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Choice Of Law And Interpreting Contracts In International Commercial Arbitration

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Article

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Introduction

Consider the following hypothetical:

American Gas, a New York corporation, contracts with Japan Shipping, a Japanese corporation, to make regular shipments of gasoline to Japan for five years at a price set in the contract. The contract requires that both parties shall, "at the request of either party, discuss modifications of the shipping rates in light of changes in circumstances presented by either party." The contract further provides that: "In the event that no agreement regarding a requested modification in light of changes in circumstances is reached, the party requesting the modification may terminate the agreement after one year." Because of increasing labor costs due to a successful strike in the Japanese shipping industry, Japan Shipping can no longer profitably ship the gasoline at the contract rates. Japan Shipping requests a meeting to discuss increasing the shipping rates, providing a detailed breakdown of its increased costs. At the conclusion of the meeting, American Gas makes clear that under no circumstances will it agree to increase the shipping rates. Japan Shipping, thinking that American Gas has been unreasonable in considering its requested modification, takes the position that the contract is terminated immediately and stops all shipping. American Gas demands arbitration. The contract specifies that the substantive law of New York is to govern the dispute but that the place of arbitration is Tokyo.

Japan Shipping's Japanese lawyer thinks he has a good defense to American Gas's breach of contract claim if the arbitrators interpret the contract using the doctrines of good faith and fair dealing as applied in Japan. However, he is concerned that because the contract is governed by New York law and New York disfavors implying obligations of good faith into an otherwise clear contract, the arbitrators will find his client in breach of the agreement.

How should the arbitrators in such a case interpret the contract? Are there significant differences in the approach to contract interpretation between civil law traditions, such as in Japan, and the common law? What practical techniques can an advocate use to influence the way in which arbitrators apply the law to the contract?

Clearly, there are important differences in the way legal systems interpret contracts. For example,

courts applying the common law usually strictly construe the language of an agreement declining to imply obligations or modify terms that are otherwise clear. Additionally, the common law has developed rules which prevent the introduction of evidence of contract intent when a written agreement is deemed integrated and complete. In contrast, courts applying civil law traditions are said to be more inclined to decide disputes in light of the general obligation of good faith found in civil codes and based on evidence of the intention of the parties found outside the terms of the agreement. Because of this, the choice of substantive and procedural law governing an international contract is important and can, at times, be case dispositive. Advocates should carefully consider the ways in which they can use the rules and nature of arbitration to their advantage to achieve the results they seek.

In Section I of this paper we discuss the way in which courts in the United States approach two contract interpretation issues that might be of concern to lawyers from civil law backgrounds. First we address the United States approach to the duty of good faith in contracts as compared with the civil law approach. We show that good faith is not entirely foreign in the common law of the United States, but is nevertheless limited. Next we discuss the Parol Evidence Rule in the United States — and contrast it to the approach taken in civil law countries to understanding contract intent.

In Section II we explain the rules governing what approach arbitrators must use to interpret contracts.

Finally, in Section III we offer suggestions on how to approach issues of choice of law and contract interpretation in international arbitrations.

I. Differences And Similarities In Approaches To Contract Interpretation

A. Good Faith

1. Good Faith In The Civil Law

It is generally said that civil law jurisdictions interpret contracts in light of the overarching obligation of good faith and fair dealing found in general clauses of civil codes. Germany is a prime example. Article 242 of the German Code imposes a general obligation of "performance according to the requirements of good faith, common habits being duly taken into consideration." In Germany, this general obligation of good faith developed after World War I as a tool to reform contracts in light of extraordinary price inflation (something done to a more limited extent in the common law under the doctrines of frustration and impossibility). In response to suits for performance despite the impact of great inflation, German courts found in Article 242 the authority to modify existing contract terms, inserting new prices, but nevertheless requiring performance.[1] From this beginning, German courts began to use the duty of good faith to imply other contract obligations such as the obligation to bargain in good faith and deal fairly, the obligation to refrain from conduct which impairs the purpose of the agreement, the requirement of an obligor to do whatever he can to ensure performance, and a general obligation to cooperate in the performance of an agreement.[2] Other civil law systems have similar good faith provisions.[3]

