ARBITRATION AND THE UNIDROIT PRINCIPLES

Detlev F. VAGTS.[1]

SUMMARY: I. *Introduction*. II. *The UNIDROIT Principles in Arbitration.* III. *When do the UNIDROIT Principles Apply?* IV. *How Well will the UNIDROIT Principles Work?* V. *Conclusion*.

I. INTRODUCTION

Modern international commerce relies heavily on the arbitration process to maintain legal security and resolve disputes, but at the same time that system gives arbitrators relatively little clarity about how they are to go about their work. Far more than national judges resolving domestic controversies arbitrators are faced with a jumble of alternative approaches and no very clear instructions about wich to give preference. This is a matter of concern for those who manage the arbitration process since businesspeople will not opt for arbitration if they have no assurances about their need for predictability.[2] Arbitration is sometimes preferred simply because it promises to be cheaper, faster and more private. However, each of these advantages is in reality subject to question. Therefore arbitration must, to be competitive with judicial systems, also offer a reasonable amount of predicatibility and certainty. It should not be viewed as affording only results that follow from arbitrator‘s desires to compromise or satisfy their rough sense of justice. Particularly in regions such as Latin America where the arbitration process does not have a long tradition behind it,[3] is important that it establish a reputation that it does provide high quality justice. One recognizes that arbitration clauses are often included in international contracts as a matter of habit,

1 Harvard Law School.

2 The values of predictability are clearly asserted in Park, William, “Neutrality, Predictability and Economic Co-Operation”, 12 *J. Int. Arb*. 9, 1995.

3 Grigera Naón, Horacio, “Arbitration in Latin America: Overcoming Traditional Hostility (An Update)”, 22 *U. Miami Inter-American L. Rev.* 203 (1991).

or because the form agreements the parties rely on include them or because one has heard vaguely about alternative dispute resolution. But all of those things depend upon arbitration's reputation and the question before us is whether the UNIDROIT principles will help toward that end.

The starting point is the question: where does the arbitrator look for guidance as to the substantive outcome? Just to list the alternatives gives the observer a sense of the difficulty the arbitrator faces. First, one instruction might say "do as the courts of the country where you conduct your proceedings would do". That would cause the arbitrator to look to the local law of the situs, perhaps including its conflicts or private international law rules. Second one might look at international law in the sense of treaties such as the Vienna Convention on the International Sale of Goods.[4] This approach might overlap with the first if local law *the first if local law* had incorporated the treaty into its internal body of rules. Third, there are vigorously pressed claims for the *lex mercatoria* or "law merchant". By this, academicians refer to a body of precedent arising out of international commercial practice, somewhat along the lines of common law.[5] It is difficult to judge just —how much of this commodity there really is; the index of the International Chamber of Commerce Yearbook indicates only a handful of references to it in arbitral awards, not all of them positive. Fourth, the UNIDROIT principles offer an approach that in some ways overlaps with the law merchant version, but gives it more coherence and predictability how much is a matter we explore below.

Sometimes the contract under which the arbitrator operates gives clarifyng instructions as to the approach to be used. It may contain a choice of law clause which will instruct the arbitrator to lok to a specific body of local rules. Or it might, tacitly or expressly, authorize a more free wheeling approach to decision-making. There seem still to be a substantial number of international contracts which fail to make the matter clear.

4 U.N.T.S., effective January 1, 1988.

5 French scholars seem particularlly positive about the *lex mercatoria*. *E.g.*, Goldmann, Berthold, *The Applicable Law General Principles of Law Lex Mercatoria in Contemporary Problems in International Arbitration* (Lew ed. 1986,); Gaillard, Emmanuel, "German and American scholars are more skeptical", *e. g*., Stoecker, Christoph, "The *Lex Mercatoria*. Does it Exist?" 7, *J. Int. Arb*, 101 (1990); Hinger, Keith, "The enigma of the *Lex Mercatoria*", 63 *Tulane L. Rev.* 615, 1989.

