Developments for Arbitration of Financial Sector Disputes.

By: Andrew Pullen, Counsel, Allen & Overy, Singapore

Introduction

Arbitration is indispensable to international commerce. A recent survey by Queen Mary, University of London recorded that arbitration is the preferred form of resolving international disputes for the majority of in-house counsel (52% of whom said it was their first choice). Parties in the financial services sector took longer than most to warm to arbitration as a means of resolving disputes, but the use of arbitration in this sector is rising. This article considers recent developments and some of the practical issues which arise.

Attitudes towards arbitration in the financial sector

Arbitration has long been popular in certain parts of the financial services sector, for example in insurance and reinsurance disputes, or disputes between members of some stock exchanges. However, court litigation, particularly in the English or New York courts, has traditionally been the default option for most international lending and capital markets transactions. It has sometimes been suggested that the lack of default and summary judgment mechanisms in arbitration makes it unsuitable for the “simple debt claims” expected in such transactions. Recent years have seen a change. Arbitration clauses have become increasingly common in financial transaction documents. Have banks and other financial institutions been converted? The answer appears to be more subtle than a simple yes or no.

The Queen Mary survey reveals that the majority of in-house counsel in the financial services sector still prefer court litigation: 82% ranked litigation as “most preferred”, whereas only 23% ranked arbitration as “most preferred” (implying that for some they were equal first choices). But those same in-house counsel generally consider that arbitration is well-suited to financial sector disputes: 69% agreed or strongly agreed and only 8% disagreed or strongly disagreed (23% had no opinion). Whilst litigation remains the general preference, the traditional scepticism of arbitration seems to have dissipated. Financial sector parties will therefore use arbitration where they perceive a real benefit to doing so.

It should therefore be no surprise that the switch to arbitration has been led by parties operating in emerging markets, where there is often concern about the cross-border enforcement of judgments. While Europe has an effective regional cross-border enforcement regime (under the EU’s Brussels Regulation and the Lugano Convention), Asia Pacific (indeed, the rest of the world) does not. Bilateral arrangements for enforcing court judgments are patchy. Singapore, for example, has such arrangements with only Australia, Brunei, Hong Kong, India, Malaysia, New Zealand, Pakistan, Papua New Guinea, Sri Lanka, the UK, and the Windward Islands.

---

1 Andrew Pullen specialises in international arbitration, including international commercial and investment treaty arbitration. He has acted for a number of financial institutions in international arbitrations, and advised ISDA on the 2013 ISDA Arbitration Guide.
3 Queen Mary Survey, page 7.
4 Queen Mary Survey, page 8.
5 Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, as extended to Denmark pursuant to the Agreement between the European Community and the Kingdom of Denmark on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters. A recast version of the Regulation (Regulation (EU) 1215/2012) has been enacted but does not come into force until 10 July 2015.
6 The Lugano Convention 2007 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters extends the Brussels Regulation regime to Norway, Iceland and Switzerland.
7 The countries named are those to which the Reciprocal Enforcement of Commonwealth Judgments Act or, in the case of post-1997 Hong Kong judgments, the Reciprocal Enforcement of Foreign Judgments Act apply. Judgments from other jurisdictions, which cannot be registered under the statutory regime, must be enforced as a debt under the common law rules of enforcement, which is a time consuming and costly exercise.
In contrast, the New York Convention of 1958 requires the courts of 149 contracting states to enforce arbitral awards subject only to limited grounds for refusing enforcement, which do not include a review of the merits. Some states undoubtedly have a better record than others in enforcing awards under the New York Convention; nevertheless, it provides a truly global framework for the enforcement of arbitral awards. The major economies of the Asia Pacific region are almost all contracting states (Taiwan being a notable exception, as a result of its political status), and have recently been joined by Myanmar, which acceded in April 2013.

In 2005, a Convention on Choice of Court Agreements was adopted under the auspices of The Hague Conference on Private International Law. This Convention’s ambition is to provide an effective global regime for enforcing judgments made pursuant to exclusive jurisdiction clauses. Eight years later, only one state (Mexico) has ratified it and it is not yet in force. The European Commission has proposed ratification (on behalf of all EU member states) in its programme for this year. If that occurs, the Convention would come into force upon the EU’s ratification, which might encourage other states to accede (perhaps including some Asian states). However, it is likely to be many years, if ever, before the Hague Convention challenges the New York Convention for global coverage.

Respondents to the Queen Mary survey were asked to rank the importance of a number of benefits of arbitration. Interestingly, expertise of the decision-maker was the number one benefit identified by in-house counsel in the financial sector. Expertise was ahead of enforceability and other commonly-cited benefits of arbitration, such as neutrality, confidentiality and flexibility.

