Fail to Choose, Choose to Fail: Reform of the Choice of Law Principles to Determine the Law Applicable to the Arbitration Agreement

1. Introduction

A number of different laws apply during the course of arbitral proceedings. Parties often select a governing law for their contract. In addition, more sophisticated parties may select the *lex arbitri*, the procedural law that will apply to the arbitration, by specifying a seat; for example, an arbitration seated in London will be governed by the Arbitration Act 1996.[1] To tailor their proceedings further, parties may select institutional rules to apply to their dispute. Notably, however, even the most sophisticated parties rarely include an express choice of law to govern the arbitration agreement.[2] Since the parties are unlikely to have made their own arrangements, it is vital that the choice of law principles are clear and predictable.

Unfortunately, the current law is both complicated and contradictory. Commercial actors are left unsure as to the approach the court will adopt on the issue, which may, in turn, alter the outcome of their substantive claim. It is argued, therefore, that the Arbitration Act 1996 should be amended to include choice of law principles to determine the law applicable to the arbitration agreement, thereby increasing commercial certainty and reinforcing London's position as a centre for international arbitration.

[1] s. 2(1) Arbitration Act 1996.
[2] *Sulamérica SA v Enesa Engelharia SA* [2012] EWCA Civ 638, [2013] 1 WLR, [11].

2. The Current Law

2.1. The Three-Stage Test

The choice of law principles to determine the law applicable to the arbitration agreement have caused confusion both within our jurisdiction and internationally. One area that is settled is the three-stage approach that the court will adopt:

(1) Is there an express choice of law?

(2) Is there an implied choice of law?

(3) In the absence of choice, which system of law has the closest connection to the arbitration agreement? [3]

Deceptively simple, the application of this test has led to inconsistent judgments which can be divided into two main streams of thought. First, it should be presumed that the law of the underlying contract applies to the arbitration agreement. Alternatively, it should be presumed that the law of the seat applies to the arbitration agreement.

2.2. Presumption in Favour of the Law of the Contract

The leading case in support of the law of the underlying contract is *Sulamérica*. The Court of Appeal, relying on the *Channel Tunnel*[4] and *Black Cawson*,[5] held that, although the arbitration agreement may be governed by a different law, "it is probably fair to start from the assumption that, in the absence of any indication to the contrary, the parties intended the whole of their relationship to be governed by the same system of law."[6] Therefore, where parties have made an express choice of law to govern the

[3] Ibid, [9].
[4] *Channel Tunnel Group Ltd v Balfour Beatty Construction Ltd* [1993] AC 334.
[5] *Black Cawson International Ltd v Papierwerke Waldhof-Aschaffenburg AG* [1981] 2 Lloyd's Rep 446.
[6] *Sulamérica* (n 2), [11]

underlying contract, that law presumptively applies to the arbitration agreement. This approach has subsequently been adopted in *Arsanovia*[7] and *Habas Sinai,*[8] and by the Singapore High Court in *BCY v BCZ*.[9]

2.3. Presumption in Favour of the Law of the Seat

On the other side of the spectrum, Popplewell LJ held in *Enka v Chubb* that there is a strong presumption that the parties have chosen the law of the seat to apply to the arbitration agreement.[10] In contrast to *Sulamérica*, the choice of law clause in the underlying contract is only relevant if it can be construed as an express choice of law to govern the arbitration agreement. This approach is supported by the earlier Court of Appeal decision in *C v D*[11] and the Singapore High Court in *Firstlink*.[12]

[7] *Arsanovia Ltd v Cruz City I Mauritius Holdings* [2013] 1 Lloyd's Rep 235.
[8] *Habas Sinai v VSC Steel Co Ltd* [2014] 1 Lloyd's Rep 479.
[9] *BCY v BCZ* [2016] SGHC 249.
[10] *Enka Insaat Ve Sanayi AS v OOO Insurance Company Chubb & Ors (Rev 1)* [2020] EWCA Civ 574, [105].
[11] *C v D* [2008] 1 All ER (Comm) 1001.
[12] *Firstlink Investments Corp Ltd v GT Payment Pte Ltd* [2014] SGHCR 12.

