbitration clause, the parties empower the arbitrators to award attorneys' fees. *Shaw Group, Inc v Triplefine Int'l Corporation*, 01 Civ 4273, 2003 US Dist. LEXIS 15578, at *8 (SDNY 5 September 2003). Conversely, in *CIT Project Finance, LLC v Credit Suisse First Boston LLC*, No. 600847/03, 2004 NY Misc LEXIS 2738 (Sup Ct NY County, 17 June 2004), the Supreme Court of New York vacated an ICDR award of attorneys' fees, holding that the parties' contractual choice of New York law meant that the arbitrators were subject to the American Rule, prohibiting the award of attorneys' fees absent explicit contractual or statutory authority.

¹⁶ UNCITRAL Rules, Arts. 38, 40. See *Willbros West Africa, Inc v HFG Engineering US, Inc*, No. H-08-2646, 2009 US Dist LEXIS 12362, at *17-18 (SD Tex 12 February 2009) (upholding attorney's fees award by UNCITRAL tribunal).

⁷ *Id.* at 88.

⁸ *Id.* (emphasis in the original).

⁹ *Id.* at 89.

¹⁰ *Id.* at 88. — As to the importance of an arbitrator's background and litigation training ("litigation baggage") see Oliver J. Armas and George Bundy Smith, "The Impact of U.S. Litigation," in: Carter/Fellas (ed.), *International Commercial Arbitration in New York*, Oxford University Press, New York 2010, pages 35-69.

apply to any award of arbitration costs to a party to compensate for dilatory or bad faith conduct in the arbitration.”¹⁷

This case should also be viewed in the context of decisions such as *Hall Street Associates LLC v. Mattel, Inc.*, 552 U.S. 576 (2008), which show that there are limits to what parties can contractually agree to in arbitration agreements.¹⁸ The parties may confer powers upon the arbitral tribunal only within the limits of the relevant laws.¹⁹ These laws, i.e. the law governing the arbitration agreement and the law governing the arbitration itself (*lex arbitri*) may limit the arbitrators’ powers or broaden them.

Finally, the decision should be considered in the context of the long-standing debate of “whose arbitration is it anyway?”²⁰ The parties’, the tribunal’s, or even the court’s? Perhaps understandably from its perspective, the Court relied on the arbitrators’ “inherent” powers. Since arbitration is a matter of contract, “implied” might be a more appropriate term, as the dissent points out. Similarly, the Court keeps referring to “sanctions.” The parties may confer (directly, in their arbitration agreement, or indirectly, by making reference to certain arbitral rules) a variety of powers to arbitrators,²¹ the law may confer additional powers.²² But an arbitrator, unlike a judge, does not possess the power, for instance, to hold a party in contempt or to compel the attendance of a witness he or she subpoenaed—here the arbitrator would need the assistance of the courts.²³ An arbitrator thus cannot “sanction” a party either, at least not in the sense of imposing a financial penalty or fine.²⁴ Part of an arbitrator’s mandate is to allocate costs in the final award (unless the parties expressly request that the arbitrator not assess costs at all). In doing so, he or she has to interpret the parties instructions in the arbitration clause. Supposedly, the arbitrators in *ReliaStar*

interpreted the underlying arbitration clause in a certain way, namely reading into it the “bad faith” exception that is typically part of the American Rule (when it applies). Finding a lack of good faith, the arbitrators were free to assess costs against that party; that merely means a finding that one party has caused the costs that the other side had occurred and thus should compensate the opponent accordingly. The Second Circuit correctly left that interpretation undisturbed, since the standard of review was limited to “clear error,” as long as a “barely colorable” argument can be made to support the outcome, an arbitral award has to be confirmed. Costs are no different from a finding on the merits in that respect.²⁵ In any event, the arbitrators awarded compensation for unnecessary fees and did not impose a “sanction.”²⁶

