

Choice of Non-state Law in International Commercial Contracts

Introduction

Party autonomy is a principle of contract law widely accepted around the world. According to the principle parties to a contract can choose the law that will govern their contract. This means that the contract will be interpreted according to that law, and if the parties have not regulated one or more issues in the contract, the court will do so according to that same law. However, currently there is much discussion about whether the parties to an international commercial contract can choose non-state law¹ to govern their contract. It can be speculated that national courts are somewhat less reluctant in applying non-state law without reservations, whereas in an arbitral setting this seems to be possible. The present paper aims to provide a general overview of the current setting and tendencies of application of non-state law to commercial disputes. Both national and international legislative responses to this question will be discussed in view of identifying some of the problems linked to the difficulty of applying non-state law.

Law Applicable to Contractual Obligations: International Instruments

According to the party autonomy (or freedom of choice) principle², parties are allowed to choose the law applicable to their contract. At the beginning of the 20th century this principle was highly disputed, however half a century later it was more or less accepted by all courts and scholars. In

¹ Non-state law can also be referred to as transnational or a-national law.

² This principle is known as *lex voluntatis*

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1980 the principle was recognised and included in the Rome Convention on the Law Applicable to Contractual Obligation (Rome Convention).³

In its Article 3 the Convention recognises the principle of freedom of choice according to which the parties can choose the law applicable to the contract. However, the first article of the Convention states that the Convention “shall apply to contractual obligations in any situation involving a choice between the laws of different countries.” This means that the law chosen should be state law.

The aforementioned was confirmed in the *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd* case⁴. The bank had sued in the London High Court for due payment by the customer, on the basis of their *murabaha* agreement⁵. The agreement contained a clause which determined that “[s]ubject to the principles of the Glorious Sharia'a, [the] Agreement shall be governed by and construed in accordance with the laws of England.” The customer refused to pay arguing that the contract was invalid because it violated Islamic law. Both the London High Court and the English Court of Appeal held that the contract was to be governed by English law. The Court held that according to the Rome Convention, there could only be one law applicable to the contract and it had to be a state law, therefore it evaluated the contract only according to English law. The basis of the decision was Article 3 of the Convention.⁶

³ Giesela Rühl, “Party Autonomy in the Private International Law of Contracts: Transatlantic Convergence and Economic Efficiency” (CLPE Research Paper No. 4/2007) (2007) 03:01 Law Research Institute Research Paper Series at 6, online: SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=921842

⁴ 1 WLR 1784 (CA 2004) (UK)

⁵ Contract of sale of goods, in which the seller buys the goods specified by the buyer in its own name; then sells them to the buyer on a deferred payment basis, payable in instalments, thus benefiting from the difference of the original and deferred prices.

⁶ *Supra* note 4 at para 48.

In the EU the Rome Convention has been replaced by the Rome I Regulation (Rome I).⁷ In the initial proposal of the Commission choice of non-state law was to be permitted, except *lex mercatoria*, on the basis that it is not precise enough. However, that formulation was rejected and Rome I entered into force replicating the Rome Convention in its prohibition of choice of non-state law.⁸ Nonetheless, heading 13 of the Preamble provides that “[the] Regulation does not preclude parties from incorporating by reference into their contract a non-State body of law or an international convention.” On the other hand, according to article 4.2, in case no law is chosen, then the applicable law is that of the state where the party who is executing the characteristic performance of the contract habitually resides. Thus, in the case where parties have not made a choice as to the applicable law, the application of non-state law by the court or the tribunal is excluded.