2. Good Faith In The United States

While historically the concept of an implied duty of good faith was foreign to the common law, it has become more common in recent times in the United States. There are three sources for this obligation in the United States: 1) § 1-203 of the Uniform Commercial Code ("UCC"), which applies to contracts for the sale of goods, states that "every contract or duty within this act imposes an obligation of good faith in its performance or enforcement." "Good faith" is defined in the UCC as "honesty in fact in the conduct or transaction concerned."[4] Article 2 of the UCC adds a special definition which "in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade."[5]; 2) a common law implied duty of good faith reflected in Section 205 of the Restatement (2d) of Contracts, which states:

> Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement;

and, 3) the United Nations Convention on Contracts for the International Sale of Goods ("CISG"), in force in the United States, which states:

> In the interpretation of this Convention, regard is to be had to its international character and the need to promote uniformity in its application and the ob-

servance of good faith in international trade.

Additionally, the common law in much of the United States has developed equitable doctrines that reach results similar to those reached using the duty of good faith in the civil law tradition, such as providing excuses for failing to perform when circumstances change as a result of clearly unforeseeable events and providing ways out of contracts that are patently unfair. These doctrines include: frustration of purpose, impossibility, unconscionability and mistake.

3. Cases Illustrating Some Of The Contours Of Good Faith In The United States

Dalton v. Educational Testing Services[6]

Dalton, a student, contracted with Educational Testing Services ("ETS"), a provider of academic testing services, to take a college entrance exam. The agreement provided that "ETS reserves the right to cancel any test score . . . if ETS believes there is reason to question the score's validity." Dalton took the exam and scored very poorly. He took a preparation course and retook the exam, this time performing significantly better — almost doubling his score. ETS, suspecting cheating, had a handwriting expert perform an analysis of Dalton's two tests. The handwriting expert concluded that the exams were not written by the same person. ETS canceled Dalton's score, refusing to look at the evidence he provided to prove that he really took the second exam. Dalton sued ETS alleging, among other things, that it violated the implied obligation of good faith and fair dealing by exercising its contractual right to cancel the exam, without considering his evidence that he took the second exam.

The court in this case found that ETS had violated the implied obligation of good faith and fair dealing by refusing to consider any of Dalton's evidence as to the reasons for the difference in scores. The court began by noting that this was a contract of adhesion between a student signing up for a test and a large company. The court then went on to explain that "by failing to make even rudimentary efforts to evaluate or investigate the information furnished by [Dalton], information that was clearly relevant to a rational decision-making process, ETS reduced its contractual undertaking to an exercise in form over substance," thereby breaching its obligation to act in good faith.[7] The court explained that to meet the obligation of good faith, ETS needed to at least *consider* Dalton's evidence before exercising its contractual rights.

Gruppo, Levey & Co. v. ICOM Info. & Comm., Inc. [8]

Gruppo, Levey & Co. ("GLC") contracted with ICOM Info. & Comm. ("ICOM") to help find a buyer for all or part of ICOM. The agreement provided that GLC would be paid a retainer of 200,000 dollars and, should a Transaction (as defined in the agreement) be consummated, a Transaction Fee of 2% of the value of the transaction. The agreement defined "Transaction" as the "sale of *all or a significant part of the Company, i.e., by sale of greater than 50% of the Company's stock* . . . for greater certainty, the term Transaction *shall not include any [other type of transaction*]." GLC spent significant time and effort locating NetCreations, a company interested in purchasing 100% of the stock of ICOM. ICOM and NetCreations eventually agreed upon a transaction under which NetCreations would acquire 40% of the stock of ICOM with call options to purchase the remaining stock over three years following closing. GLC asked ICOM for the 2% Transaction Fee but ICOM refused to pay. ICOM argued that the transaction was not the "sale of all or a significant part of the Company" as required in the agreement in order for GLC to receive a Transaction Fee. GLC sued ICOM arguing that it breached the implied obligation of good faith and fair dealing by purposely designing the transaction with NetCreations to avoid payment of the Transaction Fee.

