

The emerging popularity of  
international arbitration in the  
banking and financial sector – Is this a  
fashionable trend or a viable  
replacement?

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## **Declaration**

This thesis is submitted to the University of London in support of my application for the degree of Doctor of Philosophy. It has been composed by myself and has not been submitted in any previous application for any degree.

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London, 27 April 2016

## **Abstract**

There is no doubt that international arbitration has become one of the most favoured dispute resolution mechanisms in national and international transactions. International arbitration has evolved into a credible alternative replacement for traditional litigation. International arbitration as a private neutral forum is gaining overwhelming recognition in the world. The extent of this popularity varies in different commercial fields and this dispute settlement mechanism is treated differently in various sectors around the globe. For instance, in international construction contracts, arbitration clauses are an integral part of the contract whereas in an international syndicated loan agreement, incorporating an arbitration clause may seem rather unusual.

This trend is now changing and banking industry's traditional loyalty towards litigation and court jurisdictions is changing. According to statistics and market practice, in the past recent years, popularity of arbitration has been growing in banking and finance sector for various reasons.

Among the reasons are the unique characteristics that international arbitration has to offer, characteristics such as global enforceability and worldwide recognition of arbitral awards, which have contributed to this paradigm shift. Moreover, the possibility of using knowledgeable finance and banking experts as arbitrators to resolve disputes and conflicts in the banking and financial sector is another appealing feature of arbitration. All the perceived advantages of international arbitration, which are claimed to be the drive force of this change of trend, are scrutinised in this research.

This research analyses the historical hesitation and reluctance to use arbitration in the banking and financial sector, and elaborate the change of trend in this area and reasons for this change of attitude. The focus is on arbitrability of banking and financial disputes in the international sphere.

The practical benefits of incorporating an arbitration clause in banking and financial transactions are considered in this research. At the end it is recommended that the banking and finance sector will benefit from a wider use of international arbitration in cross-border transactions and the wider use of this neutral independent mechanism

can led to a harmonised use of international arbitration in the aforementioned sectors. This research underpins the use of international arbitration as a sensible dispute resolution mechanism in international banking and financial transactions.

## List of Abbreviations

AAA	American Arbitration Association
ADR	alternative dispute resolution
BaFin	Federal Supervisory Authority (Germany)
Bank	Bank of England
BIT	bilateral investment treaty
CDP	City Dispute Panel (UK)
CIETAC	China International Economic and Trade Arbitration Commission
DIAC	The Dubai International Arbitration Centre
DOCDEX	Documentary Credit Dispute Resolution Expertise
EC	European Community
ECB	European Central Bank
ECT	Energy Charter Treaty
EEA	European Economic Area
EFTA	European Free Trade Association
EU	European Union
FCA	Financial Conduct Authority
FET	fair and equitable treatment
FPC	Financial Policy Committee
FRB	Federal Reserve Board
FOS	Financial Ombudsman Services
FSA	Financial Services Authority
FSMA	Financial Services and Markets Act

HKIAC	The Hong Kong International Arbitration Centre
ICC	International Chamber of Commerce
ICDR	International Centre of Dispute Resolution
ICLCA	International Centre for Letters of Credit Arbitration
ISDA	International Swaps and Derivatives Association
ICSID	International Centre for Settlement of Investment Disputes
IP	intellectual property
IPB	international private banking
IPR	intellectual property rights
ISDA	International Swaps and Derivatives Association
LCIA	London Court of International Arbitration
L/C	letter of credit
LIBOR	London Interbank Offered Rate
LLC	limited liability company/corporation
MFN	most favoured nation
MIT	multilateral investment treaty
NAFTA	North American Free Trade Agreement
NYC	New York Convention
OECD	Organisation for Economic Co-operation and Development
OTC	over the counter
PRA	Prudential Regulation Authority
P.R.I.M.E. Finance	Panel of Recognised International Market Experts in Finance
RBS	Royal Bank of Scotland
SIAC	Singapore International Arbitration Centre

TBTF	too big to fail
UCP	Uniform Customs and Practice for Documentary Credit
UCTA	Unfair Contract Terms Act 1997 (UK)
UK	United Kingdom
UN	United Nations
UNCITRAL	United Nations Commission on International Trade Law
US	United States
UTCC	Consumer Contracts Regulations 1999 (UK)
WIPO	World Intellectual Property Organization

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# **Chapter One**

## **Introduction and Thesis Plan**

The world is becoming more integrated every day. The globalisation and universality of law is not discrete, and different areas of law are internationalised every day. Alongside this integration, transactions and businesses are also becoming globalised. Cross-border transactions are now inevitable in the commercial world today. International transactions have considerable risks, and the viability of any transaction is largely dependent on assessment and management of the risks involved in that transaction. Risks can be either political or legal in nature. In some transactions, economic risks might be involved.

In terms of legal risks, choice of dispute settlement mechanism can have an essential role in managing the legal risk and the transactions' effectiveness. The possibility of bringing an action against a party in default, the nature of the remedies being sought and the enforcement and recognition of those remedies are among main factors affecting the risks in the choice of dispute resolution mechanism in a cross-border transaction.

The importance of dispute resolution and conflict management is one of the most crucial elements in domestic transactions. However, in the case of multistate transactions, it can be a more challenging element as not just one jurisdiction involved; two or more different jurisdictions can be involved in the dispute resolution process.

Clearly, where there is a foreign jurisdiction involved in the contract in question, or the place of performance is in a foreign territory, or perhaps the counterparty is from a foreign country, the risks involved are of a different nature than where the transaction involves purely domestic contracts in which there is no foreign factor.

The significance of dispute settlement choice for parties to a cross-border transaction is more evident when one is looking at the nature of the remedies and the ultimate enforcement of remedies. Obviously, there has to be enforcement attached to the

remedies, otherwise the entire procedure of dispute settlement and remedy seeking would become pointless and absurd.

The contractual choice of dispute settlement mechanism is in the contracting parties' hands and it is one of the most important decisions that they make. In each contract there has to be a mechanism that provides for the resolution of disputes between parties. This mechanism is called a 'dispute resolution clause' and should be agreed upon by all the contracting parties. It is one of the most significant components of a contract and has to be drafted wisely. In agreeing to such a clause, there are several elements that need to be taken into account by the parties, including the choice of law and jurisdiction. An imprecisely drafted clause is regarded as a pathological clause and is not efficient or applicable if a contractual dispute arises. A workable clause should be clear and reflect the intention of the parties. A properly drafted dispute resolution clause can save considerable amounts of time and money if a dispute arises, in that parties would benefit from a well-thought-out drafted dispute resolution clause and refer the matter to the agreed procedure to be settled.

There are some standard clauses in each sector incorporated into contracts by relevant practitioners. Legal experts are familiar with the standard dispute resolution clauses in their specialist sectors and have templates that they can use for each contract. Depending on the key facts in each transaction, they may need to tailor the clause for that particular transaction.

In the commercial world, the main choice for dispute resolution clauses is among litigation, arbitration or, in some cases, other means such as expert determination, or mediation. When considering the nature of the particular transaction and its international implications, the parties may nominate a specific national court to deal with conflicts arising out of the contract. Alternatively, parties can opt for an arbitral tribunal and specify that, in the case of disputes in relation to the transaction, an arbitrator is in charge of settling the matter. The preference for arbitration instead of litigation may stem from the view that the courts are too public, expensive and damage long-term relationships between the parties because of the adversarial nature of courts.

Arbitration and litigation have been rivals for the past 5 decades in terms of choice as to the most appropriate means for dispute settlement in intentional transactions. It seems that arbitration has had a longer history compared to litigation. In the words of Professor Derek Roebuck:

Litigation is comparatively modern in the history of human society. It cannot predate the state, which must set up the courts which litigation by definition requires. Litigation and arbitration have been alternatives since at least the 18th century BC, when Assyrian merchants employed them in ancient Mesopotamia. But arbitration and mediation must be even older than that. Pre-state societies must have had some way other than violence to resolve their disputes.<sup>1</sup>

Arbitration is an increasingly popular replacement for commercial courts. According to Halsbury's Laws of England, arbitration is defined as:<sup>2</sup>

The process by which a dispute or difference between two or more parties as to their mutual legal rights and liabilities is referred to and determined judicially and with binding effect by the application of law by one or more persons (the arbitral tribunal) instead of by a court of law.

Professor Stuart Sime defines 'arbitration' as: 'an adjudicative dispute resolution process based on an agreement between the parties to refer a dispute or difference between them to impartial arbitrators for a decision.'<sup>3</sup> He also describes it as a private version of litigation, and in various ways, the course of arbitration is often similar to litigation.

In the commercial world, the choice between a litigation clause and an arbitration clause is one of the crucial dilemmas for the parties to an international transaction. As this research touches upon, this decision of the parties is mainly concerned with the

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<sup>1</sup> Professor Derek Roebuck as cited by Neil Kaplan, 'The Role of the State in Protecting the System of Arbitration' [2015] 81(4) Arbitration 452, 452.

<sup>2</sup> Halsbury's Law of England is one of the most inclusive authoritative legal encyclopaedias in England and Wales.

<sup>3</sup> Professor Stuart Sime, 'Res Judicata and ADR' 2015 34(1) CJQ 35, 42

fundamental principle of freedom of contracts, where parties to a contract are given the authority and power to choose whatever contractual terms they wish. .<sup>4</sup>

Litigation is known to be expensive and disruptive, and increases the costs of the transaction.<sup>5</sup> Litigation is deemed to increase the risk involved in any transaction where there is a possibility of proceedings in an unfamiliar forum with application of unfamiliar law. And where a court has issued its judgment, there are other risks surrounding the entire process, especially where there is no automatic enforcement recognised for foreign judgments in the country where the enforcement of foreign judgment is being sought. All the above-mentioned risks are litigation risks in cross-border transactions, and are risks that have to be proficiently managed and assessed by the parties so that the transaction is commercial and economically feasible. If they fail to limit their exposure such risks, this will inhibit the transaction in question.<sup>6</sup>

Furthermore, litigation and court hearings tend to be formal and are adversarial in nature as there is always a winning party and a losing party. This may have an impact on any long-term business relationship between parties and affect their course of trade.

The mechanisms used to resolve disagreements and encounters between parties are improving, looking for a less adversarial approach. Negotiation and talks are conducted to reach to mutually agreed outcomes that are desirable to all the parties. It can be said that this movement is trying to reduce the intimidating confrontations between parties and instead promote compromises and cooperation between parties in conflict.

This shift towards a more flexible and friendly conflict-handling procedure is not unique to the law and legal arrangements. Internationally, conflict resolution and conflict management has entered into a new era, and the attempt is to reach a resolution through amicable routes rather than hostile and unreceptive methods. In politics there is no room

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<sup>4</sup> See Chapter Four (4.3) where the doctrine of freedom of contracts is illustrated.

<sup>5</sup> Richard Fentiman, *International Commercial Litigation*, (first published 2010, Oxford University Press 2015) 3

<sup>6</sup> *ibid* 7

for antagonistic behaviours and cold wars. Instead, countries are encouraged to resolve any problems through talks and negotiations.<sup>7</sup>

Considerable attempts have been made for wider use of alternative dispute resolution (ADR) instead of court procedures, not only in England but also throughout the world. ADR provides for a wider range of options to resolve disputes between parties, and to do so out of court. ADR tools vary from one jurisdiction to another. The main forms of ADR are mediation, negotiation and conciliation. ADR aims to resolve disputes in a more friendly and relaxed environment.

Arbitration has traditionally been seen as an ADR method. However, because of the recent expansion in the use of arbitration in cross-border disputes and arbitration's different nature compared to other ADR methods, some scholars classify it as a separate category from ADR. The distinctive features of arbitration, such as enforceability of awards, and the fact that the third party involved in the process (arbitrator) has the decision-making power, are among the elements that makes this dispute resolution process distinguishable from other ADR methods. For instance, mediation is not binding and the mediator acts as a facilitator, unlike arbitrator who acts as a judge and renders the decision on the dispute between the other parties.

Arbitration is a desirable forum for settling international disputes in commercial contracts. The significant growth of international commerce, cross-border projects, foreign investment and financial transactions has been accompanied, over the last few decades, by the increased use of arbitration to settle disputes. Arbitration's scope has greatly expanded from the more traditional sectors, such as shipping, trade and insurance, into other sectors, such as construction and intellectual property.<sup>8</sup>

Arbitration is based on mutual agreement and is a direct outcome of parties' consent which is formed under an agreement. The arbitration procedure allows the parties a great deal of control and autonomy as to the way the settlement process operates. Arbitration

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<sup>7</sup> The Iran nuclear talk is a good example that shows the world's willingness to promote negotiations and talks rather than aggressive threats and intimidating dialogues.

<sup>8</sup> Discussed further in Chapter Three



has a reputation of being a cheaper, speedier dispute resolution system, which is also flexible and does not require rigid formalities similar to national court proceedings.<sup>9</sup>

International arbitration as a private neutral forum is gaining overwhelming recognition in the world. The extent of this popularity varies in different commercial fields and arbitration is treated differently in various sectors around the globe. The banking and financial sector have always been hostile towards the use of arbitration as a means to settle disputes.

However, the use of arbitration in trade and commerce is now a common practice,<sup>10</sup> and arbitration's popularity in the international commercial world has spread to the banking and finance industry. More specifically, after the financial crisis in late 2008, banks and financial institutions started to use arbitration more widely. The traditional approach, which was to use English courts and New York courts mainly when resolving banking disputes, started to fade and was replaced by arbitration. Both the traditional approach and the industry started to change, mainly because of the globalisation of banking and finance transactions and the rise of emerging markets, mainly in South Asia and Latin America. Participants in these markets were reluctant to agree to litigation clauses conferring London or New York jurisdictions. Instead, they preferred to impose their own national jurisdictions. In this atmosphere, global banks and financial institutes, started to see arbitration as a neutral forum that could work for both parties.

Arbitration, similar to other dispute settlement methods, has its own unique characteristics. These characteristics may be appealing to parties involved in a banking or financial transaction. Since the financial crisis in 2008, there has been a turning point in the use of arbitration in financial and banking disputes. There reasons behind this change vary from globalisation of banking services and financial products to foreign investors' lack of trust in domestic litigation.

Considering the large volume of global banking transactions that take place nowadays, and the involvement of cross-border contracts, the use of international arbitration as a

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<sup>9</sup> John F Wilson, *Carriage of Goods by Sea*, (5th edn, Pearson, Longman 2004) 324

<sup>10</sup> Sir Ronald Davison 'Arbitration – Its Future – Its Purposes' in Julio Cesar Betancourt and Jason A Crook (eds) *ADR, Arbitration, AND Mediation, A Collection of Essays* (Author House 2014) 337.

private dispute settlement mechanism should not seem peculiar to banks. One of the most significant features of arbitration is its global enforceability across jurisdictions which have signed the New York Convention on enforcement of foreign arbitral awards and as a result, international arbitration enjoys a widespread global enforceability due to the existence of New York Convention 1958.<sup>11</sup>

International arbitration appears to benefit dispute settlement in the banking and finance sector as it offers a more neutral forum and the existence of multilateral treaty network to enforce arbitration awards in places where a debtor has assets. However, there are arguments against international financial arbitration. Not every financier or banker would approve the use of an arbitration clause. Although the traditional preference for litigation over arbitration (which was the common practice for banks and financial institutes for many years) is now changing, there is still a considerable amount of international banking litigation being conducted in the courts.

To identify this issue in a proper perspective, a brief review of the recent literature on the use of international arbitration clauses in financial and banking transactions is necessary, and has been conducted in this research.

The thesis is divided into seven chapters (including the introduction and conclusion). This chapter, Chapter One, includes the thesis plan and sets out the reasons why this research is original. This chapter also contains the methodology that is used in this research, as well as the introduction, which embraces the definition of the key concepts used in this research.

In Chapter Two, the nature of the banking industry is being examined. The analysis extends to the core activities of banks in the economy in general, as well as the banking regulation mechanism. The rationale behind banking regulation is explained and this mechanism is discussed. The distinction between bank regulation and bank supervision is also elaborated. This chapter is descriptive and aims to provide an overview of the

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<sup>11</sup> The Convention on the Recognition and Enforcement of Foreign Arbitral Awards, also known as the “New York Arbitration Convention” or the “New York Convention” is one of the key elements in universal execution of foreign arbitral awards. The Convention was adopted by United Nations Commission on International Trade Law and entered into force on 7 June 1959 and is consist of 156 signatory parties.

concept of banking and the banks key role in the economy. Some of the key functions of the banks are illustrated.

Chapter Three offers a comprehensive analysis of the concept of arbitration and its key elements. Unique features of arbitration are explained in this chapter, as well as the features that may benefit banking and finance industry in particular. It also discusses that international arbitration is a plausible dispute settlement method globally because of its universal, neutral and objective features. This chapter also explains the possible legal theories behind the eligibility of arbitration.

Chapter Four contains theoretical discussions and explains the jurisprudence of arbitration and the legal theories of arbitration of banking dispute and the relationship between banks and their customers is touched upon in this chapter. It also explores whether ADR currently plays a strong role in banking dispute resolution in the United Kingdom (UK). Also, the principle of freedom of contracts and its implications for arbitration is discussed alongside the theories that might limit parties' contractual freedom.

Chapter Five offers a critical overview of the current use of arbitration in certain global banking transactions. In general, the chapter tries to analyse the compatibility of international arbitration with the particularities of the banking sector. In order to undertake a comparative analysis, some examples of the use of international arbitration clause provided in financial products are also examined in this chapter. At the end of the chapter, the use of arbitration in banking and finance sector is critiqued and the possible downsides set out.

Chapter Six examines the other end of the spectrum and favours the adoption of arbitration clauses in banking and financial related disputes. The general principles of drafting a valid arbitration clause in the banking and financial sector are also explained. In addition, this chapter examines the leading arbitral institutions, which offer special rules and special services for the arbitration of disputes arising out of banking or financial transactions. Drafting an appropriate arbitration clause for the banking and financial sector is discussed in this chapter.

Finally, Chapter Seven concludes this research. Chapter Seven reiterates that it would be beneficial to use arbitration in the context of banking and financial transactions as the benefits outweigh the drawbacks. The use of international arbitration is expanding and gaining more acceptability and approval throughout the banking and finance world, just as it has in other sectors of commercial world.

It is suggested that banks will find international arbitration an appropriate dispute settlement mechanism, especially when it comes to cross-border transactions that involve parties from outside the Europe. It is argued that whether arbitration will become the preferred method of dispute resolution in banking and other financial institutions depends on the attitudes of banks and financial institutions and the approach of market participants to using this settlement system.

This study attempts to sift through the case law and legal theories in the field of arbitration and contract law to explore some solid arguments in favour of adopting international arbitration as a viable option in resolving banking and financial sector disputes in the globalised world.. The viability of arbitration as a contractual mechanism and the business interests that it facilitates are also touched upon in this research.

In a nutshell, this research examines the viability of an arbitration clause and the use of international arbitration in banking- and financial-related disputes. The terms ‘banking-’ and ‘finance-’ related disputes have been used interchangeably in this research. The aim is to explore in both sectors the areas most affected by arbitration. Although the author appreciates that banking transactions and financial transactions are two separate concepts, the purpose has been set to use the wider meaning of finance, which includes banks as a dimension and the intention is to use the wider meaning of finance throughout the research.

This research is not focused on one particular jurisdiction; instead the issue of the practicality of international arbitration for banking and financial services is examined in a broad worldwide context.

## **1.1 Originality**

The originality of this work lies in two key points. First, the globalisation of banking and financial products has become an unavoidable phenomenon and in this respect traditional litigation does not seem to be an appropriate dispute resolution mechanism. The recent statistics as to the use of arbitration by financiers proves that there is a place for international arbitration in the resolution of banking and financial disputes.

Second, the use of arbitration in banking and finance is a new subject matter. The subject is evolving. This research is mainly based on the views of leading scholars and on pros and cons of arbitration in this sector. Practical benefits of arbitration in this sector are examined, as well as the theories behind the traditional hesitation about arbitration in this industry. As the use of arbitration is a rather novel question in commercial law, there are limited primary sources such as case law and arbitration awards to discuss and use in this research.

Therefore, a clear analysis of the use of international arbitration and its advantages and disadvantages to the banking and finance industry is missing. There is not a large literature and case law covering the use of international arbitration in banks and other financial institutions, nor is there a significant body of research that discusses the effectiveness or ineffectiveness of this settlement method in the sector.

Last but not least, the thesis tries to identify and cover all practical issues related to the use of international arbitration in the banking and financial world by offering a comprehensive analysis and comparison between different dispute settlement methods in this area. There is still need for further research and analysis in the area of international financial arbitration as this is a very novel concept.

## **1.2 Research Methodology**

To answer my research questions I dwell on doctrinal and normative legal analysis. The doctrinal analysis of primary and secondary legal materials seeks to explain the shape of existing doctrine in relation to international arbitration. This doctrinal analysis serves as the basis for the development of normative analysis – to determine how international arbitration can be used in banking and financial transactions. Examples from different jurisdictions are employed to theoretically examine the use of arbitration as a dispute settlement method in various banking transactions including loan agreements and bank guarantees.

It is true that distinctive historical and systemic considerations command different institutional solutions; this study takes this point seriously and tries to tailor the concepts borrowed from other jurisdictions to the UK current particularities. Furthermore, the case study method is applied in relation to the use of arbitration clause, as well as the option clause, in various jurisdictions.

As a note of clarification, the thesis deals exclusively with the legal implications of use of arbitration in banking industry – other types of financial institutions are not covered, such as investment or insurance firms. However, in some areas, the use of arbitration in financial sector has been touched upon briefly to provide examples of the use of arbitration in the finance industry.

The hypothesis of this research is to demonstrate that traditional national court is no longer the most efficient jurisdiction to address the requirements of an international dispute settlement procedure because of the lack of global enforceability of a domestic judgment and the complexity of the disputes involved in the banking sector. ,

One of the most significant features of arbitration is its global enforceability within its signatory countries. International arbitration enjoys a widespread global enforceability as a result of the application of the New York Convention.

As a result, arbitration is becoming more and more widespread in the financial and banking sector. Considering the huge volume of global banking transactions that now take place as well as the use of cross-border contracts, banks have no reason to reject out of hand international arbitration as a private dispute settlement mechanism.

This is the best time to encourage and invite parties and stakeholders in this industry to opt for arbitration and not to deprive themselves of the benefits of international arbitration. In the absence of national rules on the arbitrability of financial and banking disputes, it can be established that the principles of contract law and freedom of contract are not limited by arbitration and therefore there is no need to limit the use of arbitration clauses in international transactions in this field.

In order to achieve the above stated hypothesis, which is the effectiveness of arbitration as a means of dispute settlement for banking and finance sector, this research is divided into 7 chapters. In chapter one (introduction), the title of this research is explained. Chapter two provides a background knowledge as to the framework of the banking industry in order to highlight the differences of this sector in comparison with other commercial sectors.

Chapter three, provides an illustration as well as analysis of arbitration and in particular international arbitration

## **Chapter Two**

### **New Economic Trends and the Banking Sector**

#### **2.1 Introduction**

Banks are accepted as a substantial player in the development of a country's economic system, because of their critical position in the financial system.

This chapter deals with the nature of banks in general, as well as new trends in banking, including privatisation, globalisation and the inevitable regulation that follows. The establishment of a regulatory system in this sector is examined, as are the rationales for regulation.

The concept of banking and banking regulation is exhausted in academia and it has been discussed that, in the light of the extensive changes and innovation of financial services and banking activities, there is an increasing need for banking regulation. Banks must cope with new regulatory regimes to maintain the financial sustainability of the economy.

This chapter had two goals. The first is to establish the role of banking in a modern economy and how banks operate nationally and internationally. The second is to elaborate the objectives of banking regulation.

To achieve this chapter's goals, the following structure is used: first, banks and the nature of banking in general are examined. Second, the existence of regulatory framework in banking is scrutinised, as is the justification for this regulatory framework. Also, different approaches towards banking regulation are discussed. The key elements of banking regulation and banking supervision are illustrated and the role of the central bank is explained.

To explain the role of regulation in this sector, brief background information about the principles of banking and the function of financial institutions in the structure of each economy is given.



Some of the key concepts used in this chapter should be clarified. Generally, the term ‘financial sector’ can refer to both the banking sector and the securities sector. As explained in the introductory chapter, this research looks at the viability of arbitration clauses in banking transactions and mainly bank-related contracts; whenever the term ‘finance’ is used, it means the banking industry and financial institutions that operate within this industry.

The chapter deals exclusively with the legal nature and function of banks – other types of financial institutions, such as investment or insurance firms, are not covered.

## **2.2 Overview of the banking system**

The need for saving and securing money has been a necessity for mankind since ancient times, when primitive forms of banks were secure places to keep money safe.<sup>12</sup> This long history of banks undeniably contains continuous change and adaptability.<sup>13</sup> The concept of a bank comes from Italian trading during thirteenth, fourteenth and fifteenth centuries when Lombardy and Florence were centres of financial activities and economic powers in Europe.<sup>14</sup> The bankers would sit in open places on designated benches and conduct their banking business there. The Italian word for bench is *banco* and it is possible that the word ‘bank’ originated from there.<sup>15</sup>

Banks started out as deposit holders and lenders. They received money from depositors and lent it to others, and by doing so they acted as ‘intermediaries’ between borrowers and depositors.<sup>16</sup> During the centuries, this simple job of banks has not changed and the fundamental job of banks is still accepting deposits and lending. However, it is evident that today the function of banks cannot be limited to this core activity. These days, banks

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<sup>12</sup> Glyn Davies, ‘Origins of Money and Banking’ (Exeter University Projects, 25 May 2005) <<https://projects.exeter.ac.uk/RDavies/arian/origins.html>> accessed 12 April 2014

<sup>13</sup> Roy C. Smith and Ingo Walter, *Global Banking* (Oxford University Press 1996) 3

<sup>14</sup> Stephen Valdez and Philip Molyneux, *An Introduction to Global Financial Markets* (first published 1993, Palgrave Macmillan 2010) 15.

<sup>15</sup> *ibid* 15.

<sup>16</sup> Shelagh Heffernan, *Modern Banking* (first published 2005, John Wiley & Sons Ltd 2007) 1.

do more than just their traditional activities. They have become strong role players in all financial areas, including the foreign exchange and securities market.<sup>17</sup>

The second main activity of banks is offering liquidity to customers, and this is another key function of banks that differentiates them from other financial institutions.<sup>18</sup>

Banks are an integral part of the business and financial systems of a country and have an ancillary role in the execution of trade and commerce. A country's economic stability largely depends on the function of its banks, whether they are commercial/retail or central banks.<sup>19</sup>

Banks are active in balancing a country's economy through various means. One way is by facilitating international commercial payments and offering international financial facilities, such as letters of credit. Understandably, without banks and the international payment methods offered by them, no import or export could take place.

There is no universal definition for 'bank' because the general concept varies from one country to another, because of the variety in the scope of banking activities. In the absence of a definition in the statute, English judges and the common law have contributed to defining banking business through case law.<sup>20</sup> While in the early case of *Woods v Martins Bank Ltd* [1959]<sup>21</sup> the meaning of banking business was illustrated, it was also discussed that the definition of 'bank' should be open to changes over time and in different places; therefore an establishment that is a bank in place A may not be regarded as a bank in place B. Furthermore, in decision of *Re Birkbeck*<sup>22</sup> it was explained that the reputation and behaviour of the firm can lead the firm to be considered as a bank regardless of its authorisation to act as a bank.

Later, in 1966, Lord Denning offered a definition covering banking activities, which elaborated three key elements that establish a bank's business. The three core activities of a bank are accepting credit, commuting cheques and recording the records of the account.

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<sup>17</sup> Ross Cranston, *Principles of Banking Law* (First published 1997, Oxford University Press 2002) 3

<sup>18</sup> Heffernan (n 16) 3.

<sup>19</sup> Retail banking, commercial banking and central banking are illustrated further.

<sup>20</sup> See *Re Birkbeck Permanent Benefit Building Society* [1912] 2 Ch. 183 (here after *Re Birkbeck*), *Woods v Martins Bank Ltd* [1959] 1 QB 55 (here after *Woods*), *Commercial Banking Co. Ltd v Hartigan* (1952) 86 Ir. LTR 109, *United Dominions Trust v Kirkwood* [1966] 2 QB 431 (hereafter *Kirkwood*)

<sup>21</sup> *ibid* *Woods*.

<sup>22</sup> *Re Birkbeck* (n 20).

The definition provided in *United Dominions Trust Ltd. v Kirkwood*,<sup>23</sup> suggests the follows:<sup>24</sup>

There are ... two characteristics usually found in bankers today: (i) They accept money from, and collect cheque for, their customers and place them to their credit; (ii) They honour cheques or orders drawn on them by their customers when presented for payment and debit their customers accordingly. These two characteristics carry with them also a third, namely (iii) they keep current account, or something of that nature, in their books in which the credits and debits are entered.

However, the definition of bank has evolved over centuries, as the functions of banks have changed.<sup>25</sup>

It can be argued that the multifunctional character of current banks is a result of adopting the German banking model.<sup>26</sup> The number of tasks that banks undertake today is countless and banks are in fact the principal players in a country's economy. It should be noted that the role of banks is not limited to the domestic level; banks are influential in cross-border economies and have a prominent role in the global economy and the world's financial stability.

There are different models of banks. Some of the main types are commercial banks (also known as retail banks), clearing banks, investment banks (also known as merchant banks) and central banks. For the purposes of this chapter, the focus is on commercial and central banks.<sup>27</sup>

Commercial banks perform the basic task of banking, which is accepting deposits and providing loans. Commercial banks are mainly high street banks that are accessible to the general public. Central banks are completely different entities and, as explained below, are in charge of a country's financial stability.

The history of banking in the United Kingdom (UK) goes back to the sixteenth century when goldsmith banking was in place.<sup>28</sup> At this time people deposited their gold with a

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<sup>23</sup> *Kirkwood* (n 20).

<sup>24</sup> Cranston (n 17) 4.

<sup>25</sup> Thus, the answer to 'what is a bank?' takes various forms depending on time, legal system, regulatory authorities' purposes and financial environment.

<sup>26</sup> German model: where financial and industrial sectors in the society have closer links to maximise the economic wealth. See Cranston (n 17) 3.

<sup>27</sup> *ibid* 4.

<sup>28</sup> Glen Arnold, *Banking, Financial Times Guides* (Pearson Education 2014) 211

goldsmith who in turn issued them a receipt. This receipt was a piece of paper that could be traded and used as a means for credit.<sup>29</sup>

It has been claimed that the banking industry in the UK is mainly dominated by four main banks – the ‘big four’ – namely Barclays, Royal Bank of Scotland, HSBC and Lloyds Banking Group.<sup>30</sup>

### 2.2.1 Central bank as regulator and supervisor of banking transactions

Central banks are usually state-owned financial institutions, and are in charge of controlling the country’s national currency and the liquidity.<sup>31</sup> The role of a central bank may vary from one territory to another depending on the country’s economic system. Nowadays one cannot imagine a financial system without a central banking system in place, and each economy should have a central bank. Central banks are established to monitor the functions of the banks within the banking sector. Their aim is to maintain financial stability within the economy of the country. Central banks’ main task is to set up policies and frameworks for the banking industry. They also decide on the interest rate, and issue notes and coins.

In general, the functions of central banking have developed considerably in the past few decades.<sup>32</sup> The supervisory role of central banks is also expanding; arguably, central banks all around the globe are being given more responsibilities to maintain banking stability and avoid a crisis.<sup>33</sup> A good example is the 2007–2008 crisis where, , two central banks, the Bank of England and the US Federal Reserve, were assigned wider responsibilities in order to rectify the consequences of the financial crisis as far as they can and also to prevent similar crisis in future by taking extra precautionary measures. The Bank of England’s supervisory role, which was removed from it in 1997, was assigned back to the Bank after financial crisis of 2008.

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<sup>29</sup> *ibid* 211.

<sup>30</sup> *ibid* 213.

<sup>31</sup> Examples of privately owned central banks are the central banks of South Africa, Greece and Italy.

<sup>32</sup> Francesco Giavazzi and Alberto Giovannini, ‘Central Banks and the Financial System’ in Sylvester Eijffinger and Donato Masciandaro (eds), *Handbook of Central Banking, Financial Regulation and Supervision*, (Edward Elgar 2011) 4.

<sup>33</sup> Pierre C. Boyer and Jorge Ponce, ‘Central Banks and Banking Supervision Reform’ in Sylvester Eijffinger and Donato Masciandaro (eds), *Handbook of Central Banking, Financial Regulation and Supervision* (Edward Elgar 2011) 159

The core activities of a central bank can be summarised as:<sup>34</sup>

- Supervising the country's banking system
- Advising the government on monetary policies
- Issuing banknotes
- Acting as banker to the other banks
- Acting as banker to the government
- Raising money for the government
- Controlling the nation's currency reserves
- Acting as 'lender of last resort'
- Liaising with international bodies.

However, the architecture of the eurozone is a deviation from the traditional paradigm of central banks' powers. The European Central Bank (ECB) has the exclusive right to issue banknotes but cannot (*de jure*) act as 'lender of last resort', while national banks of the eurozone countries were, until very recently (2015), responsible for the supervision and regulation of systemic banks in their countries, but without the power to print money since 2001.

This research is only concerned with the activities of central banks that may affect banking transactions and will not explore other prudential activities of central banks.

There are various commentaries about the role of central banks in a country's economy. Criticism of central banks' actions in a financial crisis is common. The financial crisis of 2008 also directed much criticism towards central banks' interventions and whether the actions and policies adopted by central banks explained the reasons for the mentioned crisis.

### 2.2.2 The Bank of England

The Bank of England, the UK's central bank, was established in the seventeenth century. At the time of its establishment it was not considered a central bank, as the concept did not then exist.<sup>35</sup> The initial purpose of setting up the Bank of England was to create a

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<sup>34</sup> Valdez and Molyneux (n 14) 60.

<sup>35</sup> John H. Wood, *A History of Central Banking in Great Britain and the United States* (Cambridge University Press 2005) 32

source of funding for overseas military conflicts.<sup>36</sup> The Bank of England has several roles in the operation and balancing of the financial and banking system in the UK. One of the key roles of the Bank is issuing bank notes, which it has been doing for decades. Another key role of the Bank is to regulate the UK banking system by imposing monetary policies. The Bank is also responsible for deciding the interest rate for interbank loans, which is known as Libor, which stands for London Interbank Offered Rate.<sup>37</sup> Libor is the interest rate that a bank will use if it wishes to offer lending to other banks. Libor is normally decided around noon each day by the Bank of England by taking into account the absolute acquiescence of the Bank.<sup>38</sup> Today, the Bank of England states that its primary mission is ‘to promote the good of the people of the United Kingdom by maintaining monetary and financial stability’.<sup>39</sup>

In some jurisdictions the supervisory body is separate. For instance, in Germany the Bundesbank, which is the German central bank, is not responsible for supervision. Another governmental body, The Federal Supervisory Authority (BaFin), is in charge of supervising banks and financial institutions in Germany.<sup>40</sup>

In UK, the Bank of England has not only a regulatory role, but also a supervisory role. The last time Bank of England was in charge of the supervisory function was before 1997. Under the Labour government in 1997, the supervisory role was taken from the Bank of England and was assigned to Financial Services Authority (FSA). The argument at that time was that the Bank of England failed to do a good job and another authority was needed. The supervisory task was given back to the Bank in 2010 when the Conservative government came into power.<sup>41</sup>

In 2012, the Financial Services Act 2012 as part of Bank of England created the Prudential Regulation Authority.<sup>42</sup>

Bank regulation and supervision, in general, is illustrated below in this chapter.

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<sup>36</sup> Mark Howard and Roger Masefield, *Butterworths Banking Law Guide*, (LexisNexis Butterworths 2006) 7

<sup>37</sup> ‘Definition of Libor’ (Financial Times) <<http://lexicon.ft.com/Term?term=LIBOR>> accessed 12 April 2015

<sup>38</sup> Full discussion and explanation of Libor is outside the scope of this chapter.

<sup>39</sup> Official site of Bank of England, ‘About the Bank’ <<http://www.bankofengland.co.uk/about/Pages/default.aspx>> accessed 21 April 2014

<sup>40</sup> Valdez and Molyneux (n 14) 18

<sup>41</sup> *ibid* 19

<sup>42</sup> Bank of England, <http://www.bankofengland.co.uk/pru/Pages/about/default.aspx> accessed 2 March 2015

### 2.2.3 European Central Bank

The function of the ECB is very similar to an ordinary central bank, the sole difference being that the ECB is responsible for the financial regulation of the 17 eurozone countries that have adopted euro currency. The principal aim of the ECB is to sustain the financial stability of the eurozone and fix the interest rate within this area<sup>43</sup> and support the EU's general economic policies overall.

The ECB was created by Maastricht Treaty of December 1992. It has been responsible for conducting monetary policy for the eurozone since 1 January 1999.<sup>44</sup> However, it only received official status as a formal institution of the European Union under Lisbon Treaty in 2009.<sup>45</sup>

The role of ECB in financial stability and enhancing monetary policies in the eurozone has been criticised by experts, especially in relation to the delay in detecting the extent of the recent financial crisis. The ECB did not foresee the devastating credit crunch, which was only discovered at the time of the crisis in 2008 after the collapse of Lehman Brothers in September.<sup>46</sup> It was only after this that the ECB reconsidered its interest rate. Overall, the role of the ECB is perceived to be changing since the credit crunch in a positive way and that it should be given a more supervisory role and work closer with governments.<sup>47</sup>

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<sup>43</sup> Catherine Elliot and Frances Quinn, *English Legal System* (first published 1996, Pearson 2014) 102.