One notes the institutional elements of the arbitration process differ from the elements of national judicial law-giving in ways that complicate the development of answers to these questions.[6] Let us look for comparison to the cycle of national responses to the emergence of a question of commercial law. First the problem appears and private parties and their lawyers begin to argue about the solution. While most of the disputes are settled without resort to litigation, cases begin to come to courts. The courts consult the existing body of rules, legislative and precedential, according to the basic norms that prevail in their system. They decide cases, writing opinions that give reasons and indicate the extent of the precedent they are setting. They may be more or less assertive and candid about the extent of the creativity they are themselves exercising. Some of the cases are appealed to higher tribunals which go through the same process and finally concretize the local rule. These rulings are published through channels that bring them to the awareness of the legal profession generally. When this process is mature, lawyers are on notice of the existence of this judicial ruling. As advisers they warn their clients about the rule, perphaps discouraging them from entering into such contracts. As drafters they cope with it, excluding its operation if it is only a default rule and they disfavor it, or they make other adjustments to counter its effect-such as increasing the price their client receives. Clients react accordingly, with or without the advice of counsel. Commentators incorporate the ruling into their treatises and articles, perhap with criticisms and suggestions of modifications. Ultimately the country's legislature picks up the problem and legislates a result. It may approve of the judiciary's solution and simply codify it so that it will be more clear, more sysmmetrical and easier to find. Or it may abolish or modify it. The cycle then continues with the courts obeying the new legislative mandate as they understand it and solving problems in its sense.

The arbitral process lacks several of the links in this process. In the first place, arbitrators may not write an opinion. Under American practice the giving of reasons was in commercial cases largely discouraged on the grounds that it made the award more open to attack if fault could be

6 For a more extended comparison of arbitration with litigation see Vagts, Detlev, "Dispute Resolution Mechanisms International Business", 203 *Recueil des Cours*, 19, 1987.

found with the reasons. This was incidentally never the case in labor arbitration in America and in international cases the American Arbitration Association has taken a different tack. In other countries —Japan for example— the rules do requiere the giving of reasons to support arbitral awards. However, one does have a sense that arbitrators are terser and less systematic than judges in elaborating their reasoning. And there are, in general, no appeals on the merits in arbitration so that you do not find the work of reconciling and generalizing the outcomes of the initial decision-makers being picked up by tribunals of broader jurisdiction who get to see a variety of cases and perceive what needs to be generalized and reconciled. Even if the arbitrator does write a reasoned opinion it is generally not published, although there are some exceptions to this, as with the International Chamber of Commerce and some maritime bodies.[7] Thus the interpretation of a given arbitral panel is not circulated to other arbitrators. Since arbitrators are not members of an organized group like a national judiciary, even though there are meetings of persons who regularly do arbitral work and the overall body of the profession is not that large, informal communication about matters of substance is not as easy as it is within a state judiciary with a long tradition and esprit de corps. It follows that arbitral rulings are not swiftly and reliably communicated to lawyers and clients. It does not, therefore, become party of a body of caselaw like national judicial opinions. Because of this non-publicity lawyers and clients cannot adjust their contractual behavior to the flow of arbitral practice. A problem could persist for quite some time without an adequate, generally accepted solution. Academic commentators might pick it up, if they were closely attuned to commercial practice —as by being arbitrators themselves— but they would not have a very good sense of its ramifications. The national legislature, not being aware of the problem, would not address it and the problem might persist underground, as it were. Thus for all the atractions of arbitration in terms of its perceived economy, speed neutrality and finality it lacks the capacity to create a caselaw regime which ordinary judicial institutions possess. In concluding the analogy, however, one should note that the judicial process does not work that smoothly

7 See Carbonneau, Thomas, "Rendering Arbitral Awards with Reasons: The Elaboration of A Common Law of International Transactions", 23 *Columbia J. Trans. L.* 579, 1985.

in the international sphere where different interpretations by different national tribunals do not get resolved by appellate processes. Thus conflicting national strands of interpretation of a treaty might persist for years without any means of reconciling them other than a return to the international negotiating forum for an amendment of the document itself.

II. THE UNIDROIT PRINCIPLES IN ARBITRATION

What can the UNIDROIT Principles do to help the process? An American lawyer is irresistibly drawn to comparing it with the Restatement of Contracts. In fact lawyers from countries without a Restatement seem rather puzzled to know what sort of authority the Principles have. Both documents were drafted by groups without official legislative authority but set up in such a way as to atract respect as both knowledgeable ad disinterested. The format of each is similar, consisting of black letter —designed to look like statutory enactments, followed section by section by commentary and ilustrations. From one perspective the reader sees the product as being rather like a standard European code commentary, except that the work is produced under communal responsibility rather than individual authorship and that the black letter and the commentary come from the same source and have basically the same authority. Over the years the impact of the Restatments on the American legal scene has certainly been extensive, though not easy to describe or quantify. In the United States they have operated against a background characterized not by the absence of judicial precedent but rather by a plethora of case law. For courts overwhelmed by the masses of cases churned out by fifty state supreme courts, numerous state apellate tribunals and federal courts they proved to be an enormous assistance to judges in finding their way back to basic concepts and away from fine matching of the fact patterns of masses of cases. As one sees in the annual editions of *The Restatement in the Courts,* the extent to which Restatements are cited by judges is very impressive. One notes a major factor in the acceptability of the Restatements was their relative "neutrality". By that I mean that it would be very difficult to say in advance who would be favored by the way in which a provision of the Restatement of Contracts was drafted. The distribution of parties who would be favored by the adoption of Rule A rather than Rule B about whether a

