

Limiting Arbitration Clauses

How to retain advantages of arbitration in international contracts while retaining flexibility to solve problems

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Many speeches and articles have encouraged the use of arbitration for the resolution of international contract disputes, particularly in licensing and engineering contracts. We suggest that companies take a hard look at the potential dangers of arbitration clauses. Almost every example of international licensing presents a multi-party situation where several levels of contracts will usually be drawn up by persons of different experience, language and skills at different times and places. We wish to alert parties to international contracts on how to have the advantages of arbitration when appropriate, while retaining flexibility for fulfilling their intentions in problem situations.

Problems frequently arise in the following situations:

1. Where the arbitral forum cannot get jurisdiction over all parties to a dispute and over all necessary witnesses and documents because only some have agreed to arbitrate in the forum. We will give examples of process license, warranty, and liability disputes in international engineering projects because of nonparallel contracts. But simple subcontracting and resale agreements can cause similar problems.

2. Where litigation by a party with a third-party claimant or third-party defendant, unforeseen by the parties' arbitration contract, will force both the parties into a court, contrary to their arbitration contract. This arises in the same fact situations as mentioned above, and in contract breach and product liability cases.

3. Where the law or forum chosen by the parties cannot be applied or does not have competence to resolve the dispute (or where the arbitral judgment would be unenforceable in the country of execution).

These problems can arise also in disputes only between the parties, in cases of frustration of choice of law, *Ordre Public* and force majeure, or where there are claims relating to breach of trade regulation or penal laws (anti-trust, export controls, boycotts, etc.).

The examples will indicate how to recognize the problem areas at time of contract and how "alternate jurisdiction" clauses can avoid entrapment by ineffective arbitration or unworkable choice of law.

By alternate jurisdiction we mean the right of one or

more parties to remove all or part of a dispute from arbitration to the direct jurisdiction of a court; if not, all parties and issues can be judged by the chosen arbitral tribunal. We caution that the court chosen as an alternative must itself have competence over the subject matter, and must be able to get jurisdiction over the parties.

These problems may seem strange to U.S. attorneys who have seen U.S. courts take jurisdiction over almost any claim and assert jurisdiction over persons and documents almost everywhere in the world. The extreme delays, high costs and demands for wide-ranging jurisdiction and discovery have made U.S. courts an unacceptable alternate jurisdiction to more and more parties. We shall therefore examine within the limits of enforceability of judgments and *Ordre Public* which alternatives exist, and how to draft an arbitration clause with the necessary escape clauses.

Two Cases

As examples, we will discuss two cases of international engineering projects. In one, the fact situation made resolution of problems with the government client impossible, and in the other a multiple supplier problem led to the necessity to negotiate on unfavorable terms because of a recognized impossibility to settle all claims under the arbitration clauses governing the several contracts.

An international project engineering contract is characterized by a number of parties, separated in time and responsibilities, where failure to perform of any one may lead to frustration of bargain or impossibility to perform of one or more of the others.

Without drawing a PERT chart of the relationships and steps we can define certain major segments by responsible parties.

- Overall design (engineering).
- Overall project contractor.
- Infrastructure contractor(s) and subcontractor(s).
- Process Licensor(s) and engineer(s).
- Fabricators of general and licensed equipment and process reactors, and subcontractor(s).
- Erectors and installers.
- Start up and test specialists.
- Operator and buyer (if different).
- Counterpurchase product seller (if different) and buyers.

- Project finance institutions.
- Counterpurchase finance institutions.
- Trainers of personnel.

Assuming some duplication of roles there will be at least half a dozen parties with teams of lawyers. Some of the negotiations will be multilateral. But some, such as

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the joint venture agreements among the licensors or the engineers of different parts of a plant, may take place separately from client negotiations.

To take a real case, a pulp and paper plant in North Africa, the process water was insufficient and too salty, the raw pulp material too fibrous (and samples available for the turnkey test were dry or rotted), elements of the plant were left in cases in the sun near the sea for several years, and everything was delayed by several years. What was due from whom to whom on the contract, or any other basis?

The prime contractor, dealing with a government client saw no hope of recovery of damages and therefore aided the client in blocking claims for payment by the suppliers and subcontractors. The attitude was, if the other contractors have project or investment insurance from their governments, let them collect there first and have their governments sue the client.

From a legal point of view there was no forum where all parties, particularly the government client, could be brought for disposition of the question, who was responsible for what?

This obvious question was not easily resolved for the very basic reason that at the time of negotiating the original contract it would have been an affront to the client (and there would have been no contract) had the contractor raised the question of liability:

If the infrastructure being provided by the client is substantially delayed, or is inadequate (water supply and quality), or incorrectly engineered?

