CONFLICT OF LAWS IN ARBITRATION AGREEMENTS BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

I. INTRODUCTION

This Note considers the conflict of laws issues involved in arbitration agreements contained in commercial contracts between developed and developing countries. Discussion focuses on arbitration clauses in contracts between private persons (i.e., individuals, partnerships, and corporations) and those between private parties and public entities. The arbitration clause (clause compromissaire) is an agreement to submit disputes arising from the transaction to arbitration. Although international organizations such as the International Chamber of Commerce (I.C.C.) in Paris, the American Arbitration Association, and the Inter-American Commercial Arbitration Commission employ arbitration clauses, they fail to specify a choice of law for anything except procedural questions. Parties may draft their own arbitration clause, which can include specifications as to choice of law, place of arbitration, or choice of arbitrators. The parties may also specify whether reasons for the arbitration decision must be provided, the permissibility of challenge, as well as the right to amend or terminate the agreement. The question of applicable law arises when it must be decided which law governs the validity of the arbitration, which law determines the proceeding, and which law should be applied to the merits of the controversy.

When arbitration works smoothly, recourse to the courts is not necessary. However, even when court supervision is not required, conflict of laws problems abound in arbitration between developing and developed countries. Cooperation in the settlement of investment disputes between the developed and developing countries is minimal at best. The basic problem is that the two groups represent economic and political interests that are moving in opposite directions. If the faltering North-South dialogue is to continue, a more determined effort must be undertaken to achieve mutual rules to resolve conflicts problems. This Note first deals with the general policy and law of the developed and developing

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1 A public entity may range from an autonomous public corporation to one or more of the branches of government. Economic agreements between a private party and the public entity include short-term supply contracts, regimes set up by concession agreements, and licensing agreements.
countries regarding arbitration of commercial disputes. Next is a discussion of three instances where the question of applicable law arises. Finally, this Note argues that although arbitration is a useful institution and should be encouraged as a matter of national legal policy, it might be more realistic to develop international standards and binding rules for the transfer of technology. The purpose of this Note is not merely to examine the conflicts aspects of arbitration in the context of the North-South dialogue, but also to determine the extent to which conflicts rules may be applied to achieve the particular benefits of this method of dispute settlement.

II. POLICY CONSIDERATIONS

Parties from developed countries generally are strong proponents of arbitration clauses in commercial contracts that they enter into with parties from developing nations. This is due largely to the view held by most foreign investors of arbitration as a relatively neutral process. The privacy of arbitration proceedings and a lessened risk of disclosure of confidential technology combined with the fact that sophisticated international arbitration techniques already exist are attractive to foreign investors. In addition, arbitration offers special advantages in the settlement of disputes involving governments. For example, the private party may be spared the effect of prejudice in the local courts when governmental interests are involved, and the government frequently will prefer the privacy of arbitration to preserve its prestige.

There is an underlying attitude of distrust on the part of developed countries regarding the settlement of disputes in the courts of the developing states. The laws of developing countries are considered to be radically different from Western concepts of procedural and substantive due process. Local judges are believed to be prejudiced against foreign economic interests and ignorant of the technical, specialized knowledge held by an arbitrator having expertise with the subject matter in dispute. Investors fear the frequent exercise of executive and legislative fiat, which the local courts, even if they so desired, are powerless to affect. Moreover, investors cannot ignore the fact that host state courts often are unwilling to pay compensation for expropriation of foreign assets.

Arbitration offers some freedom from the concern that foreign courts will not protect a party's rights. The United States
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Supreme Court has stated that uncertainty regarding applicable law will almost inevitably exist with respect to any contract touching two or more countries, each with its own substantive laws and conflict of law rules. A contractual provision specifying in advance the forum in which disputes shall be litigated and the law to be applied is, therefore, an almost indispensable precondition to achievement of the orderliness and predictability essential to any international business transaction. Furthermore, such a provision alleviates the danger that a dispute under the agreement might be submitted to a forum hostile to the interests of one of the parties or unfamiliar with the problem area involved.2

In developed countries, it is well settled that parties to an international commercial contract may resolve disputes by arbitration. The United States and most Western European nations are among the forty-two signatories to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards.3 Arbitration agreements are accorded transnational validity in article 11 of the Convention. Each state is bound to “recognize” written agreements to submit disputes to arbitration on a “defined legal relationship . . . regarding a subject matter capable of settlement by arbitration.”4 The United States also has signed and ratified a number of bilateral and multilateral treaties recognizing arbitration as the vehicle of dispute settlement.5 All of the major trading countries, including the United States, have arbitration statutes that require recognition of the validity and nonvalidity of arbitration agreements.6 In addition, all recent treatise of Friendship, Commerce, and Navigation,7 except for two instances,8 pro-

4 Id. art. 11 (1).
5 12 M. Whitman, Digest of International Law. 1044-46 (1971).
7 FCN treaties are the instruments for the regulation of United States commercial relations with foreign nations. The structure of these treaties has been altered to reflect the modern emphasis on investment problems.
8 The exceptions are the treaties with Ethiopia and Muscat and Oman. A. Fatouros.
vide that arbitration agreements will be enforced, even if the arbitration is to take place in a foreign country or if one of the arbitrators is not a United States citizen.