Choice of Non-state Law under National Laws

Some countries, including Canada, have adopted legislation base on the UNCITRAL Model Law on International Commercial Arbitration. The Model Law, which has no binding force, was adopted by the UN Commission on International Trade Law in 1985 and has been amended in 2006.⁹

⁷ No. 593/2008 of the European Parliament and of the Council of 17 June 2008 on the Law Applicable to Contractual Obligations, OJ L 177/6

⁸ Willem Vernooij, “Rome I: An Update of the Law Applicable to Contractual Obligation in Europe”, online: (2009) 15 Colum. J. Eur. Online 71 at 73 http://www.cjel.net/online/15_2-vernooij/

⁹ Online: UNCITRAL http://www.uncitral.org/uncitral/en/uncitral_texts.html

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According to article 28 of the UNCITRAL Model Law, parties have the freedom to choose the applicable law; however an arbitral tribunal is bound by state law, which means that arbitrators can't decide the case on the basis of non-state law.¹⁰ This is due to the fact, that when no choice is made by the parties, the arbitrator finds the applicable law according to conflict of law rules. This in turn means that the end result, in other words, the applicable law, is going to be state law, since conflict of laws rules designate state law. However, according to article 28.4 arbitrators have to "...take into account the usages of the trade..."

In Canada, most of the Provinces have adopted International Commercial Arbitration acts which are based on the UNCITRAL Model Law. However in most cases article 28 has been modified so as to give the arbitrators the right to choose the applicable law, without having to refer to conflict of laws rules. Therefore, unlike state courts, the arbitrators are not bound by such rules.¹¹ This seems to give arbitrators more freedom in terms of application of non-state law, as opposed to applying the national law designated by conflict of laws rules.

In France also the arbitrators can choose the law applicable without being bound by conflict of laws rules. Unlike this, in the US parties have to agree in order for the arbitrator to be able to apply non-state law.¹²

The Swiss Code on International Private Law is of particular interest, because its analysis shows that application of non-state law is impossible. According to the Code the arbitrator has to

¹⁰ Stefan Kirchner, "Transnational Law and the Choice-of-Law Competence of Arbitral Tribunals in International Commercial Arbitration" (2007) online: SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=988677 at 3.

¹¹ Marvin Baer *et al.*, *Private international law in Common law Canada: cases, text and materials*, 2nd ed. (Toronto: Emond Montgomery Publications, 2003) at 645.

¹² *Supra* note 10 at 4.

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choose the rules of law to which the case is most connected. Since in an international setting there is always a state that is somehow connected to the case, then this eliminates the possibility of no state connection, therefore eliminating as well the possibility of applying non-state law.¹³

To go back to the USA, section 1-301(c) (2) of the Uniform Commercial Code (UCC) states that “an agreement by parties to an international transaction that any or all of their rights and obligations are to be determined by the law of this State or of another State or country is effective, whether or not the transaction bears a relation to the State or country designated.” The provision clearly refers to state (country) law; however, official comments provide that through incorporation parties may choose non-state law as to variable provisions of the UCC. UNCITRAL and the UNIDROIT Principles are actually explicitly stated as non-state law that may be chosen, so are trade codes.¹⁴

On the other hand, it is worth noting that although Restatement (First) of the Law of Contracts in the USA did not allow the parties to choose the applicable law, its successor, Restatement (Second), does permit party autonomy, including choice of non-state rules. More specifically, subsection 1 of the Reporter’s Note to §187 provides that “the parties may also stipulate for the application of trade association rules or well known commercial customs.” Nonetheless, as with the UCC, the parties can only replace variable rules but not the non-variable rules.¹⁵

¹³ *Supra* note 10 at 5.

¹⁴ *Uniform Commercial Code* 1957, §1-302, comment 2 (2001 Revision).

¹⁵ Symeon C. Symeonides, “Party Autonomy and Private-Law Making in Private International Law: The Lex Mercatoria that Isn’t” (2006) online: SSRN http://papers.ssrn.com/sol3/papers.cfm?abstract_id=946007 at 15.