revocation of an offer is effective only when received by the offeree is unknowable. It was not until the Restatement of Torts (Second) was under way that the appearance of neutrality was damaged. In that effort the Reporter, Professor William Prosser proposed a draft provision different from that in the first Restatement that would have made manufacturers of good intented for the consumer liable without proff of fault on their part. It was clear thas this provision would shift the balance in subsequent litigation as between two identifiable clases —injured consumers and their lawyers would benefit and manufacturers and their counsel would be disadvantaged. Representatives of the manufacturing side argued that it was inappropriate to "restate" a rule until there was clearly a majority among the state courts in its favor. To "restate", they argued, meant to reflect what the courts were doing rather than to in effect legislate a new rule, an action that lay primarily within the province of the state legislatures and secondarily —subject to rules about stare decisis— in that of state courts. Since that time lawyers for particular interest have been alert to include the American Law Institute among the fora which they must keep under surveillence if they are to protect their client's interests to the uttermost.[8]

III. When do the UNIDROIT Principles Apply?

And so we come to the first central question to be addressed by this paper: do the UNIDROIT Principles of International Commercial Contracts have promise of being widely adopted so that international arbitrators will have occasion to resort to them as they take on the task of deciding concrete cases that come before them? Preliminarily, one notes that the applicability of the Principles is by their own terms, somewhat limited. According to the Preamble to the Principles, they may be applied when the parties have agreed to apply them either by a direct reference to the Principles or by agreeing that "their contract be governed by general principles of law, the *lex mercatoria* or the like". Arbitrators may also rely upon them "when it proves impossible to establish the relevant rule of the applicable law". As to the effectiveness of express references

8 For a negative view of the political efforts behind one recent effort of the American Law Institute see, Elson, Alex & Shakman, Michael, "The ALI principles of Corporate Governance: A Tainted Process and a Flawed Product", 49 *Bus Lawyer*, 1761, 1994.

by the parties to the Principles the answer of both theory and practice is unequivocal; parties are free, subject to some rules of mandatatory, non-derogable, law, to choose their own dispositions. How often have they referred to *lex mercatoria*? The extensive literature dealing with *lex mercatoria* is in sofar as I can determine, rather reticent on this topic. It leaves one with a sense that contracting parties are not often drawn to stipulating such a reference. If they have come to the point of focusing on the issue of governing law one imagines that they will look for something more specific that will provide them with relatively plain answers. It is true that sometimes the parties will come to an *impasse*; each argues for a relatively clear and detailed set of rules-that prevailing in their country. Sometimes a party is astute enough to recognize that the laws of its own country are not particularly favorable to it —an American seller of goods or licensor of technology might be better of with some other country's set of rules. It might happen that they will agree on an independent set of rules from an outside source. This is particularly likely to happen when one of the parties is a government or a government agency.[9] A governments's nationalistic pride will naturally spur it to ask for its own law and to reject the application of some other nation's rules. A developing country may be confronted by the objection that it simply does not have a sufficiently highly developed system of law to be helpful in resolving any anticipated dispute. The contracting parties may see reference to a neutral system of law as a way of the *impasse*. They have sometimes refferred to international law (apparently meaning public international law). This has always been a somewhat questionable resort since public international law has precious litle to say about most contract issues.

In arrangements between private parties there is less motivation to get away from national law and more desire for predictability. Where neutrality is a desideratum parties will start to stipulate for *lex mercatoria* or for this more specified version thereof. Since the Principles were only published two years ago it is too early to say anything concrete about the degree of interest in specifically refering to them. A further complication then arises due to the rather significant overlap —even contradiction— of principles with the Vienna Convention on the International Sale

9 Delaume, Georges, "Comparative Analysis as a Basis of Law in State Contracts: The Myth of the *Lex Mercatoria*", 63 *Tulane Law Review*, 575, 1989.

of Goods.[10] The Convention has the tactical advantage that is applicable unless the parties provide otherwise trowing the effect of silence on the other side of the balance. Of course, there are many international contracts such as licensing, service contracts, franchises, loan agreements and so on and on which are not within the scope of the Vienna Convention at all. There are also quite a few gaps in the Convention which the Principles might fill. There are of course also a variety of internationally oriented bodies of rules available for incorporation by the parties if they so desire it. The would include INCOTERMS, a body of definitions prepared by the International Chamber of Commerce, the international rules on letters of credit and specific rules of various commodity exchanges and the like. Thus one will have to withhold judgment on the question of the degree to which the Principles are in fact incorporated into contracts by direct reference or through indirect means such as references to *lex mercatoria.*