3. Why Reform?

3.1. Criticism

There are two main problems with the current law. The first, and most obvious problem, is that the judicial divide leads to unpredictable outcomes which threaten commercial certainty. As Popplewell LJ expressed, "it would be idle to pretend that the English authorities speak with one voice."[13]

Second, the reasons which justify displacing the presumption are unsatisfactory and inadequately defined, as illustrated by *Sulamérica* itself. The Court of Appeal, having articulated that there was a strong presumption that the law of the contract should apply, went on to apply the law of the seat, with Moore-Bick LJ indicating that:

> "an agreement to resolve disputes by arbitration in London, and therefore in accordance with English arbitral law, does not have a close juridical connection with the system of law governing the policy of insurance, whose purpose is unrelated to that of dispute resolution; rather, it has its closest and most real connection with the law of the place where the arbitration is to be held and which will exercise the supporting and supervisory jurisdiction necessary to ensure that the procedure is effective. Its closest and most real connection is with English law."[14]

Although it is argued that the Court of Appeal's conclusion was correct, an alternative explanation for the result, as presented by Pearson, is to be preferred.[15] On this view, the presumption was displaced because the law of the underlying contract, Brazilian law, required both parties to consent to the arbitration, rendering

[13] *Enka v Chubb* (n 10), [69].
[14] *Sulamérica* (n 2), [32].
[15] Sabrina Pearson, '*Sulamérica v. Enesa:* The Hidden Pro-validation Approach Adopted by the English Courts with Respect to the Proper Law of the Arbitration Agreement', 29 *Arbitration International* 115 (2013).

the arbitration agreement unenforceable.[16] In contrast, under the law of the seat, English law, the agreement was enforceable. Therefore, the court applied the law which validated the arbitration agreement. It is argued, in support of Merkin and Flannery, that this validation principle would "provide a sounder and more rational theoretical foundation for the approach of the Court of Appeal" in *Sulamérica."*[17] The legislative proposal below explicitly incorporates this pro-arbitration analysis.

3.2. Why Legislative Intervention rather than Judicial Decision?

It may be argued that this proposal is rendered moot by the Supreme Court's consideration of the issue in *Enka v Chubb*,[18] in which the question "what is the correct approach to determining the proper law of an arbitration agreement?" has been considered, with judgment pending. Further, permission to appeal to the Supreme Court has also been sought on this issue in *Kabab-ji Sal (Lebanaon) v Kout Food Group (Kuwait)*.[19] With the Supreme Court on the cusp of clarifying this issue, why is legislative reform required?

Legislation is required for four reasons. First, while the Supreme Court may clarify the issue before it, legislative intervention provides the opportunity to consider holistically the different situations which may arise and to create a robust and coherent regime in response. Second, codification of choice of law principles provides clarity, as seen in the success of the Rome I and Rome II Regulations,[20] which provide a 'roadmap' to the choice of law that the court will apply. Whilst a dispute about

[16] See *Sulamérica* (n 2), [31].
[17] Robert Merkin QC and Louis Flannery QC, *Merkin and Flannery on the Arbitration Act 1996* (6th Edn., Routledge 2019), p. 549.
[18] *Enka v Chubb* (n 10).
[19] *Kabab-ji Sal (Lebanaon) v Kout Food Group (Kuwait)* [2020] EWCA Civ 6.
[20] Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I), Regulation (EC) No 864/2007 of the European Parliament and of the Council of 11 July 2007 on the law applicable to non-contractual obligations (Rome II).

applicable law may nevertheless arise, the legislative 'roadmap' enables the parties to arrange their affairs accordingly. Third, legislation may encourage a change in party behaviour. If the parties are alive to the issue at the time of drafting, rather than the time of dispute resolution, they may choose to include an express choice of law in their arbitration agreement. Fourth, legislative reform would provide an opportunity to acknowledge the importance of pro-arbitration and validation principles in determining the law applicable to the arbitration agreement. Other jurisdictions have included a validation principle within their legislation, including the Swiss Law on Private International Law[21] and the Spanish Arbitration Act 2011.[22] Such a provision would cement England's position as an attractive seat for international arbitration.

[21] Article 178(2) Swiss Law on Private International Law.
[22] Article 9(6) Spanish Arbitration Act 2011.

4. Proposal

4.1. Choice of Law Principles in the Arbitration Act 1996

The following provision ("the proposal") could be inserted following section 7 (separability of the arbitration agreement).

7A – Law Applicable to the Arbitration Agreement

(1) Unless otherwise agreed by the parties, the law applicable to the arbitration agreement shall be determined as follows –

(a) the arbitration agreement shall be governed by the law expressly chosen by the parties;

(b) in the absence of express choice, the arbitration agreement shall be governed by the law impliedly chosen by the parties, as demonstrated by the terms of the contract and all the circumstances;

(c) in the absence of choice, the arbitration agreement shall be governed by the system of law which has the closest connection to the arbitration agreement.

(2) For the purpose of determining the system of law which has the closest connection to the arbitration agreement in accordance with subsection (1)(c) –

(a) where the arbitration agreement takes the form of an arbitration clause contained within a substantive contract, and

(b) there is a choice of law to govern the substantive contract,

there is a presumption that the system of law chosen by the parties in respect of the substantive contract has the closest connection to the arbitration agreement.