The problems of private international law associated with foreign investments are of major concern in developing countries. Generally, the conflict of laws rules in most developing countries have been imported from the United States and the former colonizing powers—Great Britain, France, Italy, Spain, and Portugal. The developing nations are in a peculiarly unsatisfactory position. On one hand, they realize the vital importance of foreign investment in their countries, while on the other hand they are trying to protect their own independence and economic growth. One author accurately described the situation: "At present most of the less developed countries are in a state of reaction against nineteenth century imperialism. They have acquired a distaste for foreign capital and foreign administration and they are more anxious to protect themselves from further exploitation than to take advantage of current opportunities."9 The developing countries consider themselves relatively powerless against foreign investors and multinational enterprises in negotiations and in the enforcement of their national regulations. In fact, it is often difficult for a developing country to obtain any information about the conduct of a multinational when the company's headquarters and offices are in a developed part of the world. General agreement exists among the developing countries that foreign investment is to be permitted only under careful control and after close scrutiny.

The developing countries are reluctant to submit to any binding international arbitrations when problems arise out of their economic dealings with the developed states. State guarantees to foreign investors rarely include any provisions on arbitration as a means of settling disputes.10 One commentator described the situation as follows:

The unwillingness is to be attributed to a refusal to acquiesce a priori and without limitations, to the existing rules of international law, especially those pertaining to economic matters. The governments of underdeveloped countries seem to fear that arbitration or other international tribunals will tend to ignore the

10 A. Fatouros, supra note 8, at 353.
substantive problems involved and to apply rigid legal principles, evolved in the nineteenth century under different international conditions. . . .

A. A. Fatauros points out that arbitration would probably be more acceptable to the developing countries if the subject concerns some highly technical matter that has nothing to do with public policy. The developing states are also more favorably disposed to an arbitration proceeding in which the arbitrator is allowed to reach a decision \textit{ex aequo et bono} and not in accordance with strict law.\footnote{Id. at 354.}

The Latin American countries are representative of this attitude that foreign investment must be controlled carefully. There has been a noticeable move toward tightly-controlled economies, with development plans designed to increase national growth as quickly and extensively as possible.\footnote{An example of an \textit{ex aequo et bono} arbitration procedure is the agreement between the Greek state and the Polish FUM CEOP, dealing with the establishment of a sugar processing plant, March 3, 1960, article 34, 1960. Ephimeristis Kyreniseas Fase. 1, No. 44, 407. The agreement stated that "[t]he arbitrators judging \textit{ex aequo et bono} are neither bound by any special law nor by any rules of procedure in carrying out the arbitration."}

The developing states believe they can create industrialized societies — given sufficient foreign aid — regulated by their own national laws. Foreign investors seeking to do business in Latin America are apprehensive about the security of their investments. The spectre of expropriation and nationalization of investments may destroy any confidence investors have in the agreement.\footnote{An example of this effort to establish a secure economic order is the Andean Pact's Code on Foreign Investment. Enacted in 1971, its essential goal is to promote a healthy economic future for the host state by providing for gradual nationalization of foreign investment. The Code is reprinted at 11 \textsc{Int'l Legal Mat'ls} 126 (1972). See Zamora, \textit{Andean Common Market-Regulations of Foreign Investments: Blueprint for the Future?} 10 \textsc{Int'l Law} 153 (1976).}

Most Latin American states recognize arbitration agreements in international commercial contract disputes between private parties.\footnote{Examples of the expropriation and nationalization of foreign investments occurred in Chile and Venezuela. \textit{See Anaconda Company and Chile Copper Company-Overseas Private Investment Corporation: Arbitration of Disputes Involving U.S. Investment Guaranty Program}, 14 \textsc{Int'l Legal Mat'ls} 1210 (1975).}

The laws of El Salvador, Guatemala, and Costa Rica do not specifically mention international arbitration, but arbitration agreements have been upheld.\footnote{The term "international commercial contracts" refers to contracts between a Latin American party and a foreign party located in a Latin American state.} Nicaragua, Paraguay, Colombia,
Brazil, and Bolivia use the law on arbitrability of domestic disputes when dealing with international disputes.\textsuperscript{17} The 1940 Montevideo International Private Law Treaty\textsuperscript{18} is the law used in Argentina and Uruguay regarding international commercial arbitration.\textsuperscript{19}

Despite acceptance of arbitration to settle disputes between private parties, Latin American countries have refused to acknowledge the validity of arbitration agreements in contracts between a foreign private party and a state or state enterprise. The developing countries view private-state arbitrations as attempts by foreign investors to bring undue pressure on the state and as infringements on national sovereignty.

The Latin American experience with arbitration has been frustrating. Lionel Summers, an expert on commercial activity in the region, points out that although these nations have participated in a substantial number of arbitrations in the past, few of the decisions were in their favor.\textsuperscript{20} Parties from the developing countries frequently were coerced into arbitration and the arbitrators were rarely from Latin American states.\textsuperscript{21} The belief arose that the arbitrators, far from being a neutral force, were biased and the outcome was predetermined in favor of the developed state.

Latin American countries have consistently refused to ratify the various international arbitration conventions. Brazil is the only country in the region to ratify the 1923 Geneva Protocol on Arbitration Clauses,\textsuperscript{22} and no Latin nation has signed the 1965 World
Bank Convention on the Settlement of Investment Disputes between States and Nationals of Other States, which provides for the resolution of disputes arising between states and foreign investors doing business within those states. The Convention established the International Center for Settlement of Investment Disputes (ICSID) at the World Bank Headquarters in Washington, to which parties may voluntarily submit for binding arbitration.

Nor has any Latin American state supported the 1967 Draft Inter-American Convention on International Commercial Arbitration, which endorses compulsory arbitration clauses. None of these countries has recognized the 1975 Inter-American Convention on International Commercial Arbitration, a hybrid of the ICSID Convention and the U.N. Convention, which is much advanced in terms of meeting the objections previously raised by developing states.