IV. How Well will the UNIDROIT Principles Work?

Then one tackles the second question: will arbitrators who come to refer to the Principles find them useful in deciding disputes? The overall question may be broken down into more specific issues. Do the provisions posees enough detail so that a decision-maker is brought substantially nearer to the point of disposing of the case than it otherwise would be? Are the principles drafted as plainly and coherently as might be expected? Are the rules directed at questions that are likely to be the center of contention? Are the dispositions arrived at by the Principles going to be regarded as fairly and even handedly laid down, without unduly leaning towards any particular legal system or any set of commercial interest?

A good place to start looking at the Principles is the question of interpretation. My own experience as an arbitrator, confirmed by anecdotal evidence from conversations and readings, is that a very high proportion of the controversies presented to arbitrators involve issues not of the validity of the contract but of its meaning. Do the Principles address this

10 For an optimist view of the relationship between Principles and CISG see Bonell, Michael, "The UNIDROIT Principles of International Commercial Contracts and CISG-Alternatives or Complementary Instruments", 1996, *Uniform Law Review*, 26.

issue in a helpful way? Chapter 4 contains 8 articles aiming at this question. It is not unfair to characterize them as quite general in approach, though indicating a leaning in the direction of flexibility in the search for the parties shared intentions. They quite straightforwardly empower an arbitrator to supply an appropriate contract term where the parties have not agreed and the matter is important for the determination of their rights and duties. Many national legal systems would not confer such a power. An interesting comparison is with the provisions on interpretation contained in the Vienna Convention on the Law of Treaties.[11] Its articles 31 to 33 attempt to lay down rules to be applied by international courts and arbitrators. The treaties downplays the idea of finding the intention of the parties and mandates a search for the "ordinary meaning" of the treaty's terms.[12] Perhaps that is an appropriate difference between the two sets of rules, given the difficulty of knowing to whom in a contracting government one should attribute an intention. In a private arrangement it may make more sense to seek to learn what the contracting parties intended although in the case of a contract between IBM and Daimler Benz it would be hard to make such an individualistic determination. The UNIDROIT principles are quite open about taking into account the negotiations between the parties that came before the contract. The Viena Treaty allows references to the negotiating materials (*travaux préparatoires*) only if the study of the text itself leaves the matter ambiguous or unclear or if the result would be manifestly unfair. Both of them are more liberal than those common law jurisdictions which still take seriously the much disputed parol evidence rule that purports to make an integrated, agreed-upon text exclusive of other asserted side agreements. The approach in the Principles is consistent with its declaration that "[n] othing in these principles requires a contract to be concluded in or evidenced by writing" (Article 1.2.). This article stands at odds with the numerous provisions in national legislation, referred to as statutes of frauds in Anglo American law, which require wide categories of important commercial documents to be in writing. Indeed, the Convention on the International Sale of Goods has such a requirement. An

11 1155 U.N.T.S. 31 adopted 1969.

12 For the emphasis in international law on "ordinary meaning" as opposed to the complex search for intent see Vagts, Detlev, "Treaty Interpretation and the New American Ways of Law Reading", *European J. Int. L.*, 472, 1993.

arbitrator told to operate under the Principles would presumably be constrained to observe a national statute or other rule requiring a writing even though the Principles did not add to such requirements.

Consider how one real-life arbitration question would fare under the principles —a case from my own experience. The parties sign a contract that is to last for a period of three years, renewable for "another two year period". At the end of the five years neither party takes any formal action with respecto to continuation but they both keep on performing the contract as before. Another eight years pass and then one party delivers a written notice to the other declaring the whole arrangement to be at an end. The matter comes before an arbitrator who has to decide whether the contract was terminated upon delivery of the notice, at the end of a period of one year from the notice, at the end of two years or at some "reasonable time" within that general range. In other words, does one see this as a contract without a specified term which either can be terminated at the will of eiether party or as one intended to roll over at two year intervals or is there a default rule in the relevant law that such notice can only take effect at the end of a year or some other period? The decision-maker can read the language literally and say that "another" allows for only one two year cycle of renewal; thereafter there is no effective stipulation. One can comb through the parties' interchanges, both before and after entering into the contract, for signs of their intention. One could think about the economic consequences to each of the parties of an abrupt termination and about the possibilities of building alternative relationships. Not one of these inquiries produced a very satisfyng conclusion. The fallback rule under the Principles is that "a contract for an indefinite period may be ended by either party by giving notice a reasonable time in advance" (article 5.8). None of the Principles would give one the clearcut instruction contained in various European legislative rules about distributors and commercial agents that prescribe a default rule that to terminate a contract within that classification one must give notice of not less than a specified time in advance of its effectiveness. One is led to the conclusion that the Principles in their rules on construction have only limited guiding effect; in this they are like other statutory and treatry attempts to tell decision-makers how to approach a text. Particularly where the parties had no intention about the issue an attempt to find it must be artificial. The only useful dispo-