(3) The circumstances in which the presumption in subsection (2) can be rebutted include, but are not limited to, those in subsections (4) and (5).

(4) Where –

(a) applying the law applicable to the substantive contract would render the arbitration agreement invalid, and

(b) applying the law of the seat of the arbitration would not render the arbitration agreement invalid,

the presumption shall be rebutted and the law with the closest connection to the arbitration agreement shall be the law of the seat.

(5) Where –

(a) applying the law applicable to the substantive contract would limit the scope of the arbitration agreement,

(b) with the result that disputes that a rational businessman would expect to be dealt with in the same proceedings would be required to be submitted to separate arbitration and litigation proceedings, and

(c) applying the law of the seat, all of these disputes would be submitted to arbitration,

the presumption may be rebutted and the law with the closest connection to the arbitration agreement may be the law of the seat.

(6) In determining whether the presumption in subsection (2) has been rebutted, the court shall have regard to all the circumstances, including the extent to which the efficacy of the arbitral process would be impacted by the application of the respective laws.

4.2. Reasons for Proposal

(a) Subsection (1)

Subsection (1) of the proposal is uncontroversial; it encapsulates the current position adopted by the English courts.[23] However, this does not mean that parties cannot determine their own choice of law principles; this section would be a non-mandatory provision which the parties may deviate from, for example, through express agreement or by agreeing to the application of institutional rules pursuant to s. 4(3) Arbitration Act 1996.

(b) Subsections (2)-(3)

Subsection 2 addresses the law applicable to an arbitration agreement contained within a matrix contract. It is helpful to clarify this point because it has caused difficulty in the courts. The proposal includes a presumption that the law of the underlying contract will also apply to the arbitration agreement, which accords with the view adopted in *Sulamérica*.[24] However, the view is contentious and it has subsequently been questioned by the Court of Appeal in *Enka v Chubb*[25] and is contrary to previous Court of Appeal rulings, for example, in *C v D*.[26] The view adopted in *Sulamérica*, and refined in the proposal, is the most attractive approach for three reasons.

First, this approach most accurately reflects the parties' intentions. Where the parties have included an arbitration agreement within a substantive contract, it is likely that they expected the contract in its entirety to be governed by the same law. This general intention is reflected in the presumption that the law of underlying contract

[23] *Sulamérica* (n 2), [9].
[24] ibid (n 2), [11].
[25] *Enka v Chubb* (n 10).
[26] *C v D* (n 11).

also applies to the arbitration agreement. In most cases, that will be the end of the story. However, this *general* intention must yield to the parties' *specific* intention to submit their disputes to arbitration,[27] with the result that the presumption should be rebutted where the law of the underlying contract would render the arbitration agreement ineffective. In this way, both the presumption and the rebuttal of the presumption accord with the parties' intentions.

Second, the doctrine of separability does not preclude a presumption that the law of the underlying contract also applies to the arbitration agreement. The purpose of separability, as Born defines, is to "enhance[e] the efficacy of the arbitral tribunal as a means of dispute resolution."[28] In English law, under s. 7 Arbitration Act 1996, separability enhances the efficacy of the arbitral process where it would be undermined by the invalidity or non-existence of the underlying contract, with the result that the arbitration agreement is treated as distinct "for that purpose." However, the doctrine does not dictate that the arbitration agreement must be treated as distinct from the contract for *every* purpose;[29] on the contrary, the parties are likely to have considered the agreement as a clause of their main contract.

Third, practical difficulties arise when starting from the presumption that the arbitration agreement is governed by the law of the seat, rather than the law of the underlying contract. The submissions before the Supreme Court in *Enka v Chubb* shed light on this. Emphasising that the arbitration agreement is not "hermetically sealed" from the main contract, David Bailey QC highlighted three practical issues that arose in that case.[30] Do definitions, such as "agreement", or concepts such as "good faith,"

[27] The Court of Appeal hints at this reasoning in *Sulamérica* (n 2) at [31].
[28] Gary Born, *International Commercial Arbitration*, (2nd Edn., Kluwer Law International 2014), p. 469.
[29] *BCY v BCZ* (n 9), [61].
[30] Supreme Court Hearing, *Enka v Chubb*, Case ID UKSC 2020/0091, <https://www.supremecourt.uk/watch/uksc-2020-0091/270720-am.html> (accessed on 18/09/20).

used throughout the matrix contract fall to be interpreted under a different law in the arbitration agreement? Where the clause containing the arbitration agreement forms part of an “indivisible” term, which includes both the obligation to arbitrate as well as other rights and obligations, are those other rights and obligations also governed by the law of the seat? How do related clauses, governed by different laws, interact? These practical difficulties can be avoided when a consistent approach to interpretation is adopted, applying the same law to the entirety of the contract, with the possibility of rebutting the presumption where necessary. Therefore, the approach in *Sulamérica*,[31] and refined here, is the most appropriate.