Latin America steadfastly maintains the position that disputes involving a Latin American state must be resolved by local law. The Calvo Doctrine embodies this idea. It holds that foreign persons are given only those rights enjoyed by nationals and therefore may settle their disputes only before local authorities under local law. Most investment contracts between states and foreign nationals contain a Calvo Clause in which the foreign part-

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24 The jurisdiction covers any dispute arising from an investment agreement between a contracting state and a citizen of another contracting state, in which both parties agree to submit to arbitration. Id. art. 25. See Broches, Arbitration in Investment Disputes in International Commercial Arbitration 292 (Schmitthoff ed. 1975).


26 Id. at 18. Local arbitration law was to govern in the absence of an express agreement between the parties.

27 The 1975 Convention reiterates the provisions of the 1967 Convention concerning the validity of the arbitration clause. The 1975 Convention includes parts of the New York Convention regarding the refusal of states to recognize awards (art. 5 (1) and art. 5 (2)), and an article allowing any state to accede to the Convention (art. 9). The explicit public policy exception included in the 1975 draft (which was not included in earlier drafts) would seem to meet the major objections of the Latin American states to other drafts.

28 The doctrine was adopted in the nineteenth century to stop military interventions by the United States and Europe on the pretext of diplomatic protection of their citizens. See D. Shea, The Calvo Clause 9, 15 (1955).

29 The inclusion of the clause in all contracts entered into between foreign nationals and state enterprises is required by law in Chile, Ecuador, Mexico, Panama, Peru, and Venezuela. See, e.g., Const. art. 27 (Mexico, 1917). The clause is in common usage in Costa Rica, El Salvador, Guatemala, Nicaragua, Bolivia, and Paraguay. The clause is used rarely in Brazil, Colombia, Uruguay, and Honduras, and not at all in Argentina, the Dominican Republic, and Haiti. D. Shea, supra note 28, at 279.
ty agrees, when submitting to local law, not to use diplomatic intervention by its own government to attempt to resolve the dispute. One writer who studied the impact of the Calvo doctrine upon various methods of dispute settlement concluded that despite the growing internal harmony among Latin American states "the confidence of foreign investors ... does not in most cases presently extend to the prospect of either the host country courts or ad hoc or institutional arbitration in Latin America."31

One of the reasons for the Latin American refusal to ratify international commercial arbitration agreements is a distrust of institutional arbitration organizations, such as ICSID, based on their view that these organizations are biased. A specific objection to the ICSID convention is aimed at article 42(1), which provides that international law will be used in the arbitration if any part of the law chosen by the parties violates international standards.32 This provision is at odds with the Calvo Doctrine, which holds that a state will not be subject to foreign law or international law formulated along lines alien to its own economic and philosophic concepts. This choice of law rule explains the failure of any Latin American state to ratify the ICSID convention.

It is understandable that Latin America finds ratification of the majority of arbitration conventions unpalatable, but the Calvo Doctrine objections do not apply to purely private arbitration where a state's sovereignty is not threatened. Although Latin America may be precluded from ratifying the ICSID convention as long as the region adheres to the Calvo Doctrine, both the U.N. Convention and the 1975 Convention apply to purely private disputes and provide for review of foreign arbitrations that is as complete as that under local codes. Apparently, Latin American countries are concerned that their standards of review will be subject to international scrutiny. International commercial arbitration is not completely alien to Latin America, but there has not been much judicial interpretation of national code provisions con-

2 See Broches, supra note 24, at 1, 2, 292, 296-97.
cerning review of foreign awards. If these countries do ratify the conventions, their standards of review would not be interfered with directly, but would be measured by international standards. Latin American leaders should recognize that as their international influence increases and their arbitration law develops, their standards will be more in line with international standards. Moreover, if Latin American involvement with international trade continues to grow as expected, it would be to their benefit to become parties to these private arbitration agreements. The ratification of these conventions would improve the confidence of foreign investors and enhance the role of Latin America in the international economic order.

III. VALIDITY OF THE ARBITRATION CLAUSE

The validity of the arbitration agreement is the first issue addressed when a dispute arises over a commercial contract between parties from developed and developing countries. Generally, the validity of the arbitration agreement is determined by the characterization given it by the forum in which the clause is sought to be enforced. Therefore, it is essential to determine the validity and enforceability of the arbitration clauses within different legal systems.

Determination of the validity of the arbitration clause in terms of the applicable statutory law can be decided only by the courts. Prior to the arbitration proceeding, one of the parties may petition a court to enforce the agreement to arbitrate. Before or during the arbitration, if one of the parties brings suit and refuses to arbitrate, the court may stay its proceedings pending arbitration. The court generally will decide the issue of the validity and effect of the arbitration clause according to the law governing the contract as a whole. Therefore, the validity issue is partially dependent on the local law of the contract. Resort also could be made to the lex fori (law of the forum), although there may be no significant contacts with this law. The law of the seat of arbitration may be employed if the seat has been determined by this stage of the suit. The United Nations Convention states that arbitration cannot proceed if the arbitration agreement is “null and void,” inoperative or incapable of being performed. However, the Convention makes no statement regarding the choice of law that will

determine whether the agreement is "null and void." The point is
that the choice of law is not something that the parties necessarily
know before the action commences. Ultimately, it is the court that
decides the law to be applied to the parties' arbitration agree-
ment.

