

ARBITRATION CLAUSES: WHAT LAW GOVERNS AND WHO DECIDES?

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The title of this article “Arbitration Clauses: What Law Governs and Who Decides” raises questions that are addressed by the area of law known as “conflict of laws” or “private international law”. What this area of law deals with is the conflict that can arise in international transactions between competing legal systems. Conflict of law rules try to resolve the question of what law applies to a particular legal problem. So, for example, there are rules in Canada, and other countries, used to determine what law would apply if a Swiss chartered airplane (built in Seattle) flying from London to Vancouver and carrying nationals from 15 countries crashes with the initial impact taking place in Saskatchewan, the second impact taking place in Alberta with the plane then ploughing across the border into Montana where it comes to rest. Likewise, those same conflict of law rules would be used to determine the applicable law where an American canal pilot, employed by the Panama Canal Commission is injured during the course of a Canal transit while on board a vessel owned by a Canadian company with a port of registry at Edmonton, Alberta and who sues in Vancouver. More germane to this article, conflict of law rules are also used to determine what law should govern contracts entered into between parties, whether or not there is an express choice of law clause in the contract. So, for example, conflict of laws rules would be used to determine the proper law of a voyage charter entered into between a Greek shipowner and a B.C. forest company, negotiated through brokers in New York and Montreal respectively, and signed in London by the Greek shipowner and an agent of the B.C. forest company, for the carriage of lumber from Vancouver to China.

As might be expected, the conflict of law rules will often vary depending on the nature of the problem. So, for example, the conflict of law rules relating to torts (the plane crash case or the pilotage case reference above) will be different from the conflict of law rules that would apply to questions arising from a contract. Likewise the assessment of what law should govern a particular problem will vary from country to country. So, for example a Canadian court may use the “actionable, not justifiable” rule to determine the proper law of the plane crash described above, whereas an American court may use a “government interest” analysis to determine the applicable law. The conclusions of each court may well be different and that difference may motivate litigants to start a suit in one country rather than another.

To complicate matters somewhat further in Canada, at least, some of the conflict of law rules are set out in legislation, although most conflict of law rules have been developed as common law principles – in other words by judges on a case by case basis. In the result, determining the applicable conflict of law rules and properly applying those rules can be a difficult task for an experienced judge, let alone a commercial arbitrator without a legal background.

More to the point of this article, what law governs a dispute between two parties and who gets to make that decision are common questions raised in the context of international transactions,

particularly maritime transactions. How such questions are answered will depend, to a large extent, on where they are asked. Provided the court or arbitrator asked has “jurisdiction” to answer the question then they will, no doubt, answer it to the best of their ability. From a purely local (i.e., Canadian) point of view the court or arbitrator would be correct, provided they properly had jurisdiction, if they concluded they were the right person to decide what law governs. In other words it is the decision maker who decides the applicable law in Canada. While they may be the right person in Canada, the court of another country may not agree, and therefore issues of enforcement of a judgment or arbitration award may arise. Fortunately efforts have been made at the international level to obtain some consensus on the recognition and enforcement of foreign arbitral awards and foreign judgments. In any event, from an arbitrator’s point of view, whether an award is enforceable outside of Canada is ultimately someone else’s problem.

Who Decides

While the title of this article is “What Law Governs and Who Decides” the first issue that must be addressed is “who decides”. It makes little sense for an arbitrator to decide the applicable law if that issue is something to be referred to the court. So then, who gets to decide what law governs?

As a starting point on questions of this nature, one should look to the *Commercial Arbitration Act*. Section 5 of that Act provides in part as follows:

“5.(1) Subject to this section, the Code has the force of law in Canada.

(2) The Code applies only in relation to matters where at least one of the parties to the arbitration is Her Majesty in right of Canada, a departmental corporation or a Crown corporation or in relation to maritime or admiralty matters.”

The schedule to the *Commercial Arbitration Act* provides expressly who should decide what law governs a dispute referred to arbitration. Article 28 of the schedule provides, in part, as follows:

“Rules Applicable to Substance of Dispute

(1) The arbitral tribunal shall decide the dispute in accordance with such rules of law as are chosen by the parties as applicable to the substance of the dispute. Any designation of the law or legal system of a given State shall be construed, unless otherwise expressed, as directly referring to the substantive law of that State and not to its conflict of laws rules.

(2) Failing any designation by the parties, the arbitral tribunal shall apply the law determined by the conflict of laws rules which it considers applicable.”

How then is Article 28 to be interpreted and applied? The first sentence in Article 28(1) clearly provides that if the parties choose a particular law then the arbitral tribunal should apply that law. So, for example, if an arbitration clause provides: “the arbitration shall be in Vancouver and U.S. law shall govern”, then an arbitrator is obliged to apply U.S. law to the problem.

If there was any doubt about what the reference to U.S. law means, in our example, that is resolved in the second sentence of Article 28(1). That sentence provides that the law expressed is the “substantive law” of that country, not the “conflict of law rules” of that country. This is a significant provision designed to create certainty in the selection of the applicable law. As an example, if the choice of U.S. law included U.S. conflict of law rules then for a given legal problem an arbitral tribunal may well conclude that U.S. conflict law rules would result in the application of another law. An arbitrator would then, if applying U.S. conflict of law rules, be obliged to apply that foreign law. What, then, if that foreign law also has conflict of law rules which refer the matter back to U.S. law or some other law? Great uncertainty would be created.

Article 28(2) addresses what happens in the absence of an express choice of law. In such a case, according to Article 28(2), the arbitral tribunal “shall apply the law determined by the conflict of laws rules which it considers applicable.” This means the arbitrator decides what is the applicable law, and that is done by choosing the conflict of law rules considered appropriate. In other words if the arbitration clause provides: “disputes shall be referred to arbitration in Vancouver”, but is silent on what law governs the arbitrator must decide what conflict of law rules to use in order to decide what is the applicable law. In doing this the arbitrator will be expected to give some reasons for the choice of conflict of law rules.