Lessons Learned for the International Practitioner

Although *ReliaStar* was a domestic arbitration, the reasoning and holding of the case could apply to an action seeking to vacate a New York “international” arbitration award, and potentially to any arbitration governed by New York law. As such, a New York court will likely uphold an arbitrator’s “sanction” for bad faith conduct, including attorneys’ fees, unless parties have clearly divested the arbitrator of such authority. If parties wish to limit an arbitrator’s authority to award fees as a “sanction” for bad faith, they must do so explicitly in their arbitration agreement. Of course, whether such a provision would be upheld could involve questions of public policy, and in any event might depend on the subject matter of the contract at issue, as, by way of example, New York’s Uniform Commercial Code specifically states that “the obligations of good faith . . . prescribed in this Act may not be disclaimed by agreement . . .”²⁷

But even if the court would uphold such a limitation, is this a sound or realistic option? Removing from the arbitrator the potential sword of assessing “sanctions” against one’s client also eliminates the shield against bad faith conduct by the other side. Moreover, if parties limit an arbitrator’s ability to award attorneys’ fees as a “sanction,” what are (and what should be) the consequences when one party fails to arbitrate in good faith? As the *ReliaStar* majority noted, “the underlying purposes of arbitration, i.e., efficient and swift resolution of disputes without protracted litigation, could not be achieved but for good faith arbitration by the parties.”²⁸

ReliaStar is a reminder that careful consideration must be

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¹⁷ ICDR Art. 28(5). Rules.

¹⁸ In *Hall Street*, the United States Supreme Court held that the judicial review provisions of the FAA are exclusive and that parties are not free to draft an arbitration provision which purports to give federal courts a broader scope for review of arbitration awards than that set forth in the FAA. — For the significance of the Hall Street decision, see Thomas N. Pieper, ‘Manifest Disregard of the Law’ After Hall Street — From One Circuit Split to the Next, *International Law Practicum* (NYSBA), Vol. 22, No. 1, Spring 2009.

¹⁹ See Alan Redfern & Martin Hunter, *Law and Practice of International Commercial Arbitration* § 5-04 (4th ed. 2004).

²⁰ See V. V. Veeder, “Whose Arbitration Is It Anyway: The Parties’ or the Arbitration Tribunal — an interesting question?,” in *The Leading Arbitrators’ Guide to International Arbitration*, 2nd ed., Lawrence W. Newman / Richard D. Hill (ed.), 2008.

²¹ Such powers typically include to determine the place and language of the arbitration, or to “run” the hearing.

²² For example, to administer oaths or to issue subpoenas.

²³ See Alan Redfern & Martin Hunter, *Law and Practice of International Commercial Arbitration*, § 5-07/08 (4th ed. 2004).

²⁴ As the dissent points out, citing *InterChem Asia 2000 Pte. Ltd.*, 373 F. Supp. 2d at 358.

²⁵ In fact, the costs claim could have been brought and adjudicated as part of the merits claim (in the same or a subsequent arbitration).

²⁶ The Court expressly states that National Travelers “has not challenged the fee award on the ground that it was punitive, rather than compensatory.” At FN 3.

²⁷ N.Y. U.C.C. § 1-102(3).

²⁸ 564 F.3d at 87.

given to the substantive law of the contract, as well as the arbitral law of the seat of the arbitration, which would be the likely venue for any challenge to or enforcement of the award. ☺

Arbitration in the Middle East — Any Silver Lining in Saudi Arabia?



By Robert Blackett

The economic crisis has hit the Middle East: the construction boom seems to have generated an arbitration boom — in both the construction industry and in investment disputes.

This article reviews recent developments and trends in Dubai and Saudi

Arabia, and outlines the legal regime governing arbitration in Saudi Arabia, which is less well-established and internationally recognised than its Dubai counterpart. As we will see, while there are reported problems with the enforcement of foreign awards in the Kingdom, there have been calls for reform on the arbitration front to cater for increased foreign investment in Saudi Arabia — although the economic downturn seems to have put these on the back-burner.