<sup>44</sup>The Treaty of Lisbon on constitutional basis of the European Union came into force on 1 December 2009. <https://www.ecb.europa.eu/ecb/orga/escb/html/index.en.html> accessed 10 May 2015 [European Central Bank]

<sup>45</sup> Elliot and Quinn (n 43) 102.

<sup>46</sup> Franziska Richter and Peter Wahl, 'The Role of the European Central Bank in the Financial Crash and the Crisis of the Euro-Zone' A report based on a WEED Expert Meeting (2011) Global Marshall Plan <[http://www.globalmarshallplan.org/sites/default/files/media/ecb\\_report\\_by\\_weed.pdf](http://www.globalmarshallplan.org/sites/default/files/media/ecb_report_by_weed.pdf)> accessed 20 May 2014.

<sup>47</sup> *ibid.*

#### 2.2.4 International banking and international banking supervision

One cannot limit the functions and activities of a bank to its domestic borders. Banks and financial institutions are expanding their cross-border activities considerably and providing services to customers outside their own jurisdiction as well as inside their home jurisdiction.

International banking has been growing expeditiously during the past decades.<sup>48</sup> More precisely, during the 1960s and mid 1980s the biggest expansions were banks establishing branches in other jurisdictions.<sup>49</sup> All this expansion and growth required a competent and comprehensive regulatory system in order to review and control all aspects of the banking activities.<sup>50</sup>

Financial risks have increased as a result of the increase in the scale of banking activities and financial services. Therefore, a greater need for global controlling measures is undeniable.<sup>51</sup>

Banks have been considerably internationalised during the recent decades. Bank A may have branches in countries X, Y and Z. Each of these countries has their own national banking regulations. The question here is whether Bank A has to comply with its own country's national banking regulations or its host country's national banking regulations. There must be a mechanism in place to help with the possible conflict of national regulations<sup>52</sup> regarding prudential measures that have been designed to control systemic risks.<sup>53</sup> In order to address concerns regarding the financial regulation of international banks, the Basel Committee on Banking Supervision<sup>54</sup> was established in 1975. The

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<sup>48</sup> Heffernan (n 16) 179

<sup>49</sup> Cranston (n 17) 424

<sup>50</sup> George Alexander Walker, *International Banking Regulation Law, Policy and Practice* (first published 2001, Kluwer Law International 2001) 1

<sup>51</sup> *Ibid* 7

<sup>52</sup> Mainly, it will be parallel regulatory regimes and not conflicting regulatory regimes. See Cranston (n 17) 438.

<sup>53</sup> *ibid* 104

<sup>54</sup> For more information see <<http://www.bis.org/bcbs/about.htm>> accessed 2 April 2014 Bank for International Settlement



international community agreed that the supervision of foreign banks should be a combination of regulations in host countries and those of the bank's country.<sup>55</sup>

The Basel Committee led considerable progress in setting a new global supervisory and regulatory framework for banks that are active globally and internationally. However, the supervisory mechanism is far from complete<sup>56</sup> and there are still actions that need to be taken by the international community.

It is evident that there are some obstacles to prescribing a regulatory mechanism for international banks all around the world. As there are national supervisory mechanisms, in different jurisdictions, the issue of local control conflicts may arise.<sup>57</sup>

### **2.3 Banking regulation and supervision**

Before exploring bank regulation and bank supervision, it needs to be made clear that traditionally these two functions have been separate activities conducted by central banks and financial authorities. In recent years, different jurisdictions have adopted various approaches to merging these two functions. For instance, in some jurisdictions central banks are in charge of both putting in place regulatory frameworks and monitoring the conduct of financial services. They have adopted a dual function.

Bank regulation refers to set of rules and codes that banks and financial institutions have to follow. The supervisory authority is in charge of monitoring banks and financial institutions to see if they are acting in accordance with the rules and regulations.

It is worth mentioning that banks have always been regarded as special financial institutions that require special treatment and particular protective measures by regulatory authorities to ensure their safety and stability and ultimately reduce their risk of failure.<sup>58</sup>

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<sup>55</sup> Cranston (n 17) 105

<sup>56</sup> Walker (n 50) 11

<sup>57</sup> *ibid* 10

<sup>58</sup> As bank failures are socially and financially costly to society, banks deserve special treatment, but this should not necessarily mean that banks, as information-driven financial institutions, should be exposed to heavier regulation.

### 2.3.1 Bank regulation

‘Banking is and always will be a regulated business’.<sup>59</sup>

Even before the global financial mayhem in late 2000s, it was widely accepted that the conventional commercial logic and commercial law rules were not appropriate for banks, as banks differ fundamentally from other business types and require ‘special’ regulatory treatment.<sup>60</sup>

The banking industry is a regulated industry. Governments heavily regulate banks and financial institutions through regulatory mechanisms. This regulation is not only a matter of domestic law; it is a matter of concern for international banking as well. In cross-border banking, where there is no one authority that could impose laws and regulations, states would together draft mutually agreed contracts to regulate international banking activities.

In the UK there was no codified document regulating banks’ conduct until 1979,<sup>61</sup> when Parliament passed the Banking Act 1979.<sup>62</sup> This legislation was enacted to implement European Community (EC) banking directives.<sup>63</sup> In 1987, Parliament passed the Banking Act 1987,<sup>64</sup> which was an extended and revised version of the earlier Act.<sup>65</sup> The Banking Act 2009,<sup>66</sup> which came into force in February 2009, is the most recent banking act.

Banking Acts address concerns in relation to UK’s banking regulations. These Acts were drafted in a way to meet the necessary requirements of banking regulatory frameworks which are needed in order to monitor banking industry.

For instance Part 1, section 1 of Banking Act 1987 states that:

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<sup>59</sup> Smith and Walter (n 13) 153

<sup>60</sup> For example: B Biagio, ‘What Makes Banks Special? A Study of Banking, Finance, and Economic Development’, World Bank Policy Research Working Paper No 2408 (1999) ; EG Corrigan, ‘Are Banks Special?’, Annual Report, Federal Reserve Bank of Minneapolis (1982) ; C. England, ‘Are Banks Special?’, *Cato Review of Business & Government* (1991)

<<http://www.cato.org/sites/cato.org/files/serials/files/regulation/1991/4/v14n2-3.pdf>> accessed 3 June 2015

<sup>61</sup> Charles Proctor, *The Law and Practice of International Banking* (Oxford University Press 2010) 4

<sup>62</sup> Banking Act 1979 , The National Archives,

<[http://www.legislation.gov.uk/ukpga/1979/37/pdfs/ukpga\\_19790037\\_en.pdf](http://www.legislation.gov.uk/ukpga/1979/37/pdfs/ukpga_19790037_en.pdf)> accessed 30 July 2015.

<sup>63</sup> Proctor (n 61) 4.

<sup>64</sup> Banking Act 1987 , The National Archive, available at

[http://www.legislation.gov.uk/ukpga/1987/22/pdfs/ukpga\\_19870022\\_en.pdf](http://www.legislation.gov.uk/ukpga/1987/22/pdfs/ukpga_19870022_en.pdf) accessed 30 July 2015

<sup>65</sup> Proctor (n 61) 4.

<sup>66</sup> Banking Act 2009, The National Archive <<http://www.legislation.gov.uk/ukpga/2009/1/contents>> [10 May 2015](#)

(3)The Bank shall, as soon as practicable after the end of each of its financial years, make to the Chancellor of the Exchequer and publish in such manner as it thinks appropriate a report on its activities under this Act in that year; and the Chancellor of the Exchequer shall lay copies of every such report before Parliament<sup>67</sup>

This provision made it an absolute requirement for banks in the UK to report their annual activities to the central bank authorities. Thus, the government and relevant authorities can monitor the function of active banks and control their activities.

In another section, the Act deals with capital adequacy for each bank and financial institutions in the UK:

Schedule 3 Paragraph 4

(1) The institution conducts, or, in the case of an institution which is not yet carrying on a deposit-taking business, will conduct its business in a prudent manner.

(2) An institution shall not be regarded as conducting its business in a prudent manner unless it maintains or, as the case may be, will maintain net assets which, together with other financial resources available to the institution of such nature and amount as are considered appropriate by the Bank, are—

(a) of an amount which is commensurate with the nature and scale of the institution's operations; and

(b) of an amount and nature sufficient to safeguard the interests of its depositors and potential depositors, having regard to the particular factors mentioned in sub-paragraph (3) below and any other factors appearing to the Bank to be relevant.<sup>68</sup>

The same principles are followed in the Banking Act 2009 in terms of requirements for capital adequacy and reporting. Overall, the Banking Act 2009 strengthened depositor protection and provided mechanisms for dealing with the resolution of banks that are facing financial difficulty.

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<sup>67</sup> Banking Act 1987, s 1

<sup>68</sup> *ibid.*

The concept of regulation in general can be defined as: ‘Regulation ... is associated with a kind of market economy where the state, through legal instruments, assumes a supervisory role over economic activities.’<sup>69</sup>

Regulation is an inseparable part of the banking and finance sector in a modern economy. In fact, a banking system without a regulatory framework cannot exist. The need for regulation is driven by the sensitive nature of banks’ role in society. The state has to interfere in banking businesses to offer protection to banking customers, including individuals and corporate clients. The fact that banks are subject to regulation makes it easier for the public to trust them and have peace of mind when depositing their cash in banks. be asked what are the bodies being regulated? The answer is mainly commercial and investment banks. Other regulated firms include, but are not limited to, insurance companies, brokers/dealers, investment advisers and rating agencies.<sup>70</sup>

It has been argued that regulation can be differentiated from ordinary law in different aspects.<sup>71</sup> Regulation is different from other laws in the sense that its establishment comes from semi-governmental authorities that have a wide power to make the rules, and execute and adjudicate them.<sup>72</sup> As Professor Wood describes, regulation implies the ‘concentration of legislative, executive and judicial powers in one entity’.<sup>73</sup>

Due to the importance of money and liquidity’s role in the economy and financial stability, the failure of banks cannot be permitted to impose unreasonable costs on society.<sup>74</sup> It has been argued that bank regulation and supervision maintains the evolution of a banking system that is in charge of producing money.<sup>75</sup> Therefore, every state issues its own regulatory structure so that it enjoys a safe banking system and puts the government in a supervisory position where the banks are accountable and answerable.

Although the primary aim of bank regulation is to create a transparent link between banks and the state, financial stability and the control of risk are other major aims of banking

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<sup>69</sup> Mahmood Bagheri, *International Contracts and National Economic Regulation, Dispute Resolution Through International Commercial Arbitration* (Kluwer Law International 2000) 7.

<sup>70</sup> Philip Wood, *Regulation of International Finance*, (2007, Sweet and Maxwell) 16

<sup>71</sup> *Ibid* 25

<sup>72</sup> *ibid* 16

<sup>73</sup> *ibid* 16

<sup>74</sup> Smith and Walter (n 13) 153

<sup>75</sup> Sheila C. Dow, ‘Why the Banking System Should Be Regulated’ (1996) 106(436) *The Economic Journal* 698.

regulation. Banks and the banking industry have always faced various risks, such as legal risk, liquidity risk, settlement risk, operational risk and systemic risk.

There are several reasons behind banking regulation. One aspect is historical; according to Cranston, many of banking regulations in the United Kingdom were triggered by financial crises.<sup>76</sup> For instance, HM Treasury adopted the Banking Act 2009 after the financial crisis. This Act was designed by the main financial regulator authority in United Kingdom (the Bank of England) to overcome the aftermath of the banking failure in 2008–2009.<sup>77</sup>

The existence of a regulatory framework is best illustrated in theoretical debate. From a theoretical perspective, there are various justifications for a regularly framework, some of which are: conflict of interest, less risky activities, monitoring complex banks and controlling financial institutions.<sup>78</sup> Each reason is discussed in the below.

Conflict of interest might arise in multifunctional banks. Where a bank is involved in various activities, for instance in securities and lending, it might try to dump securities on unaware investors in order to assist clients with outstanding payments.<sup>79</sup>

Another reason for imposing regulations is to control risk and stop bank involvement in risky activities. In the case of complex banks, regulation acts as a mechanism to control and minimise this complexity. It has been argued that if there is no regulatory and supervisory mechanism imposed on banks and financial institutions, they may become too powerful economically and politically and, ultimately, ‘too big to discipline’. By way of regulation, the state is able to supervise and monitor activities carried out by major banks and financial institutions.<sup>80</sup>

The question that arises here is whether multifunctional banks are also subject to regulation. Clearly, the varied activities that are carried out by multifunctional banks – such as insurance, derivatives transactions and other activities– are somehow regulated.<sup>81</sup>

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<sup>76</sup> Cranston (n 17) 65

<sup>77</sup> Bank of England

<[http://www.bankofengland.co.uk/FINANCIALSTABILITY/Pages/role/risk\\_reduction/srr/default.aspx](http://www.bankofengland.co.uk/FINANCIALSTABILITY/Pages/role/risk_reduction/srr/default.aspx)> accessed 3 April 2014,

<sup>78</sup> James R Barth, Gerard Caprio Jr and Rose Levine, ‘Bank Regulation and Supervision: What Works Best?’ (2004) 13 *Journal of Financial Intermediation* 205 [science direct] <[http://ac.els-cdn.com/S1042957303000603/1-s2.0-S1042957303000603-main.pdf?\\_tid=8e119bb0-dc61-11e3-b580-0000aacb35d&acdnat=1400179910\\_277cd6fb1e6d95733eca534c8b3b977e](http://ac.els-cdn.com/S1042957303000603/1-s2.0-S1042957303000603-main.pdf?_tid=8e119bb0-dc61-11e3-b580-0000aacb35d&acdnat=1400179910_277cd6fb1e6d95733eca534c8b3b977e)> 10 May 2015

<sup>79</sup> *ibid* 209.

<sup>80</sup> *ibid* 210.

<sup>81</sup> Cranston (n 17) 97.

All those activities contain risks and, reasonably, there must be a mechanism or perhaps a regulatory framework to control the risks.

The challengeable issue here is the possibility of regulating securities and other non-core banking activities. It has been argued that the main reason for securities regulation is investor protection.<sup>82</sup> The main debate in this era is whether core banking activities are riskier than the other activities that multifunctional banks may be conducting, such as dealing in securities. Some predominant scholars are of the opinion that even if securities transactions are not higher risk, combining these activities with core banking would create the potential for impurity as different activities are mixed.<sup>83</sup>

There are different types of banking regulation, the majority of which fall into three types: first, prudential regulation, which is concerned with the safety and soundness of individual banks; second, conduct of business regulation, which refers to the implementation of consumer protection measures; third is the systemic regulation, dealing with the stability of the financial system as a whole.

The categories of banking regulation and the different mechanisms that government may take into account vary according to the economic climate of each country. Depending on the financial situation, governments and authorities may toughen or loosen the regulating frameworks.

In the following chapters, it will be examined whether the imposing of heavy regulations on banks affects banks' choices on dispute resolution clauses in their contracts.

### 2.3.2 Bank supervision

Bank supervision is carried out through a number of different mechanisms. There might be specific regulatory obligations for banks imposed by the authorities, or general standards of market practice.<sup>84</sup> Compliance measures are normally established by central banks.

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<sup>82</sup> *ibid.*

<sup>83</sup> *ibid.*

<sup>84</sup> George Walker, Queen Mary University of London LLM Hand-out, section 7.10

In the majority of countries, there is a statutory source for bank supervision; that is, legislation that contains the statutory powers and checks and balances for bank supervision. In the UK, the sources for banking supervision are the Banking Act 1979,<sup>85</sup> the more recent Financial Services Act 2012<sup>86</sup> and the Financial Services and Markets Act 2000.<sup>87</sup> The statutory base legalises the state's intervention in the imposition of supervisory regimes on banks, as well as regulatory frameworks for the banking industry. The supervisory controls may be performed via different methods of practice.

### 2.3.3 Rationales for bank regulation and supervision

It could be argued that in a modern economy in which banks play an influential role there is no need to justify the requirement or rationale for regulating them. The financial crisis of late 2008 and the devastating consequences that the world suffered (and perhaps in some regions is still suffering) as a result of the crisis show the importance of regulating and supervising financial bodies. This could also be a valid argument that there is a need for even more regulation of banks and financial institutions in order to prevent such global disasters.<sup>88</sup>

However, the banking literature gives several reasons for bank regulations. Distributive justice, consumer protection and prevention of fraud and money laundering are the important and most discussed reasons. One of the reasons for the emergence of regulation is to ensure that there is a just distribution of gain and loss in the market economy. Therefore, regulatory public law can work as the most effective instrument of state intervention to amend market failure.<sup>89</sup> Distributive justice and social equity have always been important concerns for societies.

Another frequently argued reason for bank regulation is the need to protect consumers who are also bank customers. There is a difference in the meaning of 'customer' and of 'consumer' in banking terminology. It can be argued that every single consumer is also a bank customer, but not every customer is a consumer. A consumer in the banking and

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<sup>85</sup> The Banking Act 1979 was enacted after the financial crisis in the UK during 1973 to 1975.

<sup>86</sup> The Financial Services Act 2012 was enacted after the financial crisis in late 2008 and 2009.

<sup>87</sup> The Financial Services and Markets Act 2000.

<sup>88</sup> Proctor ( 61) 3.

<sup>89</sup> Bagheri (n69) 7.

financial context is the party who is in need of extra protection as they tend to be as a weaker party when dealing with banks and financial institutions.

For the purposes of consumer law, corporations are not considered to be consumers. In the UK there is legislation in the area of consumer law and the most recent enactment is the Credit Consumer Act 2006, which deals with protection of consumers as borrowers.<sup>90</sup>

Monitoring and prevention of money laundering is stated to be one of the most important rationales behind not only banking regulation, but also financial regulations. Money laundering can be defined as dishonestly hiding the real source of money from banks.<sup>91</sup> Legislation for the prevention of money laundering requires banks and financial institutions to adopt policies to monitor and confirm the identity of their customers, and the origins of the money they are dealing with.<sup>92</sup>

The justification for, and the logic behind, bank regulation and supervision is one of the most highly debated subjects in both law and economics. Depending upon on the different economic structures and different governments' policies, the extent of bank regulation and supervision may vary from one jurisdiction to another.

## **2.4 Development of the regulatory frameworks in UK banking**

The global financial crisis in late 2008 shook the world's economy and resulted in major changes in international financial regulatory regimes (especially in Europe and the United States (US)). As a direct response to the disastrous crisis, the world's leading economies were determined to adopt fundamental changes to strengthen the scrutiny of the financial services, as well as to boost the operation of global standards.<sup>93</sup>

Up until the financial crisis in late 2008, UK banking regulation was described as a 'light-touch', meaning that official regulators did not take strong or aggressive measures in their

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<sup>90</sup> The Consumer Credit Act 2006 [the national archive] <<http://www.legislation.gov.uk/ukpga/2006/14/contents>> 12 February 2016

<sup>91</sup> Cranston (n 6) 70.

<sup>92</sup> *ibid* 70.

<sup>93</sup> Eilis Ferran, Niamh Moloney, Jennifer G. Hill and John C. Coffee, Jr, *The Regulation Aftermath of the Global Financial Crisis* (first published 2012, Cambridge University Press 2013) 2.



regulatory methods.<sup>94</sup> After the financial turmoil, the UK's financial sector was dramatically changed and new laws and legislations encompassing new regulatory and supervisory bodies were created. One of the earliest changes in the banking law was the Banking Act 2009. This Act aimed to protect depositors and to provide a mechanism to tackle banks' financial difficulties.

Until 2013, UK banking regulation consisted of three main organisations, namely the FSA, the Bank of England and the Treasury. After the financial crisis, the UK's regulatory policies aimed to separate risk-taking aspects of financial services from ordinary provisions of financial services. In addition to that, they aimed for strengthening banking regulation.<sup>95</sup>

The UK's financial regulatory frameworks changed after the enactment of the Financial Services Act 2012, which abolished the FSA and created two new regulatory bodies, the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA). The Act also created a new regulatory body within the Bank of England, the Financial Policy Committee (FPC).<sup>96</sup>

The FPC is in charge of macro-prudential regulations as well as identifying and eliminating systemic risks to the UK's financial system.<sup>97</sup> The FCA has a responsibility to protect consumers in financial services. It also has another fundamental task, which is to monitor and supervise the market conduct of financial institutions in the financial sector.<sup>98</sup> The PRA is also a subsidiary at the Bank of England and is responsible for the safety and soundness of individual financial firms.

In order to minimise the possibility of a financial crisis and safeguard the running of the financial services, all regulatory and supervisory parties involved have to ensure that they communicate with each other effectively.

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<sup>94</sup> Myles Neligan, 'UK's FSA to Propose Overhaul of Global Bank Regulation' (*Reuters*, 17 May 2009) <<http://www.reuters.com/article/2009/03/17/fsa-idUSLH94367220090317>> accessed 20 May 2015.

<sup>95</sup> 'UK Banking Regulation' (Economist Online undated) <[http://www.economicsonline.co.uk/Business\\_economics/Banking+regulation.html](http://www.economicsonline.co.uk/Business_economics/Banking+regulation.html)> accessed 20 June 2015.

<sup>96</sup> Financial Policy Committee, Bank of England (Bank of England undated) <<http://www.bankofengland.co.uk/financialstability/pages/fpc/default.aspx>> accessed 20 May 2015.

<sup>97</sup> *ibid.*

<sup>98</sup> Andreas Kokkinis, 'The Financial Services Act 2012: The Recent Overhaul of the UK's Financial Regulatory Structure' (2013) 24(9) *International Company and Commercial Law Review* 325.

As well as the UK, the European Union (EU) and the US also implemented key amendments to surveillance the operation of financial services. One of the major issues that needed to be addressed by economic leaders was the problem of ‘too big to fail’.<sup>99</sup><sup>100</sup> The UK has adopted a ‘ring-fence’ policy to tackle this issue. This policy requires banks to separate their retail function from other activities that may be more risky by setting up separate legal subsidiaries,<sup>101</sup> which protects banks’ assets in case the risk-taking subsidiary faces difficulties.

There are other developments and amendments in the UK affecting the banking sector. The Banking Reform Act 2013 is the most recent piece of legislation and proposes more changes for the operation of banking services in the UK.

## 2.5 Free banking

Banking systems that are free from regulation are described as ‘wildcat banking’ and ‘fraudulent banking’.<sup>102</sup> The term ‘wildcat banking’ first appeared in 1816 in the US during a period when there was uncontrolled banking.<sup>103</sup>

It should be noted that economists have different approaches to bank regulation. While some believe in restricted regulation, others are in favour of free banking proposals. It has been discussed that this variety stretches from ‘highly interventionist regulations’ to ‘outright government ownership to episodes of “free” banking’.<sup>104</sup> It is understandable or perhaps predictable that these perspectives favouring regulation or condemning it are likely to vary depending on the economic climate.

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<sup>99</sup> ‘Too big to fail’ refers to a situation where a company or an organisation has grown so much in a country’s economy that its fail would have disastrous consequences for the state. Therefore, meaning that the government/state would not allow it to fail.

<sup>101</sup> Independent Commission on Banking (ICB), *Interim report: Consultation on Reform Options* (London: ICB, April 2011), also at <<http://www.eifr.eu/files/file0910949.pdf>> [[access date]]. The ICB also known as the Vickers Commission.

<sup>102</sup> Hon Chu, Kam, ‘Is Free Banking More Prone to Bank Failures than Regulated Banking?’ (1996–1997) 16 *Cato Journal* 48, also at <[http://heinonline.org/HOL/Page?handle=hein.journals/catoj16&div=5&g\\_sent=1&collection=journals#5](http://heinonline.org/HOL/Page?handle=hein.journals/catoj16&div=5&g_sent=1&collection=journals#5)> [[access date]].

<sup>103</sup> Bank supervision was discussed in section 2.3.2 of this chapter.

<sup>104</sup> James R Barth, Gerard Caprio, Jr and Ross Levine, *Rethinking Bank Regulation: Till Angels Govern* (Cambridge University Press 2006) 18.

The roots of this debate are in the struggle between collectivists and liberalists,<sup>105</sup> which are the major schools of thought on managing the social and economic activities of individuals in society. Collectivists believe in central planning and the use of coercion, while liberalists are in favour of the voluntary cooperation of individuals.<sup>106</sup>

Liberalism supports individuals' freedom in their economic activities and is against the idea that the 'state knows the interests of the individuals'.<sup>107</sup>

It should be clarified that the banking industry is not only subject to regulation; there is also a supervisory element in this sector. Because of the significant role of banks in a country's monetary system and the fact that they also deal with the public's money, there must be a trustworthy mechanism in place to supervise banks and the banking industry's activities. Therefore an authority (normally a central bank) should investigate and monitor the appointment of bankers. The authorities, by way of licensing or chartering, must approve people who are involved in banking businesses.<sup>108</sup> This is called bank supervision or prudential supervision.

## **2.6 Banking structure and internal governance<sup>109</sup>**

In today's financial world, every bank has a head office and several branches (offshore or onshore) where the daily activities of the bank are conducted. Branches share the same legal personality as the head office and are responsible for (mainly) core banking activities.<sup>110</sup> However, on some occasions overseas branches may need to acquire separate subsidisation for legal purposes.<sup>111</sup>

Under the common law approach, branches held authority and had decision-making powers. However, then situation is rather different nowadays. Banks have reduced branch work and removed the discretionary power from branch managers and therefore, all the branches work together and are attached to each other.<sup>112</sup>

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<sup>105</sup>These theories are discussed extensively in Chapter 4..

<sup>106</sup> Bagheri (n 69) 8.

<sup>107</sup> *ibid*, 8.

<sup>108</sup> Glen Arnold, *Banking, Financial Times Guides* (Pearson Education 2014) 88.

<sup>109</sup> A detailed discussion of bank operation and its corporate governance is outside the scope of this chapter.

<sup>110</sup> Cranston (n 17) 9.

<sup>111</sup> *ibid*.

<sup>112</sup> *ibid* 9, 10.

Although branches are linked to each other, from a legal point of view the ‘principles of branch separateness’ support the view that branches of a bank must be treated as separate entities for legal purposes. For instance, a customer can sue only the specific branch where their money was deposited.<sup>113</sup>

Most banking systems share the same domestic structure. There is always a central bank responsible for dictating fundamental policies and regulation (as explained below). In terms of the internal structure of a bank, banks operate through branches and different legal entities.

The way banks operate is of vital importance. Each bank has its own unique corporate governance policy. Banking corporate governance will not be discussed in this chapter in detail; however, it is worth mentioning briefly that the main concerns for banks are capital management, liquidity management, asset management and liability management.<sup>114</sup>

Capital management refers to the amount of capital (assets) that a bank holds against its liabilities to depositors. If a bank’s assets fall below its liabilities, the bank would be unable to continue to operate, and would eventually become insolvent. It is advised that banks should hold assets worth at least 20% more than the amount of their liabilities.<sup>115</sup> Whether banks in practice hold such security in practice is arguable.

Liquidity management is defined as the balance between the amount of cash being held by banks and the money that is lent to its customers. All banks should be careful about the portion of cash that they hold in the event of depositors or creditors demanding their money.<sup>116</sup> This issue is also referred as liquidity risk for banks.

## **2.7 Private banking law**

Private banking refers to the relationship of the bank with customers. The law concerned here is mainly contract law and tort law. Regulation and supervision are not discussed in private banking.

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<sup>113</sup> *ibid* 10.

<sup>114</sup> Arnold ( n 108) 364

<sup>115</sup> *ibid*.

<sup>116</sup> *ibid*.

Private banks claim to act as a ‘financial supermarket’ for wealthy clients and offer a wide range of financial services.<sup>117</sup> Different reasons are given for this expanding market, such as financial innovations in international banking services and innovations in communications and technology. The economic climate of the years when there was a growth in international investment and international trade is another reason for the blossoming of international banking back at that time.<sup>118</sup>

Two main players in the private banking world have a long history: the United Kingdom and Switzerland. Examples of private banks examples include Coutts & Co in the UK and Bank Julius Baer in Switzerland – both of which can be traced back to the late eighteenth century.<sup>119</sup>

It may be asked what an individual (client) seeks in private banking. The answer is that the primary aim is to receive advice on wealth management, for instance through tax minimisation, estate allocation or perhaps other instruments.<sup>120</sup> In doing so, the client needs to consider the following options:<sup>121</sup>

- Investment or consumption: the decision has to be made on the amount that the client should invest and the amount that should be spent on current consumption.
- Domestic or international investment: obviously this refers to the proportion that the client should invest in their home country (domestic investment) and how much overseas. The answer to this question, according to Smith and Walter, will depend on the risks involving each type of investment. The risks may be either political<sup>122</sup> or economic.<sup>123</sup>
- Onshore or offshore investment: tax considerations are key when advising clients whether to invest offshore or onshore.

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<sup>117</sup> Smith and Walter (n 13) 92

<sup>118</sup> Cranston, (n 17) 424

<sup>119</sup> Smith and Walter (n 13) 82

<sup>120</sup> *ibid* 87

<sup>121</sup> *ibid*, 87, 88

<sup>122</sup> Political risk: where a country is not politically stable and there is a possibility of a regime (government) change. This chance of change is clearly not desirable for foreign investors as it would make the investment environment unpredictable and unstable.

<sup>123</sup> Economic risk: where the economy of a country is not stable and there might be changes to the currency exchange rate or other economy-related policies.

- Real or financial assets: depending on the financial climate, advisers in private banking can recommend the distribution of wealth in real assets, such as property or gold, or investing in financial assets, such as securities.

Private banking services are not limited to domestic clients. International private banking is offered to cross-border customers. The variety of services offered to these non-resident clients varies but can be listed as four main categories: transactions activities, credit extension, asset or portfolio management and personal services.<sup>124</sup>

Private banking is only one of several activities that are conducted by banks nationally and internationally nowadays. A more detailed discussion of private banking is outside the scope of this research.

## **2.8 Conclusion**

From what has been discussed in this chapter, it is clear that the banking industry is subject to heavy regulation and supervision from governments to ensure the smooth and safe running of this sensitive element of economy.

The essential role of banks and other financial institutions in economy and commerce is undeniable and it is evident that any minor issue that affects the performance of banks and their activities would impact upon, the entire economy, as well as financial sector of the country.

The next chapters will explore whether the regulatory framework of the banking industry can affect the dispute resolution and conflict-handling procedures in this sector.

As was illustrated above, in this research the terms 'banking' and 'finance' are being used in their broad meaning. Therefore, the choice of dispute settlement in this vast area may be looked at in a different way than in other commercial sectors. Arguably, the existence of regulation in both the finance and banking sectors may have limited the major players in this area when it comes to deciding on forms of dispute resolution, so that because of the existence of regulatory frameworks in those sectors, there are restrictions imposed on contracting parties' autonomy.

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<sup>124</sup> Smith and Walter (n 13) 97

The primary aim of this chapter was to establish a general overview of the function of banks in today world's economy and also to highlight the nature of banking transactions in a modern financial market.

The following chapters will look at bank-related transactions and one of the vital elements of these transactions, which is dispute resolution mechanism. As was explained in the introduction chapter, one of the essential features in each cross-border contract is the existence of a viable and effective dispute resolution clause. Dispute resolution clauses should be drafted clearly to oust any ambiguity and uncertainty from the main contract.

It will be explored whether the existence of banking regulation and supervision could limit parties' choice of dispute resolution clauses in bank and finance related contracts/transactions.

## Chapter Three

### The Place of Arbitration and New Economic Trends

#### 3.1 Introduction

There is no doubt that international arbitration has become one of the most favoured dispute resolution mechanisms in national and international transactions. International arbitration as a private neutral forum has evolved into a credible replacement for traditional litigation and is gaining overwhelming recognition in the world. Arbitration arguably is one of the first attempts at the privatisation of justice.<sup>125</sup>

Arbitration is designed as an alternative to litigation, which is the resolution of disputes through national courts. Arbitration differs from litigation in many aspects but the main important distinguishable feature of arbitration compared to litigation is that arbitration is not available to disputant parties as a right; instead, it could be available if there is an agreement or a present agreement between the parties to refer the dispute to arbitration as a substitute to litigation, i.e. national courts.<sup>126</sup> It is an unquestionable fact that the right to a fair trial and access to justice are among fundamental human rights, which should be available to everyone, should there be a dispute that needs to be settled. Arbitration offers a more flexible dispute settlement procedure where parties have a greater control over essential matters, including, seat of arbitration, appointment of arbitrators, procedural rules and as substantive rules.

This chapter will illustrate the structure of arbitration, as well as different types of arbitration. The characteristics of arbitration are listed in this chapter and it explains why some of those features contribute to the global popularity of arbitration. The Convention on the Recognition and Enforcement of Foreign Arbitral Awards, known as New York Convention<sup>127</sup> and the global enforceability of arbitral awards are also illustrated in this

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<sup>125</sup> Indira Carr, *International Trade Law*, (3rd edn, Cavendish Publishing 2005) 615.

<sup>126</sup> John F Wilson, *Carriage of Goods by Sea*, (5th edn, Pearson, Longman 2004) 324.

<sup>127</sup> The Convention on the Recognition and Enforcement of Foreign Arbitral Awards, also known as the “New York Arbitration Convention” or the “New York Convention” is one of the key elements in universal execution of foreign arbitral awards. The Convention was adopted by United Nations Commission on



chapter. For the purposes of this research, the concept of arbitration will not cover arbitration at the domestic level, but instead will focus on the use and application of arbitration in international contracts.

### 3.2 The world of arbitration and ADR

The use of alternative dispute resolution (ADR) mechanisms in legal actions has increased in recent years.<sup>128</sup> In particular, arbitration has become a widespread popular choice in both domestic and non-domestic claims.

The rapid globalisation and increase in cross-border transactions have resulted in the wider use of ADR. ADR is a set of techniques that are designed to resolve disputes in a non-confrontational manner.<sup>129</sup> As stated by Robert Briner and Virginia Hamilton:<sup>130</sup>

As nations increasingly affirmed their sovereignty and international trade outgrew its former structure, the dispute resolutions mechanisms developed with trade associations began to prove inadequate.

ADR is able to work as an efficient settlement method that is independent from national courts for the benefit of international disputants. The significant element in ADR is the existence of a neutral third party in a dispute. This essential character has been put to considerable use in ADR in the area of international commercial dispute settlement. In contrast, international litigation can be risky and unpredictable because the forum will be unfamiliar to at least one of the parties.

Before starting a more in-depth analysis of ADR and arbitration, it is worth mentioning that the definition of ADR and arbitration is not always straightforward in academia or in practice. According to some leading practitioners, the term ADR is ‘an irritating and

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International Trade Law and entered into force on 7 June 1959 and is consist of 156 signatory parties. For more see [http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/NYConvention.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention.html)

<sup>128</sup> The focus of this research and this chapter is on arbitration, and mainly international arbitration and its suitability for the resolution of banking and financial disputes. Other forms of ADR are touched upon briefly.

<sup>129</sup> Yona Shamir, *Alternative dispute resolution and their approaches*, a contributory report from UNESCO’s International Hydrological Programme to the World Assessment Programme , United Nations Educational, Scientific and Cultural Organisation website, <[http://webworld.unesco.org/water/wwap/pccp/pubs/summaries/ds\\_dispute.shtml](http://webworld.unesco.org/water/wwap/pccp/pubs/summaries/ds_dispute.shtml)> accessed 20 August 2014.

<sup>130</sup> Simon Greenberg, Christopher Kee, and J Romesh Weeramantry, *International Commercial Arbitration – An Asia-Pacific Perspective* (Cambridge University Press,2010) 6.

misleading acronym’,<sup>131</sup> which has to be interpreted to make proper legal sense. This frequently used phrase may indeed seem confusing and misleading as it is not clear what the word ‘alternative’ refers to, nor is it clear what method to which it is an alternative. The abbreviation ADR should be accompanied by an explanation that this phrase mainly refers to means of dispute resolution that are alternatives to court-based methods. Some literature have argued that it has to be made clear that the word ‘alternative’ reflects back to an alternative or replacement for courts.<sup>132</sup> The concept of ADR is mainly used in domestic disputes rather than international disputes. There have been various attempts by relevant authorities to promote ADR as an effective means of settlement in England. The objective is to convince and encourage individuals to use ADR instead of litigation to reduce the cost and time of the conflict-handling process.<sup>133</sup> In this sense ADR can be described as a combination of mechanisms that are offered to disputants to resolve their disputes outside the courts. These mechanisms mainly include arbitration, mediation, negotiation, conciliation and ombudsmen.<sup>134</sup>

In the United Kingdom (UK), the term ADR is mainly used in relation to mediation, conciliation and negotiation, which are conducted by a neutral person to facilitate the communication between the disputing parties. The third party acts as a facilitator of communication between parties and helps them find an agreeable solution, but does not have the power to render a decision on the merits of the dispute.<sup>135</sup>

Arbitration is regarded as a very close alternative to litigation, and only differs in some elements, such as confidentiality and flexibility, of the process.<sup>136</sup> It has to be highlighted that mediation cannot be compared to litigation or arbitration it is mainly a ‘complementary discipline’.<sup>137</sup> This means that mediation cannot be regarded as an alternative to litigation or arbitration as there is no final outcome or settlement in mediation, while a final decision can be reached in both litigation and arbitration.