Most legal systems in the developed countries exclude certain
types of commercial disputes from arbitration and an arbitration
clause in a contract dealing with excluded matters will be invalid.
In France, disputes over goodwill, patent and trademark,
bankruptcy, cartel agreements involving foreign trade, and the
validity of corporations may not be arbitrated. German law is
similar to the French except that cartel agreements involving
foreign trade may be arbitrated after approval is received from
the cartel office. Under English law, almost any case that con-
cerns money damages may be arbitrated.

In the United States, several areas of commercial transactions
are covered by regulatory legislation such as patent and
trademark statutes, antitrust laws, and securities. The United
States courts, however, have been fairly consistent in upholding
arbitration agreements when there is a clash between foreign and
domestic legislation regarding what subjects may be arbitrated.
An example of such a conflict was present in Bremen v. Zapata
Off-Shore Company. In this case, the Supreme Court ruled on the
enforcement of a contract between a German firm and a United
States firm. The contract directed that all disputes be settled in
English courts. The Bremen case did not involve an arbitration
agreement but a choice of forum clause, which is closely related
and involves the relevant choice of law analysis. The English
courts would have enforced an exculpatory clause that United
States courts would have declared invalid on public policy
grounds. The Supreme Court decided that the choice of forum
clause should be upheld. The Court stated that a refusal to
uphold the choice of forum clause would be a "parochial concept
that disputes must be resolved under our laws and in our courts
... We cannot have trade and commerce in world markets and in-
ternational waters exclusively on our terms, governed by our

34 U.N. Convention, supra note 3, art. 11 (3).
39 Id. at 7.
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laws, and resolved in our courts."\textsuperscript{40} The \textit{Bremen} case is evidence that Untied States courts are beginning to recognize the idea that flexibility in international commercial transactions is essential to the proper functioning of economic trade between countries of divergent economic and political philosophies. The Court in \textit{Bremen} acknowledged that a transaction that has relevant contacts with more than one jurisdiction may be governed by a law other than that of the forum. If the choice of the parties is reasonable, this law will be applied despite any compelling public policy provisions of the forum.\textsuperscript{41} The \textit{Bremen} case reinforced the importance of arbitration for international contractual disputes.

Another important United States case relevant to the validity issue is \textit{Scherk v. Alberto-Culver Co.}\textsuperscript{42} Alberto-Culver, a United States multinational firm, undertook to purchase from Scherk, a German cosmetic company, the trademarks and the stock of two corporations owned by Scherk. The contract was negotiated in Germany, the United States, and England, signed in Austria, and the deal was closed in Switzerland. There was an I.C.C. arbitration clause included in the contract. When Alberto-Culver discovered that there was a shortage in Scherk's inventory, it ignored the arbitration agreement and filed suit in federal district court in Chicago. The issue in the case was whether the agreement to arbitrate disputes in a contract to purchase securities was enforceable. The court upheld the arbitration clause and stated that "the subject matter of the contract concerned the sale of business enterprises organized under the laws of and primarily situated in European countries, and whose activities were largely, if not entirely, directed to European markets."\textsuperscript{43} The court stated that an arbitration clause "is, in effect, a specialized kind of forum selection clause that posits not only the situs of the suit, but also the procedure to be used in resolving the disputes."\textsuperscript{44} The court recognized that it is a matter of the public policy laws of different states and nations and that there are territorial limitations on the

\textsuperscript{40} Id. at 9.

\textsuperscript{41} In a recent New York District Court case, the court upheld a choice of forum clause stating that the respondent company had contracted to submit to arbitration in New York and under the modern view choice of forum clauses are given effect unless they are unfair or unreasonable. Detker v. Victoria Steamship Corp., No. 79-6059 (S.D.N.Y.) (1980).

\textsuperscript{42} 417 U.S. 506 (1974).

\textsuperscript{43} In \textit{Wilko v. Swan}, 346 U.S. 427 (1953), the Supreme Court held that an arbitration agreement in a contract to purchase securities was void. The \textit{Wilko} case was entirely domestic and involved no foreign contacts.

application of these laws. If there are enough significant contacts with the forum, it may allow for the use of its own public laws. A court in a developed country may decide that the location of the challenging parties in the forum constitutes a significant contact and employ its own public policy rather than that of one of the developing states. The Court in Scherk left unanswered a number of issues including any clear indication to determine in which forum the alleged infraction must be resolved.

Questions of validity frequently arise in contracts between parties from developed and developing countries as a result of the adhesive nature of the arbitration agreement. In the typical transfer of technology agreement, the supplier of the technology has a superior bargaining position and often uses this position to compel the resolution of disputes by arbitration. The Supreme Court of the United States has spoken against the coercive methods of economically powerful parties who use standardized clauses in commercial agreements. These standardized forms often are buried in the body of the contract or appended as an afterthought. The economically weaker party often is unaware of the implications of apparently innocuous clauses. Even if the weaker party is alert to the effect of the clauses, it is powerless to challenge them because of the need for the developed countries' technology. These standardized clauses may deny the party from the developing state recourse to its own courts, and leave no choice as to the location, applicable law, or composition of the arbitration procedure. The "formidable array of restrictive clauses that can be (and usually are) included in transfer of technology agreements" includes clauses that remove conflicts over inter-

45 Id. at 519.

48 Nussbaum, The Separability Doctrine in American and Foreign Arbitration, 17 N.Y.U.L.Q. Rev. 609 (1940). The I.C.C. states in article 13 (4) that challenges to the arbitrator's jurisdiction must wait until after the award is made. The U.N. Convention, supra note 3, allows the courts to retain jurisdiction if the arbitration clause is void and the arbitrator had no jurisdiction over the dispute. Under United States law, a charge of fraud must be directed at the arbitration clause itself to take the issue out of the arbitrator's competence. See Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 402-04 (1967). Under English law, claims of fraud are to be decided by the courts. The Arbitration Act, 1950, supra note 6, 24 (2) (3). However, this does not apply to arbitration arising under the United Nations or Geneva Conventions.
interpretation and breach of contractual obligations to Western courts or arbitration tribunals.