Recent developments in the Middle East

The world-wide ‘credit crunch’ may no longer dominate the news headlines as it did 18 months ago, but it has undoubtedly contributed to an economic downturn even in Middle East countries where in previous boom times, the sky had seemed to be the limit. Quite literally so, looking at Dubai’s Burj skyscraper, standing tall at 862m and completed as of January 2010. But not all construction projects in the region have had as happy an ending as that high-profile example.

Recently, Dubai’s Roads and Transport Authority has been embroiled in a standoff with an international consortium led by Japanese engineering companies over completion of the Dubai Metro project. While construction commenced again in early February 2010, newspaper reports suggest that the consortium members (which include Mitsubishi Heavy Industries and Kajima) were at one stage claiming between US\$ 2 and 3 billion in unpaid invoices.

Projects in Saudi Arabia appeared to have reached their nadir by in August 2009, when regional media publicised a report by a Dubai-based research agency claiming that about

80 projects with a total value of more than US\$ 20 billion were either on hold, or had been cancelled as a result of the economic crisis.

It would come as no surprise to anyone familiar with the construction industry to find that many of the contracts for these projects contain arbitration clauses. International arbitration in Dubai is fairly well-travelled path, with the Dubai International Arbitration Centre (“DIAC”) being a popular arbitral institution or host to proceedings. Also as of August 2009, an official with the DIAC reported that construction claims pending before DIAC tribunals were worth a total of US\$ 4.9 billion, with further increases in claims being predicted. It appears that further claims have indeed been filed since, with contractors becoming increasingly combative.

In contrast, arbitration in Saudi Arabia is less frequently encountered, and presents more of an unknown: there is no internationally recognised set of procedural rules, and the approach of the local judiciary to the enforcement of arbitral awards can be out of step with international standards and expectations. One high-profile example of a Saudi arbitration (details of which have been made public) is a real estate dispute between Emaar Properties PJSC, one of the world’s largest real estate companies, and Jadawel International. In late September 2008, arbitrators sitting in Saudi Arabia dismissed all of Jadawel’s claims, which had been for a total of US\$ 1.2 billion — more of that later. No doubt there are other large arbitrations in Saudi Arabia, although confidentiality makes it difficult to find out exactly who is arbitrating against whom.

Saudi Arabia — The legal framework governing arbitration

To be frank, Saudi Arabia is not considered to be the most arbitration friendly jurisdiction. The process of arbitration is subject to regulations issued by Royal Decree in 1983, which in principle provide the necessary legal foundation to allow arbitration of both existing and future disputes. However, that Royal Decree also retained a range of powers for the “*authority originally competent to hear the dispute*” — the Saudi Courts.

The Royal Decree requires parties to submit their arbitration clause to a competent Saudi judicial authority, as well as any award, and lays down a right for either party to appeal an award, which undermines the ideas that arbitration is meant to be final. In practice, this right to an appeal also means that any arbitration award is not considered to be enforceable (since it is not ‘final’) unless the Saudi courts have disposed of any appeal.

The Saudi arbitration regulations also, importantly, prevent any government entities from referring matters to arbitration, without the Council of Ministers having approved any such submission. That law was enacted in 1963, following the well-

known arbitration between the Arabian American Oil Co. (“ARAMCO”) and the Saudi Government. The Saudi Government challenged the tribunal’s jurisdiction, alleging that the arbitrators could not have jurisdiction over an act done by the Saudi Government in the exercise of its sovereign powers. The tribunal came to the conclusion that if there was a valid contract (which the tribunal could adjudicate over), then Saudi Government was bound and its sovereignty was not affected.

It has often been suggested that the ARAMCO decision was, at least partially, responsible for the aversion to arbitration in the Kingdom. In the ARAMCO award, the tribunal commented on Islamic jurisprudence in terms that could have been more diplomatic — essentially pronouncing that Islamic law was unable to deal with a concession contract. The tribunal stated that:

“the legal system of concessions is still in embryo form in the schools of Moslem Fiqh [Islamic jurisprudence]. [T]he ... doctrine applied in Saudi Arabia contains no particular rules which define mining concessions in general and petroleum concessions in particular.”