If the raw material (and process water) are not what the client warrants in the project specifications?

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These contingencies (which in fact were strong suspicions before contract) were not raised. They would have forced the client, one government ministry, to challenge the competence of the Public Works and Agriculture Ministries, a political impossibility. Unfortunately, the worst "ifs" all proved true.

Consortium Project

Another example is a consortium project for a petrochemical complex in eastern Europe. In a series of plants, all interdependent for feedstock and reactive chemicals, a number of chemicals and plastics were to be produced. During erection it was discovered that one unit of one plant would not function. It would not give the programmed throughput of the material it was to receive from another unit.

This shortfall would mean that the entire plant would stop because of the thousands of tons of the raw material that could not be used. The problem for the engineer, licensor, and constructor of the inoperative unit was therefore not only the penalty for the failure of the unit to meet its performance specifications, but the foreseeable consequential damage of entire shut down of the plant (worth over 10 times the inoperative unit, over 100 times the license fee).

The substantive question of reengineering or monetary responsibility for consequential damages can only be indicated, not resolved. If another unit would have caused a partial default, are they also liable, and to whom? If a counterpurchase buyer can claim to have lost profit from start-up delay in a rising market for the commodity, would he have to share his good fortune for project delay during

a falling market (as was the case). The rights to consequential damages and the means to end the breach were again unclear for two reasons.

The first reason was the same as in the prior case. At the time of negotiation of contracts no one dared to say, "But, if it doesn't work?" The second reason was that it was most unclear which law or forum would govern the license, supply, and erection contracts.

a. Prime contractor (France) to build plant for East European state.

b. Licensor (France) to provide know-how to engineer (France).

c. Engineer to work out equipment details with fabricator (U.S.-Belgium).

d. Fabricator to sell equipment to prime contractor for export.

Terms

The contracts were by their terms governed by:

a. Swedish law with ICC arbitration in Stockholm.

b. French internal law, ad hoc arbitration under parties' own rules.

c. Arbitration in Paris (under nonexistent arbitration rules).

d. French law under a different nonexistent arbitral body (seller's terms) or by French courts (prime contractor's terms).

None of the arbitration clauses had provision for a pre-arbitral expertise as set in ICC procedure. Such an expertise would probably have permitted settlement in this case.

No dispute resolution clause made provision for joinder of proceedings in the manner suggested below.

We were faced with a problem that could be a license, engineering or manufacturing defect, and no way to get the key parties into the same judicial or arbitral forum. We had not even reached questions of claims against bonds of other contractors if the whole plant could not be started on time because of the faulty unit, or touched questions of subrogation or counterclaim.

Fortunately, the problem was resolved by total rework by the process licensor who paid all costs, and thereby kept its very good reputation without testing whether penalties and legal fees would have been cheaper. How this solution could ever have been ordered by a court or arbitral body is unclear, as it involved positive action.

These two cases indicate why counsel for a party in a project engineering venture must ask the "will-it-work" question, and insist on consents to jurisdiction in case of third-party claim, even if intraparty subrogation is to be separately arbitrated subsequently or contemporaneously with the principal proceeding. Contractors should review the nature and extent of business risks and consider for what risks government or private insurance may be available, for product, process and nonperformance as well as usual risks.

Much simpler contracts for the manufacture and sale of goods can present similar problems, but the complexity of relationships and nationalities is rarely present. In many major contracts with barter or counterpurchase clauses there is no separate provision for jurisdiction of claims relating to the resale of the counterpurchase goods by which a claim by the ultimate client for product defect or failure to delivery can be resolved in a single forum.

As the scope of barter goods expands from commodities traded between merchants (e.g. raw polystyrene or urea), where product liability is rare, to more "exotic" merchandise where barter middlemen (often major corporations covering large export contracts) should be aware of the product liability risks (e.g. package vacations, consumer goods, agricultural products, textiles), such claims and suits will increase, as will the problems of determining the applicable forum and law.

Invalidation of Clause

Another risk derives from the possibility of invalidation of all or part of a choice of law or forum clause as to disputes between the parties. For example, patent and intellectual property rights, being "monopolies" given by a state are in some countries subject to determination only by the laws and by the courts of such state.

A modern trend away from such a concept of *Ordre Public* in countries like France should not be overestimated, and the risk of unenforceability of an arbitral decision on licensing issues should be reviewed, particularly in developing countries.

Similarly it is not clear whether a party, particularly a state-owned party, can agree to a standard of force majeure less broad than that in vigor in its home country. It may be considered unconscionable to enforce such a right—again, a problem of conflict with *Ordre Public*. Other examples, including hold harmless clauses found contrary to public policy, can be imagined which would so undermine the choice of law that a reserve choice of law or forum may be advisable.