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A significant case was the *Trans Meridian Trading Inc. v. Empresa Nacional de Comercializacion de Insumos*¹⁶, in which the Court of Appeal of the 9th Circuit refused the application of the Uniform Customs and Practice for Documentary Credit (UCP), although the contract expressly stated that it was “subject to the Uniform Customs and Practice for Documentary Credit (1983 Revision) International Chamber of Commerce (Publication no. 400)”. In Restatement (Second) § 3 “state” is defined as “territorial unit with a distinct body of law”. On the basis of this definition the Court held that UCP was not the law “of a foreign jurisdiction, but rather ... a compendium of commercial practices published by the International Chamber of Commerce.” So, the choice of law provision did not “prevent application of California’s Commercial Code”. For this reason the Court refused to enjoin payment on a letter of credit, which otherwise would have been granted under UCP.

Choice of Non-State Law in International Commercial Arbitration

It is an accepted principle that parties to arbitration are free to choose any law, including non-state law as the applicable law.¹⁷ In absence of choice of law by the parties, most arbitration Rules give the arbitrators the right to choose the applicable law that they find appropriate¹⁸.

The ICC Rules of Arbitration of 1998, in article 17, provide that the parties are free to choose the applicable rules of law and that in absence of such a choice by the parties, the arbitrators apply

¹⁶ 829 F2d 949

¹⁷ Vesna Lazić, “The Impact of Uniform Law on National Law: Limits and Possibilities – Commercial Arbitration in the Netherlands”, online: (2009) 13:2 *Electronic Journal of Comparative Law* 1 at 6 <http://www.ejcl.org>

¹⁸ See e.g. *London Court of International Arbitration Rules*, 1998, art. 22.3, *International Chamber of Commerce Rules*, 1998, art. 17.1.

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the rules of law they deem appropriate. They shall also take into consideration trade usages. This is different from the older version of the rules, where the arbitrators had to apply conflict of laws rules in order to determine the applicable law.

The Preamble of the UNIDROIT Principles of International Commercial Contracts (UNIDROIT Principles) of 2004 provides (article 1.101 of the Principles Of European Contract Law (PECL) has almost identical wording) that they will be applied when the parties have chosen them to be applied, and also they may be applied when the parties have decided that the contract is to “be governed by general principles of law, the *lex mercatoria* or the like; or when the parties have not chosen any law to govern their contract.”

There is evidence that the UNIDROIT Principles have been applied quite a number of times in international arbitration, such as that at the International Chamber of Commerce (ICC) Arbitration Court. The same cannot be said for the PECL though. For some reason arbitrators have not been very keen on applying these rules. In the ICC case No. 12111, for instance, the UNIDROIT Principles were accepted by the arbitrator for application, whereas the PECL rules were rejected on the basis that they were yet unknown to the international business community. It is important that even the European Court of Justice has somewhat upheld the UNIDROIT Principles in case C-334/00 *Fonderie Officine Meccaniche Tacconi SpA v Heinrich Wagner Sinto Maschinenfabrik GmbH* of 17 September 2002, where, even though the ECJ didn't make a

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direct reference to the Principles, it upheld the Advocate General's Proposal which was based on the Principles.¹⁹

The New York Convention and Choice of Non-State Law

When talking about choice of non-state law in arbitration, it has to be mentioned that the issue concerns not only the decision-making stage, but also the enforcement of the award. At this stage, since enforcement is granted by state courts and states have varying choice of law rules, questions may arise as to the enforceability of an arbitral award if the arbitrator has applied non-state law (either by the choice of parties or by its own initiative) to the case.

The Convention on the Recognition and Enforcement of Foreign Arbitral Awards (The New York Convention) doesn't seem to prevent choice of non-state law. However it allows a general public policy defence. According to S. C. Symeonides, if the parties' explicit choice was non-state law, then it would be enforceable. Similarly, if the arbitrator applied those norms when it was the choice of the parties, or when the arbitrator decided to apply such norms in cases where the parties' had authorised the arbitrator to decide *ex aequo et bono*, then the arbitral award would not be held unenforceable and on this ground alone the public order defence would probably fail.²⁰

¹⁹ Antonio Hierro & Miguel Angel Malo, "Lex Mercatoria Revisited", online: (2009) The European & Middle Eastern Arbitration Review, Section 2

<http://www.globalarbitrationreview.com/reviews/14/sections/53/chapters/512/lex-mercatoria-revisited/>

²⁰ *Supra* note 15 at 17-18.