The court found that ICOM did not breach the duty of good faith and fair dealing, reasoning that a party that has acted in compliance with the rights expressly provided in the governing contract cannot be obligated to do more. Because the contract specifically provided that a "Transaction" must be a sale of more than 50% of the company stock and specifically excluded other types of structured sales, ICOM was within its rights when it designed the transaction to avoid paying the termination fee. This was so even though there was evidence that ICOM actively sought to exploit the terms of the Agreement to its advantage. The court did not find that by so doing ICOM was "destroying or injuring the rights of the

other party to receive the benefit of the contract," to quote the Restatement.

The different conclusions reached in these two cases demonstrate one powerful limiting factor on the obligation of good faith under New York law: the obligation of good faith cannot imply duties or obligations that go against the *express* terms of the Agreement. Additionally, the different conclusions show that courts are much more likely to find an implied obligation of good faith where there is evidence of unequal bargaining power, such as in the *Dalton* case.

How would our Japanese lawyer in the example in the introduction to this paper fare if the arbitrators apply the rules of good faith as applied in these two cases to interpret the obligation in the agreement to discuss modifications of price in light of changes in circumstances? It could be argued that under *Dalton* a court in the United States should imply into the obligation to discuss modifications a limited obligation to consider honestly and in good faith Japan Shipping's requests to modify the shipping rates and the reasons for that request — i.e., information about increasing labor costs. However, given that both parties are sophisticated businesses and given the fact that the contract specifically deals with what will happen if the parties do not agree, this obligation is likely to be very limited. A court is more likely to apply *Gruppo*, and find that American Gas does not have any obligation to agree to a modification of the shipping rates given that the agreement expressly states that "[i]n the event that no agreement regarding a requested modification is reached, the party requesting the modification may terminate the agreement after one year." This provision expressly deals with the issue of what is to happen if the parties cannot agree to a requested modification, thereby making clear there can be no implied obligation to actually agree to a modification in light of changed circumstances.

This outcome may not fully satisfy the Japanese lawyer who may expect a more demanding obligation of good faith implied in the contract. Indeed, in some civil law countries, a court may well find that the duty of good faith requires American Gas to modify the agreement in light of unexpected circumstances such as a strike. However, such a strong implied obligation of good faith is not usual under New York law.

B. The Parol Evidence Rule

Another area in which the civil law and common law approach to contract interpretation is often said to be different relates to limitations on the source of information courts will allow the trier of fact to consider when interpreting a contract. In the United States (and other common law jurisdictions) the Parol Evidence Rule prohibits the use in contract interpretation of extrinsic evidence, such as prior *inconsistent* negotiations, writings, and oral agreements that contradict the terms of a written contract, if the contract is found to be the complete and final expression of one or more terms of the agreement between the parties.[9] Additionally, where it is determined that a written agreement has been adopted as the "complete and exclusive" agreement — not even *consistent additional* terms are admissible to supplement contract terms.[10] This rule limits the trier of fact's ability to interpret contracts in ways not found in many civil law traditions. For example, in Germany and Japan the Parol Evidence Rule does not exist, and although a written agreement is presumed to be accurate and complete, any other evidence supporting or assisting the judge in interpreting the contract may be admitted.[11]

Example

Another short example will illustrate the power of the Parol Evidence Rule in the United States. Suppose that American Technology enters into a contract with Japan Cellular granting it the *exclusive* right to use American Technology's software in cellular phones in Japan. The contract is in writing and includes a clause stating "this agreement is the complete and exclusive agreement between the parties." Several months after signing the agreement, Japan Cellular finds out that American Technology has licensed the same software to another company for use in pagers in Japan. Japan Cellular sues for breach of the agreement arguing that in negotiations the parties had agreed that Japan Cellular would also have the exclusive right to use the technology in pagers. Japan Cellular offers up three witnesses to the negotiations who will all testify that the parties had agreed that Japan Cellular would have the exclusive right to use the software in pagers under the agreement. American Technology nevertheless contends that this was not the final agreement.