On that premise, the arbitrators went on to hold that Saudi law needed to be “*interpreted or supplemented by general principles of law, by the custom and practice in the oil business and by notions of pure jurisprudence*” since ARAMCO’s contractual entitlement could not be “*secured in an unquestionable manner by the law in force in Saudi Arabia.*” Fifty years on, some of the distrust generated by this award may still linger, although arbitration has steadily become more popular over the years.

Saudi and Shari’a law that apply in the Kingdom today impose two further important restrictions on any arbitration proceedings. The language of the arbitration must be Arabic, and the law to be applied by a tribunal to any dispute must be Saudi Arabian — irrespective of the parties’ choice of law.

When it comes to the enforcement of arbitral awards, Saudi Arabia is now a party to the New York Convention which requires foreign awards to be enforced, save in exceptional circumstances. Although Saudi Arabia’s acceding to the New York Convention was undoubtedly a significant step for arbitration, enforcement of foreign arbitral awards remains a thorny issue.

Enforcement of awards falls within the sphere of competence of the Board of Grievances, which has the power to ratify foreign awards. A party seeking enforcement of an award must submit a petition to the Board of Grievances, following which the authority will review the award to make sure that it does not violate mandatory principles of the Shari’a. The Board of Grievances has wide powers over this procedure, which can in practice resemble a merits hearing. For instance, the Board of Grievances can invite the parties to make oral submissions on the dispute decided by the tribunal.

The most common ground for rejection of foreign arbitral

awards by the Board of Grievances is that the arbitral award is contrary to public policy (the New York Convention, Article V (2) (b)), because it does not adhere to the principles of Shari’a law. Commonly applied principles of Shari’a law in this regard are the prohibition against interest, the boycott against the State of Israel and, from a practical point of view, the requirement that arbitrators be male. Saudi Arabia also enforces its ‘reciprocity reservation’ in the New York Convention in an unusual manner. The Board of Grievances may be more willing to ratify a foreign arbitral award of another contracting state if it is satisfied that Saudi court judgments would be enforced in that state. In practice, there is little hard evidence of foreign awards being enforced by the Saudi courts.

As at the end of 2009, there seems to have been no reported case of a New York Convention award being enforced, something that might perhaps be explained by Saudi judges encouraging the parties to agree on the terms of enforcement to avoid the need for a formal ruling. However, it would be overly optimistic to deny that there are risks in seeking to secure payment of sums awarded in an international arbitration through the Saudi court system.

An alternative approach where there is a Saudi counterparty is to opt for arbitration in Saudi Arabia. Again, however, the element of uncertainty introduced through a review of an award by the Board of Grievances cannot be avoided. In the Emaar arbitration mentioned at the outset, the award (a purely domestic decision) was overturned by the Board of Grievances. It appears from press reports that damages of around US\$200 million were ordered to be paid by Emaar to Jadawel. The reality, for the time being, is that arbitration proceedings — whether domestic arbitrations or petitions to enforce foreign awards — are all subject to the Board of Grievances reviewing the underlying merits. As is the case with any appeal process, sometimes decisions get overturned.

That said, there have been calls for further reform of the judicial system in Saudi Arabia, which may well also impact on arbitration. The jurisdiction of the Board of Grievances has recently been reduced (though it continues to review foreign awards), and a national arbitration centre in Riyadh was announced by Prince Bandar ibn Salman ibn Muhammad in 2007, following Saudi Arabia’s accession to the World Trade Organisation (“WTO”). The Prince has been quoted as recognizing the increased importance of arbitration in light of the expected rise in foreign investment fostered by the Kingdom’s WTO membership. At the time of writing, the proposed institution has not yet come into existence. ©

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