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<sup>131</sup> Tony Willis and William Wood, ‘Alternative Dispute Resolution’ in Jeffrey Golden and Carolyn Lamm (eds), *International Financial Disputes* (Oxford Press 2015) 72.

<sup>132</sup> *ibid* 72.

<sup>133</sup> In England and Wales, the judiciary tries to promote ADR at early stages of a dispute. Citizens Advice Bureaus have policies to encourage individuals to use negotiation and mediation prior to engaging in court litigation. See <<https://www.citizensadvice.org.uk/consumer/taking-action-about-consumer-problems/legal-action/settling-out-of-court/who-offers-alternative-dispute-resolution-adr/>> accessed 2 August 2015.

<sup>134</sup> This classification varies in different legal systems in different countries

<sup>135</sup> Carole Murray, David Holloway and Daren Timson-Hunt, *Schmitthoff The Law and Practice of International Trade*, (first edn 1948, Sweet & Maxwell 2012) 584.

<sup>136</sup> Willis and Wood (n 131) 72.

<sup>137</sup> *ibid* 74.

Another distinctive feature between arbitration and mediation is the cost. Mediation is often a very low-cost process that is not comparable to expensive arbitration or litigation processes.<sup>138</sup>

Mediation offers a dispute avoidance mechanism and can be regarded as a means to avoid litigation or arbitration. By promoting communication between parties, there is a high possibility that the dispute matter can be addressed at the mediation stage. If conflicting parties can resolve the dispute at this stage, they save a considerable amount of time and costs.

However, in recent years, practitioners and academics have categorised arbitration at a different level and define it on its own and not in combination with other ADR methods. Furthermore, due to some characteristics in arbitration, such as global enforcement<sup>139</sup> and binding and final awards, arbitration has been distinguished from other forms of ADR such as mediation or conciliation.

More importantly, internationally speaking, arbitration has a more substantial role than other ADR mechanisms and it has been claimed that arbitration is the ‘most popular’ dispute resolution for commercial disputes.<sup>140</sup>

### 3.2.1 Conflict management in global sphere

The number of international business activities has increased significantly over the past few decades and the world is becoming more integrated. Disputes and conflicts arising out of relevant contracts and transactions will arise in the vast majority of international business activities. There has been enormous global development of international dispute handling processes. The wide use of international arbitration is one of these developments.

It has been argued that international business transactions might be more vulnerable than national and domestic transactions as some factors involved in international transactions may increase the level of uncertainty.<sup>141</sup> Financial and monetary factors, political factors

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<sup>138</sup> *ibid.*

<sup>139</sup> Arbitral awards are enforceable in the countries that are signatory to New York Convention.

<sup>140</sup> Greenberg, Kee and Weeramantry (n 130) 1.

<sup>141</sup> Christian Buhring-Uhle et al., *Arbitration and Mediation in International Business* (2nd edn, Kluwer Law International 2006) 6.

and legal factors are some of the main reasons for this vulnerability.<sup>142</sup> Financial risks will be always a source of concern in cross-border transactions because of the fluctuations in exchange rates and the availability of foreign currency.<sup>143</sup> Political issues can be a matter of concern when there is a risk of war, revolution or change of the other countries' policies that might affect the transaction in question. The main legal concern is the possibility of confrontation with another country's domestic law. This can happen when one party finds itself in an unfamiliar legal jurisdiction in another party's home country for the purposes of dispute resolution. This legal risk is one of the main reasons that for the popularity of international arbitration in international business transactions.

The opportunity of having a neutral forum where there is no fear of local bias courts has been always one of the notable advantages of arbitration. The issue of one party having the advantage of its own jurisdiction is known as the 'home court advantage' – advantage in a sense that there is a presumption by some that the home court is likely to favour the local party regardless of the nature of the claim.<sup>144</sup> As mentioned above, arbitration can address this issue and ensure that there is no local forum and that the independent arbitral tribunal is free from any attachment to either party.

Another main concern in the area of international business transactions is the growing complexity of transactions. Global trade is becoming more and more complicated as new technology enters the market. As a result of complex trade transactions, there are multifaceted technical disputes and conflicts arising out of these activities. In this context, there is a great need for a body that is competent to deal with complex issues and that acts as a neutral forum for both parties. This is where international arbitration can play a significant role.

It has been declared that in the international sphere arbitration is more successful for settling technical and complex international claims compared to litigation.<sup>145</sup> Undoubtedly, parties to an international dispute encounter issues that do not trouble disputant parties in a domestic dispute. For instance, in international and cross-border transactions, the level of the risk and uncertainties involved in the transaction are much

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<sup>142</sup> *ibid* 7.

<sup>143</sup> *ibid*.

<sup>144</sup> *ibid*.

<sup>145</sup> Nael G.Bunni, 'What Has History Taught Us in ADR? Avoidance of Dispute!', (2015) *Arbitration* 176.

higher compared to non-international transactions. Different cultures, languages, unfamiliar laws and business customs are among the factors that might make the process of dispute resolution an unpleasant experience for parties. Forum selection and jurisdictional conflict of laws rules are among other main concerns for disputant parties who find themselves in a cross-border dispute.

In these circumstances, arbitration can address the majority of these complications by offering a neutral forum, which is selected by both parties and has the authority to issue enforceable awards.<sup>146</sup>

### 3.2.2 What is arbitration?

The definition of arbitration is controversial among academics. The term itself is defined in almost every law dictionary. Arbitration can be defined as ‘a consensual process executed in a judicial manner whereby a dispute between two or more parties is finally resolved by an arbitrator’s decision’.<sup>147</sup> Arbitration is a private dispute resolution process that has unique features. The overwhelming acceptance of arbitration in global trade is because of these features. There are four fundamental features in arbitration:<sup>148</sup>

First, this is an alternative route to national courts. Second, this is a private system to resolve disputes. Third, this mechanism is controlled and selected by the parties. Fourth, it is a final and binding procedure.<sup>149</sup> Parties to a dispute may refer the matter to arbitration should they wish to enjoy a private hearing and avoid a public hearing in a court.<sup>150</sup>

Arbitration is recognised as a binding and neutral mechanism for determining disputes arising out of international transactions. The flexible process of arbitration is a more expeditious procedure than litigation to resolve disputes and it is also less costly.

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<sup>146</sup> *ibid.*

<sup>147</sup> Mahmood Bagheri, *International Contracts and National Economic Regulation: Dispute Resolution Through International Commercial Arbitration* (Studies in Comparative, Corporate and Financial Law, Kluwer Academic Publishers 2000) Chapter V – 16.

<sup>148</sup> Julian D M Lew, Loukas Mistelis and Stefan M Kroll, *Comparative International Commercial Arbitration* (Kluwer Law International 2003) 3

<sup>149</sup> *ibid.*

<sup>150</sup> Markus A Petsche, *The Growing Autonomy of International Commercial Arbitration* (Sellier European Law Publisher 2005) 10.

According to scholars, one of the main deficiencies of litigation is its slowness, which can also make arbitration a more attractive choice.<sup>151</sup> Therefore, parties to a contract with an international dimension are likely to would prefer arbitration as a conflict resolving mechanism in their disputes. It has been argued that arbitration is the best way of handling commercial disputes, as both parties have equal opportunities to be heard by a specialised arbitrator who is in charge of resolving the dispute at hand.<sup>152</sup>

However, one has to be notified of the question of arbitrability of the disputes. To protect parties involved in a dispute, some types of disputes are exempt from being referred to arbitral tribunal. State and sovereign powers set the exemptions to protect public policies. Clearly, arbitration as a private dispute resolution process, which is controlled by parties, is subject to minimum or no state supervision. This private and confidential mechanism cannot deal with public-policy-related disputes, for instance bribery. Therefore, not every dispute can be referred to an arbitral tribunal and instead only disputes that have not been declared non-arbitrable can opt into arbitration proceedings<sup>153</sup>.

However, the fact that procedural formalities differ in arbitration as a private means to settle disputes from national courts, does not make it a ‘compromised dispute resolution mechanism’ as discussed by some leading scholar.<sup>154</sup> Although arbitration is a private mechanism and there is a great amount of party autonomy involved in establishing its procedures, it is suitable to deal with disputes as principles of due process is applicable and respected in arbitration and therefore, makes this mechanism a valid and authorised alternative to court litigation.

### 3.2.3 Legal theory of international arbitration

A discussion on international arbitration cannot be comprehensive without analysing the legal theories behind this legal process. It has to be mentioned that the interactions between international arbitration and legal theory are rather limited<sup>155</sup>

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<sup>151</sup> *ibid.*

<sup>152</sup> Bagheri (n 147) 105.

<sup>153</sup> See English Arbitration Act 1996

<sup>154</sup> Stavros Brekoulakis, ‘Arbitrability – Persisting Misconceptions and New Areas of Concern’ in Loukas A Mistelis and Stavros L Brekoulakis (eds), *Arbitrability, International & Comparative Perspectives* (Kluwer law international 2009) 25.

<sup>155</sup> Emmanuel Gaillard, *Legal Theory of International Arbitration* (Martinus Nijhoff Publishers 2010) 2.

In arbitration, disputes are settled in a different way to what is prescribed in the court system and judicial structure. Arbitration is not a newly created mechanism; it has been existed as a form of dispute settlement for decades and even for centuries. Arbitration as a private forum is attracting commercial parties and by offering them the maximum party autonomy, allows them to fashion and vary its forms and structure so that it suits the commercial parties' needs.<sup>156</sup>

International arbitration is an independent dispute resolution mechanism. In this process, claims arising out of significant contractual matters are decided by party-appointed arbitrators. The process and operation of international arbitration is not attached to any state or government. Arbitrators, whom have been elected by parties, have the authority to render an award by applying the appropriate law, which is chosen by the parties. The question that may arise here is the source of the legitimacy and authority of arbitral tribunals and how this framework (international arbitration) can be explained in legal theories.

Arbitrators who are appointed by parties under the arbitration agreement must approach the settlement task in a way that a judge appointed by the state in a national court would approach it.<sup>157</sup> In arbitration, similar to litigation, there is requirement of equal treatment between parties and the principle of due process is among the fundamental features of arbitration.<sup>158</sup> This due process element in arbitration is stated to correspond to the judicial nature of arbitration and referred to as 'Magna Carta of the arbitral process',<sup>159</sup> and the failure to recognise procedural fairness is one of the grounds for challenge of an arbitration award.

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<sup>156</sup> Julian DM Lew, 'Autonomous Arbitration' in Julian DM Lew and Loukas A Mistelis (eds), *Arbitration Insights, Twenty Years of the Annual Lecture of the School of International Arbitration* (Kluwer Law International 2007) 457.

<sup>157</sup> Murray, Holloway, Timson-Hunt (n 135) 584.

<sup>158</sup> *ibid.*

<sup>159</sup> William Laurence Craig, William W. Park, Jan Paulsson, *ICC Arbitration* (3rd edn, Oceana Publication 2000) 298.

There are different theories suggested to justify the judicial nature of arbitration. Various academics and legal philosophers have taken different approaches to associating arbitration with legal systems.<sup>160</sup>

The dominant theoretical approach in international arbitration is the contractual theory.<sup>161</sup> The main focus in this theory is the contractual nature of arbitration, and according to this theory the main source of the legitimacy of the arbitration tribunal comes from the parties' agreement to arbitrate.

Contractual analysis of arbitration can seem more reasonable when one looks at the various laws and rules on arbitration throughout the world. In the vast majority of national laws on arbitration or international arbitration rules on arbitration, the essential and fundamental factor is the agreement conducted between parties. The central point in this theory is based on the idea that the arbitration process is a reflection of the parties' contractual agreement to arbitrate their disputes. The arbitration award also is the outcome of this agreement, and as all the involved parties agreed to the process of arbitration they are required to honour the award and enforce and recognise it automatically.

This is the agreement that requires them to hand the dispute resolution task to arbitral tribunals rather than courts. For instance, in the UK Arbitration Act 1996, section 6 states: "arbitration agreement" means an agreement to submit to arbitration present or future disputes.'<sup>162</sup> In Article 7 of the UNCITRAL Model Law on International Commercial Arbitration,<sup>163</sup> there is again emphasis on the agreement of parties to arbitrate: 'an agreement by the parties to submit to arbitration all or certain disputes.'

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<sup>160</sup> The four main theories proposed to elaborate the notion of arbitration and its attachment to legal frameworks are jurisdictional, contractual, mixed or hybrid and autonomous theories. See Lew, Mistelis and Kroll (24) 72; this section focuses on contractual theory only.

<sup>161</sup> The conclusion that contract is the only source of the participation duty of parties, fails to recognise the diversity of theories of arbitration. For more see Benedict Tompkins, 'The Duty to Participate in International Commercial Arbitration' [2015] Int. A.L.R. 14.

As explained in the text of this section, the focus is only on contractual theory. The author is aware of the existence of other theories of arbitration.

<sup>162</sup> Arbitration Act 1996 (UK), <<http://www.legislation.gov.uk/ukpga/1996/23/content>> accessed 4 December 2015

<sup>163</sup> UNCITRAL Model Law 1985, amended on 2006, <[http://www.uncitral.org/pdf/english/texts/arbitration/ml-arb/07-86998\\_Ebook.pdf](http://www.uncitral.org/pdf/english/texts/arbitration/ml-arb/07-86998_Ebook.pdf)> accessed 4 December 2015



In addition to the above, Article II of New York Convention<sup>164</sup> particularly stresses the agreement between parties.

All the above mentioned provisions reflect the fact that the notion of arbitration is based on free will and autonomy of parties.<sup>165</sup> This freedom and liberty of parties is reflected in arbitration agreement.<sup>166</sup> One can conclude that , arbitration is created as a result of a contract (arbitration agreement) and therefore origins of each arbitration is a contract.<sup>167</sup>

Furthermore, the contractual theory in arbitration can rationalise the parties' duty to cooperate with the arbitration process and if a party does not comply with its contractual duties it can be held responsible for the breach. This obligation stems from the arbitration agreement to which contracting parties agreed to submit their disputes. The fact that the parties decided to opt for arbitration and compel with positive or negative duties also can be elucidated by referring to the prior agreement between parties that was formed in the shape of an arbitration agreement.<sup>168</sup> Therefore, participating in international arbitration is an enforceable duty on parties where there exists a freely signed arbitration agreement. Duties of parties can be classified into two categories: positive duties and negative duties. Duties are positive in the sense that parties have a duty to arbitrate or a duty to act in good faith, as well as other procedural duties, such as providing required documentation and supplying witnesses. On the other hand, negative duties include duties such as not to pursue dispute resolution in national courts, which is an outcome of a positive obligation to arbitrate.<sup>169</sup>

In the light of the above, it can be stated that the main source of authority in arbitration, be it national or international, is the consensual autonomy of the parties. The poser of the states has to recognise this authority and enforce the legal process.<sup>170</sup>

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<sup>164</sup> New York Convention on Enforcement of Foreign Arbitral Awards 1958, Article II: 1. Each Contracting State shall recognize an *agreement* in writing under which the *parties undertake to submit to arbitration* all or any differences which have arisen or which may arise between them in respect of a defined legal relationship, whether contractual or not, concerning a subject matter capable of settlement by arbitration.'

<sup>165</sup> See US judgment, *Reily v Russel*, 34 Mo 524 (1864) 528

<sup>166</sup> See section 3.1.5 below where arbitration agreement is discussed fully.

<sup>167</sup> See also Chapter Four

<sup>168</sup> Tompkins (n 160) 14–26

<sup>169</sup> *ibid.*

<sup>170</sup> Hazel Fox, 'State and the Undertaking to Arbitrate' in Julian DM Lew and Loukas A Mistelis (eds), *Arbitration Insights, Twenty Years of the Annual Lecture of the School of International Arbitration* (Kluwer Law International 2007) 43.

### 3.2.4 Institutional arbitration and ad hoc arbitration

There are different methods for arbitrating disagreements between parties. Arbitration can be either institutional or ad hoc. In the former, parties refer their arbitration matter to one of the arbitral institutions such as the London Court of International Arbitration (LCIA).<sup>171</sup> Conversely, in ad hoc arbitration, the process is conducted by independent arbitrators nominated by the parties and there is no need for an institutional establishment.

Arbitral institutions are specialised centres, which are located all around the world and offer arbitration services. The major institutions play a regulatory role in this sector and are considered leading players.<sup>172</sup> These institutions establish the required standards and develop soft law in arbitration.<sup>173</sup> Some of the major arbitral institutions are the International Centre for the Settlement of Investment Disputes (ICSID), The World Intellectual Property Organization (WIPO) Arbitration centre, the American Arbitration Association (AAA), the Swiss Arbitration Association and the International Chamber of Commerce (ICC) Paris.

There are advantages for using institutional arbitration. The main advantage is that it is easier to force the reluctant party to participate in the institutional arbitration than in ad hoc arbitration. Also, the existence of the pre-written rules in each institution will put the parties in a better position to select their most desirable institution. However, the main drawback of institutional arbitrations is its high cost.

Ad hoc arbitration is less formal. In this method of arbitration, the parties decide all the features of the arbitration; for instance, the number of arbitrators, the applicable law and many other issues. This form of arbitrating is more flexible compared to institutional arbitration. Moreover, ad hoc arbitration can be cheaper and quicker than institutional arbitration as there are fewer administrative issues involved. In terms of disadvantages, it can be difficult for this method to proceed with if there is a less willing party in the dispute who does not wish to cooperate.<sup>174</sup>

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<sup>171</sup> LCIA, London Court of International Arbitration, located in England (The London International Court of Arbitration) <<http://www.lcia.org/>> accessed 1 September 2013,

<sup>172</sup> Simon Greenberg and Christopher Kee and J Romesh Weeramantry, *International Commercial Arbitration* (Cambridge University Press 2011) 25.

<sup>173</sup> *ibid.*

<sup>174</sup> *ibid.* 27.

### 3.2.5 Arbitration agreement

Undoubtedly, the arbitration agreement<sup>175</sup> is the most vital element of every arbitration. If the parties have decided to proceed with arbitration instead of litigation there must be a mechanism to demonstrate and prove this willingness. There also has to be an instruction to govern and guide the process of arbitration. The referral of a dispute to arbitration will be possible if there is an arbitration agreement (also called arbitration clause) in the primary contract. The arbitration agreement contains essential ingredients of arbitration, such as the parties' consent, scope of arbitration and the finality of the arbitration award.<sup>176</sup>

As arbitration is based on mutual consent of parties, an arbitration clause has to be drafted clearly and precisely. Obviously, a lack of an arbitration agreement can be interpreted as a lack of consent and as a result there would be no arbitration.

The agreement of the parties to arbitrate can be in the form of a contract, called the arbitration agreement, or can alternatively be a clause contained in the main contract, which is called the arbitration clause. There is no difference in the operation of an arbitration clause or an arbitration agreement and, as long as they have been drafted effectively and contain the essential ingredients, the arbitration process should run smoothly.

An arbitration clause may be incorporated in the main contract and stipulates that any future disputes shall be referred to arbitration. Alternatively, if there is no arbitration clause in the main contract, parties can still use arbitration – as long as when a dispute arises the parties agree to refer the matter to an arbitration tribunal. If the arbitration agreement refers to future disputes it is a *clause compromissoire*, and if it is drafted to deal with current disputes it is a *compromis*.<sup>177</sup> If there is no arbitration clause prior to the dispute arising, and at that time parties agree to arbitrate, the agreement is called a 'submission agreement'.<sup>178</sup>

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<sup>175</sup> 'Arbitration agreement' and 'arbitration clause' can be used interchangeably.

<sup>176</sup> Lew, Mistelis and Kroll (n 148) 167.

<sup>177</sup> Anthony Connerty, *Manual of International Dispute Resolution* (Commonwealth Secretariat 2006) 203

<sup>178</sup> Margaret L Moses, *The Principles and Practice of International Commercial Arbitration*, (first published 2008, Cambridge University Press, 2012) 19.

There are a number of considerations that need to be addressed in a valid and effective arbitration agreement. Arbitration agreements should be drafted clearly and precisely, leaving little or no ambiguity as to the provisions for the arbitration process. Where the agreement is vague, the court or tribunal may be able to interpret and extract the true intention of the parties by reference to the clear indications in the arbitration agreement.<sup>179</sup>

If the arbitration agreement is drafted poorly, this results in time-consuming court litigation to assess the validity of the arbitration agreement at both the commencement level and later on in the enforceability stage.<sup>180</sup>

In international arbitration, it is common to have different governing laws in place. It has to be noted that there are different legal regimes involved in a process of international arbitration and, as a result, more than one law can be present in the arbitration procedure. Different laws are applied to different components of the arbitration.

There are four main laws applicable in the process of a customary international arbitration: the law governing the main contract, the law governing the arbitration agreement, the law governing the procedure of arbitration and the law<sup>181</sup> governing the enforceability of the arbitration award.

One of the crucial issues in the arbitration process is the determination of the applicable law of the arbitration agreement and how it is different from the law of the main contract. The law governing the arbitration contract can be distinguishable from the law that governs the arbitration procedure (procedural law). These are issues that will normally be covered in an arbitration agreement.<sup>182</sup>

In the majority of arbitration clauses, the parties specify a governing law for the arbitration agreement as well as a governing law for the arbitration agreement in the main contract. In such circumstances there would be no need for court involvement to determine the proper law of arbitration.<sup>183</sup> However, if parties have not declared and stated the applicable law for any stages of international arbitration, such as the law governing the enforceability of the award or the law governing the procedure of the

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<sup>179</sup> Lew, Mistelis and Kroll (n 148) 166.

<sup>180</sup> *ibid.*

<sup>181</sup> This law is mainly the law of the state where the arbitration award has to be enforced.

<sup>182</sup> Determination of applicable law in an arbitration agreement and main contract is a complicated and technical discussion and is outside the scope of this research.

<sup>183</sup> Philippa Charles, 'The Proper Law of the Arbitration Agreement' [2014] *Arbitration* 55.

arbitration, the courts decide what law should be the proper law of the arbitration agreement.<sup>184</sup> This determination by the courts is a complicated and technical matter and in some cases it may take several months to conclude what law should be the proper law. In England, the courts have the discretion to ascertain the proper law by applying the English common law principles found in the current case law

### 3.2.6 Multiparty arbitration

Arbitration is traditionally known as an agreement between two parties that are willing to refer their dispute to a neutral body to resolve rather than to the courts. However, the reality is different from this simple presumption, and arbitration does not always consist of agreements between two parties and in fact international arbitration features in several multiparty contracts, which would result in multiparty arbitration agreements.

Arbitration as a consensual agreement could be a very straightforward dispute settlement procedure when it is conducted between two parties. This is because if the agreement is between two parties only, consent (which is the most essential element in the legality of each arbitration) can be easily extracted.

In practice, international transactions tend to involve more than two parties, and there are few global transactions that are executed by two counterparties only; therefore, there is a possibility that several contracts are viewed as one as the issue in dispute has affected them all. In these situations, each contract may have its own dispute resolution clause, which might be different from that contained in the other contracts. If the dispute arises out of a same set of facts and there is an arbitration agreement in one of the contracts, there is a possibility that there will be several concurrent arbitration and court decisions in relation to the same or similar issues, which was inherited in one, main transactions.<sup>185</sup>

Multiparty arbitration may arise out of a single contract where all the parties are committed to one contract and that contract contains an arbitration clause. This might be

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<sup>184</sup> *ibid* 56.

<sup>185</sup> Nana Adjoa Hackman, 'The Problem of Arbitration and Multi-Party/Multi-Contract Disputes: Is Court-Ordered Consolidation an Adequate Response?' University of Dundee, Centre for Energy, Petroleum and Mineral Law and Policy 9 0 <cepmlp\_car13\_5\_612306438.pdf> accessed 12 March 2015.

the case in construction industry or private finance initiatives.<sup>186</sup> Where there is one contract in place, all the involved parties must have agreed to the dispute resolution clause in the main contract to be able to enforce the clause. For the purposes of consent to multiparty arbitration, as long as parties have signed the main contract, there is a presumption that they have also agreed to the arbitration clause in the main contract.<sup>187</sup> This is simply one of the fundamental rules of contract law that if a party signs a contract then they have agreed to all clauses in that contract, regardless of whether one of them is an arbitration clause.

One of the common scenarios for a multiparty and multi-contract is where project finance is in place. There are several parties involved in project financing. It is not rare to find 15 or 20 participants in simple project. All the parties have a unique and essential role in project financing. In general, the main participants who should be party to all project financing contracts be present in each project finance structure are sponsors and investors, government, lenders, contractors (i.e. construction and operation companies) and suppliers and customers. There are various contracts that shape the structure of the project finance.

Multiparty arbitration may also arise out of a series of, or separate, contracts where there is a web of contracts between interacting parties, such as employer, contractor, sub-contractor and main contractor. There are different contracts between these parties and there is no direct contractual relationship between one contract and the others and each contract has its own arbitration clause.

Although above mentioned contracts are executed separately and independently and are binding between the parties who executed them, there might be a dispute arising out of that contract that affects another party that has another contract within the same set of transactions. To cover the parallel arbitration claims and have a smooth and expeditious arbitral proceeding, parties may consider joinder or intervention of third parties or perhaps consolidation and merging separate or related arbitration proceedings under one arbitral tribunal hearing.

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<sup>186</sup> Lew, Mistelis and Kroll (n 148) 379.

<sup>187</sup> *ibid.*

Undoubtedly, there are considerable difficulties in drafting an effective arbitration clause for contracts that involve more than two parties. Although some leading arbitral institution rules, such as International Chamber of Commerce Arbitration Rules,<sup>188</sup> offer model clauses, parties may need to take extra measures to make an arbitration clause workable.<sup>189</sup>

For instance, LCIA Arbitration Rules<sup>190</sup> contain provisions that permit joinder of a third party to the arbitration upon the application of a party. However, LCIA Rules are silent on the issue of consolidation. Unlike LCIA Rules, Article 10 of the ICC Rules permits the consolidation of two or more arbitration proceedings.<sup>191</sup>

The issue of multiparty and multi-contract arbitration can arise in banking and finance disputes as this sector normally involves several parties and several underlying contracts. Drafting an arbitration agreement for contracts in this sector is examined in Chapter 6.<sup>192</sup>

### 3.2.7 New York Convention and global enforceability: economic globalisation and expansion of international commercial arbitration

As illustrated above, arbitration is overwhelmingly accepted as an efficient dispute settlement mechanism in global transactions. In fact, the international arbitration community was declared to be ‘a great beneficiary of globalisation, since much of the dispute resolution that has been arisen from the increase of economic activity has been entrusted to the institutions of international arbitration’.<sup>193</sup>

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<sup>188</sup> See 6.3.6 International Chamber of Commerce Arbitration Rules (ICC) , International Chamber of Commerce

<sup>189</sup> Article 7 and 9 of ICC Rules deal with the request to joinder in the arbitration process. See ICC International Chamber of Commerce <[http://www.iccwbo.org/products-and-services/arbitration-and-adr/arbitration/icc-rules-of-arbitration/#article\\_9](http://www.iccwbo.org/products-and-services/arbitration-and-adr/arbitration/icc-rules-of-arbitration/#article_9)> accessed 2 January 2016

<sup>190</sup> LCIA Rules (2014), Article 20 ( The London International Court of Arbitration) <[http://www.lcia.org/Dispute\\_Resolution\\_Services/lcia-arbitration-rules-2014.aspx#Article%2022](http://www.lcia.org/Dispute_Resolution_Services/lcia-arbitration-rules-2014.aspx#Article%2022)> accessed 25 January 2016

<sup>191</sup> Ibid Article 10,

<sup>192</sup> See Chapter Six, section 6.5

<sup>193</sup> BM Cremades and DJA Cairns, ‘The Brave New World of Global Arbitration’ (2002) 3 Journal of World Investment 208.

The main reason for the attraction of arbitration is the international recognition that arbitration has received.<sup>194</sup> This international recognition derives its force from global conventions on arbitration and the enforcement of arbitral awards. Moreover, international conventions can be implicitly regarded as the main source of parties' obligations or, in other words, their 'positive duty to participate in arbitration'.<sup>195</sup>

Another scenario for multiparty arbitration is where the multiparty arbitration arises out of separate contracts or a series of contracts. In this situation, each contract will have its own dispute resolution clause, which could be arbitration clause.

The New York Convention was ratified in 1958 by the United Nations Commission on International Trade Law (UNCITRAL). This convention deals with the enforcement of international arbitral awards.<sup>196</sup> According to this convention, all awards have international effect, regardless of the territory and jurisdiction of the award to be enforced. This is sensible because if the award is not going to be enforced in the losing party's country, there would be no point in international arbitration.<sup>197</sup>

According to the New York Convention, there are three requirements for arbitral awards to be recognised and enforced in light of the Convention. Briefly, the award to be recognised and enforced has to be 'non-domestic', 'arising out of a commercial relationship' and has to be an arbitral award for the purposes of this Convention.<sup>198</sup> If the award in question satisfies these three requirements it can be enforced under the New York Convention and be enforced by the courts in the signatory country.

The New York Convention has two main elements. The first is to give effect to and recognise a validly formed arbitration agreement by encouraging national courts to refer disputes to arbitration as long as there is a valid legal arbitration clause/agreement in

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<sup>194</sup> Michael Waring, *Commercial Dispute Resolution* (College of Law Publishing 2010) 123.

<sup>195</sup> Tompkins (n 160).

<sup>196</sup> For a copy of the Convention, see United Nation Commission On International Trade Law, full text NYC < <http://www.uncitral.org/pdf/english/texts/arbitration/NY-conv/New-York-Convention-E.pdf> > accessed 21 August 2013.

<sup>197</sup> Greenberg, Kee and Weeramantry (n 47) 427.

<sup>198</sup> Stephen Jagush, 'Enforcement' in Jeffrey Golden and Carolyn Lamm (eds), *International Financial Disputes* (Oxford Press 2015) 477



place.<sup>199</sup> The second is to improve and facilitate the enforcement of foreign arbitral awards in the contracting states.<sup>200</sup>

However, there are exceptions to the enforcement of the arbitration awards, and global approaches differ.<sup>201</sup> The exception given in the Convention itself is limited to any violation of the public policy of the country where the award is to be enforced.<sup>202</sup> The Convention states that each of the contracting states:

Shall recognise arbitral awards as binding and enforce them in accordance with the rules of procedure of the territory where the award is relied upon, under the condition laid down in articles.<sup>203</sup>

This exception is unclear as there is no one standard definition of ‘public policy’ of a country, and the concept may vary from one jurisdiction to another. This may create obstacles to the enforcement of foreign arbitration awards and limit the Convention’s goal, which is the global enforcement for foreign arbitral awards.

Although the vast majority of countries in the world have ratified the New York Convention, there is no automatic execution recognised for arbitral awards, unlike court judgments, and the successful party, in the absence of voluntary obedience from debtor, still has to apply to the local courts for judicial enforcement.<sup>204</sup> Therefore, it is recommended that parties design an enforcement strategy at the time of commencing the arbitration procedure, or at an even earlier stage when they are drafting the main contract and the arbitration agreement.

It has been claimed that the Convention does not create harmonious rules on the recognition of arbitration agreements among contracting states and there are no fundamental rules dealing with its existence, and the substantive validity of the agreement and all these elements are left to be decided by the domestic courts.<sup>205</sup> This may lead to variations in courts’ interpretations of a valid arbitration agreement.

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<sup>199</sup> See Article II(2) of New York Convention, which provides that the courts of signatory states should refer the parties to arbitration if there is a valid arbitration agreement in place, even if civil proceedings have started.

<sup>200</sup> Zheng Sophia Tang, *Jurisdiction and Arbitration Agreements in International Commercial Law* (Routledge 2014) 240,

<sup>201</sup> Lew, Mistelis and Kroll (n 148) 730.

<sup>202</sup> Inka Hanefeld, ‘Arbitration in Banking and Finance’ (2013) 9 NYU Journal of Law and Business 917.

<sup>203</sup> Convention on the Recognition and Enforcement of Foreign Arbitral Awards, Article III, 10 June 1958.

<sup>204</sup> Peter B. Rutledge, ‘Forum Shopping in International Arbitration – Forum Non Conveniens and Lack of Personal Jurisdiction’ in Franco Ferrari (ed), *Forum Shopping in the International Commercial Arbitration Context* (Sellier European Law Publishers 2013) 254.

<sup>205</sup> Tang (n 199) 241.

Nevertheless, the Convention seems to work successfully in the world of global commerce, having been signed by 144 countries.<sup>206</sup>

The New York Convention has a huge impact on the use of international arbitration as an effective and viable means of dispute settlement globally and, as discussed in the leading case of *Scherk v Alberto-Culver*<sup>207</sup> by the US Supreme Court:<sup>208</sup>

The goal of the Convention, and the principle purpose underlying American adoption and implementation of it, was to encourage the recognition and enforcement of commercial arbitration agreements in international contracts and to unify the standards by which agreements to arbitrate are observed and arbitral awards are enforced in the signatory countries.<sup>209</sup>

Overall, it is a valid argument that a successful party in arbitration would have no or minimum difficulty in enforcement and recognition of an arbitral award because of the extensive ratification of the New York Convention.

### **3.3 Examples of the use of international arbitration in other controversial commercial areas**

International commercial arbitration is recognised as a neutral binding mechanism that can resolve disputes arising out of international commercial transactions. The flexible process of arbitration is a more expeditious procedure to resolve disputes than litigation and it is also less costly. Therefore, many parties to a contract with an international dimension prefer to have arbitration as a conflict resolving institution in their disputes. This preference is becoming increasingly popular in today's commercial world as it is an efficient dispute resolution mechanism.

One might argue that arbitration cannot be considered an effective alternative dispute resolution mechanism for international and banking transactions. As discussed above, one of the major reasons for the recent growth in the numbers of financial disputes referred to arbitral tribunals is the lack of trust in foreign jurisdictions and also the obstacles in the enforceability of court orders and judgments in other states. In fact, the

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<sup>206</sup> *ibid.*

<sup>207</sup> *Scherk v Alberto-Culver* (1973) 417 US 506

<sup>208</sup> *Jagush* (n 197) 477.

<sup>209</sup> *Scherk v Alberto-Culver* (n 206).

internationalisation of the financial markets has led to the popularity of arbitration for the resolution of financial disputes. In the past, financial markets were more local and, therefore, the natural choices were national courts. Similar to the growth of use of arbitration in other sectors of economy, the globalisation of capital markets and money markets has popularised arbitration.

One can argue that arbitration in banking and finance sector, is not an alternative to litigation. It, indeed, replaces litigation (forum clause) that was used by banks and financial markets for many years. Arguably, it can be stated that litigation failed to satisfy the expectations of parties in cross-border disputes in meeting global enforceability and recognition and a replacement (arbitration) was required.

Nowadays, many parties to international financial transactions consider the arbitration process a friendly forum for resolving their disputes and they are willing to insert arbitration clauses into their agreements. This huge increase in the use of arbitration is mainly because of its flexible nature that makes it easy for parties to control the process. This feature, which is known as 'party autonomy' or 'party-controlled process', is one of the distinctive features in arbitration procedure that has made it popular globally.

This popularity of the arbitration process is not common in all areas of legal practice, either in national or international contexts. In other words, it is not clear if arbitration is popular or in fact suitable for all areas of trade, finance and investment. Depending on the nature of an economic activity, the use of arbitration or any other form of ADR as opposed to litigation can vary. In the past, the research on arbitration was too general and did not focus on a specific sector.

However, the acceptance and application of arbitration clauses varies in different sectors as the policies and priorities vary from sector to sector and these differences also affect the dispute resolution mechanisms. Some areas, such as international trade, favoured the arbitration process since its commencement, whereas in some other areas arbitration was not appealing to the parties and they did not consider it as an efficient or appropriate method to resolve their disputes. These mechanisms (ADR) have been used in some areas

whereas in some other areas they are not.<sup>210</sup> For example, in disputes related to intellectual property rights, competition disputes, and securities and banking there has been a historical reluctance by the parties involved or the states to refer disputes to arbitration.

However, this pattern has started to change recently, and with the gradual awareness of arbitration as an effective alternative mechanism for cross-border disputes, it was recognised as an efficient mechanism for resolving disputes in more sectors, disputes that were previously reserved for a national court's jurisdiction. In another sense, arbitration won the hearts of the international community stage-by-stage and sector-by-sector. As internationalisation, party autonomy and free trade increased, more sectors of the economy have become amenable to arbitration.

This popularity is expanding every day and today there are areas of law where, until recently, no party would tolerate having arbitrators instead of judges deciding their disputes, but where the parties now welcome arbitration. This is because of the changes to law and public policy, the expansion of freedom of contract, and privatisation and free trade at national, regional and international levels.