The determination of the validity of the arbitration agreement raises the question of severability: whether the power of the arbitrator extends to the determination of the validity of the main contract. The arbitrator's power is generally an issue to be decided by the courts. This issue, in fact, concerns the proper extent of the jurisdiction of the courts and arbitrators, and therefore will be governed by the law of the proceedings. The issue usually arises when one of the parties charges that the main contract is illegal because of fraud, duress, etc. If the arbitration agreement is characterized as an inseparable part of the main contract, then it will not be enforced as part of an illegal contract. In the United Kingdom, and until recently in France and the United States, courts considered the arbitration clause as part of the main contract. However, in *Exercycle Corp. v. Maratta*, a United States court allowed the arbitration of a dispute in a contract challenged for lack of mutuality. Courts that do recognize the separability doctrine consider the arbitration clause to be separate from the primary contract. Thus, the arbitrator can determine whether the main contract is unenforceable due to a host of factors and still uphold the arbitration agreement. The United States, Germany, Belgium, Poland, Czechoslovakia, and France are among the countries that recognize the severability doctrine.

The validity issue makes it apparent that, in practical terms, it is often impossible to avoid litigation to settle an investment dispute. In a case where the court determines that the arbitration agreement is not valid, the dispute never will be arbitrated at all.

IV. LAW GOVERNING THE PROCEEDINGS

The system of law under which the arbitration is held is known

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52 G. DELAUME, TRANSNATIONAL CONTRACTS—APPLICABLE LAW AND SETTLEMENT OF DISPUTES: A STUDY IN CONFLICT AVOIDANCE 813.06, at 36 (1975).
53 Id.
55 Id.
56 Id.
in conflict terms as the "law of the proceedings,"57 or "loi d'arbitrage."58 It is the law of the proceedings59 that determines what conflict of laws rule should be applied to the substance of the obligation.60 The law of the proceedings determines a number of other important questions such as whether the arbitrator must give reasons for the award, whether the award must be based on substantive rules of law, and the extent to which the arbitrator's decision is subject to review by a court of law. Some jurisdictions have ruled that the law of the proceedings includes all issues except questions of formalities, capacity, and arbitrality.61 Other jurisdictions include the nationality of the award, the conflict rules that determine the decision regarding the substance of the dispute (including the law governing the validity of the arbitral agreement), and the arbitrator's license to apply rules of law or equity.62

One of the preliminary decisions made by the arbitrator is the extent to which the law of the proceedings may be chosen by the


58 A distinction should be noted between the law of the proceedings, which is dealt with herein, and the rules of procedure, which are the rules that will be applied to the arbitration proceeding and which are a combination of rules to regulate the arbitration (some of these rules are designed by the parties and others are determined by the governing body of law).

59 It is this system of law governing the arbitration that determines the rules from which derogation is not permitted. This would be the legal system of the state in which the arbitration award is deemed to be domestic for purposes of getting a confirmation of the award. Therefore, the law of the proceedings is not always the same as the seat of the arbitration.

60 Mezger, The Arbitrator and Private International Law, in INTERNATIONAL TRADE ARBITRATION 239 (M. Domke ed. 1958). Professor Goldman, one of the leading experts in the conflicts area, disagreed with this position in his 1963 Lectures at the Hague Academy of International Law, entitled Conflicts of Laws in the Field of International Arbitration in Private Law. Examples of disputes involving the "substance of the obligation" include the following:

Whether a carrier is liable for the loss of or injury to the goods or for delay in their delivery.

Whether an agent has exceeded his authority.

Whether currency restrictions prevent the payment of the amount due under the contract.

Whether a stipulation exempting the promisor from liability in certain events is effective.

Whether an agreement in restraint of trade is enforceable.


62 Mezger, supra note 60, at 233.
parties. It is the arbitrator who decides whether the parties may choose the system of law used in the arbitration. The arbitrator's decision must comply with the public policy of the legal system that will enforce the award.

The legal characterization of arbitration will determine to a large extent whether the parties will be free to choose the law of the proceedings. There are generally three views of the nature of arbitration. The first view considers arbitration agreements to be private contracts and therefore free from any system of law. In this case, the parties are free to choose the applicable law. At the other extreme is the view that arbitration essentially is a judicial process and subject to the rules of the place of arbitration. The third theory, and perhaps the most accepted, holds that arbitration is a hybrid of the two extreme views and only certain elements of the agreement are deemed independent and determinable by the parties. Most jurisdictions recognize that all contracts, and therefore arbitration agreements, are tied to a particular legal system.

What needs to be addressed at this point is the position of the more prominent states and arbitration organizations toward the power of the parties to choose the law of the proceedings.