On a different issue, with respect to an arbitration agreement not contained within a matrix contract, it does not appear necessary to include a separate subsection in the proposal. In those circumstances, it is likely that the application of the closest connection test will be straightforward and the law of the seat will be applicable.[32]

(c) Subsection (4)-(6)

Subsections (4)-(6) create a shift towards open acknowledgement of choice of law principles that enhance the efficacy of the arbitral process, an approach supported by international jurisprudence. Leading commentators, including Born, support a validation principle in determining the choice of law applicable to the arbitration agreement.[33] Some national courts have also expressly acknowledged a validation principle, such as the Austrian Oberster Gerichtshof which held that, in the case of two plausible interpretations, “the interpretation which favours the validity of the arbitration

[31] *Sulamérica* (n 2).
[32] *Enka v Chub* (n 10), [86], *Black Cawson* (n 5).
[33] *Born* (n 28), *p. 592, Merkin and Flannery (n 17), p.* 548-9.

agreement and its applicability to a certain dispute is to be preferred".[34] Beyond the national setting, a pro-enforcement approach is adopted in international conventions, including Article II of the New York Convention which renders arbitration agreements presumptively valid.[35] Subsections (4)-(6) of the proposal, which will be examined in turn, incorporate the validation principle, reinforcing London as an attractive choice of curial jurisdiction.

Subsection (4) addresses one of the most significant issues relating to the law applicable to the arbitration agreement. A argues that the law of the contract applies to the arbitration agreement, rendering it invalid. B argues that the law of the seat applies to the arbitration agreement and, under that law, the agreement is valid. In these circumstances, the validation principle would lead to the application of the law of the seat. The parties intended to submit their dispute to arbitration and would not have intended the applicable law to invalidate their agreement. Therefore, the law of the seat has the closest connection to the dispute. Of subsections (4)-(6), this conclusion is probably the least controversial and the most important. Note the use of "shall": "*the presumption shall be rebutted and the law with the closest connection to the arbitration agreement shall be the law of the seat".*[36] In these circumstances, in order to ensure the efficacy of the arbitral process, it is necessary to conclude that the law of the seat is applicable.

This can be contrasted with subsection (5) which addresses the impact of the applicable law on the scope of the arbitration agreement. Unlike validity, it cannot be presumed conclusively that the parties did not intend to submit some disputes to

[34] *Austria No. 19, R GmbH v. O B.V. (Netherlands), O Co Ltd (Japan) and others, Yearbook Commercial Arbitration 2009 - Volume XXXIV* (Van den Berg (ed.)), p. 405.
[35] Art II (1) and (3), United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards.
[36] Emphasis added.

arbitration and others to litigation. Hence the use of "may": "*the presumption may be rebutted and the law with the closest connection to the arbitration agreement may be the law of the seat.*"[37] This is consistent with *Fili Shipping v Premium Nafta*, where the House of Lords indicated that the starting assumption is that rational businessmen would have intended all disputes arising out of their relationship to be decided by the same tribunal.[38] However, where there are good reasons to limit the scope of the arbitration agreement, the presumption will not be rebutted. This formulation strikes the appropriate balance between respect for the parties' commercial decisions whilst also upholding pro-arbitration principles.

Finally, subsection (6) provides more general guidance for the court in determining the closest connection in circumstances beyond those prescribed in subsections (4)-(5). By explicitly directing the court to consider pro-arbitration principles in their analysis, the court's underlying considerations should now be openly discussed in their judgment as one factor amongst all of the circumstances.

[37] Emphasis added.
[38] *Fili Shipping Co Ltd and others v Premium Nafta Products Ltd and others* [2007] UKHL 40 [2007] Bus. L.R. 1719, [7].

5. Conclusion

The choice of law principles to determine the law applicable to the arbitration agreement are unnecessarily complicated and unpredictable. The criticisms levelled at the current law can be addressed by amending the Arbitration Act 1996 to include a comprehensive regime and "roadmap" to judgment: (1) the court will apply the familiar three-stage test, (2) in determining the closest connection, the court will presume that the law of the contract will apply to the arbitration agreement, (3) the presumption will be rebutted in circumstances where the efficacy of the arbitral process would be undermined, for example, where the agreement to arbitrate would be invalidated. By openly acknowledging the validation principle and pro-arbitration analysis, England's position as an attractive choice of curial jurisdiction will be strengthened. Merkin and Flannery expressed "hope" that the courts would "be so bold" as to adopt a validation principle.[39] It is argued that, if the courts cannot or will not acknowledge such a principle, the legislature should take this bold step.

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[39] Merkin and Flannery (n 17), p. 549.