A combination of factors, therefore, is driving the growth in financial sector arbitration. For a party doing business in Asia, enforcement risk will typically be reduced if it insists on an arbitration clause rather than the traditional English or New York jurisdiction clause. Even if there is a relevant bilateral judgments treaty, in a deal with a counterparty with assets in multiple jurisdictions, or with multiple counterparties based in a variety of jurisdictions, arbitration may provide the creditor with the option of enforcing against assets in several places. Of course, parties could simply litigate in the local courts (and avoid cross-border enforcement altogether) but levels of expertise, reliability and efficiency of the courts vary considerably between jurisdictions. Parties will often feel that specialist arbitrators are better equipped to deal with disputes under complex financial transactions than the courts of many countries.

The ISDA Arbitration Guide

The growing use of arbitration is well illustrated by a recent project by the International Swaps and Derivatives Association (ISDA). ISDA is the global trade association for the over-the-counter (OTC) derivatives market (i.e. derivatives not traded on an exchange). ISDA Master Agreements are the industry-standard framework documentation for OTC derivatives. They provide for parties to choose between English governing law and jurisdiction, or New York governing law and jurisdiction. However, parties may amend these provisions by including an arbitration clause in the Schedule to the Master Agreement. This is increasingly common. There has been a series of disputes over recent years arising out of derivatives transactions; typically involving transactions under which counterparties have incurred losses in the market turmoil arising from the global financial crisis.

The ISDA project recognises this development and seeks to assist ISDA’s members by providing model arbitration clauses tailored to the ISDA Master Agreements. The project originated in January 2011, in a memorandum to ISDA’s members discussing the use of arbitration for derivatives transactions and seeking their feedback on the steps that ISDA could take to assist them. Following several rounds of consultation, the 2013 ISDA Arbitration Guide containing the model clauses was published in September 2013. ISDA

---

11 Queen Mary Survey, page 8.
12 Allen & Overy advised ISDA on this project.
members enthusiastically engaged in the consultation process, particularly in the Asia Pacific region. For example, over 100 members dialled into a meeting held in Singapore to discuss the proposals.

As the Master Agreements have been drafted to operate under English or New York governing law, the model clauses retain these two options and do not provide for the choice of other governing laws. The choice of arbitral seats and institutional rules, however, is much more extensive, reflecting the global nature of the derivatives market and the fact that arbitration is particularly popular in emerging markets. In choosing the rules and seats to include, ISDA has been guided by feedback received from its members in the consultation. At an early stage it became clear that there was significant demand for Asian options; in particular, clauses providing for arbitration at SIAC and HKIAC. Model clauses providing for both institutions’ rules, with Singapore and Hong Kong seats respectively, have been included in the Guide alongside options in Europe and the United States.

In addition to the model clauses, ISDA’s Arbitration Guide provides a general introduction to arbitration, including an explanation of key concepts such as the seat of arbitration and the role of arbitral institutions. The model clauses have been kept relatively simple, in order to make them as straightforward as possible for members to use. The Guide also provides information on possible “add-ons” which users may encounter or wish to consider (such as optional arbitration clauses, discussed below, or “fast-track” provisions, designed to provide a short-cut to the resolution of simple cases and ameliorate concerns about the lack of summary judgment).

**Broader trends**

Derivatives are by no means the only financial transactions in which arbitration clauses are to be found. In Asia, loan agreements increasingly contain arbitration clauses, and arbitration clauses have long been common in project finance documents. The complexity of project finance deals, typically involving multiple parties and a large suite of agreements, presents particular drafting challenges which require arbitration lawyers to liaise closely with the transactional lawyers who have devised the contractual structure of the deal. To maximise the effectiveness of the dispute resolution regime, it is essential to identify which groups of agreements within the suite are likely to give rise to related disputes that should be heard together, and ensure that the arbitration clauses adequately cater for this, typically by conferring joinder and consolidation powers upon the arbitral tribunal.

Capital markets transactions such as bond issuances also present issues that require careful consideration. A key risk faced by sponsors is disputes concerning the adequacy of disclosures. If investors bring proceedings against the sponsor, the sponsor will typically wish to claim under an indemnity provided to it by the issuer. To take advantage of the New York Convention, the agreement between sponsor and issuer may provide for disputes to be arbitrated. However, unless the investors have also entered into an agreement to arbitrate their claims against the sponsor, those claims will have to be litigated. The sponsor then risks getting caught in the middle of inconsistent decisions, and in any event must deal with multiple proceedings. However, particularly where the bonds are to be publicly offered, it may be difficult to design a structure including an arbitration agreement between sponsor and investors.

