

Editorial

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A Prognosis and Remedies

The Proper Law of Contract

The development of international commercial arbitration presents a wonderful opportunity for the resolution of differences arising under or connected with international commercial agreements, each governed by the proper law of contract determined by the rules of conflict of laws. The fundamental factor which determines the proper law of contract is that the two parties to the international contract are subject to the sovereign jurisdiction of their two countries and the national laws and the courts of the two countries. Since the object of the law is to help the formation, performance and enforcement of rights and obligations under the contract, the proper law of contract to govern was correctly defined by no less an authority than Professor J. H. C. Morris, the co-author of Dicey and Morris *Conflict of Laws*, “not as the law intended by the parties, but as the ‘system of law by reference to which the contract was made or that with which the transaction has its closest and most real connection’ (per Lord Simmonds in *Bonython v. Commonwealth of Australia*, 1951, AC 201). This formulation was approved by the House of Lords in *Tomkinson v. First Pennsylvania Banking and Trust Company*, 1961, AC 1007, and by J. McNair in *Rossano v. Manufacturers Life Insurance Co. Ltd.*, 1963–2, QB, 352”, (*Cases on Private International Law*, 4th edition, 1968, pages 279–280).

Choice of Law and Jurisdiction

Professor Morris then comes to the crux of the problem, which is the recent trend towards the autonomy of the parties to choose the applicable law and the jurisdiction of a court thereunder, though they have no connection with the contract. He observes:

“The crucial question is, therefore, can the parties select the law of a country with which their contract has no substantial connection? In *Re Herbert Wagg and Co. Ltd.*’s Claim 1956 Ch. 323, 341, J. Upjohn said: ‘This court will not necessarily regard the parties’ choice of law as being the governing consideration where a system of law is chosen which has no real or substantial connection with the contract looked on as a whole.’ There is no reported case in which a

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contract, void in its entirety by the law most closely connected with it, has been upheld by reason of the parties' choice of another legal system under which the contract was valid. All the reported cases refer to the validity of particular clauses such as arbitration or exemption clauses. With the exception of the cases on arbitration clauses there is no reported case in which a different result would have been reached if the court had applied the objective test." (*op. cit.*, p. 280).

It is in this context that Rule 180, formulated in Dicey and Morris' *Conflict of Laws*, 11th edition, has to be understood. The Rule says: "the term 'proper law of a contract' means the system of law by which the parties intended the contract to be governed or, where their intention is neither expressed nor to be inferred from the circumstances, the system of law with which the transaction has its closest and most real connection". This Rule, however, is qualified by the statement that the existence or validity of the choice of law clause is itself to be decided by the *lex fori* (*op. cit.*, pages 1176 to 1178). This means that the parties cannot make their contract subject to a law and the jurisdiction of a court which is not "the system of law by reference to which the contract was made or that with which the transaction has its closest and most real connection" (Morris).

Russell on Arbitration, 20th edition, page 64, also says:

"The jurisdiction of the court to entertain disputes cannot be ousted by agreement."

Although Russell refers to the jurisdiction of the court to decide questions of law arising out of or in connection with the arbitration agreement, the jurisdiction of the court is also territorial. For instance, Sections 2(c) and 31(4) of the Indian Arbitration Act 1940 give exclusive jurisdiction to support and supervise arbitration only to that court in which an action would have been filed but for the arbitration agreement which provides an alternative method of dispute settlement but is still subject to the support and supervision by the court of the forum. Similarly, Section 204 of Chapter 2 of the U.S. Arbitration Act 1925 gives exclusive jurisdiction over arbitration to that district court "in which save for the arbitration agreement an action or proceeding with respect to the controversy between the parties could be brought, or in such court for the district and division which embraces the place designated in the agreement as the place of arbitration if such place is within the United States". Thus, it is only if more than one court has jurisdiction under the proper law of contract that the parties can choose one of them. But the parties cannot choose a court which has no inherent jurisdiction over the subject-matter of the arbitration at all (*Hakam Singh v. Gammon India Ltd.* All India Reporter, 1971, SC 740).

The American Conflict of Laws Rules is stated by Scoles and Hay (*Conflict of Laws* 1984, Chapter 18.2) as follows:

"Ordinarily the chosen law must bear some relationship to the parties or the transaction, nor may the parties override certain important policies of the forum or of the State whose law would otherwise be applicable. Within these limits, party autonomy is now recognised by S.187 of the Restatement, Second and the case law adopting it as well as by S.1-105 of the Uniform Commercial Code."