An English court ruled in *James Miller and Partners, Ltd. v.*

63 Wilner, supra note 49, at 651.
64 Id. Wilner cites as an example of this position the Etat Francais v. Comite de la Bourse d'Amsterdam et Mauren, Cour de Cassation, 21 June 1950, 39 REV. CRIT. DR. INT. PR. 609 (1950). There the court stated: "Every international contract is of necessity bound to the law of a state." Id. at 609.
65 The majority of foreign investment laws does not contain many provisions regarding the settlement of disputes and the applicable law. The Greek investment code is an exception as it provides for the settlement of disputes by arbitration between the government and foreign investors over the interpretation and application of instruments of approval issued by virtue of this law. One arbitrator (sometimes two) is to be appointed by each of the parties within a certain period of time. A third (or fifth) arbitrator, who may be a foreign national, is then elected by those already appointed. The arbitrators' decision is final and without appeal, binding upon both the Greek government and the foreign investor. Cited in A. Fatouros, supra note 8, at 186-87.

Other exceptions are worthy of mention. In India, under the petroleum concession rules, disputes between the government and the licensee regarding the license, royalties, alleged breaches, or the amount of compensation to be paid by the government upon acquisition of the concession, can be submitted to arbitration. The Pakistan legislation is similar as it makes provisions for arbitration of questions over the cancellation or renewal of petroleum leases and the amounts to be paid the government in the event of purchase of the plant after termination of the lease. The government and the licensee appoint one arbitrator each, if the two arbitrators disagree, an umpire is appointed. Similar laws are also found in Libya, Morocco, Iran, and Mali. See A. Fatouros, supra note 9, at 186-87.
That the law of proceedings is independent and the parties are free to choose the system they desire. The case involved a Scottish firm that contracted to carry out construction at an English firm's plant in Scotland. The contract was concluded in Scotland on an English standard form contract, and included an arbitration clause. When a dispute arose, a Scottish arbitrator was appointed. The arbitration took place in Scotland and employed Scottish procedures to which the English firm objected. The House of Lords held that the law governing the proceedings, in this case Scottish, could be different from the law governing the substance of the case, which was English law. No case has been reported in which the parties either chose as the law of the proceedings a system of law other than the proper law of the contract, or completely failed to exercise their power to choose the law governing the arbitration. However, the court in James Miller emphasized that effect would be given to the choice of law made by the parties.

It cannot be doubted that the courts would give effect to the choice of law other than the proper law of the contract. Thus, if the parties agreed on an arbitration in Switzerland, it may be held that whereas English law governs the validity, interpretation and effect of the arbitration clause as such (including the scope of the arbitrator's jurisdiction) the proceedings are governed by Swiss law. It is also submitted that where the parties have failed to choose the law governing the arbitration proceedings, these proceedings must be considered, at any rate, prima facie as being governed by the law of the country in which the arbitration is held, on the ground that it is the country most closely connected with the proceedings.67

67 (1970) A.C. 583, 616, per Lord Wilberforce, citing A. Dicey & J. Morris. The Conflict of Laws 1047-48 (8th ed. 1967). See also Smedresman, supra note 57, at 269-70, who notes that the ninth edition of Dicey & Morris has revised this passage to emphasize the parties' freedom of choice. Preceding the sentence which starts off "[i]t cannot be doubted . . ." it now states:

It is, however, for the parties not only to choose the law which is to govern their agreement to arbitrate, but also the law which is to govern the arbitration proceeding. Normally the parties exercise this power by determining (expressly or by implication) the country in which the arbitration is to take place, i.e., normally the proper law of the contract, which includes the agreement to arbitrate, coincides with the choice of the law governing the arbitration proceedings. Also changed was the phrase "the proceedings are governed by Swiss law," to "but the arbitration proceedings (including the extent to which they are subject to judicial control) will be governed by Swiss law." The final sentence now reads: "those proceedings will almost certainly be governed by the law of the country in which the arbitration is held. . . ."
James Miller held that the law of the proceedings is independent and may be different from the law applied to the merits of the dispute.

There are a number of problems with the James Miller analysis. The difficulties become evident when considering the rules regarding the proceedings in the International Chamber of Commerce arbitration convention. Under the I.C.C. rules, the law of the proceedings is that chosen by the parties, "or failing such choice, the rules of law of the country where the arbitrator holds the proceedings."\(^8\) One of the problems is that it is doubtful that a law of the proceedings can be identified or "chosen" at an early stage in the proceedings. Another question is that since a particular court may have jurisdiction to oversee an arbitration, even after the proceeding has begun in another forum using a foreign system of law, of what use is the notion of the law of the proceedings?

In order to deal with these questions, it must be recognized that any time a transaction has a number of different foreign contacts and the parties are from different countries, the use of several forums to resolve the dispute is inevitable. The arbitration clause will affect only particular issues. In order to ascertain the forum in which each issue will be decided, the various national courts should determine the full extent of their jurisdiction over the parties and proceedings. This can be achieved if the courts give effect to the parties choice of forum and their specification regarding the arbitration process. Such action will help contain the litigation. In fact, the Scherk v. Alberto-Culver Co.\(^9\) case dealt with this problem when it considered the effect of the I.C.C. arbitration clause. The arbitration agreement selected Paris as the site of the arbitration so that, under I.C.C. rules, French law was the law of the proceedings chosen by the parties. When the United States firm tried to enjoin the I.C.C. arbitration on the ground that the particular subject was not arbitrable under United States law, the court refused and stated:

A parochial refusal by the courts of one country to enforce an international arbitration agreement . . . would invite unseemly and mutually destructive jockeying by the parties to secure tactical litigation advantages. In the present case, for example, it is not

\(^8\) INTERNATIONAL CHAMBER OF COMMERCE, RULES OF CONCILIATION AND ARBITRATION art. 16 (1955), reprinted in INTERNATIONAL COMMERCIAL ARBITRATION, supra note 24.

inconceivable that if Scherk had anticipated that Alberto-Culver would be able in this country to enjoin resort in arbitration, he might have sought an order in France or some other country enjoining Alberto-Culver from proceeding with its litigation in the United States. Whatever recognition the courts of this country might ultimately have granted to the order of the foreign court, the dicey atmosphere of such a legal no-man's-land would surely damage the fabric of international commerce and trade, and imperil the willingness and ability of businessmen to enter into international commercial agreements.