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In this regard, the case of *Deutsche Schachtbau-und Tiefbohrgesellschaft v Ras Al Khaimah National Oil Co*²¹ is interesting. The enforcement had been challenged because the arbitrators had applied general principles which form the basis of a number of national legislations on contracts. The English court, where the enforcement was being sought, held that the award was enforceable and wasn't inconsistent with English public policy. It is of importance, that in England the Arbitration Act of 1996 does allow choice of non-state law.²² So the question is, whether this would have been the decision of a court whose national law does not allow choice of non-state law; would the choice of non-state law be considered inconsistent with the country's public policy?

Non-state Law: Problem of Uncertainty

The main problem with choice of non-state law (and hence a very important reason why courts are reluctant to apply such law) is that usually the content of the chosen body of rules is not concrete; there are no codes and even no single opinion as to their substance. Often this means that there is uncertainty as to the sources of the particular "body" of non-state law chosen. The sources of *lex mercatoria*, for instance, are various, including international conventions, usages etc. A very good example is the choice of the Sharia'a by the parties to a contract. The relevant case is *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd*.²³ As mentioned above, the English courts refused to interpret the contractual clauses according to Sharia'a. The reason for this is that Sharia'a is not a uniform codified set of laws, but rather consists of the holy book of

²¹ [1987] 3 WLR 1027, reversed on other grounds, [1990] 1 AC 295.

²² Michael Pryles, "Application of the *Lex Mercatoria* in International Commercial Arbitration" (2008) online: International Council for Commercial Arbitration <http://www.arbitration-icca.org/articles.html> at 14.

²³ *Supra* note 4.

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Islam (*Qur'an*), sayings of Mohammed (*hadith*) and ongoing scholarly interpretations. There are specific Sharia's boards that determine whether a contract is compliant with Islamic law or not. Therefore, it would actually have been impossible for English Judges to decide on that matter. The problem is that the content of non-state law is vague, or else experts would be called in to clarify necessary issues, just as it is done in cases where the applicable law is a foreign national law. So, the issue lies not only in the judge's lack of knowledge, but in the fact that there is uncertainty among all lawyers as to the content of any given non-state law.

In international arbitration, however, there have been cases where *lex mercatoria* has been applied; more specifically there are a number of such ICC cases, some of them not very recent.²⁴ This means that at least in arbitration it is possible to decide the case on the basis of a non-state law. The difference in approach might have a few explanations. Very often parties choosing international commercial arbitration are professionals in their field, often big companies that can afford the costs of arbitration; therefore they are probably keen on applying the trade practices they themselves create and apply in business, and since arbitration, being a voluntary choice, is meant to be more favourable towards the party's choice, in other words, is somehow expected to satisfy their wish and expectations, it is less stringent and tends to allow choice of non-state law. After all, international commercial arbitration seems to be aimed at satisfying the needs of the international business community. One can even go so far as to think that there is some kind of a competition between state courts and arbitration courts, so the latter are trying to "win customers" by offering more flexible terms. Other than that, there are probably also sovereignty issues involved in this matter. For instance in the *Shamil Bank of Bahrain EC v Beximco*

²⁴ See e.g. ICC Case No. 8365 of 1966, Case No. 3131 of 1979, Case No. 9875 of 1999 as cited in *Supra* note 22 at 16.