Place of Arbitration

Certain international arbitral institutions, by their Rules, provide for the place of arbitration to be outside the two countries of the two parties to the arbitration agreement (International Chamber of Commerce, Arbitration Rules—Rule 12; and London Court of Arbitration—International Arbitration Rules—Rule 7(1)). It was recognised by the House of Lords that the international character of the City of London as a commercial centre is the reason for its choice as the place of arbitration proceedings rather than any preference for the application of English rules to such arbitrations (per Lord Wilberforce in *Compagnie d'Armement Maritime S.A. v. Compagnie Tunisienne de Navigation S.A.*, 1971, AC 572 at 596). Unfortunately Lord Diplock, in the same case, said at page 604:

“It is not now open to question that if parties to a commercial contract have agreed expressly upon the system of law of one country as the proper law of their contract and have selected a different curial law by providing expressly that disputes under the contract shall be submitted to arbitration in another country, the arbitrators must apply as the proper law of the contract that system of law on which the parties have expressly agreed.”

This has given rise to the argument that the parties can choose a place of arbitration and the curial law of that place though these may have no connection with the contract.

Redfern and Hunter (*International Commercial Arbitration*, 1986, pages 42–43) state that a neutral State in whose territory such arbitration is held may reasonably be regarded as being entitled to exercise a degree of control over the arbitral process on a territorial basis, in return for allowing the arbitration to be held in their country and “indeed, it would be unusual for a State to lend its support to the arbitral tribunal operating within its jurisdiction without claiming some degree of control over the conduct of those arbitral tribunals”.

With respect, these observations of Lord Diplock and Redfern and Hunter are assuming that by choosing a place of arbitration in a neutral country the parties to the arbitration intend to make the law and the jurisdiction of the court of that place applicable to the arbitration. Firstly, this assumption is incorrect. If the choice of such a place of arbitration does not imply application of the substantive law of that place, there is no reason to think that it nevertheless implies the application of the procedural law of that place. Parties rarely intend to split the substantive and procedural laws at the time of entering into an international arbitration agreement (Klein in *The Art of Arbitration*, pages 189 and 192). Further, in the majority of cases, the law governing the substantive contract, the law governing the arbitration agreement and the law governing the conduct of arbitration will be the same (*Naviera Amazonica v. Compania International*, 1988–1, Lloyd’s Law Reports 116 at 119 CA). The argument that *lex arbitri* means the law of the place of the arbitration, or the law governing arbitration, as distinguished from the substantive law governing the contract has also been negated by F. A. Mann (1969–18, *International and Comparative Law Quarterly*, pages 997–1001) and by Erwin Spiro (*Re-examination of the “Proper Law”*, in *Law and International Trade*, page 354).

Secondly, such an agreement by the parties would be opposed to the public policy of the system of law with reference to which the contract was made or which has the closest and most real connection with the contract. Such a choice of law and jurisdiction would, therefore, be illegal and void (Sections 23 and 28 of the Indian Contract Act 1872 which codifies and revises the rules of English Common Law).

Arbitration is not Business but Justice

As observed in the preface to *Russell on Arbitration*, 20th edition, "we are, it seems, at the beginning of international forum shopping". The so-called international centres of commercial arbitrations are attracting arbitrations by procuring arbitration agreements including choice of law and jurisdiction which favours the use of these centres. Such agreements favour the economically stronger parties to the detriment of economically weaker parties who have to incur the risk and expense of participating in arbitrations held in a country which has no connection with the proper law. What is worse is the suggestion that the procedural law of these places would apply to these arbitrations including the delivery of awards which in turn would attract the jurisdiction of the courts of these places over these arbitrations. This would mean that neither the proper law would apply to the procedure of the arbitration nor would the courts of the country of the proper law have jurisdiction over the arbitration and the resulting award. Such a result is perpetuated for the future by Article 1(2) of the Uncitral Model Law which makes the proper law inapplicable to an arbitration held outside the country of the proper law or the Model Law. Even the plea of forum *non conveniens* would thereby be excluded. As Paula C. Jaffe has shown (*Arbitration—the Journal of the Chartered Institute of Arbitrators*, London, August 1989, page 184) as regards London some 50,000 arbitrators are appointed each year, making some 10,000 awards, and the expenses incurred by foreign parties on the lawyers, arbitrators and the courts become the invisible export earnings of the U.K. The English Arbitration Act of 1979 was enacted to attract arbitrations to London and was expected to secure about £500 million per year of invisible exports. In 1986 the U.K.'s net overseas earnings from financial institutions were £9,375,000,000, making the U.K. the world's largest net invisible exporter.

Since such business aims are contrary to justice to the economically weaker foreign parties dragged to these centres, it is time to curb the so-called freedom of contract of choice of law and jurisdiction and hark back to the basic principles of conflict of laws applying the proper law, substantive as well as procedural, and restoring jurisdiction to the courts of the country with respect to whose legal system the contracts were made and with which they have the closest and most real connection.