Nevertheless, it should be noted that there are still disputes that cannot be subject to arbitration for different reasons, which could be either public policy concerns or parties' preferences. Many disputes that have a regulatory or criminal law dimension are good examples of where arbitration cannot apply. In these areas, arbitration as a private dispute resolution process cannot be a replacement for courts and judges who enforce and safeguard the state's laws.<sup>211</sup> Clearly, a leading international arbitral tribunal, either ad hoc or institutional, does not have a mandate to deal with a criminal or regulatory matter, whether it is a domestic crime or an international crime. This is mainly because of the sensitivity of criminal cases on one hand, and the contractual and mutually agreed nature of the arbitration process on the other. It is rather difficult to reconcile these two diverse

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<sup>210</sup> Norbert Horn, 'Non-Judicial Dispute Settlement in International Financial Transactions' in Norbert Horn and Joseph J Norton (eds), *Non-Judicial Dispute Settlement in International Financial Transactions* (Kluwer Law International 2000) 1.

<sup>211</sup> Alexis Moure, 'Arbitration and Criminal Law: Jurisdiction, Arbitrability and Duties of the Arbitral Tribunal' in Loukas A Mistelis and Stavros L Brekoulakis (eds), *Arbitrability, International & Comparative Perspectives* (Kluwer Law International 2009) 207.

objectives, i.e. the public policy and regulatory objectives in criminal law and the interests of private parties in regulatory law. These two objectives cannot always be merged, though there is an emerging trend towards the arbitrability of some regulatory disputes, at least in international arbitration.

Family-law-related matters are another area where arbitration cannot be applied. In contrast, mediation is regularly used in family cases and parties are encouraged by courts to settle their disputes through mediation to achieve expeditious outcomes. However, this is applicable only in the domestic level and no family case would be referred to international arbitration to be adjudicated by arbitrators.

The issue of whether a particular dispute can be referred to an arbitral panel to make the appropriate decision is known as the issue of arbitrability. It is a straightforward question of whether a specific dispute can be submitted to arbitration or whether there is a legal prohibition of arbitration.<sup>212</sup> Arbitrability is referred to as the ‘subject matter capable of settlement by arbitration’ in New York Convention 1958.<sup>213</sup>

For the purposes of this research, this section lists some of the areas of law where arbitration was not approved from the outset and the dispute in question was not considered to be arbitrable. However, this approach has been moderated and arbitration is increasingly finding its place in more areas of law and commercial disputes leaving only few matters for the courts to settle.

One of the areas where the use of an arbitration clause has been problematic is that of intellectual property (IP) disputes. The notion of IP rights is a relatively new concept in commercial law. Only in the nineteenth and twentieth centuries did this area of law start to expand, and the need for the protection of these rights by granting exclusive privileged rights was recognised.

The existence of an intellectual property right would normally depend on the registration of the IP with a state or state-related agency. The state or the agency can revoke, amend

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<sup>212</sup> Loukas A Mistelis, ‘Arbitrability-International and Comparative Perspectives’ in Loukas A Mistelis and Stavros L Brekoulakis (eds), *Arbitrability, International & Comparative Perspectives* (Kluwer Law International 2009) 4

<sup>213</sup> New York Convention Arts II (1) and V (2)(a)

or grant such rights to individuals.<sup>214</sup> It is this feature of some kinds of IP rights, such as patents, that make them not amenable to arbitration and private dispute settlement.

IP rights have similar features to other property rights. For instance, they are transferable, which means they can be bought or sold by individuals. However, there are some particularities that are unique to IP rights and, as a result, may make it difficult for the potential disputes to be resolved by arbitration.

One of these characteristics is the state's involvement in the process of creation and recognition of IP rights to a much greater extent than in non-IP rights. Because of the sensitive and complex nature of these rights, public authorities have to be involved from the early stages of conception of intellectual property rights (IPRs). The majority of IPRs must be registered in order to exist.<sup>215</sup> The registration of the rights will be in the office recognised by the state authority.<sup>216</sup>

Arbitration may seem a viable option in resolving IPRs disputes for several reasons. First, the fact that these disputes are international rather than domestic can be a good justification to refer the conflict to an arbitration panel where there is no question of nationality. By this, parties can avoid the problem of conflicting jurisdictions as well as possible conflicting judgments.

Second, the confidentiality in arbitration is exactly what parties would desire in a IPR dispute. Where there is a risk to reputation or if intellectual secrets exist, nothing other than a confidential dispute resolution panel can be appropriate in resolving IPRs disputes.

Third, almost all IPRs are technical and have a complex nature. Each IPR requires an expert to explain the nature and the specifics of the right. Therefore, it would make more sense to have the dispute resolved by a panel of experts, which is an option in arbitration process, rather than going the litigation route where the judge would presumably have very little or no knowledge about the technical issues involved in the dispute. This has to be reminded that judges in some jurisdictions are indeed especially trained for IP related disputes and are experts in IP and IPRs. The UK Intellectual Property Enterprise Court

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<sup>214</sup> Lew, Mistelis and Kroll (n 148) 209.

<sup>215</sup> Trevor Cook and Alejandro I Garcia, *International intellectual Property Arbitration* (Kluwer Law International 2010) 7

<sup>216</sup> *ibid.*

and Patent court, are two specialised courts in IP disputes which are located in London.

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In addition to having specialised courts dealing with IP matters, one can argue that a court can instruct an expert to provide their opinion on the technical issues, but clearly this would make the litigation process even more costly and more time consuming.

Fourth, because of the specific nature of IPRs, speed of the dispute resolution is vital. In the majority of scenarios, the claimant requires a fast solution because any delay in the proceedings might have serious consequences. For instance, where there is a dispute about copyright infringement, it needs to be resolved as fast as possible.

All of the above mentioned factors make arbitration a desirable choice for parties with a dispute in international intellectual property. To facilitate arbitrating IP disputes, the WIPO created an arbitration and mediation centre in Geneva, Switzerland, in 1994.<sup>218</sup> This centre is designed to deal with disputes involving IP property matters, but not exclusively for this purpose.<sup>219</sup> Since its establishment, this centre has dealt with a variety of international disputes from jurisdictions all around the world, including Austria, China, France, Germany, Hungary, India, Ireland, Italy, Japan, the Netherlands, Panama, Spain, Switzerland, the United Kingdom (UK) and the United States (US).<sup>220</sup>

IP disputes may contain contractual aspects or a regulatory aspect. Where the dispute is arising between private parties and as a result of a contract, use of arbitration would be easier. For instance, if parties are disputing whether a registered copyright has been transferred to person A via valid contract or not, this could be referred to arbitration. On the other hand, where the case deals with a regulatory aspect, for instance whether the patent has been validly registered in country X, that issue would involve public policy matters and cannot be arbitrated.

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<sup>217</sup> For more see: HM Courts and Tribunals <<https://www.gov.uk/courts-tribunals/patents-court>> accessed 12 January 2016

<sup>218</sup> WIPO Arbitration and Mediation Centre (World Intellectual Property Organisation) <<http://www.wipo.int/amc/en/center/background.html>> accessed 12 February 2016

<sup>219</sup> *ibid* (n 214), 263.

<sup>220</sup> *ibid*.

To sum up, although there are some restrictions on IP disputes in terms of their arbitrability, the majority of IP disputes can be referred to an arbitration tribunal,<sup>221</sup> and recent surveys and statistics reveal that the majority of parties with an IP dispute have chosen international arbitration to resolve their disputes.<sup>222</sup>

According to Professor Park, the issue of arbitrability of tax disputes is similar to the story of an elderly farmer who once was asked by a clergyman whether he believed in infant baptism. Although he was a sceptic, but in order to avoid a theological controversy with the clergyman, he replied: 'Believed in it? Reverend, I've seen it done!'<sup>223</sup>

Tax-related disputes might seem non-arbitrable at first glance. As tax is regarded as a fund-raising method by states, this can make the national courts reluctant to refer tax-related disputes to private institutions such as arbitration tribunals. Instead, national courts will be more inclined to resolve the dispute through litigation and preserve the sovereign prerogative.<sup>224</sup>

However, the issue of arbitration in tax goes beyond the domestic level and when discussing tax arbitration cross-border tax disputes should also be considered.

There are various tax categories that are more complicated than others and where more than one national court may hold jurisdiction in the matter. For instance, the overlapping of tax of two separate countries in one transaction, or where there is a tax-related dispute between a foreign investment and a host state. To facilitate cross-border tax disputes, countries may enter into tax treaties. A tax treaty is signed between countries mainly to avoid double taxation and tax evasion. For instance, A should not be paying tax in two territories where their income tax is subject to more than one fiscal authority; in other words, the same income should not be taxed twice.

It has been argued whether arbitration should be allowed in tax treaties, but recently some countries and international organisations have agreed that the provision for arbitration be

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<sup>221</sup> *ibid* (n 214), 271.

<sup>222</sup> Cook and Garcia (n 214) 49.

<sup>223</sup> William W Park, 'Arbitrability and Tax' in Loukas A Mistelis and Stavros L Brekoulakis (eds), *Arbitrability, International & Comparative Perspectives* (Kluwer Law International 2009) 179

<sup>224</sup> WIPO (n 217) , 180.



formalised in tax treaties.<sup>225</sup> The Organisation for Economic Cooperation and Development (OECD)<sup>226</sup> has proposed mandatory arbitration in cases where ‘two states cannot agree on the correct tax allocation’.<sup>227</sup>

In situations where there is a tax dispute in relation to a foreign investment that involves a foreign investor and the host company, settlement of tax disputes by an appropriate becomes vital. The existence of an investment treaty in the form of a bilateral investment treaty (BIT<sup>228</sup>) can affect the rights of the parties. BITs are designed to protect and promote foreign investment. They normally include dispute resolution rules in the different categories of disputes, and the offered mechanism in the vast majority of the BITs is international arbitration.<sup>229</sup>

Where a BIT is in place, the issue of tax disputes is usually addressed in the treaty, and whether a tax-related dispute can be brought before an arbitral tribunal depends on the wording of the BIT. However, there is not one standard practice in tax related matters. In some BITs, such as the Energy Charter Treaty (ECT), tax-related disputes are excluded.<sup>230</sup>

Although arbitrability and tax may be a delicate issue, it has to be pointed out that arbitration has not been completely excluded from the taxation area and it is making its way into this area gradually.

### **3.4 Globalisation and privatisation of justice (the greater role of private law and private arrangements, including private justice)**

As a result of globalisation and the internationalisation of commerce in the world, cross-border transactions have increased. One of the fundamental issues that had to be dealt

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<sup>225</sup> Park (n 437)

<sup>226</sup> For more information see The Organisation for Economic and Co-operation and Development <<http://www.oecd.org/about/>> accessed 17 February 2016.

<sup>227</sup> Michelle S Bertolini and Pamela Q Weaver, ‘Mandatory Arbitration within Tax Treaties: A Need for a Coherent International Standard’ ( Social Science Research Network 2012) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2003897](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2003897)> accessed 25 February 2016

<sup>228</sup> BITs are agreements that establish the terms and conditions for investments by nationals and companies of one country in the jurisdiction of another country.

<sup>229</sup> Lew, Mistelis and Kroll, (n 148) 768.

<sup>230</sup> Park (n 437) 191.

with in cross-border transaction was that of applicable law. The question of applicable law arises especially in construction contracts where foreign investors were and foreign investments are involved.<sup>231</sup> Foreign investors are keen to use arbitration to avoid local tribunals.<sup>232</sup> Arbitration can be as a symbol of private justice and private dispute resolution became and remains very popular among investors. This general view increased during the decades and resulted in the internalisation of private law.

It might be argued that the function of arbitration at the domestic level is different from its international function. This view suggests that the advantages of using arbitration in domestic disputes are different from its advantages in the international sphere. For instance, global enforceability is not counted as an advantage when in a dispute both parties are from one state and the subject matter of the contract is also within the same territory. In such a dispute, the entire dispute settlement procedure, its remedies and ultimately the enforcement all fall under one legal jurisdiction.

In any international transaction more than one legal system is involved. When it comes to choosing the appropriate dispute resolution mechanism, parties may have a choice of both arbitration and litigation in national courts. In practice, litigation is inconvenient in international business as it is not easy to mutually agree on a particular national court. Each party may have a different preference and wish to persuade the other parties to accept their choice. The situation, where there is a dilemma between parties in choosing a mutually agreed national court, can become more challenging where there are more than two parties to the transaction, and where it is a multiparty contract and all of the parties are from different legal jurisdiction

Even if all the parties involved in the transaction reach an agreement on appointing one national court to deal with their dispute, there might be other obstacles, such as jurisdictional conflicts, lack of appropriate applicable law, procedural divergence and enforcement challenges and risk at a later stage after the judgment.

International arbitration, as an independent process that is free from potential bias and partiality claims, can be a viable option in any transaction in today's business

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<sup>231</sup> Yves Dezalay and Bryant G Garth, *Dealing in Virtue* (University of Chicago Press 1996) 86

<sup>232</sup> *ibid.*

environment, one that avoids the abovementioned drawback to litigation in national courts. Arbitration is a viable solution for all disputed financial transactions. Arbitration is based on party autonomy, therefore there is no affiliation between national judicial systems and any arbitral tribunal and, according to Prof. Mistelis, ‘tribunals do not owe any allegiance to a particular State’.<sup>233</sup>

Furthermore, the dilemma is highlighted in those transactions that are more associated with national and parochial considerations, both in terms of regulatory elements, such as securities transactions, and private law inclination by one of the parties, for example in a loan agreement.

### **3.5 Nature of the investor–state arbitration (investment arbitration)**

Encouraging foreign investment has been always one of the key missions in all economies. Countries have adopted various measures to promote intentional investment within their borders, and there is no doubt that international investment is vital for all countries.

One of the main concerns in investment contracts is the issue of dispute resolution. Each investment involves series of contracts. As many parties are involved in these contracts, it is obvious that the issue of disputes arising from these contracts must be addressed. Disputes are not unusual in the course of an international investment project, such as in construction contracts or operational contracts.. Therefore, the issue of dispute resolution mechanism is of the essence. Given the multinational nature of the majority of investment projects, even the simplest project-financing structure includes a network of interrelated agreements between the sponsors, lenders, insurance companies and host government. In recent decades, investment arbitration has developed alongside the growth of foreign investment.

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<sup>233</sup> Mistelis (n 211) 7.

Foreign investors want a way to settle their disputes that is not associated with the courts of the host country as they fear that there would be no fair and equal treatment where the opposing party is the state or state-owned entity.<sup>234</sup>

Arbitration, and the possibility of avoiding domestic courts, is one of the privileges offered to foreign investors. Internationally there are laws in force that aim to protect investors.<sup>235</sup> Foreign investors are keen to deploy a dispute resolution mechanism, which is not dependent on the host country because of the fear of lack of fair and equal treatment.<sup>236</sup>

However, the investment arbitration process is different to that of commercial arbitration. Investment dispute arbitration entails special features and characteristics that are not present in commercial arbitration disputes.

The substantial difference between commercial arbitration and investment arbitration is the source of the power that is devolved to the arbitration tribunal.<sup>237</sup> In investment arbitration there is no requirement for an arbitration agreement, unlike in commercial arbitration. Instead, treaties take the role of an arbitration agreement in the sense that as long as there is a treaty signed between the host country and the investor's country arbitration can proceed. These treaties are often of BITs if there are two countries involved or a multilateral investment treaty (MIT) if the treaty is between more than two countries.

The main convention operating in investment arbitration is the Washington Convention or the Convention on the Settlement of Investment Disputes between States and Nationals of other States, which is also referred to as ICSID Arbitration rules.<sup>238</sup> ICSID operates under the auspices of the World Bank and provides an institutional framework for international investment arbitration. The Washington Convention also regulates, and to a

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<sup>234</sup> Moses (n 177) 231.

<sup>235</sup> All the Commonwealth of Independent States and most developing countries have adopted specific laws to promote and encourage foreign investment. See Mistelis (n 88) 762.

<sup>236</sup> Moses (n 177) 231.

<sup>237</sup> Loukas A Mistelis and Stavros L Brekoulakis (eds), *Arbitrability, International & Comparative Perspectives* (Kluwer Law International 2009) 765

<sup>238</sup> The World Bank sponsored the Washington Convention in 1965, and the purpose was to establish a neutral forum for resolving disputes between states and investors who are nationals of other states. For more see World bank group, ICSID Convention, Regulations and Rules <[https://icsid.worldbank.org/ICSID/StaticFiles/basicdoc/CRR\\_English-final.pdf](https://icsid.worldbank.org/ICSID/StaticFiles/basicdoc/CRR_English-final.pdf)> accessed 14 January 2016

significant extent facilitates, the recognition and the enforcement of ICSID arbitral awards.<sup>239</sup>

Needless to say, states and investors both benefit from a respected investment arbitration centre. For instance, in the case of developing countries, the protection offered to foreign investors can ensure a rapid and encouraging growth in the country and investors have the opportunity to conduct business and construction in a protected environment where legal risks involved in the investment have been minimised.

Some may argue that the fundamental element of arbitration, which is the consent of parties to arbitrate their dispute, is missing in investment arbitration as there is no arbitration agreement as such to evidence the parties' consent. However, the existence of a treaty between signatory countries is an indication of the consent of the countries to opt for the terms included in the treaty, and arbitration is one of those terms. The consent of one party, the respondent state, is given upon the signature and ratification of the BIT, which is a standing offer to arbitrate. The consent of the claimant (the investor) is given by the request for arbitration with the Request of Arbitration, thereby perfecting the arbitration agreement.<sup>240</sup> Therefore, as long as a treaty is in place, which the concerned countries have signed, there is a presumption that both parties have consented to all terms entailed in the treaty including the arbitration clause. The use of international arbitration in investment disputes is popular in the field of global investment. The features offered by this dispute resolution method, including neutrality by and independence from the host state, enhances the legitimacy of this method. Moreover, it has been stated that investor-state arbitration can work as the most appropriate mechanism as it separates the dispute resolution process from the political environment of the host state.<sup>241</sup>

The discussion of investment arbitration is relevant to this research because of the fact that banks and other financial institutions act as international (foreign) investors and

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<sup>239</sup> Article 52(4) of ICSID rules states: (4) The award shall be final and binding on the parties. The parties waive any time limits for the rendering of the award, which may be provided for by the law of the country where the award is made.'

<sup>240</sup> See generally, Jan Paulsson, 'Arbitration without Privity' (1995) 10 ICSID Review 232..

<sup>241</sup> Kate Miles, 'International Investment Law and Universality: Historical of Shape-Shifting' [2014] C.J.I.C.L 986.

frequently find themselves in investment treaty arbitration where the definition of the word ‘investment’ applies to them. This issue is further discussed in Chapter five.<sup>242</sup>

### **3.6 Main factors affecting choice of arbitration over litigation in banking transactions**

Dispute resolutions clauses are an integral part of cross-border transactions. Sophisticated parties ensure that there is either an arbitration clause or a forum clause included in the main contract to enhance the certainty and efficiency of the agreement and reduce the risk associated with conflict-handling procedures.

Jurisdiction and arbitration both offer similar appealing characteristics to parties and both are considered to be effective dispute-handling methods. Both these choices are regarded as valid choices made by parties as long as the choice is based on consent and basic contract law principles.<sup>243</sup>

It has to be mentioned that although arbitration and litigation have similarities, it is only in respect to contract law and the fact that they both have to be based on mutual consent of the parties to be recognised as valid.<sup>244</sup> In fact, these two methods of dispute resolution are fundamentally diverse in terms of structure and procedure.

Arbitration as a means of dispute settlement seems to offer parties distinctive features that are not available in litigation or other ADR processes. Some of these unique characteristics may seem advantageous in relation to bank and financial sector disputes. The most remarkable features, which are considered to be a benefit in this sector, are confidentiality and global enforceability. Unique features of arbitration are explained in this section and their appropriateness for banking and the financial sector is examined.

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<sup>242</sup> See section 5.1.3.

<sup>243</sup> See Article II of the New York Convention (NYC) and Articles 3(c), 5(1), 6(a) and 9(a) of the Hague Choice of Court Convention, Article 23 of the Brussels I Regulations; for more see Zheng Sophia Tang, ‘*Jurisdiction and Arbitration Agreements in International Commercial Law*’, (2014, Routledge) 3

<sup>244</sup> Tang (n 199) 4.

### 3.6.1 Confidentiality and privacy

The arbitration procedure is a confidential and private procedure.<sup>245</sup> Parties who have decided to proceed with arbitration are able to hold the procedure behind closed doors, unlike hearings in national court proceedings. Arbitration is a private process and is confidential to parties, and pleadings are not open to public. No individuals other than the parties with an interest in the case are allowed to attend the hearing. Arbitration can provide a shield for parties who, for a variety of reasons, do not wish to publicise their dispute.

The issue of confidentiality and disclosure of information during proceedings are very important. This has to be noted that these two issues, may have different implications in different proceedings. In fact, there seems to be a conflict between the confidentiality objectives and the disclosure and transparency policies in some financial transactions. While in securities transactions, maximum disclosure and transparency are required by the law, but in loan agreements that involve credit risk full disclosure and transparency could be undesirable for systemic impacts of bank failure. In banking and even banking regulation for the prudential regulation, confidentiality is favoured while as far as the securities regulations are concerned, disclosure of information is favoured. As a matter of fact, one of the major features of securities regulation is mandatory disclosure of information by issuers

Also for the sake of financial stability, banks are inclined and may be required by the law to maintain secrecy and confidentiality in relation to certain facts about their activities. Clearly, confidentiality can be more easily secured via arbitration than litigation. However, there is some disagreement among scholars and practitioners in relation to the requirement of confidentiality in international conventions and national laws.<sup>246</sup> To safeguard the confidentiality in the arbitration process, parties who wish to preserve confidentiality and secrecy in their arbitration process are advised to state this

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<sup>245</sup> The confidentiality of international arbitration has been challenged by some authors. The argument is that the privacy of arbitration proceedings is a 'contentious and unsettled' subject. For more on this see Gary B Born, *International Commercial Arbitration* (Kluwer Law Publications 2014) 2780

<sup>246</sup> *ibid* 89–90.

requirement explicitly in the arbitration agreement/clause when the agreement or clause is drafted.<sup>247</sup>

Confidentiality in banking could be questioned from anti-money laundering regulation point of view. For this reason the choice of arbitration, which is associated with confidentiality, should be balanced against the use of litigation, which is more inclined towards disclosure and transparency.

Parties who wish to benefit from the confidentiality feature in arbitration should secure the confidentiality of the process through their arbitration agreement. If there is no clear requirement for confidentiality stated in the arbitration agreement, the majority of arbitration rules will not give effect to the request for confidentiality and there would be no binding obligation to keep the arbitration confidential.<sup>248</sup>

It has to be noted that absolute confidentiality may not be easily achieved in practice, and especially in situations where the arbitration is concerned with slightly more complicated issues such as multiparty or multi-contract elements. Confidentiality may be also be difficult where there is a chance that the matter may be referred to the court in order to support arbitration.<sup>249</sup>

The possibility of having a private panel to resolve the any future dispute may have some advantages for commercial issues where companies and businesses wish protection from any possible damage to their reputation, and a confidential arbitration tribunal can best serve their needs.

The same logic can be used to justify the welcoming approach towards arbitration from bankers and financiers. One of the main concerns in bank-related disputes is the bank's reputation. The banking industry relies on the reputation of banks and financial institutions. For instance, no bank would wish to publicise its conflict with a state borrower about a loan agreement. Whether the dispute has arisen in relation to the terms and conditions of a loan at a later stage, or whether it is because the foreign state has

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<sup>247</sup> Gerard J Meijer and Richard H Hansen, 'Arbitration Clauses for International Financial Disputes' in Jeffrey Golden and Carolyn Lamm (eds), *International Financial Disputes* (Oxford Press 2015) 166

<sup>248</sup> Lew, Mistelis and Kroll, (n 148) 177.

<sup>249</sup> *ibid* 30.



defaulted, both parties – the bank and the borrower foreign state – would prefer to settle the matter confidentially and not wish it to become public.

Arbitration awards are not published and are not case law, unlike a court judgment.. As a result, there is no precedent in arbitration awards and this lack of precedent has resulted in the creation of some ‘secret law’ where it is not possible to determine or predict the possible outcomes of a case.<sup>250</sup> The fact that arbitration does not create precedent can be regarded disadvantageous in the use of arbitration clauses as an efficient dispute settlement clause in contrast to litigation where precedent is indeed created by well-established courts’ decisions. The existence of precedent in both civil and criminal matters enhances the predictability and certainty of the law in relevant areas. While courts are obliged to follow precedent, they are allowed to depart from the earlier decisions (i.e. precedent) on occasions where the strict compliance with precedent results in rigidity.

However, bankers enjoy this high level of confidentiality in arbitration, especially in the aftermath of the 2008 financial crisis. According to statistics, bankers are willing to conduct confidential proceedings to minimise damage to their reputation.<sup>251</sup> According to leading experts in this area, the option to not to ‘wash ... dirty linen in public’ is one of the main reasons for selecting arbitration over open court litigation.<sup>252</sup>

The confidentiality of arbitration has always been one of the strong points for advocating arbitration against litigation and national court proceedings. In fact, in *Merrill Lynch*<sup>253</sup>, one of the arguments used in the defence of private settlement and the avoidance of public adjudication of disputes was that publicity might threaten market confidence and make investors reluctant to participate in market activities. However, the US Supreme Court came to a diffident conclusion:<sup>254</sup>

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<sup>250</sup> Kathryn A Sabbeth and David C Vladeck, ‘Contracting (out) Rights’ (2009) 36 Fordham Urb. L.J. 803, 807.

<sup>251</sup> Klaus Peter Berger, ‘The Aftermath of the Financial Crisis: Why Arbitration Makes Sense for Banks and Financial Institutions’ [2009] 3(1) LFM 54, 58.

<sup>252</sup> Michael Brown and Claire Morel de Westgaver, ‘Banking and Finance Arbitration on the Rise – a Trend to Follow?’ (Financier Worldwide, April 2013) <<http://www.financierworldwide.com/banking-and-finance-arbitration-on-the-rise-a-trend-to-follow/#.VaUkK5NUWB0>> accessed 7 June 2015.

<sup>253</sup> *Merrill Lynch, Pierce, Fenner & Smith, Inc v Ware*, 414 U.S. 117, 136, 94 S Ct 383, 394, 38 L.Ed.2d 348 (1973), at 136.

<sup>254</sup> Brekoulakis (n 153) 25.

There is no explanation of why a judicial proceeding, even though public, would prevent lessening of investor confidence. It is difficult to understand why muffling a grievance in the cloakroom or arbitration would undermine confidence in the market. To the contrary, for the generally sophisticated investing public, market confidence may tend to be restored in the light of impartial public court adjudication.<sup>255</sup>

### 3.6.2 Speed and cost

Arbitration process has a reputation for being a speedy dispute resolution mechanism. In domestic claims, when is compared to arbitration, because of the heavy caseload of national courts and lengthy court timetables, arbitration appears as a more expeditious settlement process. However, in international arbitration, as the dispute matter frequently concerns complex and technical legal issues, the settlement process is not always fast and may take up to several weeks or months.

One of the particular advantages of arbitration is its enormous flexibility, in the sense that parties can decide on a time frame for arbitrators to issue their award. As arbitrators are instructed by parties and paid by the parties, they have to comply with any reasonable timetable established by the parties.<sup>256</sup> The timetable set for awards can lead to a prompt arbitration process.

Additionally, arbitration is considered as an expeditious process, which is designed to avoid the usual delays associated with court proceedings. Arbitration provides a great deal of flexibility for the parties, as well as the possibility to tailor the process based on each party's needs and requirements.<sup>257</sup>

Moreover, arbitration and ADR have been publicised for their economic and expeditious character by various practitioners and scholars.<sup>258</sup> There is no doubt that time is of essence in banking and other financial matters. It will make a considerable difference if a proceeding about a market-related claim takes longer than expected as rates and values

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<sup>255</sup> *Merrill Lynch, Pierce, Fenner & Smith, Inc v Ware*, 414 U.S. 117, 136, 94 S Ct 383, 394, 38 L.Ed.2d 348 (1973), at 136.

<sup>256</sup> Lew, Mistelis and Kroll (n 148) 175.

<sup>257</sup> Brown and de Westgaver (n 251).

<sup>258</sup> James R Butler, 'Arbitration as a Means of Enhancing Consumer Relations' (1993) 110 *Banking L. J.* 536

are constantly changing in this sector. Due to the sensitivity of banking and financial transactions, parties would much rather resolve the dispute in the minimum possible period of time. Therefore, arbitration, which is known to be a fast dispute resolution mechanism, may be an appealing option in this sector.

However, as mentioned above, although arbitration has a reputation as being a swift dispute resolution process, in some complex cases it can take as long as court proceedings.<sup>259</sup> The arbitration process, when it involves complex and intricate matters, may last as long as court proceedings or possibly longer.<sup>260</sup> To address this drawback in arbitration, some arbitral institutions offer expedited arbitration services through which parties receive a faster settlement procedure.<sup>261</sup>

For the same reason, banks and financial institutes are advised to incorporate an arbitration clause that includes a 'right to choose'. This means that they can choose between standard or expedited arbitration proceedings.<sup>262</sup>

Another challenge to the claim that arbitration is a speedier process is the lack of summary judgment in the arbitration process, but it is available in litigation and national courts.<sup>263</sup>

Another claimed advantage of arbitration is its lower costs compared to litigation. However, again similar to the time frame factor, arbitration, when it involves a complex matter, may come at a high cost, which includes the cost of the arbitrators, venue costs and other associated charges. Therefore, arbitration is unlikely to be considerably cheaper than litigation.<sup>264</sup>

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<sup>259</sup> Berger (n 250) 58.

<sup>260</sup> Carr (n 125) 620.

<sup>261</sup> For instance, DIS, which is The German Institution of Arbitration, offers different arbitral services, including special rules for expeditious proceedings. For more see <<http://www.dis-arb.de/en/16/rules/dis-supplementary-rules-for-expedited-proceedings-08-srep-id4>> accessed 4 June 2015

<sup>262</sup> Berger (n250) 54, 58.

<sup>263</sup> Murray, Holloway and Timson-Hunt (n 135) 587.

<sup>264</sup> *ibid.*

### 3.6.3 Expertise

It is evident that banking disputes are complex and there is a need for expert judges if those disputes are to be referred to the courts. Judges in courts are clearly very knowledgeable on the law and legal arguments. However, in complex and technical banking and finance disputes, where the disputes are extremely complex and difficult legal and finance matters, the expertise of the judges may be questionable. For instance, in structured finance products, such as synthesised debt obligations, there are many contracts and legal matters involved which make the entire operation of the financial product rather complicated.<sup>265</sup> A thorough assessment of the extent of the legal issues involved in some cases requires an extensive knowledge of economic and policies as well as market expectations.<sup>266</sup>

Arguably the lack of sufficient expertise of judges when dealing with complex financial matters, compared to finance and banking expert arbitrators is another drawback of court systems compared to arbitration. According to experts and practitioners in this area, national judges do not have the required knowledge about complex financial products. Although the extent of judges' knowledge varies from one jurisdiction to another, it is safer to claim that arbitrators have a more technical understanding of complex financial and banking transactions.<sup>267</sup>

As was mentioned above, there is no doubt that finance and banking involve complex transactions; it has been argued that national judges in the majority of cases would not have the required knowledge to absorb the disputed matter. For example, as one commentator stated: 'it would be highly impossible and very time consuming to explain complex financial terminology such as gun jumping or collateralised debt obligation to a national judge.'<sup>268</sup> In the majority of cases involving financial matters, judges require financial experts to understand and assess the technical issues involved in the case. Well-informed experts are appointed by the judges to provide information and meaning as to some of the technical and complicated concepts such as 'fair market value', which

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<sup>265</sup> Hanefeld (n 201) 917–918.

<sup>266</sup> *ibid.*

<sup>267</sup> Brown and de Westgaver (n 251).

<sup>268</sup> Berger (n 127) 54.

frequently comes up in derivatives claims.<sup>269</sup> Financial derivatives are complex and even the courts that are based in finance- and banking-friendly jurisdictions<sup>270</sup> constantly obtain help from relevant experts and these courts have regarded the expert testimony advantageous when deciding a complex financial matter.<sup>271</sup>

The role of financial experts in the resolution of international financial disputes is undeniable and the significance of their role is more evident in the absence of a specialised court or tribunal devoted specifically to financial and banking disputes.<sup>272</sup>

Therefore, local judges' lack of required expertise and competence and relevant experience in the financial and banking sector is stated to be one of the most significant reasons that push parties towards arbitration.<sup>273</sup>

It is worth mentioning that in order to overcome the possible lack of technical knowledge of courts in dealing with complex and technical disputes in financial and banking disputes, some jurisdictions have created specialist courts dealing with above mentioned disputes. For instance, in autumn 2015 a specialist banking court was established in the UK in the Royal Courts of Justice.

#### 3.6.4 Party autonomy

Party autonomy is one of the desirable features of arbitration. Arbitration is an independent and private panel where disputing parties have the authority to appoint the decision-making panel by way of mutual agreement. Additionally, parties are able to decide what law governs the arbitration process. In other words, they can agree on substantive or procedural aspects of the dispute resolution process.<sup>274</sup>

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<sup>269</sup> Jeffrey Golden, 'The Particular Role of Experts in Arbitrating Financial Disputes' in Jeffrey Golden and Carolyn Lamm (eds), *International Financial Disputes* (Oxford Press 2015) 357.

<sup>270</sup> London and New York courts are deemed to be the two favourite jurisdictions for banking and finance disputes.

<sup>271</sup> Golden (n 145) 356.

<sup>272</sup> *ibid* 357.

<sup>273</sup> *ibid*.

<sup>274</sup> Stefano Cirielli, 'Arbitration, Financial Markets and Banking Disputes' (2003) 14 *Am Rev Int'l Arb.* 243

It is by virtue of party autonomy that parties are able to decide not only on the regulations governing their dispute resolution process, but on the place of the arbitration.<sup>275</sup> Therefore, it is reasonable to state that: ‘In essence, arbitration is an institution by which individuals adjudicate disputes privately insofar as the law allows.’<sup>276</sup>

Party autonomy in contracts appears as the freedom of contract doctrine, which was discussed in previous chapters. As was mentioned, parties are free to enter into contracts and can decide on the subject matter of the contract. The same mechanism is applied in arbitration agreements. Parties to the contract are free to choose the system they wish to settle their dispute. If they wish to adopt arbitration, then they have the authority to choose their desirable arbitrator (or arbitrators) to adjudicate their case.

### 3.6.5 Global enforceability

Another significant advantage of arbitration compared to litigation is the global enforceability of arbitral awards in cross-border disputes. As it was stated above in this chapter, ease of enforcement was one of the main factors that resulted in the popularity of arbitration in commercial contracts. This global enforceability of arbitral awards is claimed to be one of the rationales for selecting arbitration over other dispute resolution methods in international transactions.

In the past, as least as far as the capital market is concerned, the markets were local and parochial and therefore, the need for arbitration was not that acute but with the internationalisation of financial markets, the more international elements and therefore the need for arbitration is higher.

It is worth mentioning here that there is a difference between recognition and enforcement. Although there is a link between enforceability and recognition, these two terms should not be used interchangeably as they have different meanings. A foreign arbitration award is recognised if it has been recognised by other foreign courts in which

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<sup>275</sup> See JS McClendon and RE Goodman, *International Commercial Arbitration in New York* (Transnational Publisher 1986) 3–4

<sup>276</sup> Bagheri (n 147) 19.

there would be no further proceedings as to the decided matter.<sup>277</sup> On the other hand, a foreign arbitration award is enforced if the court has assisted the successful party to obtain the compensation and the outcome that has been sought by the successful party.<sup>278</sup>

In differentiating between enforcement and recognition, it has been stated that:

The purpose of recognition on its own is generally to act as a shield. Recognition is used to lock any attempts to raise in fresh proceedings issues that have already been decided in the arbitration that gave rise to the award whose recognition is sought.

By contrast, the purpose of enforcement is to act as a sword. Enforcement of an award means applying legal sanctions to compel the party against whom the award was made to carry it.<sup>279</sup>

As it was discussed above,<sup>280</sup> the New York Convention provides provisions for both global enforcement and global recognition of foreign arbitral awards.<sup>281</sup> Section 101 states:

(1) A New York Convention award shall be *recognised* as binding on the persons as between whom it was made, and may accordingly be relied on by those persons by way of defence, set-off or otherwise in any legal proceedings in England and Wales or Northern Ireland.

(2) A New York Convention award may, by leave of the court, be *enforced* in the same manner as a judgment or order of the court to the same effect.<sup>282</sup>

It might be argued that because of the Brussels Convention on Jurisdiction and Enforcement of Judgments,<sup>283</sup> which is applicable to judgments issued in European

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<sup>277</sup> Jagush (n 197) 476.

<sup>278</sup> *ibid.*

<sup>279</sup> Alan Redfern, J Martin Hunter, Nigel Blackaby and Constantine Partasides, '*Redfern and Hunter on International Arbitration* (Oxford University Press 2009) para 11.24, also Kluwer Arbitration, <<http://www.kluwerarbitration.com/CommonUI/document.aspx?id=Ch11-ipn26305>> accessed 11 August 2015

<sup>280</sup> See section 3.1.5.

<sup>281</sup> For more information see United Nations Commission on International Trade Law, <[http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/NYConvention.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention.html)> accessed **12 December 2015**

<sup>282</sup> New York Convention 1958, section 101; also (Kluwer Arbitration) <<http://www.kluwerarbitration.com/CommonUI/document.aspx?id=ipn12044#a0536>> accessed 11 August 2015.