In United States jurisdictions applying the Parol Evidence Rule, the testimony of the three witnesses

as to the intention of the parties would not be allowed because it is evidence of a prior inconsistent term. The court would interpret the agreement based on the written contract. In Germany and Japan the judge would be allowed to hear the evidence and give it whatever weight he felt it deserved in light of the presumptions in favor of a writing.

II. Interpreting Contracts In International Arbitration

The question of what approach arbitrators are legally required to use when interpreting contracts in international arbitration is determined by the national law applicable to the dispute and the rules under which the arbitration is being held.

A. National Laws

The national arbitration law in most countries requires that arbitrators decide the dispute first and foremost in accordance with the substantive law chosen by the parties in their agreement. This is done either directly in the national arbitration law or through national contract law, which generally provides that parties are free to choose the law that governs their contract.

A good example of a national arbitration law is the UNCITRAL Model Law on International Commercial Arbitration ("UNCITRAL Model Law"), upon which many nations, including Japan, base their arbitration law. The UNCITRAL Model Law provides that "[t]he arbitral tribunal shall decide the dispute in accordance with such rules as are chosen by the parties as applicable to the substance of the dispute."[12] When the parties do not select the law to govern their agreement, the result is that the tribunal must "apply the law determined by the conflict of law rules which it considers applicable."[13] Some countries, such as Japan, have modified the UNCITRAL Model Law choice of law provision to provide that: "the tribunal shall apply the law of the State with which the dispute has the closest connection without referring to any conflict in the rules of law."[14]

As an alternative to having a dispute decided on the basis of the choice of law chosen by the parties in their agreement, The UNCITRAL Model Law also provides that where the parties *expressly* authorize it, the "tribunal shall decide *ex aequo bono* or as amiable compositeur."[15] It is important to note that under this provision the parties must *expressly* agree to authorize the tribunal to exercise these powers.

In addition to making reference to the law chosen by the parties, the UNCITRAL Model Law also requires that "[i]n all cases, the arbitral tribunal shall decide in accordance with the terms of the contract and shall take into account the usages of the trade applicable to the transaction."[16] As is discussed below, this provision arguably provides leeway to apply international norms to interpreting contracts even when such norms are not directly a part of the substantive law chosen in the contract. However, such an application in practice appears to be limited.

B. Organizational Arbitration Rules

Most international arbitrations are administered by organizations with their own rules such as the International Chamber of Commerce ("ICC") or, ad hoc, using the UNCITRAL Arbitration Rules. These organizational rules of arbitration also require arbitrators to decide disputes by reference to the law designated by the parties or, when no choice is made, by reference to choice of law rules, and, in many cases, by taking into account usages of trade. For example, Article 33 of the UNCITRAL Rules of Arbitration provides that:

> The arbitral tribunal shall apply the law designated by the parties as applicable to the substance of the dispute. Failing such designation by the parties, the arbitral tribunal shall apply the law determined by the conflict of laws rules which it considers applicable.
>
> The arbitral tribunal shall decide as amiable compositeur or *ex aequo et bono* only if the parties have expressly authorized the arbitration tribunal to do so and if the law applicable to the arbitral procedure permits such arbitration.
>
> In all cases, the arbitration tribunal shall decide in accordance with the terms of the contract and shall take into account the usage of the trade applicable to the transaction.