Parties to international commercial agreements should realize that different countries may have jurisdiction at different stages of the arbitration proceeding. The notion that only the law of the seat may be the law of the proceedings is obsolete. In the typical international arbitration, it may not be clear where the seat is located. Often the panel may convene in one place, meet in another, and issue the award somewhere else. The Scherk case demonstrates how useless it is to designate a seat in the arbitration agreement. Indeed, the seat of the arbitration often is completely fortuitous. It may simply be the place where the proceeding is convened for the arbitrators to meet. In such a case, the seat is unconnected with the parties or the transaction, except as a place of convenience.

The right of the parties to chose the law of the proceedings is gaining support in international legal organizations. The notion of contractual freedom and the independence of procedural law is provided for in the U.N. Convention. The Convention states that a court may refuse to recognize and enforce an award when "the composition of the arbitral authority or the arbitral procedure was not in accordance with the law of the country where the arbitration took place. . . ." This section of the convention, when read carefully, indicates that the procedural law may be different from the law of the seat of the arbitration. The law of the seat ordinarily would be applied if there were no other selection by the parties. The I.C.C., which was a moving force behind the U.N. Convention, pushed for the adoption of a "supranational" award, free from the various national, formal, and procedural requirements. The 1975 I.C.C. rules free arbitrators from local procedural law. Article 11 reads:

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70 Id. at 516-17.
71 U.N. Convention, supra note 3, art. V (1)(d).
The rules governing the proceedings before the arbitrator shall be those resulting from these rules and, where these rules are silent, only rules which the parties (or, failing them, the arbitrator) may settle, and whether or not reference is thereby made to a municipal procedural law to be applied to the arbitration.  

A number of New York cases have appeared to uphold the spirit of article 11 and the freedom of the parties.

Although there is growing acceptance of the freedom of parties to choose the law of the proceedings, it is not a legal doctrine parties can rely on when drawing up a contract. Considerable opposition exists in the developing countries to the total independence of the law of the proceeding and to party autonomy. The idea of a neutral procedure free from the supervision of national laws is feared by the developing states. Their fears are reflected in the logic of the Calvo Doctrine. The developing countries are convinced that party autonomy in the choice of the law of the proceedings will give parties from the developed states another tool which may be used in negotiations. However, opposition to party freedom is found in local courts, especially in the developed states, where there is a reluctance to give up jurisdiction. Furthermore, many courts refuse to allow the parties to choose the law of the proceedings. Procedural law is essentially mandatory, composed of nonwaivable safeguards. This does not change simply because a contract involves international aspects. The local courts rely on this fact to avoid giving effect to party autonomy. The various national arbitration statutes specify exactly what the parties are free to choose. Therefore, unless the local law permits party autonomy, the law of the proceedings may be set by mandatory rules of law and, accordingly, the parties will not be free to choose.

Generally, it can be concluded that the move to give effect to party autonomy is growing. This is a positive sign. The special requirements of international arbitration require that courts begin to recognize the power of parties to choose the law of the proceedings. It seems reasonable to allow party autonomy and

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73 INTERNATIONAL CHAMBER OF COMMERCE, RULES OF CONCILIATION AND ARBITRATION art. 11 (1975), reprinted in INTERNATIONAL COMMERCIAL ARBITRATION, supra note 24, at 40. (Schmitthoff ed. 1980).


modification of local procedural rules if the rights of the parties are preserved adequately. Of course, the protection of these rights and the standards used in determining them are precisely the issues with which the developing countries are most concerned. Their fears are warranted because even though private international law is more or less uniform, substantive contract law often is radically different. Given the existing inequality in bargaining strength, the developing states have an interest in maintaining the *lex fori* notion and in retaining some control over the law applied in the arbitration.

V. LAW APPLICABLE TO THE MERITS

There are a number of conflicts issues involved in determining the rules of substantive law that the arbitrator applies to disputes regarding the merits of the contract. The general rule is that the arbitrator must follow the conflict rules of the law applicable to the merits.76

Choice of law clauses in arbitration agreements are often part of the "boilerplate" section of international contracts.77 They are not effective in managing future disputes and are more or less superfluous from the developing countries point of view. However, such clauses are still considered effective bargaining tools and as a means to reassure clients wary of arbitrations held in unfamiliar forums. When an arbitration clause and a choice of law agreement appear together in an international contract amiable construction will not be allowed,78 and the system of law79 provided for should be applied to the merits of the dispute.80 Stipulations of foreign law are fairly common in I.C.C. arbitrations, where the seat of the proceedings varies.81

76 Of course the arbitrator can avoid this if the law of the proceedings provides for a means other than the use of substantive law as used in the courts. This would all depend on the local laws' position regarding the freedom of the parties to choose the law of the proceedings in addition to the parties power in determining he substantive law.


79 Renvoi is usually not applied in contract cases, particularly when there is a choice of law. Dicey & Morris, *surpa* note 69, at 723-23; *Restatement (Second) Conflict of Laws* § 186 (1971).