The ISDA project saw a demand for clauses providing for arbitrations at Asian institutions and seats. This is consistent with broader trends. Whilst parties typically wish to arbitrate in a neutral third country, rather than litigate in either party’s home courts, the availability in Asia of reliable seats of arbitration and arbitral institutions increasingly encourages them to keep the dispute in the region. For example, it is common to see arbitration clauses in finance documents governed by English law in which the parties select Singapore as the seat of arbitration.

**Optional arbitration clauses**

Arbitration is sometimes combined with an option to litigate, typically exercisable by the finance parties. These clauses, known as “optional arbitration clauses” or “split clauses”, enable the party or parties entitled to exercise the option to elect, after a dispute has arisen, whether to use arbitration or the courts. Generally,
even if the arbitration clause provides for a seat in Asia, in English law agreements if the option to litigate is exercised, the borrower is required to litigate in the English courts, although the finance parties often reserve the right to bring proceedings in other courts (a “hybrid jurisdiction clause”). Optional arbitration clauses give a great deal of flexibility to the party or parties entitled to exercise the option, and are attractive to them for this reason. (Of course, they are not attractive to the party unable to exercise the option.)

Caution is needed, however. Recent cases in Europe serve as a useful reminder of the risks associated with the use of such clauses. It had long been market practice in Russian finance deals documented under English law to include clauses providing for arbitration with a unilateral option to litigate, exercisable by the lenders. In a number of cases, Russian courts had accepted jurisdiction where lenders had exercised their option to litigate, apparently upholding the effectiveness of such clauses. However, in a 2012 decision, the Russian Supreme Arbitrazh Court held that such a clause was unenforceable in its entirety, because the unequal nature of the clause violated the equality of rights to which parties were entitled. In that case, the party entitled to exercise the option to litigate had not done so; it wished to arbitrate the dispute and applied for a stay of the Russian court’s proceedings. The Supreme Arbitrazh Court refused. Separately, the French Supreme Court recently struck down a hybrid jurisdiction clause (with no arbitration element).

In many jurisdictions in Asia the efficacy of optional arbitration clauses is untested. There is therefore the risk that a court may take the same view as the Russian court and take jurisdiction over a case which a party believed it had the right to insist be resolved by arbitration. The validity of the optional arbitration clause might also be challenged by a party seeking to resist enforcement of an arbitration award. A party including such a clause in its agreements must therefore weigh the benefits carefully: do the benefits of flexibility outweigh the additional risk?

The future

The logic of the New York Convention and the ability to select arbitrators familiar with the disputed transactions suggest that arbitration of financial sector disputes is here to stay. At present, financial disputes make up a relatively small proportion of disputes resolved by arbitration. Financial sector disputes represented approximately 3.2% of SIAC’s cases in 2011, and approximately 3.4% in 2012. However, the numbers are only likely to grow: as arbitration clauses are included in more deals, cases inevitably follow. Industry model clauses, such as those developed by ISDA, may encourage parties, who would not otherwise have done so, to use arbitration, and in any event ought to help parties avoid basic drafting mistakes and find common ground in negotiations.

Arbitration practitioners and institutions will need to ensure that the arbitral process meets the needs of these users. The recent wave of innovations in arbitral rules, such as the introduction of emergency arbitrator provisions, expedited procedures, and joinder and consolidation procedures, is a positive development by the institutions. It opens up a range of choices for parties and their advisers. For example, the “simple debt claim” is not always as simple as it first appears – defences based on alleged mis-selling, regulatory infringements, or lack of capacity or authority when entering into a transaction might significantly complicate a dispute (and thereby prevent summary judgment if the dispute were to be litigated in court). However, there may be some types of transaction (“on-demand” guarantees, perhaps) where the debt claim really should be simple in the vast majority of cases, and where expedited procedures could be a real benefit in the absence of a summary judgment mechanism. The potential risks of optional arbitration clauses are a reminder that, with any arbitral innovation, one eye must be kept on the enforceability of the agreement to arbitrate and, ultimately, of the award. However, imaginative and thoughtful innovation is key if arbitration is to live up to its claims of flexibility. It falls to practitioners to work out how best to use these (and other) procedures for financial sector disputes.

---

15 Decree of the Supreme Arbitrazh Court of the Russian Federation No 183/12 dated 19 June 2012 in relation to a dispute between Russian Telephone Company as plaintiff and Sony Ericsson Communications Rus as defendant.
14 French Supreme Court, First Civil Chamber, 26 September 2012, Ms X v Banque Privee Edmond d Rothschild, No. 11-26.022
15 6 cases out of 188 filed in 2011; 8 cases out of 235 filed in 2012. Source: SIAC.