<sup>283</sup> Brussels Convention on Jurisdiction and the Enforcement of Judgments in Civil and Commercial matters 1968 Lex Mercatoria

courts, European litigants are in a better position compared to disputing parties from outside the European Union (EU). This convention provides the provisions in which facilitate the enforcement of European court judgments by requiring the court to enforce court orders issued from EU Member States. Therefore, European parties can take their disputes to either litigation or arbitration and either way they will obtain an outcome (judgment or award) that will be enforceable.

As banking and financial transactions started to spread globally more international participants from emerging markets such as South America, China, Russia, the Middle East and Asia entered the field. As a result, banks and financial institutions realised that the enforcement issue, which is well handled within Europe by effective cross-border enforcement measures, could be a challenge if they were dealing with, for instance, an ordinary debt recovery case where the assets were located in a developing country.<sup>284</sup>

Overall, it is this global enforceability feature of arbitration that has resulted in the gradual acceptance of this dispute resolution mechanism in the banking and financial world. Enforceability is more essential in transactions where parties from China or Russia and other emerging markets are involved.<sup>285</sup>

However, the case of *JP Morgan Europe Ltd v Primacom*<sup>286</sup> may suggest a different approach. In this case there was a loan facility agreement between JP Morgan and Primacom, and the agreement provided for English law as the governing law and England as the jurisdiction. This was an exclusive jurisdiction clause.<sup>287</sup> The English Commercial Court held that, within the EU jurisdiction, the first court to deal with the dispute would have priority over other courts while it is deciding if it has the jurisdiction to deal with the matter. No other court can interfere while the first court is involved in the case unless and until this court decides that it has no jurisdiction over the case. The Commercial Court added that it does not make a difference to the case if there is an exclusive jurisdiction clause incorporated into the agreement. From this judgment one can conclude

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<http://www.jus.uio.no/lm/brussels.jurisdiction.and.enforcement.of.judgments.in.civil.and.commercial.matters.convention.1968/doc.html> accessed 22 December 2015

<sup>284</sup> Jagush (n 197) 475.

<sup>285</sup> Simon James and Robert Lambert, 'Arbitration in the Finance Sector: Avoiding the "Italian Torpedo"', [2006] Int. A.L.R 40

<sup>286</sup> [2005] 2 Lloyd's Rep. 665.

<sup>287</sup> An exclusive jurisdiction clause limits parties to only one jurisdiction. Using an exclusive jurisdiction clause results in legal certainty so that parties know where they can sue and be sued.



that if in a loan agreement there is a forum choice rather than arbitration, even if it is an exclusive jurisdiction clause, there is a possibility that debtors who are trying to evade their payment obligation will start proceedings in other courts and not the nominated court. By doing so they would be delaying payment, which would clearly not be favoured by lenders.<sup>288</sup>

It shows that perhaps litigation may not be the best-suited dispute resolution method even in Europe where the Brussels Convention and relevant regulations are applicable. In these circumstances, arbitration may be able to address the enforcement problem and be a better dispute resolution system. Unlike in litigation, in arbitration the arbitral panel normally does not have to stay any commenced arbitration just because there is an extant court procedure dealing with the same case as long as parties have validly incorporated an arbitration clause into their agreements.<sup>289</sup> However, the court may stay the proceedings if it finds out that there is an arbitration agreement between parties, and in some cases the court may stay the proceeding even if there is no arbitration agreement between parties. A good example is the case of *Shanghai Construction (Group) Co. Singapore Branch v Tan Poo Seng*<sup>290</sup>, in which the court in this case ordered a temporary stay of proceedings where there was no arbitration agreement.<sup>291</sup>

It should be noted that arbitration does not guarantee global enforcement, even in New York Convention signatories. Parties should be aware of the risks involved in a country where local courts do not promptly enforce foreign arbitral awards.<sup>292</sup> According to leading practitioners in the area of banking and finance parties can minimise this risk by taking extra cautions when drafting the arbitration clause and relevant terms for the enforcement of any award. By doing so, they can prevent the local courts from misinterpreting the arbitration agreement and delaying the enforcement of the award.<sup>293</sup> Moreover, the network of the existing legal framework for recognition of foreign court

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<sup>288</sup> James and Lambert (n 285) 40.

<sup>289</sup> *ibid.*

<sup>290</sup> *Shanghai Construction (Group) General Co. Singapore Branch v Tan Poo Seng* [2012] SGHCR 10

<sup>291</sup> Darius Chan, 'Stay of Proceedings in Favour of Arbitration Under the Court's Inherent Jurisdiction' (Kluwer Law Arbitration Blog, 15 August 2012) <<http://kluwerarbitrationblog.com/blog/2012/08/15/stay-of-proceedings-in-favour-of-arbitration-under-the-court%E2%80%99s-inherent-jurisdiction/>> accessed 7 May 2015

<sup>292</sup> Brown and de Westgaver (n 251).

<sup>293</sup> *ibid.*

orders is not as widespread as the extensively recognised the New York Convention.<sup>294</sup> This has resulted in the change of attitude towards international arbitration among banks and financial institutions in a way that they start to consider international arbitration as a suitable means in settling cross-border disputes in this sector.

### 3.6.6 Neutrality

The question of neutrality of the settlement panel is one of the main concerns for the disputant parties. Arguably, court systems in some jurisdictions may be regarded as lacking the required neutrality and as not acting independently because of various legal or political incentives.<sup>295</sup>

Another well-recognised advantage of an arbitral tribunal is the neutrality of the arbitral panel. In a classic cross-border transaction, parties would be concerned about a choice of an unfamiliar jurisdiction, especially in some developing countries or even developed countries where there is a high risk of corruption. In these circumstances, an independent arbitrator (or a panel of arbitrators) can be the preferred option for parties as, according to some scholars, neutral forums reduce the risk of hometown advantages.<sup>296</sup> The necessity for a neutral decision is greater in a situation where one of the parties is a state and there would be a higher risk of a partial court decision if the dispute is referred to the state's home jurisdiction.

Arbitrators are expected to apply neutral justice during the arbitration process and it is essential for them to stay away from *ex parte* relationships (i.e. for the benefit of one party only) and they must remain impartial and independent for the entire duration of arbitration.

In various arbitration Acts it is common to find provisions dealing with neutrality and impartiality of arbitrators. For instance, section 33(1) of the Arbitration Act 1996 (UK) requires the arbitrators to 'act fairly and impartially as between the parties'. Moreover,

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<sup>294</sup> Jagush (n 197) 474.

<sup>295</sup> Maria Davies, 'The Use of Arbitration in Loan Agreements in International Project Finance: Opening Pandora's Box or an Unexpected Panacea?' (2015) 32(2) *Journal of International Arbitration* 143.

<sup>296</sup> Karyl Nairn, 'Arbitration: The Latest Fashion or a Classic Choice' (2002) 11 *JIBFL* 431.

there are measures designed to deal with lack of neutrality of arbitrators and section 24 of the Arbitration Act 1996 (UK) deals with the issue of the court removal of arbitrators. If arbitrators lack claimed qualifications or impartiality,<sup>297</sup> the court can remove the arbitrator.<sup>298</sup>

On slightly a different note, arbitrators are under the obligation to conduct the process of arbitration with a fair manner, in other words, giving both parties equal opportunities to present their cases and supporting documents.<sup>299</sup>

### 3.6.7 Finality

Arbitral awards are final and no appeal can be made from the tribunal's decision.<sup>300</sup> This finality feature of arbitral awards is a considerable advantage of arbitration and has been referred to by advocates of arbitration in extensive literature. The fact that the dispute can be settled for once and all is highly regarded by disputant parties, especially in international disputes. The finality feature of arbitration awards and the fact that these decisions can be enforced internationally are two of the great benefits of this dispute resolution mechanism for parties involved in international transactions.<sup>301</sup>

However, it is worth mentioning that the lack of a right of appeal in arbitration can be regarded as either advantageous or disadvantageous depending on the claimant and defendant's viewpoints. In some claims, finality of arbitral awards is beneficial as ends a dispute and terminates it in a conclusive way. On the other hand, where an aggravated party believes that there is an error or mistake in decision of arbitrator, the possibility of appeal and review by courts in other judicial authorities is not a straightforward matter.

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<sup>297</sup> See also Article 11(1) ICC Rules for a right to challenge arbitrator for lack of independence.

<sup>298</sup> See section 24 of the Arbitration Act 1996 (UK), The National Archive, <<http://www.legislation.gov.uk/ukpga/1996/23/section/24>> accessed 10 August 2015.

<sup>299</sup> Due process rules.

<sup>300</sup> There are limited grounds for challenging the arbitrators' decision. Most important ones challenge the award on the grounds of an arbitrator's lack of impartiality and independency. See UNCITRAL Model Law Article 12 (2), < [https://www.uncitral.org/pdf/english/texts/arbitration/ml-arb/06-54671\\_Ebook.pdf](https://www.uncitral.org/pdf/english/texts/arbitration/ml-arb/06-54671_Ebook.pdf)> accessed 12 January 2016

<sup>301</sup> Murray, Holloway and Timson-Hunt (n 135) 579.

### **3.7 Conclusion**

Arbitration has been one of the most frequently used dispute resolution methods in commercial law for decades. Considering the rapid internationalisation of commerce and business, alongside the expansion of cross-border trade, and the increasing desire of contracting parties for greater party autonomy and privacy and confidentiality, international arbitration is becoming a very popular global choice throughout the globe in different sectors. .

International arbitration, by offering a universal and neutral dispute settlement procedure to parties involved in either commercial transactions or international investment projects, is a viable replacement for traditional national court, i.e. litigation, processes.

One of the overriding features of arbitration is that the parties can exercise the maximum party autonomy in this dispute-handling process. For instance, they have the autonomy to choose their arbitration process, the seat of arbitration, the governing law as well as the applicable law. Additionally, they can enjoy the privacy and confidentiality that is available in arbitration. Confidential dispute settlement procedure is not available in court litigation where most disputes are heard publicly.

Most importantly, global recognition and enforcement of arbitral awards is one of the most valuable characteristics of international arbitration. This universal recognition, which is driven by New York Convention 1958, is one of the main persuasive factors for international parties to use arbitration to resolve their disputes. Global enforceability of arbitral awards is not available in foreign judgments, in that enforcing and recognising court judgments of a national court and seeking enforcement in a different jurisdiction, i.e. a foreign jurisdiction, is always challenging and depends on existing protocols or agreements between the relevant countries.

In addition to the above, it was explored that arbitration, as a consensual process, requires clear consent of the parties. The fact that parties are foregoing their right to litigation, i.e. referring disputes to court and asking the judges to resolve the matter, and choosing arbitration has to be embodied in their arbitration agreement. An arbitration agreement is

the most essential element to enable parties to go to arbitration as it contains parties' clear consent to arbitration.

All the aforementioned features of international arbitration make this method an appropriate choice for banking dispute resolution. Secrecy and confidentiality, which are offered in arbitration, seem to be very appealing to banks and financial institutions that wish to preserve the confidentiality of dispute settlement procedure.

## Chapter Four

### Dispute Settlement Trends in Banking Transactions

#### 4.1 Introduction

As was discussed in Chapter Two, the banking industry plays a fundamental role in the development of countries' economies by offering various financial and monetary services and commodities, which help in the growth of businesses both nationally and internationally. From a domestic perspective, each jurisdiction has its own preferred mechanism for dispute handling. In the UK, litigation is claimed to be one of the most popular ways to settle possible conflicts between banks and their customers, as well as conflicts between banks. Although banking litigation is used extensively in England,<sup>302</sup> there are other means of dispute handling also in use. For instance, there are some measures designed to resolve disputes outside court and without the need for judges and lengthy hearings. Banking mediation schemes and expert determination are some examples.

As it will be explained below in this chapter, there are other official bodies in existence, such as the Financial Ombudsman Services, which deal specifically with only domestic bank-customer disputes.<sup>303</sup>

Considering the globalisation of lending and other services offered by banks, more jurisdictions are involved in cross-border transactions and cross-border dispute resolutions are unavoidable. Cross-border transactions can involve risk in some form or another for both contacting parties. To reduce the level of risk involved in these transactions, parties engaged in the transaction should consider risk-mitigating measures. Incorporating a dispute resolution clause into the agreements is one such act that would protect parties against uncertainties and possible risks involved in the transaction. By

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<sup>302</sup> Peter Cartwright, *Banks, Consumers and Regulation* (Hart Publishing 2004) 151.

<sup>303</sup> Financial Ombudsmen Services is explained at the end of this chapter.

thinking ahead and providing a mechanism for dispute handling in the contract, parties exercise due diligence as they increase the sustainability of their contractual relationship.

As it was mentioned above, the traditional pattern for dispute settlement for banks is litigation<sup>304</sup> (for both national and international disputes) and alternative dispute resolution methods can be used if the consumer prefers to avoid litigation and is willing to opt for other conflict handling disciplines.<sup>305</sup>

However, it can be argued that the internationalisation of banking transactions, whether it be lending, letters of credit or bank guarantees, will push banks to relinquish their inclination for litigation and instead choose arbitration.

In previous chapters,<sup>306</sup> the nature of the banks and banking transactions were discussed to some extent.<sup>307</sup> This chapter will first look at the roots of dispute resolution choices. It will then be discussed that all banking transactions are of a contractual nature and, therefore, the normal rules of contract law are applicable. For instance, a loan agreement is a contract by nature: a contract between a lender and a borrower. It has to be examined whether these parties have the authority and autonomy to choose the dispute resolution method in their contracts. It also discusses whether contracts in the banking sector have the same structure as contracts in other commercial sectors. In this chapter, the following arguments will be perused.

Banks are involved in a huge variety of transactions. These transactions are contracts by nature; therefore, as a result of the application of freedom of contract principles, contracting parties have the free choice of incorporating their own favoured dispute resolution clause in the contract. In this section bank contracts are explored. Nonetheless, this principle is not an absolute principle under contract law and there are limitations imposed on the doctrine of freedom of contract.

In the next section, banking disputes and the possible ways of handling these disputes are discussed.

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<sup>304</sup> Cartwright (note 301) 151.

<sup>305</sup> *ibid.*

<sup>306</sup> See Chapter Two

<sup>307</sup> Chapter Two.

The conclusion discusses whether arbitration's lack of popularity is because of the restrictions imposed on parties' willingness to insert an arbitration clause into the contract or whether there are other reasons for this hesitancy. It has to be borne in mind that, regardless of the method of dispute settlement, it is vital that parties have considered a dispute resolution clause and have not neglected to consider the importance and profound implications of this clause on contractual rights and obligations arising out of the main contract.

## **4.2 Banking transactions**

Banks may become involved in a variety of transactions, depending on the nature of the business activity. Mortgage loans, deposit-taking, syndicated lending and guarantees are just a few examples of a bank's activities. Depending on the size and type of the bank (commercial or investment), transactions could be different.

It is obvious that all these transactions are 'contracts' and the normal rules of contract law should apply. This contractual nature of banking transactions may play a role in the choice of dispute resolution method for the transactions. The issue will be covered further in this section.

The main source of regulating bank-customer relationships is the contract existing between them. There are different forms of contracts between banks and their customers. The differences depend on the services offered by the banks and nature of their customers.

Contracts between a bank and customers may take different shapes, but the main forms can be categorised as:<sup>308</sup>

- a. contracts conducted between banks and large corporate customers;
- b. contracts conducted between banks and smaller corporate or unincorporated business customers;
- c. Contracts conducted between banks and consumer customers.

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<sup>308</sup> Graham Roberts, *Law Relating to Financial Services* (Global Professional Publishing 2009) 1.



Although the contract between a bank and its customer is an essential document in their relationship, historically, in the UK, unlike in other European countries such as Germany and the Netherlands, there was no one single document that could be used as a standard contract.<sup>309</sup> Nowadays, banks have adopted codes of practice, which are not legally binding and are only part of the soft law in banking law. Despite being legally enforceable, English courts may take the codes of practice into account when dealing with implied terms in the bank-customer relationship.<sup>310</sup>

Once a contract exists between a bank and its customer, their relationship is subject to state regulation.<sup>311</sup> The extent of regulation varies from one jurisdiction to another. In some countries, such as the UK, self-regulation is in place, and in some banking areas, matters are only covered by the operation of the Financial Ombudsmen Services.<sup>312</sup>

The regulation of bank-customer contracts is rather narrow and it is mainly limited to current legislations in this area. The main laws regulating ordinary bank-customer contracts are the Unfair Contract Terms Act 1977 (UCTA) and the Unfair Terms in Consumer Contracts Regulations 1999 (UTCC).<sup>313</sup> There are also other guides issued by the former Financial Services Authority (FSA) which is now the Financial Conduct Authority (FCA) and Prudential Regulation Authority in 2012.<sup>314</sup>

Both the UCTA and the UTCC are designed to protect potential consumers and customers. By virtue of these two pieces of legislation, contracting parties can bring an action against terms included in a contract if they seem unreasonable or unfair in some way.

The above mentioned Acts play an important role in the banking sector where the presumption is that the customers are in the weaker position. In particular banks should be aware of the below sections in the UCTA 1977:<sup>315</sup>

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<sup>309</sup>Ross Cranston, *Principles of Banking Law*, (First published 1997, Oxford University Press 2002) 133

<sup>310</sup> *ibid.*

<sup>311</sup> *ibid.* 144.

<sup>312</sup> *ibid.* 145.

<sup>313</sup> Charles Proctor, *The Law and Practice of International Banking* (Oxford University Press 2010) 309.

<sup>314</sup> FCA and PRA are explained in Chapter 2

<sup>315</sup> Proctor (n 312) 309.

- Section 2(2): according to this section, banks are prohibited from excluding or restricting their liability for breach of contract or negligence unless it is reasonable to accept their exemption of liability.
- Section 3: the bank's standard terms cannot exclude or restrict liability for its own breach of contract or entitle the bank to render a performance which differs substantially from that reasonably expected of him, or to render no performance at all.
- Section 4: the contract cannot force a consumer to indemnify the bank against any liabilities which it may sustain during a negligence action or for the breach of contract, unless the reasonableness test is satisfied.

The Unfair Terms in Consumer Contracts Regulations 1999 is similar to the 1977 UCTA. The difference is that the 1977 Act is applicable to all types of contracts whereas the 1999 Regulations have a narrower scope and only apply where there are consumers involved in a contract.<sup>316</sup>

A banking contract should be examined in light of the involved parties in the contract and all relevant parties should be identified.<sup>317</sup> Like any contract, a banking contract imposes rights and duties on the contracting parties. For the banks, when they enter into a contract with their customers, they bear duties and responsibilities not only in relation to their customers, but also in relation to third parties with whom they may be required to conduct business because of their customers.<sup>318</sup>

#### 4.2.1 The bank-customer relationship

One cannot imagine a business without its customers. Banking business is no different to any other business. Every bank needs to attract customers and maintain a good relationship with them in order to survive. But how can a business become more appealing in the eyes of its customers?

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<sup>316</sup> *ibid* 310.

<sup>317</sup> George Walker, *Banking Law, Policy and Practice*, teaching handout for LLM programme, Queen Mary University 2010.

<sup>318</sup> Mark Howard and Roger Masefield, *Butterworths Banking Law Guide* (LexisNexis Butterworths 2006) 79

The answer is, clearly, by offering decent services to their customers. When it comes to banks, in essence they are entities that have been created to offer services to customers. There has to be a customer who requires banking services such as depositing, lending or securities dealing. Therefore, banks must enter into contracts to create a legal relationship with their customers.

The customer in this sense is a broad concept. It includes those who borrow from banks, those seeking financial advice, those who require securities-dealing and fund management and those who require any other available banking service. The question of who is a bank customer and who is not may be of importance where protection is offered to bank customers in the regulations, but the concept of a customer is undefined in the legislation.<sup>319</sup>

The basic customer connection with a bank is where a customer has an account with bank X. As pointed out by Cranston, it was established in the English case law<sup>320</sup> that ‘anyone who opens an account, is a customer for the purposes of statutory protection’.<sup>321</sup> However, it is necessary to bear in mind that simply holding an account with a bank does not mean that all the banking features are applicable to the customer’s relationship with the bank. For instance, the bank’s fiduciary duty or duty of confidentiality may not be absolute towards their customer.<sup>322</sup>

Sovereign customers are another category of bank customer. Lending to other states began in the 1970s, fell after the debt crisis in the 1980s<sup>323</sup> and started to gradually pick up again in the 1990s.<sup>324</sup>

States are regular customers for banking loans. Foreign states may borrow from banks via their central bank or another monetary authority.<sup>325</sup>

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<sup>319</sup> Cranston (n 308) 130.

<sup>320</sup> *Commissioner of Taxation v English, Scottish and Austrian Bank Ltd.* [1920] AC 683 (PC).

<sup>321</sup> Cranston (n 308) 130.

<sup>322</sup> Samahir Abdulah,, ‘The Bank’s duty of confidentiality, disclosure versus credit reference agencies; further steps for consumer protection : ‘approval model’’. ‘(2013) European Journal of Current Legal Issues, Vol 19, No 4 (2013) also available on : < <http://webjcli.org/article/view/296/405> > accessed 15 January 2016

<sup>323</sup> The international debt crisis, also referred as Latin American debt crisis, took place when Latin American countries (mainly Brazil, Argentina and Mexico) were declared unable to pay their foreign debts during 1982-1989. For more information, see: Federal reserve bank of Chicago , history < <http://www.federalreservehistory.org/Events/DetailView/46>> accessed 12 April 2015

<sup>324</sup> Roy C Smith and Ingo Walter, *Global Banking* (Oxford University Press 1996) 21.

<sup>325</sup> *ibid.*

The nature of the relationship between customer and bank is contractual.<sup>326</sup> The leading English case in this area is *Foley v Hill*.<sup>327</sup> In this early case, the relationship between bank and customer was discussed and it was argued as to whether this relationship was a fiduciary or contractual one. The court held that the relationship between a customer who has deposited money and a bank is purely contractual and both parties have contractual obligations. This relationship is arguably not a fiduciary relationship where the bank has to act in best interests of the customer.<sup>328</sup>

In contrast to the above argument, the nature of the relationship between bank and customer is a topic of debate between judges and scholars. Some academics state that although the nature of this relationship is based on a contract and, therefore, the relationship should be a contractual relationship, this primary relationship may entail more than one type of relationship.

Moreover, the relationship between bank and customer may include the relationship between creditor and debtor, as well as relationship between principle and agent, bailor and bailee, and beneficiary and trustee.<sup>329</sup> In other words, one relationship may have be interpreted in different words and include various definitions.

Fiduciary relationships are one of the most disputed relationships and they regularly come up in bank and customer litigation cases. According to the Law Commission, the duty of fiduciary can be explained:

Broadly speaking, a fiduciary relationship is one in which a person undertakes to act on behalf of or for the benefit of another, often as an intermediary with a discretion or power which affects the interests of the other who depends on the fiduciary for information and advice.<sup>330</sup>

As was stated above, it has to be highlighted that in the case of ordinary banking transactions, the relationship between a bank and its customer is purely contractual and expressed terms and implied terms of the contract will govern the relationship. There would be no fiduciary relationship or any other type of relationship.<sup>331</sup>

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<sup>326</sup> Proctor (n 312) 300.

<sup>327</sup> *Foley v Hill* (1848) 2 HLC 28.

<sup>328</sup> Proctor (n 312) 300–301.

<sup>329</sup> LS Sealy and RJA Hooley, *Commercial Law* (Oxford University Press 2009) 615–619.

<sup>330</sup> Para 1.3 of the Law Commission Report No.236

<sup>331</sup> Charles Hewetson and Nicholas Elliot, *Banking Litigation* (first published 1999, Thomson Reuters 2011) 33; for more details, see *Bank of Scotland v A Ltd* [2001] 3 All E R 58 *per* Lord Woolf M.R. at [25].

#### 4.2.2 Duties and obligations owed by a bank to its customers and vice versa

As was explained above, the main method of regulating and governing the relationship between a bank and its customers is a contract. A contract is a mechanism that sets the rights and duties between the parties and is, in fact, the main source of obligations and duties between parties.

The bank-customers relationship is based on a contract and obviously there are duties and obligations alongside the contract and which are integral to it.

Similar to any other contract, there may be different categories of terms, such as implied terms, expressed terms or statutory terms, present in a banking contract. Express terms are those that both the bank and the customer have incorporated into the agreement and are both are aware of. Implied terms are terms that are not expressly written in the contract but all parties know that the fulfilment of the terms is vital to the contract. For instance, banks have a duty to use reasonable skill and care when providing services to their customers. This term may not have been expressly stated in the contract itself, but both parties would expect that the existence of such a duty is an implied term in the contract. Some of the most important implied terms were discussed in the early case of *Joachimson v Swiss Bank Corp.*<sup>332</sup> The Court of Appeal held that based on the nature of the contractual relationship between the bank and its customer, the court is allowed to imply the terms, which are as follows: First, the term has to be vital for the efficiency of the business in the contract. Second, the term has to be very obvious to the completion and performance of the contract that its absence would be absurd. Third, the question of whether the term has been standardised in a particular type of contract. Fourth, whether the term is part of the customary trade usage and custom of the business in question.<sup>333</sup>

Statutory terms are imposed upon both parties as a result of banking codes or statutory measures. For instance, duties set out in the Financial Services and Markets Act 2000 (FSMA) for banks are part of the statutory terms in a banking contract that neither party has the right to waive.

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<sup>332</sup> [1921] 3 KB 110.

<sup>333</sup> Sealy and Hooley (n 328) 623.

Generally speaking, despite contractual obligations that are sourced directly from the contract, the main duties of a bank are:<sup>334</sup>

- duty to advise;
- duty to take reasonable care when performing a service for the customer;
- duty to keep customer's affairs confidential;
- duty to act in good faith;
- fiduciary duty (under some special circumstances).

In the vast majority of cases, disputes and disagreements arising out of banking contracts are related to these duties and obligations, and the parties' conflicting views as to the extent of these obligations. Some of the abovementioned duties are self-explanatory, such as the bank's duty to take reasonable care in the delivery of a service to its customers, whereas others, such as the duty to advise or confidentiality, are more controversial in the banking industry.

It may seem rather peculiar that a duty to advise is imposed on banks, just after it was stated that the relationship between a bank and its customer is of a contractual nature. Parties to a contract should not and would not normally expect to be advised by the other party as to the risk or other matters involved in the contract. Therefore, this duty of advice imposed upon banks is a unique feature in banking transactions.<sup>335</sup> In general, the bank's obligation to advise customer is enforced – or not enforced – on banks by law, and if there is no regulatory framework on this issue, the bank is not under any obligation to advise the customer.<sup>336</sup>

The duty of confidentiality or secrecy, which is owed by banks to their customers, is one of the more widely discussed bank duties, albeit may seem a straightforward concept. Arguably, performing this duty in the practice of banking is relatively challenging.<sup>337</sup> The bank's duty of confidentiality is not just a moral duty, it is, indeed, a legal obligation that the bank owes to its customers as an implied contractual term.<sup>338</sup>

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<sup>334</sup> Hewetson and Elliot (n 330) 21.

<sup>335</sup> Cranston (n 8) 206.

<sup>336</sup> Hewetson and Elliot (n 330) 23.

<sup>337</sup> Cranston (n 8) 167.

<sup>338</sup> Sealy and Hooley (n 328) 689.

This duty of confidentiality is discussed in the 1924 case of *Tournier v National Provincial and Union Bank of England*<sup>339</sup> where the judges in the Court of Appeal found that this duty existed for banks.<sup>340</sup> Although this case is one of the most cited cases in banking law and it is the founding case of a bank's duty of confidentiality, the practicality of the case in instituting the nature of this duty has been doubted by leading banking law scholars.<sup>341</sup> Nonetheless, there are some well-established principles that were concluded from this 1924 case and which can still be used today.

It has to be noted that this duty of confidentiality is not an absolute duty and is, indeed, a qualified duty.<sup>342</sup> The principles stemming from the *Tournier* case allow a bank to avoid the duty of confidentiality and disclose customers' information under some exceptional circumstances. For example, where the bank is compelled by law or by financial legal authorities such as the FCA or Prudential Regulation Authority (PRA) to disclose the information and there is in fact compulsion by law, or where the bank has a public duty to disclose the customer's information and there is a matter of public interest involved in the case, or if the bank's own interests necessitate the disclosure of information, or, finally, where the customer has consented to the disclosure of information (preferably in writing).<sup>343</sup> Overall, the issue of confidentiality is one of the major concerns for banks, both at the time of litigation and even prior to litigation.<sup>344</sup> The fact that banks are obliged to keep certain banking activities confidential and private can clearly affect their choice between arbitration and litigation.<sup>345</sup>

However, as it was highlighted above, the bank-customer contract is not the only source of obligations. There are other sources that affect the bank-customer relationship and create obligations and duties for both parties. There are two main sources that may influence this relationship: the Banking Code and statute. Under English law, the Banking Code was first published in March 1992<sup>346</sup> and was terminated in November

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<sup>339</sup> [1924] 1 K.B. 461

<sup>340</sup> Cranston (n 308) 168.

<sup>341</sup> *ibid* 169.

<sup>342</sup> 'The Banker's Duty of Confidentiality to the Customer' (2005) 45 *Ombudsman* (Financial Ombudsman Services, April 2005) <[http://www.financial-ombudsman.org.uk/publications/ombudsman-news/45/45\\_bankers\\_duty.htm](http://www.financial-ombudsman.org.uk/publications/ombudsman-news/45/45_bankers_duty.htm)> accessed 10 June 2015

<sup>343</sup> Cranston (n 8) 174–181,

<sup>344</sup> For more on confidentiality in banking and arbitration, see section 3.4.1.

<sup>345</sup> See section 3.4.1.

<sup>346</sup> Howard and Masefield (n 317) 83.

2009 after the financial crisis. The Banking Code was replaced with FSA. This establishment produces policies and guidelines for good banking practice.

### **4.3 Doctrine of freedom of contract and the rationales behind it<sup>347</sup>**

The concept of a contract is understood by most people, as they have entered into a contractual arrangement at some point in their lives. Simple examples are purchasing a coffee in the morning or a train ticket when travelling to work. At the heart of most legal relations lies a central legal institution, which is the law of contract.

The law of contract has its roots in several economic theories and there is a significant link between sets of economic, social and political values and the law of contract. Contracts come in various shapes and forms. Some contracts involve private law matters, such as marriage contracts, employment contracts, insurance contracts, sale of goods contracts and banking contracts, such as consumer credit contracts.<sup>348</sup>

The law of contract is mainly based on theories that try to explain the operation of the law of contract.<sup>349</sup> One of the prevalent theories is the will theory, which is linked to the laissez-faire philosophy. In this theory, the law of contract and contractual obligations, as well as the enforcement element, are all associated with the free will of the contracting parties.<sup>350</sup> According to McKendrick, 'freedom of contract' and 'sanctity of contract' are dominant ideologies in this theory.<sup>351</sup> However, today this theory is not as solid as it was previously and as a result of the development of other theories, such as consideration theory, frustration theory, duress theory and illegality theory, the will of the parties is largely discredited and, therefore, the will of the party is not the only dominating factor in the formation and operation of contracts.

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<sup>347</sup> Arbitration is in fact an extension of freedom of contract at the jurisdictional level.

<sup>348</sup> This research (as pointed out earlier) deals with commercial contacts in a sense that includes commercial contracts and financial transactions.

<sup>349</sup> Ewan Mckendrick, *Contract Law* (first published 1990 Palgrave, Macmillan 2011) 2.

<sup>350</sup> *ibid.*

<sup>351</sup> *ibid* 3.



The doctrine of freedom of contract is one of the fundamental theories in modern law of contract. This theory establishes the formation doctrine in contract law.<sup>352</sup>

It has been argued that the doctrine of freedom of contract theory is a consequence of the laissez-faire<sup>353</sup> economic theory, which was a dominant economic theory during nineteenth century. Laissez-faire or economic liberalism is an economic theory which would follow in a liberalism society. In a liberalist society, legal frameworks should be designed to facilitate the society's economic activities.<sup>354</sup>

Different interpretations may defend the laissez-faire approach. The philosophy behind this theory is the right of freedom of choice between individuals. Anyone can make a choice that is in their own best interest. In this type of market, state regulation is not needed and may indeed be considered unnecessary.

In a laissez-faire society, private individuals should be free from interventions by the state and/or government in their business activities. The rules of private law are considered as an appropriate mechanism to establish and maintain this self-regulating feature<sup>355</sup> by combining freedom and order in a market economy.<sup>356</sup> The role of private law in this sense is to provide a set of legal frameworks in which parties can arrange their business activities and give them legal shape.<sup>357</sup> However, as it will be discussed below in this chapter, the argument is that under some special circumstances, this freedom of parties may be restricted by the state's involvement in the formation and regulation of contracts between individuals. The fact that there is no freedom for parties to insert an arbitration clause in consumer banking transactions, for example, shows that parties' powers have been limited.

In a private law system, rules are designed and applied by the authorities rather than the state. The government may legislate the law but it would not enforce the right; as this is a

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<sup>352</sup> Brian H Bix, *Contract Law, Rules and Theory, and Context* (Cambridge University Press 2012) 43.

<sup>353</sup> Laissez-faire is one of the economic theories that believes private parties should be free of a state's intervention in their transactions.

<sup>354</sup> Mahmood Bagheri, *International Contracts and National Economic Regulation* (Kluwer Law International 2000) 11.

<sup>355</sup> In a market economy prices are set freely and the rules of supply and demand govern.

<sup>356</sup> Manfred E. Streit, 'Economic Order, Private Law and Public Policy' (1992) 148(4) *Journal of Institutional and Theoretical Economics*, 675

<sup>357</sup> Bagheri (n 353) 11.

private law system it is up to individuals to enforce their rights.<sup>358</sup> Rights and obligations are based on voluntary actions and can easily be replaced by new arrangements between the parties. As a result, the market is largely self-regulated and outside state control. Party autonomy and party freedom are fundamental concepts in such a market.

The essential feature of contract law in a market economy society is freedom of contract in the sense that parties have the free choice to make their own contracts based on their desired terms.<sup>359</sup> This is a liberal attitude towards contract law and gives overwhelming importance to the parties and their free will. This important element of contract law has, in practice, greatly affected the operation of contracts.<sup>360</sup> In this regard, contracting can be described as ‘a self-interested competitive exchange, subject only to minimal rules of fair play’.<sup>361</sup>

During the nineteenth century, there was worldwide industrialisation: societies were looking for increased wealth and more economic transactions so as to participate in the wave of commercialisation. Freedom of contract enabled those who were engaged in business activities to regulate their own affairs with minimum or no intervention from the state. Courts may have been involved, but only if there was a dispute between parties and they have were asked to resolve the dispute.<sup>362</sup>

Freedom of contract has two aspects. According to this doctrine, first, one has the freedom to enter into an agreement (contract) with whomever one wishes. The second aspect is that the subject matter of the contract can be decided by the parties. Parties to a contract can decide freely on the content of the contract. The application of this theory to contracts may result in unwise or unfair bargains between parties in practice, subject to the fact that parties have entered into those contracts of their own free will.<sup>363</sup> The courts would not normally become involved to protect parties who have entered into these contracts as they have been exercising their freedom to contract.

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<sup>358</sup> *ibid* 11.

<sup>359</sup> *ibid* 12.

<sup>360</sup> *ibid*.

<sup>361</sup> *ibid*.

<sup>362</sup> Richard Stone, *The Modern Law of Contract* (first published 2002, Routledge. Cavendish 2005) 3.

<sup>363</sup> *ibid* 4.

The fact that contracting parties in a transaction may suffer losses or damages if the transaction turns out to be unfortunate is considered as a fair and just risk only if the parties have the same bargaining power in the process of the contract.<sup>364</sup> Hence the existing doctrine of freedom of contract and the importance given to the will of parties' justifies the enforcement of agreements.<sup>365</sup>

One may ask whether the private self-regulating approach can replace public regulation. To answer this question, a line should be drawn between different business activities in an economy. In some activities and economic transactions, such as loan agreements, a private self-regulatory mechanism may be sufficient to govern different aspects of the activity, such as rights and obligations. Whereas in some other transactions, such as securities transactions, there must be involvement of public regulation and government to protect the undertaken activities which, in the case of securities transactions, is protection of investors.

#### **4.4 Evading/qualifying the doctrine**

Freedom of contract is not an absolute doctrine and it is, in fact, a qualified principle. This doctrine can be restricted for various reasons. For instance, the application of implied terms in the contract may seem contrary to the basic principles of this theory. According to this theory, parties to an agreement are bound to the chosen terms of the agreement. They have consented to all the express terms in the agreement. However, in practice, there are circumstances where parties may find themselves in a situation in which they have not agreed to the terms of an agreement but are still held responsible. This is the case with implied terms of an agreement.<sup>366</sup>

There are other areas where the principle of freedom of contract has been restricted. These are discussed in the section below.

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<sup>364</sup> William Lucy, *Philosophy of Private Law* (2007 Oxford University Press) 405.

<sup>365</sup> Bix (n 351) 132.

<sup>366</sup> *ibid* 55.