A converse issue arises where a debtor nation limits interest or penalty clauses because of unavailability of foreign exchange. If such regulation is penal in nature, payment of such sums in accordance with contractual choice of law clauses may not be permitted on the principle that a contract to do a criminal act is void. The same clause may, of course, be legal as to another obligor elsewhere, or as to a guarantor, or offshore affiliate of the obligor. Therefore, *nonparallel guarantees* by the obligor may be needed to secure *parallel rights* and responsibilities if the obligee has given late payment penalties to its suppliers. There may be clauses for subrogation of another party (or affiliate), if an act is not permitted to the principal obligor (e.g. by exchange controls).

Parties to international contracts must therefore consider two sets of possibilities that can thwart their agreed rights:

1. That their choice of law or forum be limited by supervening principles of law, either of one of the parties or of the forum.¹

2. That in the case of dispute involving a third party as plaintiff or defendant (e.g. in product liability claims or commercial claims) a different tribunal than that to which the parties have agreed can determine their rights under a standard of law other than that chosen for the resolution of their disputes among themselves.

Such contingencies must be considered when choosing law or forum (arbitral or court) and may lead to a *renvoi* to another forum if the choice of forum and law is not respected integrally. In the alternative the parties may be able to grant to the arbitrator the right to ignore certain provisions of law if he is to act as an "aimable compositeur."²

In addition to problems of parallelism arising out of purely contractual claims, there is the risk of claims which may not fall within the scope of a clause attributing jurisdiction over "all matters arising out of or relative to this contract or the breach thereof." Such issues can include counterclaims alleging antitrust violations brought by persons accused of failure to perform or to pay. The state interest in the respect of such laws may permit such a counterclaim to be brought to court regardless of arbitration on the contract. Such removal of the contract dispute from arbitration must be foreseen in the drafting of dispute resolution clauses. It may be advisable to have an "assist in defense or suit" clause in the contract, even if the party asking assistance in a litigation must agree to pay the legal costs of the other party to the arbitration clause.

For example consider the export seller who refuses delivery on the ground that the buyer intends to dispose of the goods in violation of export control, boycott or patent and trademark laws. Of course, such exclusions should be provided by contract, but such resale restrictions may not be valid under the law chosen for the contract, or may be against *Ordre Public* in the law of the buyer, his ultimate customer, or even of the place of signing the contract, the public order of which may always govern.³

Another problem that may lead to claims outside the disputes resolution or arbitration clause is civil (or even criminal) liability of any party to a series of contracts—engineer, fabricator, erector or licensor for product defects or damages. This could have occurred in the case of an engineering contract mentioned above. Clauses in the agreement between the parties allocating their rights should not bar impleader of the licensor in a case where the licensee is sued, or vice-versa. The need to pass outside an arbitration clause is particularly obvious when the party sued is other than the party contractually responsible.

Parties to a licensing contract may agree to a stipulated maximum penalty for nonperformance of the process, or for that and all other liabilities, usually in an amount not more than the license fee.⁴ Trademark licensors, particularly franchisors, have not always provided for the liabilities put on them by a line of cases starting in 1962.⁵

In Europe a similar provision on trademark licensor liability appears in the draft Council Regulation of Euro-trademarks of the Common Market.⁶

Alternate Jurisdiction

The use of alternate jurisdiction clauses is not new, as they are known in Dutch practice. They must, however, be drafted after review of the likely forum of claims and disputes. The tribunal responsible for putting such a clause in action may be the enforcement court for the arbitration clause, or the judge empowered to name arbitrators. An alternate jurisdiction clause attributes substantive as well as procedural competence and must be reviewed separately as a judicial choice of laws clause.

Now it may be appropriate to propose a draft of an addition to a dispute resolution clause. This is submitted more as the basis for reflection on the needs of particular laws and parties than as a model. We suggest adding to the chosen dispute resolution, choice of law, forum and arbitration clause provisions for small disputes (single arbitrator, simplified procedure, short-time period), pre-

arbitral expertise of technical matters and language to the effect:

"The parties to this agreement expressly take cognizance of the fact that the rights and obligations of the parties hereto may be subordinated to the rules of law of other jurisdictions and to obligations and rights of third parties, whether or not in privity of contract with the parties hereto.

"The parties therefore agree that neither party shall be responsible for the failure of a person not under its effective management or capital control to agree to submit to the jurisdiction or the procedure for dispute resolution named above.