Article 17.1 of the ICC Rules includes a similar provision allowing the parties to decide the rules that govern their dispute and also requiring: "In all cases the Arbitral Tribunal shall take account of the provisions

of the contract and the relevant trade usages." Many other institutions also have similar rules requiring arbitrators to consider the law chosen by the parties and usages of trade.[17]

Generally, arbitrators will interpret contracts by reference to the law selected by the parties. The reference to "usages of trade" in institutional and organizational rules does, arguably, open the door to introducing general principles of international contract law not found in the law selected by the parties. However, in practice, although arbitrators often cite to usages of trade for support in their opinions, they usually do so to confirm the result they reached under the law selected in the contract. Indeed, as one commentator has argued, when parties have selected a developed principle of law to govern their dispute there is no justification for applying general principles of law, as the explicit choice of law "exhibits a common understanding of or familiarity with such law, as well as an invitation to be bound specifically to a relatively inflexible standard."[18]

III. Practical Advice For Approaching Issues Of Choice Of Law And Contract Interpretation In International Arbitration

Given the importance of the choice of law selected by the parties to govern their contract, it is important for lawyers to consider ways to in which they can have some influence on how arbitrators will interpret and apply the applicable law when they interpret the contract in dispute. There are several things to keep in mind.

A. Selecting The Right Arbitrator

An arbitrator's application of the law is influenced in large part by his or her personal background. An advocate must consider this reality and not assume that an arbitrator will apply the rule of law technically applicable without reference to this background. Because of this, it is crucial to carefully consider the legal education, writings, and background of potential arbitrators. Does an arbitrator's background make him or her likely to understand and be sympathetic to the legal arguments you plan to use to defend or prosecute your case? For example, consider selecting an arbitrator more familiar with civil law traditions if you plan to use good faith as a defense.

Additionally, when the tribunal consists of three members, pay attention to who is selected as Chair. The Chair is often given authority to make procedural decisions that may have a significant impact on the outcome of the case.

B. Using Experts

The use of experts to opine on the law is particularly important where the arbitration panel is comprised of individuals from diverse legal backgrounds. Typically, when an issue of law such as how an ambiguous contract term should be interpreted in the appropriate jurisdiction arises, it will make sense to have a qualified law expert, such as a law professor, testify as to how the law would be applied in that jurisdiction. Additionally, experts can submit statements for the consideration of the tribunal.

C. Use Arbitration Rules To Your Advantage

As mentioned above, national arbitration laws based on the UNCITRAL Model Law as well as many organizational rules of arbitration allow the tribunal to consider usages of trade in addition to the contract and substantive law applicable to the dispute. Advocates should consider using this provision to argue for the incorporation of generally accepted international contract principles found in documents such as the CISG and the UNIDROIT Principles of International Commercial Contracts when doing so works to their advantage. Although there is no guarantee that your interpretation of applicable international usages of trade will be adopted, it does not hurt to try.

D. Customize Your Arguments To The Arbitrators' Background

The approach to legal argument in the common law and civil law can be quite different. The typical example is the common law use of case law to persuade a judge of what the law is as compared to the civil law use of academic commentary on the law. When arbitrating a dispute before arbitrators from a common law background be sure to support your arguments with case law. Similarly, when arbitrating before an arbitrator from a civil law background, support your arguments with sufficient academic commentary on the law.

E. Aggressive Presentation of Facts

The process of presenting facts in arbitration is more flexible than in national courts. The arbitrators them-

selves review information for relevance and admissibility. Thus, advocates should consider presenting all the facts and information that support their case, even where it would not be strictly relevant or admissible in a court.

Even when arbitrators ultimately rule that evidence is not admissible, the procedural realities of arbitration may allow you to receive some of the benefits of the evidence without actually getting it admitted. For example, if the arbitrators decide that the Parol Evidence Rule applies to the dispute by reference to the choice of substantive law, the procedural realities of arbitration may diminish its importance. This is because arbitrators act as both judge of the law (i.e., deciding if the evidence is indeed parol evidence) and as trier of fact (evaluating the probative value of that evidence). This procedural reality allows the advocate an opportunity to make his case to the trier of fact with evidence that would never even reach the trier of fact in a United States court. Of course, the arbitrator may attempt to decide the case without using the evidence, but in many cases the fact that the arbitrator has seen the evidence may well influence his or her decision.