#### 4.4.1 Exclusion clauses or exemption clauses

One of the areas in which the scope of freedom of contract may be limited is the exclusion clause. Exemption clauses in a contract are those terms that limit or exclude the liability of one party. Exemption clauses in contracts are very common and their introduction may limit the party's liability or evade all together. At first glance, exemption clauses may seem similar to other terms of the contract that both parties have voluntarily agreed to. However, the courts have attempted to regard these terms as a separate category and apply a different set of rules to them when addressing them in cases that come before them. In fact, judges are reluctant to give effect to exemption clauses in a contract in practice (depending on the extent of the exemption clause). The reason for this reluctance is possibly the inequitability nature of these terms.

#### 4.4.2 Paternalism

Another principle that may seem to have limited the freedom of contract and free choice of parties is that of legal paternalism.<sup>367</sup> Under this principle, the state (or perhaps legal authorities) may restrict the actions of individuals, regardless of their will, in order to protect them from their own actions. An example is in the case of minors and individuals with mental disabilities, where the concept of contractual incapacity is designed to protect these two groups.<sup>368</sup>

In contract law, the question may be whether parties' preferences are, in fact, in their own best interests<sup>369</sup> and, if it becomes evident that those preferences are not for their own good, the further question is whether the parties' autonomy should be set aside and the state interfere. Paternalism is a theory that justifies state intervention in the market to protect consumers and investors.

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<sup>367</sup> A full analysis of paternalism is outside the scope of this chapter.

<sup>368</sup> Michael J Trebilcock, *The Limits of Freedom of Contract* (Harvard University Press 1993) 147.

<sup>369</sup> *ibid.*

It has to be noted that there are debates around the legitimacy of this theory. For instance, Trebilcock has quoted from John Stuart Mill<sup>370</sup> to argue that:

His own good, either physical or moral, is not a sufficient warrant [for invading his liberty]. He cannot be rightfully compelled to do or forebear because it will be better for him to do so, because it will make him happier, because in the opinion of others, to do so would be wise ... these are good reasons for remonstrating with him, or reasoning with him, or persuading him, or entreating him, but not for compelling him with any evil in case he do otherwise.

One of the crucial issues when applying and approving paternalism theory is the question of how it is possible to do good for someone by prohibiting them from achieving their own wishes.<sup>371</sup> The controversial issue is that while paternalism claims to protect the market by protecting individuals, it is against the fundamental policies of a free market where parties' free choice is of great importance.

It may be possible to reconcile the above-mentioned conflicting paradigm by stating that market participants have consented to state regulation in the market, which may be in contrast with their wishes, to protect them from their own mistakes. This may seem a rational view as, in practice, consumers are willing to forsake their freedom of choice in the market so as to enjoy state protection.

#### 4.4.3 Doctrine of inequality of bargaining power

This theory deals with the equality of parties at the time of conducting the contract.

It is not clear when this doctrine started to exist. McKendrick believes that the source of this theory lies in the judgment of Lord Denning in the case of *Lloyds Bank v Bundy* [1975]<sup>372</sup> where there was a dispute between an elderly man and Lloyds Bank.<sup>373</sup>

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<sup>370</sup> *ibid*148.

<sup>371</sup> Gerald Dworkin, 'Paternalism' in Edward N. Zalta (ed), *The Stanford Encyclopedia of Philosophy* (summer 2014 edition) <http://plato.stanford.edu/archives/sum2014/entries/paternalism/> accessed 10 January 2016.

<sup>372</sup> *Lloyds Bank v Bundy* [1975] QB 326.

<sup>373</sup> McKendrick (348) 305.

In this case, Mr Bundy was an elderly farmer and both he and his son held bank accounts with Lloyds for many years. His son also held his company's bank account with the same branch. The father had guaranteed the son's company overdraft for a charge of £7,000 over his farm (his only property). Mr Bundy (the father) had consulted a solicitor and was advised that he could not afford to put more than this amount into his son's business.

Later, his son and the bank manager went to visit the father and requested him to increase the security amount for the overdraft to £11,000. The elderly Mr Bundy, based on the advice that he received from the bank manager, signed the charge document that the son and bank manager had brought with them.

The son's debt defaulted and the bank tried to enforce the charges to obtain the father's house. The elderly Mr Bundy claimed that he relied implicitly on the bank manager's advice at the bank where he had held an account for several years. The bank manager was, in fact, acting on behalf of bank as well as advising Mr Bundy and, therefore, had a conflict of interest. The elderly Mr Bundy was given no opportunity to seek independent legal advice in relation to the increased charge.

Lloyds Bank was not successful and the charge was set aside, with the guarantee being removed, based on the undue influence and the inequality of bargaining power.<sup>374</sup> The controversial judgment given by Lord Denning established general principles of inequality of bargaining power:

English law gives relief to one who without independent advice enters into a contract upon terms which are very unfair or transfers property for a consideration which is grossly inadequate, when his bargaining power is grievously impaired by reason of his own needs and desires or by his own ignorance or infirmity, coupled with undue influence or pressures brought to bear on him by or for the benefit of the other.<sup>375</sup>

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<sup>374</sup> Jill Poole, *Case Book on Contract Law* (Oxford University Press 2006) 656.

<sup>375</sup> [1975] QB 326.

Overall, the application of this theory in the courts is rather limited and courts are not willing to interfere in contracts merely based on the argument of inequality of bargaining power.<sup>376</sup>

#### 4.4.4 Public policy

One of the significant areas where freedom of contracts has been limited is in transactions where a matter of public policy is involved. In fact, public policy is one of the most frequently argued reasons for limiting the principle of freedom of contract.

There are several categories where public policy requirements stop contracting parties from exercising their right to freedom on terms of the contract. However, for the sake of discussion in this research, banking and financial transactions are good examples to show the intervention of the state. As was explored in previous chapters, banking- and finance-related transactions are subject to state regulations and parties involved in the market transaction are not free to trade as they wish. The state and government monitor and regulate this area in order to protect consumers against banks and finance giants.

It can be argued that for the above-mentioned reason, one may not be able to acknowledge the existence of freedom of contract and party autonomy in market-related agreements. Moreover, in an ordinary consumer agreement, whether both parties fully assented to the terms of the agreement, is a question that may need to be investigated.

The primary players in a financial market are investors and consumers. To make viable choices in their business activities, both have to have great deal of information about financial products. However, in practice, normally there is a case of information asymmetry and possible insider dealing in the market.

Freedom of contract is restricted in financial markets and the banking industry. As a result of regulatory frameworks in these environments, parties to financial agreements are restricted to rules in relevant regulations.

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<sup>376</sup> Daniel D Barnhizer, 'Inequality of Bargaining Power' (2005) 79 U. Colo. L.Rev. 139  
<[http://heinonline.org/HOL/Page?handle=hein.journals/ucollr76&div=10&g\\_sent=1&collection=journals](http://heinonline.org/HOL/Page?handle=hein.journals/ucollr76&div=10&g_sent=1&collection=journals)>  
accessed 27 May 2015

It may be argued that one of the reasons why arbitration is not as popular in the banking and finance sector as it is in the commercial world is the fact that there are limits imposed on parties' choice and authority to choose their favoured dispute resolution mechanism. As this is a highly regulated environment, parties have to follow the regulations and do not have much of a say.

However, it has to be stated that the limited use of arbitration by the banking industry is not due to the regulatory limits on the freedom of contract. It can be validly argued that, for the sake of consumer protection, there should be some limitation on the freedom of contract, including the freedom of choice of arbitration in consumer-related contracts.

#### **4.5 Disputes involving banks and possible ways to settle them – dispute resolution clause in banking contracts**

Disputes and conflicts are sometimes unavoidable in transactions. Any wise contracting party should include a clause in the main agreement to deal with any disputes that may arise. Dispute resolution clauses direct the parties to the relevant authority in order to settle the conflict between them. These clauses are terms incorporated into agreements and are, in fact, part of the main contract.

It has been argued that the dispute resolution clause is different from other terms of the contract in the sense that it deals with a more sensitive issue – the choice of a competent jurisdictional authority.<sup>377</sup> The fact that private parties have the power to exclude courts, which are the judiciary element of the state, can be regarded as limiting courts authority.<sup>378</sup> This argument and the conflict between private and public powers have made the issue of dispute resolution even more complex and technical.<sup>379</sup>

Banks are faced with legal actions on a regular basis. The daily caseload of a court shows that a large number of cases involve bank-related matters. Disputes that banks may

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<sup>377</sup> Zheng Sophia Tang, *Jurisdiction and Arbitration Agreements in International Commercial Law* (Routledge 2014) 2.

<sup>378</sup> *ibid* 156.

<sup>379</sup> *ibid*.



become involved in vary from business to business and business to customer. Some of the most frequent types of disputes in the banking area are:<sup>380</sup>

- loan recovery;
- enforcement of security or guarantees;
- disputes relating to credit cards;
- customer complaints about overcharging;
- claims against banks for negligent advice;
- issues with letters of credit;
- syndicated loan agreements;
- disputes between banks resulting from bank-to-bank transactions.

Clearly, the legal actions and complaints that banks face goes beyond this list and the list is not extensive. This list suggests some possible legal actions in which banks may be involved and in which they may require an effective mechanism for dispute resolution. Bank litigation is no longer a straightforward matter as a result of the increased variety and complexity of the services offered by banks and financial institutions.<sup>381</sup>

Once a dispute arises between a bank and a customer, it has to be resolved. Generally, there are different avenues available to resolve disputes: litigation, alternative dispute resolution (ADR) and arbitration.

Banks have favoured litigation for many years. However, sometimes ADR is used in the resolution of bank disputes. Looking at both national and international banking disputes, there are some developments as to the use of ADR and arbitration in resolution of banking disputes.

In the UK, according to the standard practice, complainants concerning banks must start with bank's own internal dispute resolution procedure.<sup>382</sup> Banks are required to establish written complaint-handling procedures for customers and provide their customers with a copy of the rules and guidelines of the internal grievance body.<sup>383</sup> Clearly, each bank has

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<sup>380</sup> David Leibowitz and Claire Lester, 'Banking and Finance Disputes' in Russell Caller (ed) *ADR and Commercial Disputes* (Sweet and Maxwell 2002) 13.

<sup>381</sup> *ibid.*

<sup>382</sup> Hewetson and Elliot (n 330) 70.

<sup>383</sup> Graham Roberts, *Law Relating to Financial Services* (Global Professional Publishing 2009) 4.

its own internal compliant procedure.<sup>384</sup> According to the banking code of practice, if the dispute is not settled within eight weeks, the customer can refer the matter to the FOS authorities.<sup>385</sup>

In the case of international banking, more legal problems may arise in the process of dispute handling. If more than one system of law applies to the contract, potential legal challenges will be present in the case. As it was stated above, it is common practice for banks to rely on litigation instead of arbitration or any other ADR mechanism.<sup>386</sup>

If the case is litigated, the standard rules of conflict of laws will be applied to the foreign element in the case, and the court will use the rules of its jurisdiction to decide whether it can deal with the case and what law should be applied, which is called applicable law or proper law.<sup>387</sup> Each jurisdiction has its own rules of private international law or conflict of laws system that determines the question of compatible jurisdiction and the applicable law in cross-border transactions where the choice of law is omitted.<sup>388</sup>

This function of determining the correct jurisdiction by the courts and finding the applicable law is always a time-consuming and complex matter. Parties to an international contract (whether it be a banking contract or other commercial contract) can easily avoid this hassle by indicating the choice of law in the contract. An example of the choice of law clause is: ‘This agreement shall be governed, construed and interpreted in accordance with the laws of England and Wales.’<sup>389</sup>

Several factors affect the parties in terms of the appropriate choice of law. In international trade, factors such as the location of the performance, the delivery of goods or trade customs may affect the choice. In the international banking context, the most important factors affecting this choice have been always tradition and convenience.<sup>390</sup>

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<sup>384</sup> To see Barclays Bank as an example:

<<http://www.barclays.co.uk/ContactUs/HowtoComplain/P1242559890096>> accessed 12 January 2016 .

<sup>385</sup> Roberts (n 382) 4.

<sup>386</sup> George Walker, ‘Bank Remedies: Judicial and Arbitral Recovery’ in Norbert Horn and Joseph J Norton (eds). *Non-Judicial Settlement in International Financial Transactions* (Kluwer Law International 2000) 43

<sup>387</sup> Andrew Haynes, *The Law Relating to International Banking* (Bloomsbury Professional Limited 2010) 1

<sup>388</sup> Carole Murray, David Holloway and Daren Timson-Hunt, *Schmitthoff The Law and Practice of International Trade* (first published 1948, Sweet & Maxwell 2012) 498.

<sup>389</sup> *ibid* 2.

<sup>390</sup> *ibid*.

Banks have always tried to include an applicable law clause in the contract so that the law is that with which they are familiar.

The issue of express choice of law is an integral part of each international transaction, and banking transactions are no different. In a case where parties have omitted to include an express choice of law in the agreement, the operation of contract and, more importantly, the dispute resolution process may become problematic for both the parties and the courts.

In the absence of a choice of law clause (governing law clause) the proper law will be determined by applying the Rome I Regulation<sup>391</sup> in the courts of England and Wales.<sup>392</sup> Rome I Regulation provides guidelines to determine the proper law if there is no clear choice of law incorporated in the main contract and it is applicable to contracts entered into on or after 17 December 2009. This Regulation recognises parties' freedom to choose the applicable law of the contract, whether implied or expressed.<sup>393</sup> In circumstances where parties have omitted to indicate the governing law of the contract, the court can determine the appropriate law by applying Articles 4–8 of the Regulation. The purpose of this Regulation was to create a unified set of rules for European courts when they deal with conflict of law matters.<sup>394</sup>

However, it has to be highlighted that this Regulation is only applicable to EU Member States and non-member countries have to apply other conflict of law rules, which may vary from one jurisdiction to another.

In addition to the governing law of the contract, there is another issue that has to be addressed by the parties to international transactions, and that is the issue of jurisdiction. A jurisdiction clause will specify which court has jurisdiction over any disputes arising out of the contract. If the parties failed to incorporate a jurisdiction clause into their agreement, after the dispute has arisen, each party may start the proceedings against the

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<sup>391</sup> Rome I Regulation (EC) 593/2008. EU regulations have immediate effect and are directly enforceable.

<sup>392</sup> Murray, Holloway and Timson-Hunt (n 387) 501.

<sup>393</sup> Article 3(1).

<sup>394</sup> Murray, Holloway and Timson-Hunt (n 387) 504.

other in their own favoured jurisdiction and, consequently, more than one court will be involved in the same dispute.<sup>395</sup>

Overall, parties to a contract with an international element have to make sure that both a governing law of the contract clause and a dispute resolution clause have been incorporated in their contract. A dispute resolution clause may require parties to refer the conflict to either a selected court or jurisdiction, or to a selected arbitral panel. If parties neglect to address the issue of these clauses, the operation of the contract and, more importantly, possible dispute handling in the future will be a complex matter.

Therefore, it can be argued that by incorporating an arbitration clause in cross-border contracts, all the trouble associated with choice of law, whether it is governing law or proper law, can be avoided. Arbitrators, unlike judges, do not belong to any legal jurisdiction. According to an American court, ‘the chief advantage of arbitration is the ability to resolve disputes without aspects associated with the legal systems’.<sup>396</sup>

#### **4.6 ADR in UK banks**

It was discussed above that banks traditionally have mainly favoured litigation over arbitration in international banking disputes.<sup>397</sup> Until recently, parties have not often chosen the dispute resolution mechanism in financial and banking sector. For many years the standard procedure was proceedings in the state court (forum choice), and arbitration had a limited role in this industry.<sup>398</sup> In recent years, in light of the judiciary’s policies to encourage individuals to use ADR in their legal disputes, there has been a movement to solve disputes arising in relation to banks and financial institutes with ADR methods. The aim is to reduce the number of cases referred to litigation and thereby to enable the courts to manage their case load more efficiently. In England and Wales, FOS and city dispute panels are among the groups that offer ADR services.

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<sup>395</sup> *ibid* 538.

<sup>396</sup> *Delaware Coalition for Open Government v Strine* [2012] WL 3744718.

<sup>397</sup> Hewetson and Elliot (n 330) 65.

<sup>398</sup> Inka Hanefeld, ‘Arbitration in Banking and Finance’ (2013) 9 NYU Journal of Law and Business 917–918.

In 2001, the FOS replaced the Banking Ombudsman, which had been in existence since January 1986.<sup>399</sup> This body was created as part of the FSMA. The aim was to create an establishment that would be in charge of the settlement of disputes between consumers and small businesses on one side and banks or financial institutes on the other side.<sup>400</sup>

FOS replaced all the existing redress schemes already in place:<sup>401</sup>

- Banking Ombudsman;
- Building Societies Ombudsman;
- Investment Ombudsman;
- Insurance Ombudsman;
- Personal Insurance Arbitration Service;
- Personal Investment Authority Ombudsman;
- Securities and futures authority complaints bureau and arbitration scheme;
- Financial services authority directs regulation unit and independent investigator.

One of the most significant features of FOS is that those hearing the cases take into account substantive fairness. This issue of fairness has always been one of the essential features in dispute handling by ombudsmen.<sup>402</sup>

Normally there is not a face-to-face hearing if disputes are brought to FOS and instead are dealt with on paper submissions.<sup>403</sup> FOS focuses on early resolution of disputes by way of offering an opportunity to individuals and small business to issue a complaint against giant banks and financial institutions. Although the basis of the decision is fairness, as was traditional for ombudsmen,<sup>404</sup> in practice FOS tends to resolve a considerable number of cases where both parties are happy with the final outcome.

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<sup>399</sup> Hewetson and Elliot (n 330) 70.

<sup>400</sup> Financial Ombudsman Services official website: <<http://www.financial-ombudsman.org.uk/about/aims.htm>> accessed 10 August 2015.

<sup>401</sup> Rhoda James, 'The New Dispute Resolution System in the UK Financial Services Industry' [2002] J.I.F.M 191.

<sup>402</sup> *ibid.*

<sup>403</sup> *ibid.*

<sup>404</sup> *ibid.*

The City Dispute Panel<sup>405</sup> (CDP) was created in 1994 in the City of London and offers dispute resolution services to the financial sector. It has its own rules for arbitration, mediation, conciliation and expert determination. Experts on this panel apply CDP designed rules alongside the Arbitration Act 1996 provisions. It is claimed that CDP is a body that was created to provide dispute resolution services to commercial and business activities and to protect their commercial image and reputation.<sup>406</sup>

CDP panellist, people who are acting as either arbitrators or mediators, are known to be neutral and independent as well as having sufficient knowledge and experience of the market and industry.<sup>407</sup> All this, can make CDP as an appealing option for banks and their customers to direct their conflict resolution process to this institute.

CDP has a model clause that is frequently used in arbitration agreements for financial disputes:

Clause A Arbitration

(x) Any dispute or difference arising out of or in connection with this [Contract] shall be referred to arbitration under the Arbitration Rules of The City Disputes Panel in force at the date the dispute or difference arises.<sup>408</sup>

## 4.7 Conclusion

This chapter illustrated the nature of banking disputes. It explained that banking transactions are of a contractual nature. The nature of banking transactions and contract law rules and theories of contract law will help to better understand the place of arbitration in banking contracts.

A bank's decision on the choice of litigation or arbitration (or any other form of ADR) can have a considerable impact on the outcome of a case and the entire handling of the dispute process. Litigation and court proceedings proved to be a more desirable choice for bankers, and the reasons for this popularity need to be explored further. It was

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<sup>405</sup> City Dispute Panel, for further details see

<<http://www.citydisputespanel.org/index84d3.html?article=1&lang=english>> accessed 12 January 2016

<sup>406</sup> Hewetson and Elliot (n 330) 66.

<sup>407</sup> *ibid.*

<sup>408</sup> Contract clauses, City Dispute Panel, available at:

<<http://www.citydisputespanel.org/indexaa7b.html?article=9&lang=english>> accessed 30 August 2015.

examined whether this unpopularity of arbitration in banking transactions could be because of the limitations imposed on these types of contracts as result of banking regulations or perhaps the restrictions on freedom of contract. The answer is negative. Banks did not favour arbitration in the past and it was not because of the existence of regulatory frameworks, nor was it because parties' powers were restricted because of there being a banking transaction in question. This unpopularity was mainly because of other reasons, such as the bankers' familiarity with courts and the nature of the banking disputes, which, at the time, were not complicated and, therefore, did not require expert arbitrators. The actual reasons for bankers' reluctance were discussed in Chapter Three.<sup>409</sup>

The suitability of international arbitration has to be considered by taking into account the banking dispute in question. Presumably, arbitration as a private means of dispute resolution may not be an appropriate choice in all banking disputes, but be an advantageous method in some specific types of disputes. It seems that in areas such as bank guarantees and loan agreements, international arbitration have successfully delivered parties expectations, and in finance sector, derivatives disputes benefit from arbitration clauses in the International Swaps and Derivatives Association (ISDA) agreement. This topic is discussed further in the next chapter.

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<sup>409</sup> See sections 3.5 and 5.1.1.

## Chapter Five

### Compatibility of Arbitration for Banking Dispute Resolution

#### 5.1 Introduction: Contemporary role of arbitration in banking and financial sector – change of landscape

Traditionally, arbitration and alternative dispute resolution (ADR) have never been popular among bankers and there has been always reluctance in the banking sector to use arbitration.<sup>410</sup> According to some leading practitioners in banking and finance sector, bankers had a ‘herd mentality with a strong respect for customs’, and there are other reasons for banks’ unwillingness to try private adjudication.<sup>411</sup>

For various reasons, bankers have always been unwilling to use arbitration as a dispute resolution mechanism notwithstanding borrowers’ potential interest in using arbitration. However, there is no established trend and practice learnt from the borrowers’ side. The views among borrowers, whether they are interested in arbitration as a means of dispute resolution in their agreement with banks or not, are rather mixed. It has been discussed that in some cases, because of the weaker bargaining power of the borrower, the lender imposes their favoured dispute settlement mechanism, which is normally a clause giving jurisdiction to the lender’s national courts.

Banks, in general, seek equitable settlements or what is known as ‘split the baby’ awards.<sup>412</sup> In the majority of cases, lenders (banks) seek an award that would entitle them to payment of the borrower’s debt. This can be achieved easily in the national courts in the banks’ jurisdiction.

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<sup>410</sup> Andy Moody and Yang Zhao, ‘P.R.I.M.E Finance: The New Arbitral Institution’ (*The In-House Lawyer Eversheds*, 3 July 2012) <<http://www.inhouselawyer.co.uk/index.php/financial-services-and-regulatory/9901-prime-finance-the-new-arbitral-institution>> accessed 22 February 2016

<sup>411</sup> William Park, ‘Arbitration in Banking and Finance’ (1998) 17 Annual Review of Banking Law, 216, <[http://heinonline.org/HOL/Page?handle=hein.journals/annrbfl17&div=6&g\\_sent=1&collection=journals#219](http://heinonline.org/HOL/Page?handle=hein.journals/annrbfl17&div=6&g_sent=1&collection=journals#219)> accessed 22 June 2015,

<sup>412</sup> *ibid.*



For the past recent years, litigation was the favoured choice of banks, both nationally and internationally, as a means to resolve their disputes. Depending on the contract, the forum choice could be either the bank's home jurisdiction or one of its major financial centre's jurisdictions.<sup>413</sup> In the vast majority of cases, a forum clause would be included in the contract. Popular forum choices have been and remain London, New York and Frankfurt.<sup>414</sup>

Conversely, in recent years and in particular after the financial crisis of 2008, the use of international arbitration in the resolution of financial and banking disputes has increased. According to practitioners in banking and finance sector, arbitration has become the 'market standard' mainly in markets outside of Europe and North America.<sup>415</sup>

The pressure of globalisation and the need for a non-national forum is one of the main reasons for this growth.<sup>416</sup> Moreover, it is true that this approach is changing now because of the fact that it is easier to enforce foreign arbitral awards than it is foreign judgments in some jurisdictions. Moreover, the inefficiency of the judicial instruments in international finance called for an alternative system in which arbitration and ADR were to be replaced.<sup>417</sup>

Not only financiers, but also bankers have realised the benefits of arbitration tribunals compared to domestic courts. However, considering the previous record of bankers' and financiers' reluctance to engage in arbitration, even the current level of recognition of arbitration can be considered a success. Currently, there are several arbitration institutions in the world that provide international financial arbitration services.

The use of arbitration can be seen in some areas of consumer contracts. As discussed in Chapter Two, consumer contracts similar to banking transactions are subject to regulations. However, there are some cases where the courts have prevailing arbitration

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<sup>413</sup> Norbert Horn and Joseph Norton (eds), *Non-Judicial Dispute Settlement in International Financial Transactions* (Kluwer Law International 2000) 1

<sup>414</sup> *ibid* 2.

<sup>415</sup> Moody (n 409)

<sup>416</sup> Professor JH Dalhuisen, 'Arbitration in International Finance, The Emergence of P.R.I.M.E' (SSRN, 8 October 2012), <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2158764](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2158764)> (accessed 22 February 2013).

<sup>417</sup> Roberto G MacLean, 'The Growing Importance of Arbitration in International Finance' (2000) 6 *NAFTA Law & Bus. Rev.* 35, 36–37.

clauses incorporated into consumer contracts before them. The leading US case is *AT & T Mobility LLC v Conception*.<sup>418</sup> The US Supreme Court decided that the arbitration clause and waiver of class action were both valid terms of the contract with a consumer.<sup>419</sup>

As a result of increasing globalisation, the pure national litigation system is not considered as sufficiently efficient to deal with international finance disputes. For instance, the geographical expansion in capital markets today and the need for worldwide enforcement of decisions explain the challenges of the litigation system where the judgments may not be enforceable globally.

Also, arguably the judges may not have the required expertise when dealing with a complex issue, for example, a syndicated lending issue. This lack of expertise is another reason why national courts can be unattractive to disputing parties. Other issues, such as the possibility of corruption in some jurisdictions, as was mentioned above, the lack of relevant expertise, delays and lack of confidence are all factors that make litigation in national courts a less favoured option for the parties and instead lead them to choose arbitration.<sup>420</sup>

There is no doubt that there is considerable risk in international litigation in terms of time and costs. Additionally, the unpredictable nature of the decisions rendered by foreign courts and the subsequent challenges to enforcing foreign awards are among the factors that have encouraged finance and banking litigants towards arbitration (most commonly in cross-border transactions).

Arguably, bankers are aware of the high costs and discomfort involved in litigation. They would be reluctant to take on the risk of litigation at the risk of losing their customers as a result of the adversarial nature of litigation, and, clearly, if there is a suitable alternative to the lengthy and expensive litigation process they are willing to consider it.<sup>421</sup>

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<sup>418</sup> *AT&T Mobility LLC v Conception*, 131 S. Ct. 1740, 1745 (2011)

<sup>419</sup> Bass Berry and Sims PLC, *Supreme Court Decision Favours Arbitration Clauses in Bank Deposit Agreements* (Bass Berry Publication, 2012) < <http://www.lexology.com/library/detail.aspx?g=e4dc03d7-b552-449c-8af5-a34f573c43c4> > accessed 14 June 2015

<sup>420</sup> Jeffery Golden, 'Arbitration and International Finance' (seventh annual conference on international arbitration and mediation, King's College London, 26–27 April 2012)

<sup>421</sup> Charles Hewetson and Nicholas Elliot, *Banking Litigation* (first published 1999, Thomson Reuters 2011) 63.

However, as the number of cross-border banking transactions grows, and as more emerging markets join the world of banking and finance, the need for a neutral and independent dispute resolution mechanism is more evident. These cross-border transactions are complex and accompanied by a great deal of risk and uncertainty.

Some of the key features of international arbitration are regarded as advantageous for the resolution of finance and banking disputes.

## **5.2 Areas affected by arbitration in banking sector**

As discussed in previous chapters, the nature of banking transactions combined with the heavily regulated banking operations mean that banks may not be allowed the autonomy and freedom to choose arbitration. However, there has been a rapid increase in the extent of the attention given to international arbitration in both the banking and finance sectors in the recent years, and there are examples of the use of arbitration clauses in various banking transactions. In fact, there is a distinctive change of trend in the practice of dispute handling in these sectors. While in some cases banks may favour arbitration, in other cases the customers' preference prevails. This tendency could change when parties are involved in international financial transactions. This section deals with some main areas of banking transactions that have been affected by arbitration more than other transactions, namely loan agreements and trade finance, the latter of which includes letters of credit and bank Guarantees. The use of international investment arbitration where banks act as a foreign investor and seek arbitration as a redress is also reviewed.

### **5.2.1 Loan agreement**

The primary function of banks has always been lending. According to leading scholars in the area, 'loans are bank's assets'<sup>422</sup> and lending has always been one of the key income sources for banks both nationally and internationally.

Lending in its simplest form is accepting deposits from the public and giving the money to loan applicants. Banks are recognised as the main provider of funds required by

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<sup>422</sup> Ross Cranston, *Principles of Banking Law* (Oxford University Press 2003) 299.

borrowers. Banks offer different types of commercial lending to both public and private borrowers, but normally use the general term ‘facility’ to refer to them all.<sup>423</sup>

The most common form of lending is via a loan agreement. A loan agreement is a contract between two parties, a borrower and a lender (also known as a creditor). The subject matter of this contract is the provision of funds by the lender to the borrower. In return, the borrower is obliged to repay the funds according to the terms and conditions set out in the contract. This contract is the loan agreement.

The mechanism of lending and its structure have developed alongside the expansion of financing. Bank lending can be done for different reasons. There are different types of loans available; they can be categorised by the different characteristics in the loan agreement. For instance, loans may be characterised by the purpose of the loan. Good examples are project finance or public finance.<sup>424</sup> In the former, the loan agreement is concluded in the process of project finance. The amount of money that is provided to the project company (the borrower) is intended to be spent on a specific infrastructure or industrial project that the primary aim of the project. In the latter, the loan is provided for the purposes of public finance. In this case, the loan is to be used by the government only for the purposes that they see fit.

Loans can also be categorised based on the nature of either the borrower or the lender. A lender can be an individual bank or financial institution, or could be a combination of banks or financial institutions. The latter is known as syndicated lending, which will be explored further in the next section. On the other hand, the borrower may also have different legal personalities. A borrower may be a private individual who makes a loan request to a bank. If the bank agrees to the loan application, the loan is referred to as retail lending or consumer credit. One area where the business of lending and the arbitrability of the relevant disputes could face restrictions is that of consumer borrowing.<sup>425</sup>

Loans may be categorised based on other features, such as the term of the loan or its facilities. The former is the time period wherein the funds should be repaid by the

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<sup>423</sup> *ibid.*

<sup>424</sup> Joanna Benjamin, *Financial Law* (Oxford University Press 2007) 157.

<sup>425</sup> *ibid.*

borrower to the creditor. Facilities of the loan are conditions that have been set out by the lender (creditor) and the borrower is obliged to comply with the terms.<sup>426</sup> The four main forms of loan facilities are:

1. overdraft facilities;
2. term loan facilities;
3. revolving facilities; and
4. clearly syndicated loan facilities.<sup>427</sup>

The next section is an overview of one of the most basic types of lending that is frequently offered by banking industry.

### 5.2.2 Term loan

The most basic form of bank lending is a term loan. This is where the loan has to be repaid to the bank immediately if it is upon demand. Term loans are made for an agreed period. A short-term loan is defined as lasting a year or less; a medium-term loan is between one and five years; if longer than five years, it is as a long-term loan.<sup>428</sup>

Depending on the amount to be lent and on the legal personality of a borrower, term loan agreement documents can be simple or complex. Although the structure of a loan agreement may seem very simple as it is only a contract covering borrowing, the legal difficulties that may arise from this agreement can be complex and technical; for this reason, the drafting of loan agreements requires a mechanism to preserve the interests of the involved parties.<sup>429</sup>

At the time of drafting a loan agreement, there are key issues that both lender and borrower have to consider to create a viable and effective contract. Loan agreements are contractual in nature and, therefore, the first issue that needs to be decided is the governing law of the contract, i.e. loan agreement. Another essential matter, which needs

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<sup>426</sup> *ibid* 158.

<sup>427</sup> Cranston (n 421), 299.

<sup>428</sup> Benjamin (n 423) 159.

<sup>429</sup> Andrew Haynes, *The Law Relating to International Banking* (Bloomsbury Professional Limited 2010) 80.

to be foreseen in the actual contract, is the issue of dispute resolution and the clause to provide for this.

### 5.2.3 Syndicated lending

Syndicated lending<sup>430</sup> appeared as the size of the loans continued to grow. Syndicated lending is used where the requested size of the loan is so substantial that one bank or one financial institution cannot provide it, or perhaps the risk involved is so high that a sole bank would not wish to lend on its own.<sup>431</sup>

In circumstances where the principle amount cannot be provided by a single lender, whether it is a bank or another financial institution, syndicated lending can be undertaken by a number of lending authorities. Unlike a bilateral bank loan agreement, syndicated loan agreements can be multiparty contracts as more than one bank is lending to the borrower. The lending is conducted through a contract. The bank syndicate (also called as the bank consortium) could be a true syndicate or a participation syndicate.<sup>432</sup> The issue of disputes arising in a lending process and the dispute management process are of paramount importance in lending contracts because of their sensitive nature and the value of funds involved in these contracts.

### 5.2.4 Dispute resolution in loan agreements

In England, one of the common ways to deal with loan agreement disputes is by referring them to the Financial Ombudsman Services (FOS).<sup>433</sup> If the disputant parties are unsuccessful in resolving the matter via the bank's internal complaint-handling procedure, in the absence of a dispute resolution clause in the agreement, they would need to refer the matter to the FOS.

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<sup>430</sup> The matter of syndicated lending is beyond the scope of this research. This section deals with dispute resolution in syndicated lending.

<sup>431</sup> Cranston (n 421) 55.

<sup>432</sup> *ibid* 54.

<sup>433</sup> Financial Ombudsman services are covered briefly in Chapter Four.

Arbitration has been a desirable choice for use in all contractual disputes, especially in the developing world.<sup>434</sup> Nonetheless, the question of arbitrability of disputes arising out of loan agreements, both domestic and international, is a controversial issue. On one hand, considering the contractual nature of these agreements, which are contracts between borrowers and lenders, any restrictions on incorporating an arbitration clause into the agreement may be unacceptable. On the other hand, considering the regulatory nature of banking and financial transactions, the state may impose some limitations or restrictions on the freedom of contract, including the use of an arbitration clause in lending agreements.

It has to be noted that the forum clause is a favoured option among private borrowers and lenders of international credit.<sup>435</sup> The main drawback of this approach is where a defaulted borrower has assets in many countries, making it nearly impossible to enforce the judgment that is rendered by one particular state court; but an arbitration award has a better chance of being enforced internationally.<sup>436</sup>

It is not uncommon to see the chosen dispute-governing mechanism in term loan agreements. In recent years, it has become relatively common practice to find arbitration clauses in loan agreements. The arbitration clause could say:

All disputes arising from or relating to this Agreement shall be finally settled in accordance with the Rules of Conciliation and Arbitration of the International Chamber of Commerce in effect on the starting date of the arbitration proceeding, by one or more arbitrators to be appointed in accordance with these Rules.<sup>437</sup>

It has to be noted that the choice of international arbitration will arise (more frequently) in situations where there is an international dimension to the contract. For instance, if the borrower is a government of a developing country and wishes to obtain a loan from a well-recognised European financial institution, the loan agreement may either contain a forum clause stating the preferred jurisdiction for the formal resolution mechanism, or an arbitration clause be incorporated in the contract. In this case, and in other cases where a

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<sup>434</sup> Ilias Bantekas, 'Arbitrability in Finance and Banking' in Loukas A Mistelis and Stavros L Brekoulakis (eds), *Arbitrability, International & Comparative Perspectives* (Kluwer Law International 2009) 293.

<sup>435</sup> Horn and Norton (n 412) 6.

<sup>436</sup> *ibid.*

<sup>437</sup> Sample loan agreement template, provided as study materials for LLM programme at Institute of Advanced Legal Studies, March 2015.

state is a party to the loan agreement (such as sovereign debt), the issue of the dispute resolution mechanism may be more complicated. Clearly, the national courts of the state cannot be regarded as a choice that pleases both parties.

Although the general assumption is that the lender will have the dominate control throughout a loan application procedure, and that it is the lender that will determine the dispute resolution mechanism, Park is of the opinion that debtors have an ‘economic muscle power’ which enables them to reject a jurisdiction clause that provides for dispute resolution in the lender’s home court.<sup>438</sup> Park cites Brazil<sup>439</sup> as an a good example of a developing country in which New York law was accepted as the governing law, but international arbitration was the chosen dispute resolution mechanism.<sup>440</sup>

As touched upon above, the banking community has generally favoured litigation in the case of a dispute arising out of loan agreements. It is worth mentioning that only in a very few jurisdictions has arbitration experienced more popularity than litigation in loan agreements. Brazilian law has been providing facilities for arbitration clauses in their loan agreements for a long time.<sup>441</sup> Also, former Soviet Union countries are regular users of arbitration clauses in their loan agreements because of the lack of trust in their local courts.<sup>442</sup> One possible reason for this behaviour of banks is that court litigation traditionally produces desirable outcomes for the lender, which is usually the party with the stronger bargaining power in a loan agreement.<sup>443</sup>

The emergence of unilateral dispute resolution clauses<sup>444</sup> is evidence of the exercise of the lender’s power to choose its preferred dispute resolution mechanism. Incorporation of such clauses in a loan agreement gives the control of the dispute settlement to one party (in the vast majority of cases the lender) to elect the most appropriate settlement procedure, either arbitration or litigation, based on its own preferences.