"The parties further agree that in case of any claim or conflict as to how the rights between the parties are to be settled as stated above, the parties will submit to the alternate jurisdiction of a tribunal having jurisdiction over one of the parties; in case of claims made by third parties claiming against such party, or in case of claims made by one party jointly against the other party and a third party, or in case of claims of subrogation by one party against the other. Each party further agrees to appear as a witness and to produce all documents in a case involving the other party in a matter governed by this clause, to the same extent that the first party would be required to do so. In such case to the extent that such appearance or production of documents requires the application of this clause, the requesting party shall provide security for and pay all reasonable expenses of the other party, including attorneys fees.

(optional) "The parties further agree that between them this contract shall be considered an agreement of guarantee and subrogation and the parties agree that upon the conclusion of any litigation in which they appear or participate pursuant to this clause and notwithstanding the decision of any courts in such matter, recourse may be had to the dispute resolution method provided by this contract for the final determination of all rights and liabilities between them, including all reasonable fees and expenses (including attorneys fees) engaged by them.

"Pending the conclusion of such litigation the parties agree that the tribunal named as responsible for the (settlement of disputes between them) (naming of the arbitrators) shall have sole and exclusive jurisdiction to assure their compliance with their obligation hereunder.

"If the full intent of the chosen means of dispute resolution above cannot be respected integrally by the body having jurisdiction, the parties may choose another forum and body of law effective for all or part of the disputes arising out of and hereunder. Either party may invoke the competence of the alternate jurisdiction named below (name) by application thereto for such claim as cannot be settled pursuant to the chosen means of dispute resolution. Such claims or issues shall be removed from the competence of the chosen means of dispute resolution only for the particular claim or issue impossible of resolution there in the sole judgment of the alternate body.

Any need to refer such issues to a judge may make the arbitration ad hoc, or require prior agreement of an arbitration administration body (e.g. AAA, ICC, ICSID, London Court of Arbitration). The award of such an ad

hoc arbitration may not benefit as a "foreign" award under enforcement treaties.⁷

If it is important to have a valid arbitration clause to simplify disputes between parties. It is equally important in many cases to permit the parties to apply to a court when attacked from without or when nonparallel dispute resolution among parties and third persons could be more costly and dangerous if the parties are bound to arbitrate. The choice of the ultimate arbiter of removal from arbitration, having discretion as to the ultimate forum to assure respect for the parties' choice of laws and procedure, is a most serious decision, more serious than the basic choice of court or arbitral resolution and the arbitral forum.

NOTES

1. For example the law of the forum applies in Swiss arbitration and is likely to be followed in the United Kingdom and elsewhere.

2. The notion of "aimable compositeur" exists particularly in French, Belgian and Spanish Law. The "mediator-in-equity" can be governed by a choice-of-law clause as a guide. Wherever he sits he can use nonimperative provisions of law, but cannot ignore the Ordre Public of the forum.

Care should be taken not to refer matters to an aimable compositeur if the procedure and the award are not granted legal effect at the place of the procedure. In cases outside a set of rules (e.g. ICC) this procedure resembles ad hoc arbitration with the problems of enforcement described below.

3. Another example would be requirements for filing and approval of license agreements or other contracts. By choosing a foreign law the requirements of compliance by the parties with a regulatory condition for the valid performance of the contract will not necessarily be waived, and an arbitral judgment under the chosen law (e.g. of licensor) may be opposed in the other country (of licensee) or may violate exchange controls or other "ordre public" laws.

4. It has been suggested that a nominal amount (the license fee) can be the limit on damages (not the "liquidated" value of loss of bargain), particularly if the buyer acknowledges that he is aware of the risks and has undertaken to insure them (without subrogation, we assume). See "Limiting Licensor's Liability," Peters, *Les Nouvelles*, March 1982, p. 69. We assume the clause would require the licensor to obtain a similar agreement as a condition to the validity of any sublicense.

5. See "Products Liability and the Trademark Owner: When a Trademark is a Warranty," Goldstein, 32 *Bus. Lawyer* 957 (1977) for a review of the theory and cases under U.S. law. See "Licensors and Strict Liability," Crowley, *Les Nouvelles*, June 1983, p. 125.

6. "Proposal for a Council Regulation on Community Trade Marks," COM (80) 635 Final 2 (27 November 1980). Article 21, Licensing, paragraph (3) provides:

"The proprietor of a Community trademark shall ensure that the quality of the goods manufactured or of the services provided by the licensee is the same as that of the goods manufactured or of the services provided by the proprietor."

7. See suggestion of Georges R. Delaume in "Arbitration with Governments: 'Domestic' vs 'International' Awards," Delaume, *International Lawyer* 687 at 688.