Conclusion

International arbitration is likely to involve serious questions of contract interpretation. There are clearly important differences in the way courts interpret contracts in the civil law and common law traditions, such as the use of good faith and rules limiting the evidence that can be considered when interpreting contracts. Under the laws of most countries and the rules of many of the institutional arbitration bodies, arbitrators are required to interpret contracts with reference to the law chosen by the parties in the contract, if any, while also taking into consideration, to a limited extent, usages of trade. In light of these rules it is important to consider ways in which as an advocate you can influence the way in which applicable law is applied, such as by carefully considering the background and education of the arbitrators; considering the use of experts to testify on the applicable law; customizing your legal arguments to your arbitrators' backgrounds; using usages of trade to add to your arguments on the law; and, taking an aggressive approach to presenting facts in light of flexible rules of evidence.

Endnotes

1. *See* Mark Snyderman, *What's So Good About Good Faith? The Good Faith Performance Obligation in Commercial Lending*, 55 U. Chi. L. Rev. 1335, 1365 (1988); *See also* Werner Ebke & Bettina Steinhauer, *The Doctrine of Good Faith in German Contract Law*, *in Good Faith and Fault in Contract Law* 172, 178 (Jack Beatson & Daniel Friedmann, eds. 2002).

2. *Id.*

3. *See, e.g.,* Article 1135 of the Belgian Civil Code, which states that "agreements obligate not only for what is expressed therein, but also for all the consequences which equity, usage or the law gives to an obligation according to its nature."

4. UCC 1-201(19); *see also* E. Allan Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. Chi. L. Rev. 666 (1963).

5. UCC 2-103(1)(b).

6. 588 NYS 2d 741 (Sup. Ct. 1992).

7. 588 NYS 2d at 747-8.

8. This hypothetical is based on *Gruppo, Levey & Co.* v. *ICOM Info. & Comm., Inc.*, 2003 U.S. Dist. LEXIS 11213, *aff'd*, 2005 U.S. App. LEXIS 6860 (2d Cir. 2005), with some minor simplifications.

9. Restatement (2d) Contracts §§ 209, 215.

10. *Id.* §§ 210, 216.

11. CISG-AC Opinion no 3, *Parol Evidence Rule, Plain Meaning Rule, Contractual Merger Clause and the CISG*, 23 October 2004, Rapporteur: Professor Richard Hyland, Rutgers Law School, Camden, NJ, USA, *citing*, Otto Palandt (Helmut Heinrichs), *Bürgerliches Gesetzbuch*, § 125 BGB Rn. 15 (64th ed., Munich 2005) and Makoto Ito, *Minjisoshoho [Law of Civil Procedure]* 266, (3rd ed., 2004); *see also* Koshi Yamaguchi, *The Limited Enforceability of Termination and Non-Renewal Clauses in Japan*, *available at* http:..www.kclc.or.jp/english/sympo/EUDialogue/yama.htm.

12. UNCITRAL Model Law, art. 28.

13. *Id.*

14. Japanese Arbitration Law (Law No. 138 art. 36(2) (2003)).

15. UNCITRAL Model Law, art. 28(3); *ex aequo bono* is Latin for "according to what is right and good," and is used together with amiable composition to refer to deciding the case according to principles of equity not necessarily connected with one nation's statutory law. The ability to act as amiable compositeur gives the arbitrator the power to depart from the application of the rule of law and decide the dispute using principle of fairness. *See generally*, Karyn Weinberg, *Equity in International Arbitration: How is Fair is "Fair"? A Study of Lex Mercatoria and Amiable Composition*, 12 B.U. Int'l L.J. 227 (1994).

16. UNCITRAL Model Law, art. 28(4).

17. *See* Christopher Drahozal, *Commercial Norms, Commercial Codes, and International Commercial Arbitration*, 33 Vand. J. Transnat'l L. 79, 113 (2000).

18. Note, *General Principles of Law in International Commercial Arbitration*, 101 Harv. L. Rev. 1816 (1988). ■

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