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<sup>438</sup> William W. Park, *Arbitration in Banking and Finance* , 17 ANN.Rev. Banking , L.213 (1998) 245.

<sup>439</sup> *ibid*.

<sup>440</sup> See Deposit Facility Agreement between Banco Central do Brazil and Republica Federativa do brasil (as guarantor) and Citibank, N.A. (as agent), 22 September 1988

<sup>441</sup> Maria Davies, ‘The Use of Arbitration in Loan Agreements in International Project Finance: Opening Pandora’s Box or an Unexpected Panaca?’ (2015) <<http://www.kluwerlawonline.com/JOIA2015007>> accessed 19 June 2015.

<sup>442</sup> Davies (n 440).

<sup>443</sup> *ibid* 145.

<sup>444</sup> Unilateral dispute resolution clauses are fully discussed in Chapter Six at section 6.3.



A more complicated form of bank lending is syndicated lending; this is where arbitration and the choice of dispute resolution method can become more of a crucial issue for both borrower and lender.

The majority of international syndicated loans contain a dispute resolution clause and recent trends show that the use of arbitration is increasing in this area, especially in cases where the borrower (or its assets) is located in one of the New York Convention signatory countries, as the syndicated agreement provides for arbitration.<sup>445</sup>

### 5.2.5 Trade finance

Trade finance, or financing for trade, is a process that secures the international payment procedure in cross-border trade. Letters of credit and contract guarantees (or bank guarantees) are mainly used in international trade and international construction contracts.

Trade finance provides the secure payment process between a seller and buyer that are not residing in the same territory. As they are not both in the same jurisdiction, the issue of payment and the delivery of goods may be of concern to them, and therefore there is a need for a mechanism to ensure that both parties will keep their promises and fulfil the contract.

Different types of documents may be used in this financing process and they all are described by different names. However, in practice in England, the main documents are guarantees of bonds and letters of credit, which are commonly used by UK banks.<sup>446</sup> This research only focuses on dispute resolution processes in these two groups of banking documents.

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<sup>445</sup> Martin Hughes, *Legal Principles in Banking and Structured Finance* (Tottel Publishing Ltd 2006) 20.

<sup>446</sup> Haynes (n 428) 276.

### 5.2.6 Letters of credit

In general, there are two types of letters of credit in the commercial world: the first is the documentary letter and the second is the standby letter of credit.<sup>447</sup> The documentary letter of credit is widely used in international trade; it is one of the most common ways to secure international payment, and is a payment mechanism adopted by traders in circumstances where the seller is doubtful about the payment for the goods or services provided by the seller and seeks a secured payment mechanism. A bank can become involved to make the payment process more trustworthy for the supplier.<sup>448</sup>

In the simple letter of credit, the bank issues a letter of credit as requested by the buyer and in the interest of the seller as a guarantee of funds; then there is an advising bank that undertakes to pay the seller upon receiving the necessary documents (which vary from contract to contract). The advising bank acts on behalf of its customer, i.e. the seller.

If all the parties to the letter of credit agree, the letters of credit are subject to Uniform Customs and Practices for Documentary Credit (UCP). UCP is a code of rules produced by International Chamber of Commerce (ICC). UCP 600 is the most recent version of the code and came into force in July 2007.<sup>449</sup>

Clearly, the letter of credit being used in today's international commerce has a complicated structure. A minimum of four contracts and four parties are involved in the process of obtaining a letter of credit. It could be argued that one of the reasons why the arbitration clause has not been a popular choice in letters of credit is because of the number of contracts involved in the process. Having at least four contracts and four parties would make arbitration a rather challenging choice as the dispute resolution mechanism, especially as arbitration is normally (albeit not always) agreed by the parties at the time of drafting the contracts.

Until recently, disputes involving a letter of credit usually would be taken to the courts. Regardless of where the parties were from, the courts in London or New York would have dealt with them. For instance, in the case of *Power Curber International Ltd v*

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<sup>447</sup> Hughes (n 444) 185.

<sup>448</sup> Cranston (n 421) 384.

<sup>449</sup> International Chamber of Commerce, 'ICC's New Rules on Documentary Credits Now Available' (4 December 2006) <<http://www.iccwbo.org/news/articles/2006/icc%E2%80%99s-new-rules-on-documentary-credits-now-available/>> accessed 12 May 2016

*national Bank of Kuwait*<sup>450</sup>, the parties were from two countries (an American company and a Kuwaiti bank, respectively), yet it was the English courts that were allocated to resolve the dispute.<sup>451</sup> More specifically, Lord Denning held that the Kuwaiti bank should make the payment according to the letter of credit, and that the disputes in the main contract should not affect the letter of credit.<sup>452</sup>

It seems that this trend has been subject to some changes in recent years. Documentary credit is another area of semi-commercial semi-banking disputes that has been affected by arbitration. The issue of payment in international trade is of great importance because of the different currencies involved and the fluctuations in the foreign exchange market.

If the parties wish to choose an alternative method to litigation, they can refer their matter to the ICC and resolve the matter under the Documentary Credit Dispute Resolution Expertise (DOCDEX) Rules. This set of rules is offered by the ICC to bankers and international traders as a fast and cost-effective mechanism to resolve their documentary credit disputes.<sup>453</sup> In this process, decisions are taken by a panel of three. The DOCEX Rules were first launched in 1997 and were later expanded. Today, these Rules are applicable towards the most updated version of UCP rules, as well as all former versions. Another available option for parties that wish to choose arbitration over litigation is an institute located in US called the International Centre for Letter of Credit Arbitration ICLCA).<sup>454</sup> This arbitral institute is one of the places that offer arbitration services for disputes that specifically relate to letters of credit.

The second type of letter of credit, a standby letter of credit, has functions very similar to those of a bank guarantee. In a standby letter of credit, rather than sending documents, the recipient has to submit a statement to the bank to facilitate payment of the sum. In some contexts the standby letter of credit is examined under the concept of a bank guarantee. Standby letters of credit are discussed in the following section.

In recent years, there has been a considerable increase in the use of international arbitration for disputes about letters of credit. As explained above, the ICC and the

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<sup>450</sup> POWER CURBER INTERNATIONAL LTD. v. NATIONAL BANK OF KUWAIT S.A.K. [1981] 2 Lloyd's Rep. 394

<sup>451</sup> Indira Carr, *International Trade Law* (3rd edn, Cavendish Publishing 2005) 479.

<sup>452</sup> Principles of autonomy of letters of credit.

<sup>453</sup> International Chamber of Commerce, 'Introduction to ICC DOCDEX', International Chamber of Commerce, <<http://www.iccwbo.org/products-and-services/arbitration-and-adr/docdex/>> accessed 12 August 2015

<sup>454</sup> For more information see International centre for letter of credit arbitration, <<http://www.icloca.org/index.html>> accessed 3 June 2015

specific rules for documentary credit are the main examples that demonstrate the movement towards arbitration. Another example is the ICLCA (the Centre), which is based in the US and has affiliates in London and China. This Centre has published arbitration rules<sup>455</sup> for disputes arising out of letters of credit internationally. The rules are a modified version of the United Nations Commission on International Trade Law (UNCITRAL) Arbitration Rules and are tailored for letters of credit disputes.<sup>456</sup>

### 5.2.7 Bank Guarantees

Another important banking instrument that is used in cross-border trade is a bank guarantee. A bank guarantee acts as a safety measure in international trade. The bank, acting as a guarantor, will be obliged to pay an agreed sum to a beneficiary if the other party in the contract does not fulfil their obligations. In other words, bank guarantees can work in the favour of both the seller and buyer as protection against non-payment or non-delivery.

According to Cirielli,<sup>457</sup> arbitration clauses can be incorporated into bank guarantees in three different ways:

1. Where an award was issued during the arbitration proceeding and the guarantee is to be paid to the beneficiary;
2. Where the arbitration clause was included within the bank guarantee itself;
3. Where the arbitration clause was incorporated into the main contract.

In the early years of the use of the arbitration clause in the banking sphere, Park recommended that in circumstances where there only exists an arbitration clause in the main contract but not in the bank guarantee itself, the court should still refer the dispute to the arbitral tribunal.<sup>458</sup>

Bank guarantees and arbitration agreements are a complex matter to some extent. In various cases, the award issued by the arbitral tribunal was challenged by the courts. For

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<sup>455</sup> International Centre for Letter of Credit Arbitration (ICLOCA) Rules of Arbitration , < <http://iiblp.org/wp-content/uploads/2014/12/ICLOCA-Rules-of-Arbitration.pdf> > accessed 12 August 2015

<sup>456</sup>Institute of International Banking Law and Practice, International Centre for Letter of Credit Arbitration, About Us, see <<http://iiblp.org/about-us/international-center-for-letter-of-credit-arbitration/>> accessed 12 August 2015

<sup>457</sup> Stefano E Cirielli, 'Arbitration, Financial Markets and Banking Disputes' (2003) 14 Am Rev Int' Arb. 264.

<sup>458</sup> Park (n 437) 238.

example, in October 2008, the Swiss Federal Supreme Court decided on the validity of an arbitration award and declared that ‘the arbitral tribunal was competent to decide on a party’s request that its contractual partner should refrain from calling a bank guarantee’.<sup>459</sup>

Current practice globally implies that the use of arbitration clauses as dispute settlement methods in bank guarantees and letters of credit is on the rise and banks and other financial institutes are considering this method viable and efficient to resolve disputes in this area.<sup>460</sup>

### **5.3 Banks as investors and financial products as protected investment measures**

Another area where the use of international arbitration should be analysed is where banks act as foreign investors in a host country. As was discussed in Chapter Three,<sup>461</sup> investment arbitration is one of the key categories of international arbitration that is widely used globally. As was explained in Chapter Three, unlike commercial arbitration, there is no contract between parties that can require them to arbitrate their disputes, and an arbitration agreement or arbitration clause does not exist in investment arbitration. Instead, there is an investment treaty in place that has been concluded between countries (two or more) and can act as a legal framework to refer disputes arising between the investors (who are normally foreign investors) and the host country to arbitration tribunals. These treaties are referred as bilateral investment treaties (BITs) or multilateral investment treaties (MITs).<sup>462</sup>

BITs and MITs are integral parts of foreign investment and depending on agreements concluded between states; they can offer various protections to investors that could be either corporations or individuals. The ultimate aim in providing such protections is to promote foreign investment in the host country. For instance, most favoured nation

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<sup>459</sup> George von Segesser, ‘A Complex Matter: Bank Guarantees and Arbitration’ (Kluwer Law Arbitration Blog, 13 February 2009) <<http://kluwarbitrationblog.com/blog/2009/02/13/a-complex-matter-bank-guarantees-and-arbitration-agreements/>> accessed 20 August 2013

<sup>460</sup> Inka Hanefeld, ‘Arbitration in Banking and Finance’ (2013) 9 NYU Journal of Law and Business 9, 917.

<sup>461</sup> See Chapter Three section 3.4.

<sup>462</sup> *ibid.*

(MFN) treatment and fair and equitable treatment are among the protections that are usually included in BITs. However, this research does not address these protections and is only concerned with the possibility of arbitrating disputes between investors and the host countries, something that is also included in most BITs and MITs.

BITs provide a protection mechanism that enables foreign investors to bring claims against host states in the process of foreign investment. Clearly, foreign investors are given this opportunity to avoid the hassle of involvement in local courts and unfamiliar litigation procedures. In this respect, banks that operate as investors can sue states under International Centre for Settlement of Investment Disputes (ICSID) arbitration rules if BIT provides the relevant rights and the legal protection.

The question that might arise here is whether banks can be considered as investors. Answering this question is of vital importance since banks can only benefit from BITs if they are regarded as investors.<sup>463</sup> To answer this question, it has to be clarified to what extent financial and banks products can qualify as investors for the purposes of BIT protection. Whether banks and financial institutions are regarded as foreign investors in host states is of an imperative importance as it can indicate whether these organisations that have contributed to foreign investment can issue actions against the host country at the ICSID arbitration panel if there is no arbitration agreement and therefore no contractual relationship between the host country and the investor.<sup>464</sup>

The term 'investment' is used with a broad and extensive meaning in the majority of BITs, and that justifies banks commencing investment arbitration against host states.<sup>465</sup>

It is worth mentioning that not all BITs have adopted the same approach in the definition of the term 'investment'. Different treaties use different wordings and each treaty wording be interpreted differently. The term investment can be applied to banking services and financial products.

In some BITs, such as the China-Belgium BIT,<sup>466</sup> , the term investment is defined as 'every kind of asset invested by investors of one State in the territory of other State ...

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<sup>463</sup> Dan Sarooshi, 'When International Financial Institutions Arbitrate: What Law Governs International Investment Arbitration' (2012) 27 *Butterworths Journal of International Banking and Financial Law* 612

<sup>464</sup> *ibid.*

<sup>465</sup> *ibid.*

including shares, stock, debentures, claims to any performance having a financial value'.<sup>467</sup> The majority of investment treaties include bonds, securities and loans as investment categories for the purposes of ICSID claims.<sup>468</sup>

However, some other treaties tend to limit the scope of application of the term 'investment'. More specifically, they may contain provisions that impose restrictions on possible claims arising out of banking or financial products.<sup>469</sup> For instance, in the US BIT model 2012, the dispute resolution for a dispute related to financial services is distinguished from the dispute resolution regime for other types of investment.<sup>470</sup>

In a recent case of *Abaclat and Others v The Argentine Republic*,<sup>471</sup> the issue of bonds being deemed as investments under the ICSID Convention<sup>472</sup> was discussed by the arbitral tribunal. The case concerned a mass claim brought against the Argentinian government in relation to dishonoured bonds under the terms of BIT between Italy and Argentina.<sup>473</sup> In this case the term 'investment' had to be interpreted by the tribunal to see whether the bonds in question could be arbitrated in the ICSID. The majority view was that the investment matter in question resulted in the creation of a value that is protected under the BIT. Therefore, the bondholders right to claim reimbursement from Argentinian government and the interest on bonds satisfied this requirement and therefore the bonds did constitute an investment under the ICSID Convention.<sup>474</sup> The *Abaclat* approach was confirmed by other investment tribunals in more recent decisions.<sup>475</sup>

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<sup>466</sup> Agreement between Belgium and China on encouragement of investment, entered into 1 December 2009

<sup>467</sup> Sarooshi (n 462) 612.

<sup>468</sup> David W Rivkin and Mark W Friedman, 'Financial Products as Investments Under Bilateral Investment Treaties and Other Multilateral Instruments With Consents to Arbitration' in Jeffrey Golden and Carolyn Lamm (eds) *International Financial Disputes* (Oxford Press 2015) 111

<sup>469</sup> *ibid.*

<sup>470</sup> 2012 US Model BIT, Article 20, For more, see Rivkin and Friedman (n 59) 112.

<sup>471</sup> *Abaclat and Others v. Argentine Republic*, ICSID Case No. ARB/07/5, Formerly known as *Giovanna A Beccara and Others v The Argentine Republic*

<sup>472</sup> The World Bank sponsored the Washington Convention in 1965, and the purpose was to establish a neutral forum for resolving disputes between states and investors who are nationals of other states. For more see World bank group, ICSID Convention, Regulations and Rules <

[https://icsid.worldbank.org/ICSID/StaticFiles/basicdoc/CRR\\_English-final.pdf](https://icsid.worldbank.org/ICSID/StaticFiles/basicdoc/CRR_English-final.pdf) > accessed 14 January 2016

<sup>473</sup> ICSID CASE NO. ARB/07/5.

<sup>474</sup> *ibid.*

<sup>475</sup> See the text of the case here: <<http://www.italaw.com/sites/default/files/case-documents/italaw1276.pdf>> accessed 12 January 2016

In another recent ICSID case, *Renée Rose Levy de Levi v Republic of Peru*, a French national started proceedings against Republic of Peru, claiming that the agreement between France and Peru on the promotion and protection of investment was violated.<sup>476</sup> The case concerned a bank's liquidation in Peru, and the Claimant and her father were shareholders. The Claimant's main argument was that Peru had treated the bank arbitrarily and illegally and therefore had violated the rights granted to her and her father in the BIT between Peru and France.

However, the arbitral tribunal did not find the abovementioned arguments credible and rejected Ms Renée's claim. This case shows the use of arbitration (investment arbitration) in bank-related disputes.

To sum up this section, it can be stated that the use investor-state arbitration is increasing substantially as lenders (mainly banks and other financial institutes) try to safeguard themselves against defaulting states.

#### **5.4 Main areas affected by arbitration in financial-sector financial transactions and securities (capital markets)**

Although this research addresses the practicality of arbitration clauses in banks, it is worth mentioning the applicability of arbitration in some financial products. First, a brief background as to the bases of the finance is needed.

In their simplest definition, finance and financing are mainly concerned with linking the parties who have the money and resources with those who can carry out economic activities but do not have the sufficient funds. In other words, finance knowledge is to obtain money from the former and provide it to the latter who can invest and help the economy to grow.

There are two methods of financing, one is through the intermediation of banks, which take deposits and give loans to those who can invest them (as mentioned above). This is normally done through 'contracts'. Alongside this indirect financing there is a direct method of financing where the investor (the party with sufficient funds who does not

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<sup>476</sup> ICSID Case No. ARB/10/17,



wish to conduct the economic activities) purchases securities , also called ‘capital markets’, from the issuers, who need capital either as lenders (debt securities, called ‘bonds’) or as investors (equity capital, called ‘shares’). Capital markets are one of the major funding sources of corporate finance. In a capital market the capital is provided by investors in securities, unlike loan agreements where the capital is provided by the banks.<sup>477</sup> The securities are either traded in organised stock exchanges or in an informal market called ‘over the counter’ (OTC). However, because of the nature of securities and the weakness of the investors, regulations exist that are enforced by regulatory regimes in stock exchanges and OTC markets.

This section explains some of the major financial transactions. Further below, whether these transactions have been affected by the use of international arbitration will be discussed.

It is worth mentioning that financial law has three main components:<sup>478</sup>

1. Market practice: this is the establishing of soft law, including codes of practice and guidance that are highly influential but arguably not binding.<sup>479</sup>
2. Case law: including reported or unreported judgments in financial law. This is not a very comprehensive source, partly because of the traditional reluctance of banks to publicise their litigation and also because of the unsystematic nature of case law in general.<sup>480</sup>
3. Legislation: mainly refers to the current statutes enacted for the purposes of governing financial law.<sup>481</sup> In recent years, the EU has produced regulations for Member States.

This regulatory control of securities market has been always an obstacle when it comes to the parties’ choice of dispute settlement mechanism. As a result of regulatory mechanisms in this sector, parties to a financial transaction are unable to exercise their freedom of contract power as fully as they could in a commercial transaction.<sup>482</sup>

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<sup>477</sup> Benjamin (n 423) 172.

<sup>478</sup> *ibid* 4.

<sup>479</sup> *ibid* 47

<sup>480</sup> *ibid* 5

<sup>481</sup> For example, the Financial Services and Markets Act 2000 (UK).

<sup>482</sup> See Chapter Four discussion on the principle of freedom of contract and the fact that parties to a contract are free to choose the dispute resolution method for their contract, as well as decide on other contractual terms.

The entire commercial and financial legal sector has been affected by globalisation and the increase in cross-border transactions; securities markets are no exception to this trend. The significant effect of globalisation is seen in the internationalisation of the securities market and in the increase of cross-border investment.<sup>483</sup>

The use of arbitration in the securities sector can be problematic because of the heavy regulation of this sector. In a securities transaction, the state's involvement in regulating securities transactions may affect the parties' autonomy to choose arbitration as the dispute resolution mechanism.

The question of whether financial disputes are capable of being handled by arbitration is of key importance. The issue of arbitrability of disputes arising out of financial transactions must be addressed contractually to be able to refer such disputes to arbitral tribunals. It can be argued that as financial transactions play substantial role in commerce and involve major commercial activities, disputes arising out of these transactions are of a commercial nature and could be resolved through commercial arbitration.<sup>484</sup>

#### 5.4.1 Bonds (debt instrument)

According to Buckley, a bond can be defined as 'a promissory note, under seal to pay money'.<sup>485</sup> A promissory note can either be issued by the government or by a corporation. Foreign bonds and Eurobonds are mostly issued by governments; in some cases, companies or big corporations may be able to issue foreign bonds as well as domestic bonds. Foreign bonds are issued in the domestic market but by issuers that are not resident in the domestic territory.<sup>486</sup> The extent of the world bond market is increasing massively and even most developing countries have expanded their bond market internationally. Eurobonds can be issued both by governments and financial institutions.

The possibility of including an arbitration clause in bond issues is another challenging debate. The use of arbitration clauses in bond issues can be traced back to the early

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<sup>483</sup> Mahmood Bagheri, *International Contracts and National Economic Regulation, Dispute Resolution Through International Commercial Arbitration* (Kluwer Law International 2000) 76.

<sup>484</sup> Judith Gill and James Freeman, 'Practical Issues Specific to Arbitration Containing Financial Products' in Jeffrey Golden and Carolyn Lamm (eds) *International Financial Disputes* (Oxford Press 2015) 326

<sup>485</sup> Adrian Buckley, *Multinational Finance* (Prentice Hall Financial Times 2004) 41

<sup>486</sup> *ibid* 42.

twentieth century,<sup>487</sup> although, as mentioned by Domke, this use was not the most helpful for the protection of bondholders.<sup>488</sup> In the case of sovereign debts (debts that include sovereign bonds), the use of arbitration is stated to have been commonly used in the second half of the nineteenth century.<sup>489</sup> In addition, in recent years there has been a constant use of international arbitration in conflicts involving sovereign bonds.<sup>490</sup> However, it has been argued by Waibel that the bondholder's position is always a weak one, whether in court or in an arbitral tribunal.<sup>491</sup>

The situation might be different for sovereign bonds. According to Waibel, it is rare to see an arbitration clause in sovereign bonds today, with the exception of Brazilian bonds as they incorporate UNCITRAL Arbitration Rules.<sup>492</sup>

#### 5.4.2 Financial derivatives

Derivatives are one of the most frequently used finance instruments at present. They were specifically created to manage fluctuating financial risk in the market.<sup>493</sup> The number of derivatives has accelerated since the 1970s.<sup>494</sup> Derivatives are insurance contracts, and in the words of Benjamin:

A derivatives contract is ... a bilateral contract (i) under which the rights and obligations of the parties are derived from, or defined by reference to, a specific asset type, entity, or benchmark; and (ii) the performance of which is agreed to take place on a date significantly later than the date on which the contract is concluded.<sup>495</sup>

According to predominant scholars, the financial sector has always had the tendency to use courts for dispute settlement purposes in disputes concerning derivatives contracts,

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<sup>487</sup> Norbert Horn, 'Non-Judicial Dispute Settlement in International Financial Transactions' in Norbert Horn and Joseph J Norton (eds), *Non-Judicial Dispute Settlement in International Financial Transactions* (Kluwer Law International) 6

<sup>488</sup> *ibid* 6.

<sup>489</sup> Michael Waibel, 'Sovereign Defaults before International Courts and Tribunals', (Cambridge University Press 2011), 157

<sup>490</sup> Michael Waibel, 'Opening Pandora's Box: Sovereign Bonds in International Arbitration', (2007) *The American Journal of International Law* Vol. 101, No. 4 (Oct., 2007), pp. 711–759

<<http://www.jstor.org/stable/pdf/40006317.pdf?acceptTC=true>> accessed 14 July 2015

<sup>491</sup> Horn (n 486)

<sup>492</sup> Waibel (n488)

<sup>493</sup> Benjamin (n 423) 64.

<sup>494</sup> *ibid*.

<sup>495</sup> *ibid* 65.

and the chief jurisdictions have always been London and New York courts.<sup>496</sup> The courts in these popular jurisdictions experienced a high volume of cases involving financial products and financial claims when the financial credit crunch commenced in late 2008. Between 2009 and 2011, 50 decisions that only involved derivatives were issued by courts in London; more precisely, International Swaps and Derivatives Association (ISDA) agreement documentation.<sup>497</sup>

This preference is rational one, considering the commercially flexible nature of these jurisdictions and the high competence of the judges, who can exercise the common law approach of issuing consistent judgments in the area of financial markets.<sup>498</sup>

This historical tendency of the financial sector and banks to lean towards litigation is said to be changing now and arguably the use of arbitration has developed in the area of financial derivatives more than in any other area of finance. The globalisation era, the increase in cross-border financial transactions and the appearance of new financial products and concepts, such as Islamic finance<sup>499</sup> and Sharia law banking rules, may require a more specialised dispute resolution system.<sup>500</sup>

Recently, the ISDA<sup>501</sup> published the 2013 ISDA arbitration guide that reflects the impact of arbitration as a means to resolve disputes in ISDA agreements. According to the ISDA memorandum for its members,<sup>502</sup> there has been a substantial increase in the use of arbitration in the financial sector. This was the case in relation to the ISDA Master Agreement involving parties mainly from emerging market jurisdictions.

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<sup>496</sup> Stephen Rosen, 'Increasing use of arbitration in financial markets disputes' (2015) Global, Lexology <<http://www.lexology.com/library/detail.aspx?g=a968dfcb-071e-4c9a-b3de-cc470b741623>> accessed 11 August 2015.

<sup>497</sup> *ibid.*

<sup>498</sup> *ibid.*

<sup>499</sup> Islamic finance and Islamic banking have different legal frameworks. The use of international arbitration in this sector is increasingly considerably and there are various organisations that promote arbitration in Islamic banking and finance. As a matter of fact, there is a globally recognised course in Islamic banking and financial arbitration at the Chartered Institute of Arbitrators in England. See Chartered Institute of Arbitrators <<https://www.ciarb.org/news-views-events/events/diploma-in-islamic-banking-finance-arbitration>> accessed 12 August 2015

<sup>500</sup> Rosen (n 86).

<sup>501</sup> The International Swaps and Derivatives Association is an organisation that monitors the over the counter (OTC) derivatives trade and is based in New York. For more about ISDA, see ISDA, safe, efficient markets <<http://www2.isda.org/about-isda/>> accessed 11 August 2015

<sup>502</sup> International Swaps and Derivatives Association, Inc. <[http://www.isda.org/uploadfiles/docs/FLRC\\_ISDA\\_Arbitration\\_Memo\\_Jan11.pdf](http://www.isda.org/uploadfiles/docs/FLRC_ISDA_Arbitration_Memo_Jan11.pdf)> accessed 12 January 2016

In April 2013, the ISDA released a number of model clauses. The model clauses provide for six different combinations of governing law, arbitral rules/institution and seat of arbitration, and are:

- English law; London seat; ICC Rules of Arbitration (the ICC Rules);
- New York law; New York seat; ICC Rules;
- English law; London seat; London Court of International Arbitration (LCIA) Arbitration Rules;
- choice of English or New York law (except for the arbitration agreement itself, which is to be governed by Hong Kong law); Hong Kong seat; Arbitration Rules of the Hong Kong International Arbitration Centre (HKIAC);
- choice of English or New York law (except for the arbitration agreement itself, which is to be governed by Singapore law); Singapore seat; Arbitration Rules of the Singapore International Arbitration Centre (SIAC); and
- New York law; New York seat; International Arbitration Rules of the American Arbitration Association – International Centre for Dispute Resolution (AAA–ICDR).<sup>503</sup>

The above shows that arbitration has been welcomed in the financial derivatives world.

In addition to ISDA's model clause, there are other places where the use of arbitration has been associated with ISDA Master Agreement. The Panel of Recognised International Market Experts in Finance (P.R.I.M.E Finance),<sup>504</sup> which is a newly established arbitral institution dealing with only financial and banking disputes, has published a model arbitration agreement to be used by as an amendment to the 1992 and 2002 ISDA Master Agreements.<sup>505</sup> This is called 'P.R.I.M.E. Finance Arbitration Amendments for use with 1992 and 2002 ISDA Master Agreements'.<sup>506</sup>

Another area that shows acceptance of arbitration in financial markets is hedging agreements. In a recent case of a hedging agreement for oil prices between Sri Lanka and three international banks, Citibank, Deutsche Bank and Standard Chartered Bank, the question of arbitration or litigation as a means of dispute settlement was raised. The state-owned company involved, Ceylon Petroleum, stopped payments to the three banks after

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<sup>503</sup> Herbert Smith Freehills Dispute Resolution <<http://hsf-arbitrationnotes.com/2013/04/18/isda-issues-model-arbitration-clauses-for-use-with-master-agreements/>> accessed 12 January 2016

<sup>504</sup> P.R.I.M.E Finance is fully discussed in Chapter Six in section 6.1.1.

<sup>505</sup> Gerard Meijer and Richard H Hansen, 'Arbitration Clauses for International Financial Disputes' in Jeffrey Golden and Carolyn Lamm (eds), *International Financial Disputes* (Oxford Press 2015) 154.

<sup>506</sup> For more, see Panel of Recognised International Market Experts in Finance <<http://primefinancedisputes.org/arbitration/21-2/>> accessed 11 August 2015.

the plunge in oil prices. Each bank initiated separate proceedings. Deutsche bank<sup>507</sup> started the claim under ICSID rules and it was awarded US\$60 million, plus a reported US\$7 million in interest for defaulting on an oil hedging agreement. Similarly, Citibank brought an action against Sri Lanka through the LCIA sitting in Singapore. However, it lost its US\$192 claim as the tribunal held that, under Sri Lankan law, the hedging agreements were speculative and Ceylon Petroleum had no authority to enter into them. On the other hand, Standard Chartered Bank took litigation proceedings against Sri Lanka via the UK court, which ordered Ceylon Petroleum Company to pay US\$162 million to Standard Chartered Bank for breaching their hedging agreement. As is clear from this example, the parties, based on the terms and conditions of each agreement, were able to refer their dispute to either the courts or arbitral tribunals.

#### 5.4.3 The possible counterarguments against the use of international arbitration in the banking and finance sector

International arbitration seems to benefit dispute settlement in the banking and finance sector by offering a more neutral forum and the existence of multilateral treaty network to enforce and acknowledge arbitration awards in places where a debtor has assets.<sup>508</sup> However, there are arguments against the concept of international financial arbitration. Not every financier or banker approve the application of arbitration clause in this sector. Although the traditional preference for litigation over arbitration (which was the common practice for banks and financial institutes for many years) is now changing,<sup>509</sup> a considerable amount of international banking litigation is conducted in the courts.

The use of arbitration as a dispute resolution process has been challenged in this area. One of the main things undermining the arbitration process versus litigation is the lack of

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<sup>507</sup> *Deutsche Bank AG v Democratic Socialist Republic of Sri Lanka* (ICSID Case No. ARB/09/2)

<sup>508</sup> Michael Brown and Claire Morel de Westgaver, 'Banking and Finance Arbitration on the Rise – A Trend to Follow?' (*Financier Worldwide*, April 2013) <<http://www.financierworldwide.com/banking-and-finance-arbitration-on-the-rise-a-trend-to-follow/#.VaUkK5NUWB0>> accessed 7 June 2015.

<sup>509</sup> Stephen Jagush, 'Enforcement' in Jeffrey Golden and Carolyn Lamm (eds) *International Financial Disputes* (Oxford Press 2015) 474.

precedent in arbitral awards. One of the distinctive features in arbitration is that there is no precedent in arbitration awards.<sup>510</sup>

However, there is no widely accepted approach among experts as to whether arbitrators can create precedent or not. Some have argued that because of the confidential nature of arbitration, the concept of precedent (binding of a former decision on a later similar matter) cannot be used by arbitrators. On the other hand, some experts have argued that, although not always, some arbitrators do follow and cite other arbitrators and try to endorse consistency in arbitration awards.<sup>511</sup> As a result of this uncertainty and the presumed lack of binding precedent for arbitrators, commercially minded judges took the lead as adjudicating body in banking and finance disputes, and parties preferred the court system when it comes to a choice between arbitration and litigation.<sup>512</sup>

Another commonly discussed factor that might sway the parties to litigate their disputes is the possibility of summary judgment in the court system, unlike in arbitrations. The ability of courts to issue summary judgments is considered as a great advantage by bankers. For instance, in a simple debt matter, the bank will prefer the summary procedure over any complex and prolong alternative.

However, it has been argued that issuing a summary judgment is not completely unheard of in arbitration procedure and that it is inaccurate to state that the summary process is unavailable in arbitration. Because of the mutually agreed nature of an arbitration agreement, parties can set out an expedited process similar to that of summary judgment in the court system.<sup>513</sup>

According to one report on practitioners' points of view on international arbitration and project finance,<sup>514</sup> there are positive and negative views among bankers and financiers towards the existence of an arbitration clause in financing contracts. Some favour arbitration to avoid domestic courts. Within the same report, other bankers are reluctant

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<sup>510</sup> The issue of precedent in arbitration has been challenged by academics, see Mark C Weidemaier 'Toward a Theory of Precedent in Arbitration' (SSRN, 23 April 2010) <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1594970](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1594970)> accessed 27 February 2013.

<sup>511</sup> *ibid.*

<sup>512</sup> James Freeman, 'The Growth of Arbitration in the Finance Sector' (Allen & Overy Publication, 2 February 2012) <<http://www.allenoverly.com/publications/en-gb/Pages/The-growth-of-arbitration-in-the-finance-sector.aspx>> accessed 22 February 2013.

<sup>513</sup> *ibid.*

<sup>514</sup> Roundtable organised by *International Business Law Journal* in 2003

to incorporate an arbitration clause in their agreements, because of the multiparty factor in the majority of financing contracts, and difficulties in multiparty arbitration procedures. There also exists an attitude among bankers that their right to reimbursement is so obvious and simple that they would not need to submit its breach to any jurisdiction or tribunal. Therefore, they do not see the need to include an arbitration clause in their financial agreements.<sup>515</sup>

The most distinguishable advantage of the arbitration process is declared to be the global enforcement of its awards. It should be pointed out that even in the signatory countries to the New York Convention, enforcement might be challenging. For instance, there are reported cases from India and Saudi Arabia where the enforcement of arbitral awards has not been straightforward. In India, foreign arbitration awards have to be 'registered' to be enforceable.<sup>516</sup> In Saudi Arabia no arbitral awards have been enforced. Considering the fact that both these countries have ratified the New York Convention, and are regarded as participant states, one can conclude that the issue of enforcement cannot always count as an advantage of the arbitration process. While a foreign court judgment being enforced in that court's territory or some other foreign territory is not impossible, parties to international transactions still value this feature of arbitration and prefer it to the risks associated with attempting to enforce a judgment issued from a foreign court but which requires enforcement in a foreign territory.

Banks do not deprive themselves from this interest and although they acknowledge the possible and probable difficulties of enforcing arbitral awards in some of the signatory states, they consider arbitration as a mechanism that can substantially reduce the enforcement risk.<sup>517</sup> As risk management is one of the essential tasks in international contracts, any actions that can reduce the severity of this risk will be taken into account to safeguard the prosperity of the main contract. However, although there are undeniable advantages in the use of ADR and arbitration in international transactions, including

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<sup>515</sup> Jean-Georges Betto, 'International Arbitration and Project Finance: Viewpoint of Practitioners' (2003) *Int'l Bus L J* 831.

<sup>516</sup> Freeman (n 102).

<sup>517</sup> *ibid.*



banking and financial transactions, there is strong evidence to show that the public prefer substantial awards issued by the courts.<sup>518</sup>

One of the factors that may dissuade parties from arbitration is the narrow discretionary power of arbitrators. As arbitration is a consensual procedure, parties have agreed upon the extent of the power of the arbitration as well as all elements involved in the arbitration process. This is stated as a general downside to arbitration. It has been argued that the arbitrator's decision-making power is much less than that of a judge sitting in a courtroom.<sup>519</sup> This disadvantage may be one of the reasons that bankers are unwilling to refer disputes to arbitration. After all, parties that opt for arbitration are after a final and definite solution to their dispute and the limited power of the tribunal would not satisfy their expectations and would not lead to a satisfactory outcome.

As a matter of fact, in some jurisdictions may appear to force arbitration upon parties. This is the case in the US where it seems to have become a common practice in some areas of finance and banking to include mandatory arbitration clauses to avoid lawsuits. More significantly, mandatory arbitration clauses can be found in credit card and debit card agreements and some other types of loan agreement in the US. This banking practice is not eagerly welcomed by consumers and, in fact, there are some organisations established to end or perhaps control so-called forced arbitration and to instead make it a voluntary procedure to protect consumers in the field of banking and finance.<sup>520</sup>

Mandatory arbitration clauses in the aforementioned circumstance seem unfair and disadvantageous to one party (banks' customers) instead of benefiting them. As arbitration is a confidential and private procedure – it is conducted behind closed doors – it is difficult to perceive its unlawfulness. This may be the case when one party is a consumer, an ordinary person who had no autonomy in agreeing to the arbitration clause in the first place, and the other party is a big corporation, perhaps a bank, which possibly had the full choice of law. Therefore, one should draw a line to distinguish mandatory arbitration from voluntary arbitration.

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<sup>518</sup> MacLean (n 416) 39 and 43,

<sup>519</sup> Anthony Connerty, *Manual of International Dispute Resolution* (Commonwealth Secretariat 2006) 203.