80 The merits of the contract include such issues as performance, discharge through force majeure, frustration or impossibility, liability for loss or damage of goods, and agency problems. G. Cheshire, *Private International Law* 236-37 (9th ed. 1974).

81 The arbitration clause in Scherk v. Alberto-Culver Co., 417 U.S. 506 (1974), provides an example:
The essential validity of choice of law clauses generally is not a matter of dispute. However, most legal systems place theoretical limits on the validity of these agreements: either the *lex fori* or the proper law of the contract is controlling. Most of the legal systems in developed states give due regard to the concept of party autonomy. Under English law, the intent of the parties determines the "proper law of the contract." In the United States, the Uniform Commercial Code and the *Second Restatement of Conflicts of Laws* recognize party autonomy.

A difficult problem arises when the choice of law is something other than that of the forum or that of one of the parties' domiciles. This is especially so if the choice of law appears to be an attempt to avoid a mandatory local rule. In England, the courts have shield away from the dictum in *Vita Foods Products, Inc. v. Urus Shipping Co.*, to the effect that as long as a choice of law is legal, bona fide, and does not violate public policy, no connection with England is necessary, and the choice will be honored.

In the United States, the Uniform Commercial Code requires a reasonable relationship between the chosen law and the business transaction. Although the *Restatement of Conflicts of Laws* makes a distinction between those areas in which the parties are free to choose the applicable law and those areas in which they are not, the choice nevertheless will be given effect if a reasonable basis is found and there is no violation of public policy. The *Restatement's* position indicates that contract law, unlike the law

The parties agree that if any controversy or claim shall arise out of this agreement or the breach thereof and either party shall request that the matter shall be settled by arbitration in accordance with the rules then obtaining of the International Chamber of Commerce, Paris, France, by a single arbitrator, if the parties shall agree upon one, or by arbitrator appointed by each party and a third arbitrator appointed by the other arbitrators. In case of any failure of a party to make an appointment referred to above within four weeks after notice of the controversy, such appointment shall be made by said chamber. All arbitration proceedings shall be held in Paris, France, and each party agreed to comply in all respects with any award made in any such proceeding and to the entry of a judgement if any jurisdiction upon any award rendered in such proceeding. The laws of the State of Illinois, U.S.A. shall apply to and govern this agreement, its interpretation and preformance.

*Id.* at 509 n. 1.

82 *DICEY & MORRIS, supra* note 69, at 732.
83 U.C.C. § 1-105.
84 *RESTATEMENT (SECOND) CONFLICT OF LAWS* § 187 (1971).
86 U.C.C. § 1-105.
87 *RESTATEMENT (SECOND) OF CONFLICT OF LAWS* § 187 (1971). Some of the areas in which the parties are not free to choose the law are substantial illegality, formalities and capacity.
of the proceedings, is really supplemental. Contract law generally aims to give effect to, and is subordinate to the terms of the agreement.

In practice, the "reasonable connection" requirement is not a problem in contracts between developed and developing states because the choice of law is usually that of one of the parties. Generally, the courts will accept anything that is commercially reasonable. The arbitrator, whose position is itself the result of a private agreement, is not bound to effectuate a nation's interests, and typically is more inclined than the courts to uphold choice of law clauses. However, there is a problem when the courts must determine the law to be applied to the merits if there are no stipulations regarding this law in the contract. The English courts attempt to determine the "system of law with which the transaction has its closest and most real connection."8

Some contracts between developing and developed states include choice of the clauses that stipulate that arbitration is to be performed "under the English Arbitration Act," or "under the arbitration laws of New York." This type of clause is generally considered to be a choice of procedural law. If the contract also includes a choice of the site of arbitration, a choice of procedure would be redundant, indicating that the clause is actually a choice of substantive law. If the clause appears by itself, a choice of seat and a selection of the substantive law is intended.9 Considering the uncertainty involved with the use of these clauses, it is best not to use them at all.

Notwithstanding an explicit choice of law by the parties, the law of the proceedings will determine the substantive law. The choice of law clause will result in the use of local substantive law of the legal system specified as long as the conflict rules of the forum so allow. Of course, the developing countries favor limits on party autonomy and insist that local law be applied to the dispute.

VI. CONCLUSION

The prospects for cooperation between the developed and developing countries in the settlement of investment disputes by arbitration are less than promising. The developing countries are moving toward planned economies with an express favoritism for

88 Dicey & Morris, supra note 69, at 721; Bonython v. Commonwealth of Australia, (1951) A.C. 201 (P.C.).
89 Smedresman, supra note 57, at 298.
national investors as a means to economic growth. Although developing countries are seeking to industrialize their economies, and although foreign capital and technology are necessary to achieve this aim, foreign investment will be controlled carefully by the developing nations. On the other hand, developed countries prefer the status quo to the extent that in the atmosphere of indecision and absence of agreed upon rules they are able to exact the best deals for themselves. Any hope for cooperation in the establishment of a viable arbitration process as a method of dispute settlement depends on a clear assessment by both groups of their interests. If cooperation is to be achieved, developed countries should recognize the developing countries' attitude that foreign investments will be accepted only if a positive contribution is made to the developing nation's economy. There must be some minimum agreement on the substantive issues of foreign investments if an effective process of dispute settlement by arbitration is to be achieved. The mechanism for dispute settlement should not require the parties to politicize what are essentially business problems. The goal is the promotion of healthy economies and world trade. Considering the obstacles to effective international arbitration using the present conflict rules, especially from the developing countries point of view, it will be more useful to promulgate international substantive standards and rules on investment codes and leave dispute settlement to the national courts.

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