sition at this point in the process is a default rule, a type of rule that develops only out of the experience of judges and legislatures.

Let us try another type of situation that has often been litigated. The parties agree that a specified quantity of a certain product is to be delivered on a specified date at a certain price. Just before that date a government embargo, an event entirely beyond the control or contemplation of the parties, causes one of the raw material components of the product to become extremely scarce and expensive. The producer says that it can either deliver the goods six months late or it can produce them at the appointed date at a price 10 % higher. The buyer sues for the precise promised performance. What does an arbitrator find in the Principles? The situation does not seem to fall under the force majeure clause since performance is not impossible though more difficult and expensive. It does, however, seem to fall within the articles dealing with "hardship". In terms of article 6.2.2 it is a situation "where the occurrence of events fundamentally alters the equilibrium of the contract [...], because the cost of a party's performance has increased [...]" If one assumes that the other parts of the definition are in place —that the event occurred after the contract was concluded and were unforeseeable and uncontrollable the party is entitled to claim hardship. Article 6.2.3 proclaims that the disadvantaged party (seller) is entitled to request renegotiation. If no agreement is reached, the court —which includes an arbitrator according to article 1.10— may either terminate the contract or adapt it "with a view to restoring its equilibrium". The American lawyer is inclined to raise an eyebrow over the second branch of this choice. Like courts elsewhere American judges have adopted ideas of force majeure or impossibility and have relieved parties of their contractual obligations where they find such conditions are in place. But, unlike some European courts, Americans and Britons have not felt entitled to go the further step of rewriting the contract to make it fair under the changed conditions.[13] Thus on this point the Principles make a clear choice in favor of the European or civil law solution. Of course the pragmatist would say "but that simply leaves one face to face with the problem

13 See Houtte, Hans van, *The UNIDROIT principles of International Commercial Contracts and International Commercial Arbitration: Their Reciprocal Relevance* (unpublished paper presented at colloquium of ICC Institute of International Business Law and Practice, París, pp. 20-21, oct. 1994.

—what does it mean to restore the equilibrium". Without a rich case law how does one cope with that issue? Aside from the question of clarity one wonders about the policy of such a "liberal" provision. An American busines lawyer has made the argument that international commercial contracts are characteristically entered into by sophisticated parties who are each making the most careful estimate they can of their respective costs and risks under the contract.[14] Entry into the contract assures them that they can rely on the other party as to its performance. It upsets that reliance to know that an arbitrator may liberate the other party from its commitment because it proves more onerous than expected. It seems doubtful that private parties would often write such an escape clause into a contract on their own volition.

The American lawyer has already noticed one sense in which the Principles tilt away from Anglo-American toward European law. There are others, such as the provision on negotiation in bad faith (article 2.15), the clause on "surprising terms" (article 2.20) and on gross disparity (article 3.10), which have a European flavor although there are American doctrines in each case that might go part way toward filling the gap. The idea of "unconscionability" is such a device. A European arbitrator would find that these references would awaken recollections of the way in which those terms are used in his or her home country. Without expertise, I would assume that the same might be said of a Latin American arbitrator. An American, on the other hand, would have to start afresh puzzling out what these unfamiliar terms meant.

V. CONCLUSION

In the context of arbitration one's estimation is that the UNIDROIT Principles will be helpful in a limited way in terms of giving guidance about the way in which contract disputes are to be decided. They certainly give more guidance than the oft-touted but elusive rules of the general *lex mercatoria*. But they are too general and too flexible to constrain arbitrators in deciding the sort of specific issues on which dis-

14 Hill, Richard, "A Businessman's View of the UNIDROIT Principles", 13 *J. Int. Arb.*, 121, 1996.

agreements are likely to turn. They will be more helpful where the parties, their lawyers and the arbitrator all come from civil law jurisdictions, than in disputes across the common law-civil law divide. Their common legal heritage will enable them to flesh out concepts that the Principles only refer to in phrases too terse to give concrete guidance.