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Pharmaceuticals Ltd case mentioned above, the English Court held that English law, “... distinguished internationally for its popularity and high quality, should not be diluted by religious principles.”²⁵

Nevertheless, the difficulty of applying non-state law even in arbitration should not be ignored, because there is always the problem of ambiguity of the chosen law. Some have argued that although when talking about non-state law it is impossible to identify a distinct body of rules, there is a general standard in every given case. The suggestion is that it is the parties that should show and persuade the arbitrator what the applicable standard is in each case, which can derive from international conventions, general principles of law, trade usages etc.²⁶ This argument is mainly for the choice of *lex mercatoria*. However, taking into account the view that the sources of *lex mercatoria* are various, including international conventions, usages, customs etc, it seems that in practice it will be difficult to determine the “scope” of the applicable *lex mercatoria*. The problem will not arise in cases where the parties agree with each other. However, in cases where the parties have disagreements, this might prove to be more challenging, especially where there is a complex set of rules and usage that may all be referred to as being the current *lex mercatoria* on that specific matter. This process might be long and difficult both for the parties and the arbitrators, whereas, especially in arbitration, time and procedure should be very efficient, since they constitute one of the advantages of arbitration.

²⁵ Andreas Junius, “Islamic Finance: Issues Surrounding Islamic Law as a Choice of Law under German Conflict of ALws Principles” (Winter 2007) 7 Chi. J. Int'l L. 537 at 3.

²⁶ *Supra* note 22 at 13.

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This uncertainty is addressed to some extent by the adoption of international instruments such as the Vienna Convention on the International Sale of Goods, the UNIDROIT Principles and the PECL mentioned above, which are considered to represent contemporary *lex mercatoria* and can be chosen by parties as the law applicable to their contract, as opposed to using the rather vague term of *lex mercatoria*.²⁷ The advantage of these instruments is that they were drafted taking into account both common law and civil law traditions and they are “tailor made” for an international setting.

Another solution might be the physical incorporation into the contract of the rules that the parties want to apply to their contract rather than incorporation by reference only, because it is in this latter case that the uncertainty of the content of the chosen rules arises. This, however, can prove to be problematic, as it is not always possible to incorporate a set of rules into a contract. For instance, attaching the entire Sharia’a to a contract doesn’t seem realistic (it is probably even impossible). However, if no other solution is possible, at least some important clauses may be incorporated.

²⁷ *Supra* note 19.

Conclusion: Developments

It is interesting how different jurisdictions deal with the question of arbitrators' powers as to choosing non-state law as the applicable law. It seems, however, that legislators are becoming more liberal toward the idea of non-state law governing international contracts. For example, with recent legislative modifications, the State of Oregon (Oregon Revised Statutes §81.120) and the State of Louisiana (Civil Code art. 3540) now have new, unrestricted choice of law rules which allow the parties to choose not only state law but any law.²⁸

As to the Rome Regulation, according to V. Lazić both the Rome Convention and the wording of the Preamble of the Regulation don't prevent parties from using a non-state law (even though they don't address it explicitly). Therefore, jurisdictions who used to allow this under the Convention, will interpret the Regulation similarly. He states, however, that there are authors who do not think this interpretation is true.²⁹ Lazić's interpretation seems reasonable, because, as mentioned above, the initial Proposal presented by the Commission permitted choice of non-state law. However, it seems that the legislator was not willing to provide a "clear-cut" answer, possibly because of country by country policy differences. Therefore the relevant provision of article 3 was "substituted" in the Preamble (heading 13), which states that "[t]his Regulation does not preclude parties from incorporating by reference into their contract a non-State body of law or an international convention." Thus, the phrase "does not preclude" seems to have been chosen in order to give space for various interpretations. However, although this may have been

²⁸ *Supra* note 3 at 19.

²⁹ *Supra* note 17 at 4.

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done deliberately, in terms of uniformity it is not the best solution precisely because of the possibility of varying interpretations. Something that might be of interest is how the European Court of Justice will interpret this provision and whether it will hold that countries that do not allow choice of non-state law are in violation of the Regulation.³⁰

Although still a much disputed issue in state courts, choice of non-state law has often been upheld in international commercial arbitration. However, the application of non-state law is not easy from a practical point of view, given the fact that non-state law is usually vague. This argument is more so true for state courts, which also seem to have state sovereignty and policy reasons when opposing application of non-state law.

³⁰ *Supra* note 17 at 5.

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