Article 28(2) is interesting in that it is not the way a judge would decide such a problem. A judge if faced with an international contract without a choice of law clause would apply his/her conflict of law rules to determine the proper law. So, if a judge is sitting in Vancouver, Canadian conflict of law rules would be used. If a judge is sitting in Seattle, U.S. conflict of law rules would be used. An arbitrator sitting in Vancouver, however, can use whatever conflict of law rules he/she deems appropriate. According to the drafters of Article 28(2) it was presumed that an arbitrator would probably look to factors that connect a contract or dispute to a particular country (which is a common conflicts approach) to determine which conflict of law rules to apply.

To summarize, under the *Commercial Arbitration Act* where there is a referral in a contract to arbitration in Vancouver, but the contract is silent on what law applies, the arbitrator must decide which conflict of law rules apply and then, using those conflict of law rules, determine what is the applicable law.

What Law Governs?

Courts in different countries, and by implication arbitrators in different countries, will answer this question differently. There was a time when the questions would be answered the same way in England and in Canada. There was a time when the question would have been answered differently. Likewise, the U.S. approach to such a question has changed and developed over the years and has not always been consistent with the approach (or approaches as the case may be) taken by English or Canadian jurists. That being said it is an extremely interesting area of the law and one that is, to a very large extent driven by facts. That, of course, is not to say that legal principles are not important – they are. Rather it is to say that the law relating to “choice of law” questions in respect of contracts requires that one looks to the facts of each case in order to determine what is the “proper law” of the dispute.

As indicated by Article 28(2) of the *Commercial Arbitration Act*, an arbitrator will first have to decide what conflict of law rules to apply where there is no express choice of law. The arbitrator will then have to apply those rules to determine the applicable law.

Choice of law in the case of contracts is somewhat uniform in the common law countries. This is not to say it is the same in those countries. Rather, it is to say there is some consistency in approach. Fortunately for lawyers and arbitrators, William Tetley in his text International Conflict of Laws 1994 (Blais Publishing, Montreal) sets out summaries of the conflicts of law rules applicable to contracts in various countries. As examples Professor Tetley provides the following information:

England: the proper law of the contract is that chosen by the parties so long as the choice is *bona fide* and not contrary to public policy. If there is no express choice then efforts are made to determine the intention of the parties. Intention of the parties may be inferred by the choice of jurisdiction or place of arbitration (eg. High Court of England or London arbitration). If that does not achieve a result then the proper law is the country whose system of law the contract has the **closest connection**. To determine this issue factors such as the place of dispute resolution, the place of contracting, and the place of performance will be considered.

United States: where there is no express choice of law then one usually will determine the proper law by “**ascertaining the place of most significant contracts** between the parties and the subject matter of the contract.” In other words, one would look to factors such as the residence of the parties, the place of dispute resolution, the place of contracting, and the place of performance like in England.

Canada: like in England where there is an express choice of law that will usually determine the issue. Where there is no express choice of law then the court will attempt to infer or imply a choice of law. Where that cannot be done then the court will look to the **closest and most real connection**. Again in determining the closets and most real connection factors like the residence of the parties, the place of dispute resolution, the place of contracting and the place of performance will be significant. In shipping cases, the port of registry and the flag of the vessel would also be considered as factors.

J.G. Castel in his text Canadian Conflict of Laws, 1997, 4th Ed. (Butterworths, Toronto) has a good discussion of the Canadian approach to this problem. As set out by Tetley, Castel says there are three general rules in Canada: 1) if there is an express choice then it is usually applied; 2) if there is no express choice then efforts will be made to determine if there is an implied choice; and 3) if no implied choice then one looked to the system of law with the closest and most real connection.

In relation to determining the parties intention in the absence of an express choice, an agreement to arbitrate in Vancouver will usually, but not always, result in the conclusion that the parties intended by that reference that Canadian law would apply. Likewise if the parties agree that dispute will be resolved in B.C. Supreme Court then it will likely be concluded that the parties intended B.C. law to apply. Other factors that will be used to determine the intention of the parties, according to Castel, include the following:

1. the form of document used;
2. the currency of the transaction;
3. the language used;
4. a connection with a preceding transaction;
5. the nature and location of the subject matter of the transaction; and,
6. the residence or head office of the parties.

Where there is no express or implied choice of law the court will then look to the law that has the **closest and most real connection**. Again as set out above the factors the court will look at, according to Castel, include the following:

1. the place of contracting;
2. the place of performance;
3. the place of residence or business of the parties; and
4. where the subject matter of the contract is located.

To summarize, the applicable law of the contract will be decided by the application of a set of conflict of law rules determined by the arbitrator. Where there is an express choice of law in the contract that choice will govern. Where there is no express choice of law then under the Canadian and English approach efforts will be made to determine the intention of the parties from the contract. If there is an arbitration clause calling for arbitration in Vancouver then there is a strong inference to be made that the parties intended Canadian law to apply. Where the intention of the parties cannot be ascertained then a decision based on the closest and real connection should be used to determine the issue.

Summary

Who decides the applicable law and determining the applicable law raises interesting legal issues for lawyers to solve. In general terms the arbitrator will decide, if the parties have not, through the application of conflict of law principles selected by the arbitrator. To a very large extent that decision will be based on the arbitrator's assessment of what the parties intended, or where that assessment cannot be made what legal systems appears to have the closest connection to the dispute. Of course this uncertainty is easily avoided by stating expressly what law governs in the arbitration clause.