<sup>520</sup> Fair Arbitration Now is one of the organisations that is trying to stop mandatory arbitration as, according to them, it 'stacks the deck against consumers': <<http://www.fairarbitrationnow.org/>> accessed 1 May 2014

#### 5.4.4 Conclusion

From this chapter, it can be concluded that, as a result of the revolution in the nature and scope of banking and financial transactions, there is a need to review the issue of dispute resolution mechanism in this sector. There are some arguments against the use of international arbitration in the banking and finance sector.<sup>521</sup>

The first argument is because of the contractual nature of loan agreements. One of the most common causes of disputes arising out of loan agreements is a borrower defaulting on payment, which amounts to a breach of contract by one party (the borrower). In return, the lender or other party is entitled to specific performance by the other party and/or perhaps any other compensation that is incorporated into the agreement. Arguably, these types of disputes do not contain complicated technical issues and only concern simple non-payment matters. It has been claimed that international loan agreement disputes can be resolved more swiftly in courts and by judges than by arbitrators, as these disputes relate to complex legal matters, not of factual complications.<sup>522</sup> The issue of borrower non-payment is a simple matter and does not involve contentious disciplinary matters. The claimant in such a case (the lender) usually seeks a court order to force the borrower to pay. It has been stated that where the bank is seeking payment, it is not regarded as a 'dispute'<sup>523</sup> and therefore there is no need for dispute resolution.

This issue of the simplicity of disputes arising out of bank loan agreement is one of the main objections that banks have when they encounter arbitration, in the sense that these claims are called 'one-shot money disputes' that involve straightforward payment by the borrower and there is no other complication involved.<sup>524</sup> It must be mentioned that this simplicity argument put forward by bankers against arbitration may be a naive one; disputes arising from loan agreements are not simple and may involve legal complexities

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<sup>521</sup> Some of the reasons against the use of arbitration in banking and finance industry were discussed Chapter Three section 3.4.

<sup>522</sup> Davies (n 440). See also Henry P de Vries, 'International Commercial Arbitration: A Contractual Substitute for National Courts' (1982) 57 Tul L Rev 42

<sup>523</sup> Hewetson and Elliot (n 420) 69.

<sup>524</sup> Klaus Peter Berger, 'The Aftermath of the Financial Crisis: Why Arbitration Makes Sense for Banks and Financial Institutions' [2009] 3(1) LFM 54.

such as the ‘compatibility of the grounds for termination embodied in the representations and warranties or covenants’.<sup>525</sup>

In addition to default cases, there may be other loan agreement disputes involving a bank that concern multijurisdictional factors or reputation-threatening cases. In these circumstances, banks have to consider how they can succeed in cross-border disputes. In fact, although banks may prefer litigation for more simple claims, there has been a considerable shift towards arbitration in relation to more costly and complex national and international disputes.<sup>526</sup>

A valid argument is that in simple default cases, where the borrower is in default, there is no need for the extensive expertise of the arbitrators. However, if the case involves other matters, such as a bank’s breach of its duty of care, or claims that a bank is too generous or too close-fisted with their credit, court proceedings are no longer a straightforward matter. The orders are unpredictable and, in some cases, judgments have been returned against lenders.<sup>527</sup>

Another point that rejects the preference of arbitration clause over litigation, is that the high quality of arbitral tribunals, which is claimed to be vested in knowledgeable arbitrators, compared to judges, is questionable and may not always be the case. The fact that there is a discretionary power given to parties that enables them to choose their favoured arbitration process, and the fact that there is no requirement set for the arbitrator, means that parties have the absolute freedom to choose arbitrators. Another reason for the popularity of litigation among UK bankers is the doctrine of precedent in the English legal system and other common law countries.<sup>528</sup>

Considering the large volume of cases dealt with in English courts and New York courts (the two most favoured forums in banking litigation), judges are faced with some

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<sup>525</sup> *ibid.*

<sup>526</sup> George Walker, ‘Bank Remedies: Judicial and Arbitral Recovery’ in Norbert Horn and Joseph J Norton (eds), *Non-Judicial Settlement in International Financial Transactions* (Kluwer Law International 2000) 47.

<sup>527</sup> Edward F Mannino, *Lenders Liability and Banking Litigation* (first published 1989 Law Journal Press 2006) 1–31,

<[https://books.google.co.uk/books?id=PrZ7O8rga08C&pg=PA3&lpg=PA3&dq=lender+liability+and+banking+litigation&source=bl&ots=d1Fwk2cpNq&sig=8L\\_kb5HAVV9T6a905fuIpFYZUf8&hl=en&sa=X&ei=0xWIVc68N4GBU5mbgZgB&ved=0CDQQ6AEwAw#v=onepage&q=lender%20liability%20and%20banking%20litigation&f=false](https://books.google.co.uk/books?id=PrZ7O8rga08C&pg=PA3&lpg=PA3&dq=lender+liability+and+banking+litigation&source=bl&ots=d1Fwk2cpNq&sig=8L_kb5HAVV9T6a905fuIpFYZUf8&hl=en&sa=X&ei=0xWIVc68N4GBU5mbgZgB&ved=0CDQQ6AEwAw#v=onepage&q=lender%20liability%20and%20banking%20litigation&f=false)> accessed 22 June 2015.

<sup>528</sup> Davies (n 440) .

recognised principles from previous judgments. The fact that there are established rules in the abovementioned field, combined with the convincing precedent in this area, can make the judges' job less challenging, as they can follow the existing rules and precedent in the industry. However, this may make it difficult for judges to vary their rulings as any variation to the established rules in this sector may not be welcomed by some major lenders.<sup>529</sup>

Moreover, in a discussion of arbitration versus litigation, the existence of legal precedent in banking law is considered to be one of the reasons why bankers chose litigation over arbitration, even in multinational disputes.<sup>530</sup> However, in some other areas of finance, such as derivatives, court decisions have been inconsistent, leading to a shift from litigation to arbitration. In particular in the process of dealing with cases against Lehman Brother's bankruptcy, courts in New York and London produced contradicting judgments in the determination of whether section 2(a)(iii) of the ISDA Master Agreement<sup>531</sup> was enforceable.<sup>532</sup> The court in England, the Court of Appeal, held that the section was indeed enforceable in the case of *Lomas v Firth Rixon*,<sup>533</sup> but the New York Bankruptcy Court of Southern District of New York rejected the enforceability argument in the *Metavante* case.<sup>534</sup> There is no straightforward answer to the question of whether arbitration can offer a solution to this problem. It is unlikely that an arbitral tribunal, which is comprised of independent experts, in some cases three or five, who are from different jurisdictional backgrounds and are all specialised in the area, will be affected by differences of judgments of national courts.<sup>535</sup> Thus, perhaps, international arbitration can indeed provide a suitable alternative to national courts.

The confidentiality of arbitration may seem desirable for banks and financial institutions as it keeps the reputation of banks safe in the eyes of the public. This remarkable characteristic of conducting a private and confidential dispute resolution process may be very expedient for financial institutions, especially in times of crises and credit

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<sup>529</sup> *ibid.*

<sup>530</sup> *ibid.*

<sup>531</sup> ISDA Master Agreement is the standard form published by ISDA and is used in derivatives transactions.

<sup>532</sup> Davies (n 440).

<sup>533</sup> *Lomas v Firth Rixon* [2010] EWHC 3372

<sup>534</sup> Davies (n 440).

<sup>535</sup> *ibid.*

crunches.<sup>536</sup> However, some bankers and lawyers may think differently and be opposed to this confidentiality and privacy feature.

According to some leading practitioners in this area, if the vast majority of the disputes were referred to arbitration to enjoy a confidential and private settlement, the outcome of the cases is not transparent or public. They argue that this lack of publicity and disclosure may result in less accountability and ultimately less contribution to the ‘growth of the substantive law’ involved in the area as it would not be publicly available.<sup>537</sup>

However, opposing this argument, it can be argued that banks should stabilise their status and should avoid any risk that could jeopardise their stability. The prudential banking regulations are put in place by central banks and the Basel Accords to ensure that banks do not lend carelessly and do not putting themselves at risk of bankruptcy and are able to spread any potential risks to other banks. Therefore, any event, be it a piece of information or a lawsuit or claim against a bank, can harm the reputation of a bank and the risk-free atmosphere that they are seeking to create and preserve. The litigation of banking disputes is conducted publicly and thus could put banks and their activities at risk.

In this situation, arbitration, which is conducted privately and confidentially, can avoid unnecessary exposure of banks to the unnecessary disclosure of information and ultimately can help to achieve the purpose of prudential regulation of banks, which is to keep any type of risks away from banks and create a calm and stable environment in which banks can perform.

Moreover, recent cases show that the litigation-based process is not used as often as before in international loan agreements. A wider range of borrowers and lenders is willing to use non-judicial mechanisms in their contracts.

A good example of the use of an arbitration clause in a loan agreement is a Russian case<sup>538</sup> that was decided on 21 February 2011. The Russian Supreme Court concluded

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<sup>536</sup> *ibid.*

<sup>537</sup> Walker (n 525) 49.

<sup>538</sup> *Sberbank v Business-Lada LLC, Lada-Forward LLC et l* (Case N A55-11220/2010).

that ‘arbitration clauses included in boilerplate contracts<sup>539</sup> are invalid unless the parties confirm their intent to arbitrate after the dispute arises’.<sup>540</sup>

Both Claimant (*Sberbank*) and Respondent (Business-Lada LLC) had a number of loan agreements that included an arbitration clause that referred the disputes to the arbitration institution at the investment company Sberbank Inves Story. At the time when the dispute arose, the Claimant managed to rely on the arbitration clause, obtain and eventually enforce the award in Russia.

It can be stated that, in general, the use of arbitration has increased in relation to lending agreements, although some critics argue that there is no need for arbitration clauses or any other extraordinary mechanism in loans. They believe that as there is nothing complicated in lending disputes, the simple matter of non-payment or a default in repayment of loans can be dealt with in courts and, therefore, is no need for arbitration.<sup>541</sup>

According to leading practitioners and scholars in the banking field, there is a growing dissatisfaction with the cost and the delays involved in the litigation process;<sup>542</sup> as a result there is a tendency towards the use of ADR and arbitration. It can be concluded that apart from non-payment and borrower default cases, for other legal matters involved, ADR methods are appropriate mechanisms for resolving banking disputes.<sup>543</sup>

Overall, it can be concluded that many factors suggest that arbitration is a good alternative to litigation in international banking and financial disputes. These factors include the location of the debtor’s assets, configuration of the foreign judgment treaties, exchange control, reluctance of the courts to award punitive damages and the enforceability of security. As a result, the traditional litigation system needs to be closely analysed to evaluate its appropriateness for this sector.<sup>544</sup> The increasing use of arbitration in finance and banking suggests a change in trend and, perhaps, the need for a reform of the old system and a new mechanism to ensure the satisfaction of the

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<sup>539</sup> A standard form contract between two parties that does not allow for negotiation.

<sup>540</sup> Available at Practice Law by Thomson Reuters Legal Solutions <<http://arbitration.practicallaw.com/6-506-3230#>> accessed 20 May 2015

<sup>541</sup> Berger (n 523) 54.

<sup>542</sup> Hewetson and Elliot (n 420) 71.

<sup>543</sup> *ibid.*

<sup>544</sup> Jeffrey Golden and Peter Werner, ‘The Modern Role of Arbitration in Banking and Finance’ in Jeffrey Golden and Carolyn Lamm (eds) *International Financial Disputes* (Oxford Press 2015) 17

contracting parties when it comes to dispute resolution. This satisfaction can be improved if arbitration responds to the user's requirements and tries to rectify the possible loopholes in this dispute resolution method. International arbitration as a neutral and private forum seems to have the potential to replace traditional national courts in banking and finance industry disputes just as it did in the international trade and construction sector.

## **Chapter Six**

### **Reconciling the Conflicting Trends in the Use of Arbitration for Resolution of Banking Disputes**

#### **6.1 Introduction**

This chapter deals with the recent developments in the use of international arbitration in banking and financial sector. It discusses that in the past few years there has been a change in the way that banks regard international arbitration and they now see it as an effective dispute resolution method and are willing to incorporate arbitration clauses into their agreements. This change has been mainly due to the globalisation of banking services and financial products and foreign investors' lack of trust in domestic litigation.

Moreover, the issue of option clauses in general and in banking contracts in particular is illustrated and different approaches taken by various jurisdictions are explored. What is meant by a dispute resolution option clause and why contracting parties might be willing to insert such a clause within their agreements are explained. The use of an option clause in banking transactions, more specifically in loan arrangements, is examined and it is explored that it is mainly one party that is given an option to select the dispute resolution procedure and that party, in the vast majority of cases, is the lender.

Further on, key arbitral institutions that offer special services for arbitrating banking and financial dispute resolution are examined, and which institutes could be more effective in dealing with banking and financial disputes is scrutinised.

At the end of the chapter, drafting an effective arbitration clause is discussed. The considerations that need to be taken into account when drafting an arbitration clause for banking and financial industry related contracts are discussed. There are some crucial issues that need to be covered fully in international arbitration clauses. Issues such as the place of arbitration, rules on arbitration and number of arbitrators are among some of the



important questions that all have to be addressed in an arbitration clause for it to be effective.

## **6.2 Recent developments in the use of arbitration in international banking – the emerging popularity of arbitration**

As was discussed in previous chapters,<sup>545</sup> bankers have traditionally favoured litigation as the dispute resolution mechanism in their contracts<sup>546</sup> and have been reluctant to consider other available options.<sup>547</sup> In the past, there existed little evidence to show the applicability of arbitration and approval for ADR in banking- and finance-related disputes globally.

However, this hostile approach towards arbitration in the finance world started to change in light of the leading US cases of *Scherk v Alberto Culver*<sup>548</sup> and *Shearson/American Express, Inc v. McMahon*<sup>549</sup> where the arbitrability of securities was discussed and where the US Supreme Court supported arbitration versus litigation. Another leading American case on this topic is *Mitsubishi Motors Corp v Soler Chrysler-Plymouth Inc* where the arbitration agreement incorporated in the main contract was favoured and the court was required to acknowledge such agreement.<sup>550</sup> Following these cases, the global acceptance of arbitration increased<sup>551</sup> and arbitration started to appear more plausible to banks and financiers.

The unwillingness of banks to consider arbitration started to decrease significantly after the financial crisis of 2008–2009 when banks found themselves in disputes involving defaulted borrowers, mainly from outside the EU. At this point, some of the global banks and main financial institutes started to appreciate the global enforceability of arbitral

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<sup>545</sup> Chapter Four, section 4.5 Banks' historical reluctance towards arbitration.

<sup>546</sup> Charles Hewetson and Nicholas Elliot, *Banking Litigation* (first published 1999, Thomson Reuters, 2011) 65.

<sup>547</sup> Kalus Peter Berger, 'The Aftermath of the Financial Crisis: Why Arbitration Makes Sense for Banks and Financial Institutions' [2009] 3(1) LFMR 54.

<sup>548</sup> *Scherk v Alberto* 417 US 506, 518 (1974)

<sup>549</sup> *Shearson/American Express, Inc v McMahon*, 482 US 220 (1987)

<sup>550</sup> *Mitsubishi Motors Corp v Soler Chrysler-Plymouth Inc.*, 473 U.S. 614 (1985)

<sup>551</sup> Berger (n 546) 54–60

awards as opposed to the judgment enforcement issues arising from local court decisions.<sup>552</sup>

As was mentioned above, in the era of globalisation, transactions are not limited to national and domestic markets. The regime of the structure of banking activities has shifted. As a result of the internationalisation of banking and finance services, alongside the emergence of multinational banks, the banking industry had to reconsider its attachment to one jurisdiction and its courts. Moreover, both the changes in the nature of international banking activities and the growing popularity and convenience that arbitration offered have led to a wide acceptance of arbitration.

In international transactions, clearly more than one jurisdiction is involved. The convergence of choice of jurisdictions may be problematic when it comes to the dispute resolution mechanism. In some cases, there are already treaties or conventions to help the transaction run smoothly. For instance, where two international parties are from EU Member States, there are policies in force for the recognition and enforcement of judgments issued from courts within the Member States.<sup>553</sup>

Considering the huge volume of global banking transactions that take place nowadays, and the involvement of cross-border contracts, the use of international arbitration as a private dispute settlement mechanism should not sound peculiar to banks. As was touched upon above,<sup>554</sup> one of the most significant features of arbitration is its global enforceability within countries signatory to relevant conventions. As was illustrated in Chapter Three, international arbitration enjoys a widespread global enforceability as a result of the New York Convention.<sup>555</sup>

Banks, alongside financial institutions, are happy to have a forum clause as long as it is their familiar and customary forum, but whenever the other parties wish to include their own jurisdictions as a choice of forum, banks start to consider arbitration. This has been the case in sovereign lending. For instance, a well-established financial institution, when entering into a loan agreement with a foreign state X, is pleased with litigation as long as

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<sup>552</sup> Inka Hanefeld, 'Arbitration in Banking and Finance' (2013) NYU Journal of Law and Business 917.

<sup>553</sup> See Chapter Four in which the Brussels Convention and Brussels Regulations are discussed.

<sup>554</sup> See Chapter 3, section 3.2.6.

<sup>555</sup> *ibid* 3.6.5.

both parties agree to litigate any potential disputes in the financial institution's home jurisdiction or another jurisdiction of its preference. If the other party, foreign state X, wishes to choose its own country's courts as the forum choice for this contract, the financial institution would be highly likely to reject that and instead consider arbitration to avoid the unfamiliar foreign jurisdiction.

In other words, banks and other financial institutes tend to impose their favoured dispute resolution clause upon the borrower as lenders are considered to be the parties with stronger bargaining powers and the borrower has to accept the lender's choice.

More specifically, in a global financial market there is no unified and authorised body to regulate financial transactions and, according to some leading academics in this area, there is no such body as a 'world parliament or congress' to legislate global financial law. Therefore, interpretations of international financial contracts may become problematic because of this lack of unified law.<sup>556</sup> This issue may be more evident where there are conflicting decisions issued from various national courts and there is no one 'over-arching international hierarchy' to resolve the conflicting decisions.<sup>557</sup>

Despite this, some have argued that the popularity of arbitration in the banking sector in EU countries is not as high as its popularity in other parts of the world, such as Asia. This can be explained by showing that, in Asia, the main reason for including an arbitration clause in banking contracts is to obtain the benefit of the worldwide enforcement of arbitration awards. This is not a concern for EU countries; as Member States of the EU, they are bound by the Brussels I Regulation to enforce and recognise court judgments in commercial and civil matters issued in other Member States, which explains why arbitration is less popular.<sup>558</sup>

Having said that, the use of financial arbitration has not been ignored in the EU and there have been developments in recent years. In particular, arbitration clauses have been favoured in loan agreements and financial derivatives. This trend is mostly due to the

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<sup>556</sup> Jeffrey Golden and Peter Werner, 'The Modern Role of Arbitration in Banking and Finance' in Jeffrey Golden and Carolyn Lamm (eds), *International Financial Disputes* (Oxford Press 2015) 12.

<sup>557</sup> *ibid.*

<sup>558</sup> James Freeman, 'The Growth of Arbitration in the Finance Sector', (*Allen & Overy Publication*, 2 February 2012) <<http://www.allenoverly.com/publications/en-gb/Pages/The-growth-of-arbitration-in-the-finance-sector.aspx>> (accessed 22 February 2015).

involvement of states and international organisations in the transactions. State parties are reluctant to submit their disputes to a foreign court, so in this circumstance an independent arbitration tribunal would be the best option. This is more significant in transactions between a party from an EU Member State and a party outside the EU because the latter is not bound by EU regulations.

The question of whether arbitration clauses should be considered in finance and banking contracts has emerged because of several factors. However, when it comes to countries outside the EU, European contracting parties will be concerned about leaving potential disputes to litigation in an unfamiliar jurisdiction. In recent years, many financial institutions and banks have increased their business in emerging markets in countries with slightly less predictable judicial systems.<sup>559</sup> In these circumstances, an arbitration tribunal, as an independent panel, can be a safer option for banks and financiers. This issue of enforceability is one of the key arguments that have been put forward by advocates of arbitration in the banking and finance industry. Arguably, by using arbitration, parties can ensure that the outcome of any dispute settlement will be enforced in the relevant jurisdiction.<sup>560</sup>

The issue of global enforceability is more of a concern for parties that are contracting in regions where the enforcement of the court judgements cannot be guaranteed. For instance, it may be the case that the judgments issued by London or New York courts are not enforceable in some jurisdictions. If that is the case, clearly, there would be no logic behind litigating a dispute in those courts as the vital element of the judgment – which is enforceability – is missing.<sup>561</sup>

It has to be highlighted that in cases where parties contract in some specific geographical regions, the enforceability of court decisions are dealt with by the authorities in those regions and, therefore, the enforcement of court decisions can be guaranteed. The most significant example, which was briefly mentioned above, is where parties are contract within the EU and European Free Trade Association<sup>562</sup> (EFTA) where, as a result of the

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<sup>559</sup> *ibid*

<sup>560</sup> Golden and Werner (n 555) 14.

<sup>561</sup> *ibid* 15.

<sup>562</sup> EFTA includes Switzerland, Norway, Iceland and Liechtenstein. For more info see The EFTA States <<http://www.efta.int/about-efta/the-efta-states>> accessed June 2015.

Brussels and Lugano agreements, court judgments issued in this area are secured and enforcement is not a concern to either party.<sup>563</sup>

Another example is where parties contract in the Middle East region. In this region there exist some conventions that can ensure the enforcement of the court judgments issued within the signatory countries.<sup>564</sup> These conventions are the Arab League Judgements Convention 1952, the Riyadh Convention 1983 and the 1995 Arab Gulf Cooperation Council Protocol.<sup>565</sup>

Similarly, in Latin America there are some conventions in force that ensure the enforcement of judgments in this region. The 1889 and 1940 Montevideo treaties, and the Bustamante Code of 1928, deal with the enforcement of civil and administrative decisions.<sup>566</sup> However, the abovementioned conventions and protocols, the degree of enforceability of these treaties and agreements varies from one region to another, and the enforceability of court decisions may be questioned, despite these treaties.

Two surveys were conducted by Queen Mary University, School of International Arbitration, and Price Waterhouse Coopers in 2006 and 2013. Both surveys were conducted to assess the popularity of international arbitration in the corporate world.<sup>567</sup>

The first survey, in 2006, showed that 73% of its respondents preferred international arbitration as a means to resolve their cross-border disputes. The main reasons for this preference are stated to be the advantages that are offered by the process of international arbitration. Flexibility of the procedure, enforceability of the awards and privacy are the main advantages that affected this preference by major corporate parties. On the other hand, the cost and time spent on the procedure were mentioned to be the main disadvantages of arbitration in the view of corporate parties, as well as the possibility of court intervention into the arbitration procedure and third parties joining the arbitration process.

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<sup>563</sup> Golden and Werner (n 555) 16.

<sup>564</sup> *ibid.*

<sup>565</sup> *ibid.*

<sup>566</sup> *ibid.*

<sup>567</sup> First survey conducted, in 2006, was 'International Arbitration: Corporate Attitudes and Practices 2006' (PwC/QMUL 2006 Survey) and second survey, conducted in 2013, was 'Corporate Choices in International Arbitration, Industry Practice'. Both Surveys were conducted under supervision of Prof Loukas Mistelis from Queen Mary University and Gerry Lagerberg, partner in Price Waterhouse Coopers LLP.

The survey also showed that the majority of corporations choose institutional arbitrations over ad hoc arbitration. The most popular institutions ranked by respondents were the International Chamber of Commerce (ICC), the London Court of International Arbitration (LCIA) and the American Arbitration Association/International Centre for Dispute Resolution (AAA/ICDR). The reasons stated for this ranking were reputation, familiarity with the proceedings, costs and fees, and the convenience of the process.<sup>568</sup>

The survey also examined corporations' views as to the costs of international arbitration. It was regarded that although the costs of international arbitration are the same as litigation, in more complex cases, arbitration can appear to be 'better value for money'.

The survey conducted in 2013, among 101 corporate counsel focusing on the financial, construction and energy sectors, showed that although international arbitration is the most favoured form of dispute settlement across these sectors, it is the least preferred in the financial sector.<sup>569</sup> These results indicated that the majority of in-house counsel in financial services companies still prefer court litigation, despite the fact that they consider arbitration 'well-suited' to their industry. The general consensus was that they would use arbitration only if they recognise a real benefit in doing so.<sup>570</sup>

The survey also indicated that international arbitration is still a popular choice for businesses, although the cost of arbitration remains as a main concern. This may be interpreted to conflict with the findings of the 2006 survey where corporations stated that the cost of international arbitration in complex cases is 'better value for money'.<sup>571</sup>

It is fair to state that arbitration has been the trend followed for dispute resolution throughout several sectors and its use is becoming more and more widespread in the financial sector and the banking industry. The survey also asked its participants if the 2008 financial crisis had affected their choice of dispute settlement process and interviewees claimed that they started to use mediation more often after the crisis.

One of the surprising findings in the 2013 survey was that half of the respondents reported that the 2008 financial crisis did not result in an increase in international

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<sup>568</sup> PwC/QMUL 2006 survey (n 566) 12 and 13.

<sup>569</sup> SurvPwC/QMUL 2006 Survey (n 566). For more information see School of International Arbitration <<http://www.arbitration.qmul.ac.uk/research/2013/index.html>> accessed 14 January 2016.

<sup>570</sup> PwC/QMUL 2013 Survey (n 566).

<sup>571</sup> PwC/QMUL 2006 Survey (n 566) 20.

disputes. This claim is in contrast to the statistics published by major arbitral institutions, which reported a considerable increase in the number of case referrals, especially between 2007 and 2009.<sup>572</sup> Moreover, according to another report, which was published by the LCIA, the number of financial-agreement-related disputes referred to it rose during 2010 and 2011. In 2011, 17.5% of all the referred cases were involved in financial disputes, whereas it was 11.5% the previous year.<sup>573</sup>

In the finance sector, as well as the banking sector, there is considerable movement towards the general acceptance of arbitration. According to some leading practitioners in this area, the 2013 International Swaps and Derivatives Association (ISDA) arbitration agreement is significant evidence of the growing interest in the possible usefulness of arbitration in the financial market.<sup>574</sup>

### **6.3 Unilateral arbitration clauses in banking practice**

There is no doubt that the two main dispute resolution methods in international disputes are currently litigation and arbitration. Depending on the nature of each dispute, whichever of these methods that is best suited to the circumstances will be used.<sup>575</sup> Each of the methods has its advantages and disadvantages. Litigation, for example, offers the possibility of summary judgment as well as default judgment, whereas arbitration can secure a more widely accepted award, which is enforceable globally.<sup>576</sup>

It has to be noted that the choice of either mechanism has to be based on the consent of both parties and, in another sense, this choice has to be based on the mutual consent<sup>577</sup> of

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<sup>572</sup> PwC/QMUL 2013 Survey (n 566) 10.

<sup>573</sup> Michael Brown and Claire Morel de Westgaver, 'Banking and Finance Arbitration on the Rise – A Trend to Follow?' (Financier Worldwide, April 2013) <<http://www.financierworldwide.com/banking-and-finance-arbitration-on-the-rise-a-trend-to-follow/#.VaUkK5NUWB0>> accessed 7 June 2015.

<sup>574</sup> Golden and Werner (n 555) 2.

<sup>575</sup> Anthony Connerty, *Manual of International Dispute Resolution* (Commonwealth Secretariat) 13.

<sup>576</sup> Brown and de Westgaver (n 572). It must be added that the issue of arbitral awards and their enforcement may be challenging in some jurisdictions even though those jurisdictions are New York Convention signatories. Good examples are Russia and Saudi Arabia where local courts tend to challenge the enforcement of foreign arbitration awards. For more information see Chapter Three, 3.1.5 'Global Enforceability of arbitration awards'.

<sup>577</sup> This characteristic is mainly based on the principle of freedom of contract where parties have the free choice to enter into agreements and they also have the free will to agree on the terms and subject of the contract. For more, see Nathan M Crystal and Francesca Giannoni-Crystal, 'Enforceability of Forum

all the involved parties.<sup>578</sup> The obvious difference between the two mechanisms is that arbitration provides a private panel that is independent from states, and it works as an alternative to the litigation process. No state should prevent contracting parties from exercising this choice by forcing them to resolve their matters exclusively in courts.<sup>579</sup>

In the past few years, there has been a trend to combine these two choices to have the best of both mechanisms. Unilateral arbitration<sup>580</sup> option clauses or unilateral option clauses can provide such a mechanism. A unilateral arbitration clause is a dispute resolution clause that provides for arbitration, but gives one party the choice to refer the dispute to litigation if it wishes to do so.<sup>581</sup> However, option clauses are not always one way and they can provide the option to arbitration or litigation to be exercised by either party.

If such a clause is included in the main contract, parties can refer the dispute to either a court or an arbitral panel, depending on the type of the dispute or issues, such as assets of the defendant or enforcement mechanism in the relevant location.<sup>582</sup> The issue can become more controversial in cases where option clause only gives the power to choose the dispute settlement method to one party. Case law has been evolving in relation to the recognition of option clauses globally.

In the finance and banking world, these unilateral jurisdiction clauses are normally drafted in a way which is in favour of creditors as they give the creditor authority to sue the borrower in any court or jurisdiction where there is a chance of debt recovery,

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Selection Clauses: A “Gallant Knight” Still Seeking Eldorado’(Charleston School of Law, 1 May 2011) <[http://works.bepress.com/cgi/viewcontent.cgi?article=1054&context=nathan\\_crystal](http://works.bepress.com/cgi/viewcontent.cgi?article=1054&context=nathan_crystal)> accessed 10 January 2016.

<sup>578</sup> Zheng Sophia Tang, *Jurisdiction and Arbitration Agreements in International Commercial Law* (Routledge 2014) 3.

<sup>579</sup> *ibid* 5.

<sup>580</sup> Unilateral option clauses also called ‘one-sided’, ‘optional’, asymmetrical’, ‘hybrid’, ‘split’, etc. See Deyan Draguiev, ‘Unilateral Jurisdiction Clauses: The Case for Invalidity, Severability or Enforceability’, (2014) 31(1) *Journal of International Arbitration*, 19

<sup>581</sup> A survey conducted by Clifford Chance in February 2013 Marie Berard, ‘Unilateral option clauses in arbitration: a survey to their effectiveness’ (Briefing Notes, Clifford Chance) <[http://www.cliffordchance.com/briefings/2013/02/unilateral\\_optionclausesinarbitration.html](http://www.cliffordchance.com/briefings/2013/02/unilateral_optionclausesinarbitration.html)> accessed 7 June 2015

<sup>582</sup> Philip Clifford and Oliver Browne, ‘Finance Agreements: A Practical Approach to Options to Arbitrate’ (2006) 1(6) *Global Arbitration Review* <[http://www.lw.com/upload/pubContent/\\_pdf/pub1762\\_1.pdf](http://www.lw.com/upload/pubContent/_pdf/pub1762_1.pdf)> accessed 7 June 2015.



regardless of having an exclusive or non-exclusive jurisdiction clause<sup>583</sup> in the main contract.<sup>584</sup> Although the use of these clauses may seem contrary to the principles of parties' equality in contracts, such clauses are now used in financial markets and banks more frequently.<sup>585</sup> More specifically, in syndicated lending documentations it is common to find option clauses that are exercisable only by the finance parties.<sup>586</sup>

Although unilateral jurisdiction or arbitration clauses have become popular in some jurisdictions and especially among banks,<sup>587</sup> the use of unilateral option clauses in financial and banking agreements has been criticised in recent years as, in most cases, the clause gives the choice to the party that has more bargaining power in the contract. Perhaps for the same reason this clause is referred to as a 'one-sided' and 'asymmetric' clause.<sup>588</sup>

Furthermore, the jurisdictions that have rejected the validity of such clauses have argued that the clauses are uncertain. Different jurisdictions have different views on the validity of option clauses. In England, it was decided in 1983 that a litigation clause with an option to arbitrate is a valid clause.<sup>589</sup> This decision was confirmed in the 1984 case of *Continental Bank NA v Aeakos SA*,<sup>590</sup> where Court of Appeal judges did not question the validity of the unilateral jurisdiction agreement.<sup>591</sup> In another case where there existed an arbitration clause alongside an option to litigate, the court recognised the validity of the clause.<sup>592</sup>

All the above discussed cases show that, in England, the tendency is to observe such clauses as valid and enforceable. In Sweden, however, as a general view, such clauses are

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<sup>583</sup> Richard Fentiman, 'Unilateral Jurisdiction Agreements in Europe' [2013] 72(1) C L J 24–

<sup>584</sup> *ibid.*

<sup>585</sup> *ibid.*

<sup>586</sup> Judith Gill and James Freeman, 'Practical Issues Specific to Arbitration Containing Financial Products' in Jeffrey Golden and Carolyn Lamm (eds), *International Financial Disputes* (Oxford University Press 2015) 333.

<sup>587</sup> Brown and de Westgaver (n 572).

<sup>588</sup> Marie Berard and James Dingley (Practical Law, 1 August 2014) <<http://uk.practicallaw.com/7-535-3743#>> accessed 16 July 2015.

<sup>589</sup> *Westfal-Larsen & Co. v Ikerigi Compania Naviera (The Messianiaki Bergen)* Q.B.D. (Commercial Court) (Bingham J) 20 October 1982

<sup>590</sup> [1994] 1 WLR 588 (CA)

<sup>591</sup> Fentiman (n 582).

<sup>592</sup> *Law Debenture Trust Corp Plc v Elektrim Finance BV* [2005] 1 All ER (Comm) 476

valid but the validity is based whether the party with the stronger influence has incorporated the clause into the agreement; if it has, the clause is invalid.<sup>593</sup>

In another case in this area, the Commercial Court in London confirmed the validity of unilateral option clauses. In the case of *Three Shipping Ltd v Harebell Shipping Ltd*,<sup>594</sup> the dispute was between a charterparty and the vessel owner. The clause in the contract provided that:

The courts of England shall have jurisdiction to settle any disputes which may arise out of or in connection with this Charterparty but the Owner shall have the option of bringing any dispute hereunder to arbitration.<sup>595</sup>

As was pointed out by the judge, the clause was clearly designed to give ‘better rights’ to the owner by providing for him to sue the charterparty in both English courts and an arbitration tribunal.<sup>596</sup> However, despite having regarded this clause as advantageous for one party only, the court still validated the clause.

Generally speaking, English courts support the theory that a party person has the right to sue and be sued legally; they have also recognised the validity of exclusive jurisdiction clauses and arbitration clauses even though the process of enforcing these clauses may restrict the mentioned rights and obligations.<sup>597</sup> As a result, English courts are reluctant to issue anti-suit injunctions, as they want to preserve party autonomy and freedom in contracts. It has been stated that jurisdiction clauses are the fundamental expression of party autonomy in private international law and that as long as there is no strong evidence indicating duress, error, incapacity or any other fundamental infringing factor involved in the drafting of the clause, it has to be rendered valid and enforceable, and the same approach should be taken in relation to unilateral clauses.<sup>598</sup>

This may be a valid argument if both parties have, of their own free will, agreed on the unilateral jurisdiction clause. As was explored in Chapter Four, terms that seem unfair to one party can be acceptable only if both parties were aware of that term and had equal bargaining powers at the time of incorporating that term into the agreement.

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<sup>593</sup> Philip Clifford and Oliver Browne (n 581).

<sup>594</sup> [2005] 1 Lloyds Rep 509

<sup>595</sup> Hew R Dundas, ‘Unilateral Arbitration Agreement’ [2005] 71(1) Arbitration 101–102

<sup>596</sup> *ibid.*

<sup>597</sup> Tang (n 577) 156.

<sup>598</sup> Draguiev (n 579).

In the case of lending, a unilateral jurisdiction clause in favour of the lender/creditor is only minimising the risk of borrowers' non-payment and is also increasing the banks' willingness to provide more finances to borrowers.<sup>599</sup> On the other hand, one may argue that the lenders, in this case banks, are in a stronger position as credit providers, and the borrowers have no choice but to accept the unilateral jurisdiction clause in favour of the banks.

In examples from Bulgaria and Russia, the judges have questioned the validity of unilateral option/jurisdiction clauses. More specifically for example, in a judgment issued by the Bulgarian Supreme Court on 2 September 2011, the option clause included in a loan agreement that gave only the lender the right to choose between litigation and arbitration was declared void by the court.<sup>600</sup>

In judgment issued by the Russian court on 19 June 2012, the unilateral option clause was rendered void as the court decided that it was against the principle that both parties should have equal procedural rights.<sup>601</sup> It was decided in the Russian Supreme Court that the existence of an option clause in a contract violates public policy and the parties' equal right to justice.<sup>602</sup>

Another European example of not approving the clause is the case of *Ms X v Banque Privee Edmonds de Rothschild*,<sup>603</sup> where the highest court in France rejected the validity of the exclusive jurisdiction clause. The case was between a French national and a Luxembourg bank and there existed an exclusive jurisdiction clause (namely, the courts in Luxembourg) and a unilateral jurisdiction clause (in favour of the bank) that would give the bank the right to sue not only in the courts in Luxembourg, but in any other jurisdiction it wished.

The French national started proceedings against the bank in France. The first court rejected its own jurisdiction because of the existence of an exclusive Luxembourg

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<sup>599</sup> Fentiman (n 582) 24–27.

<sup>600</sup> Berard (n 587).

<sup>601</sup> *ibid.*

<sup>602</sup> *Russkaya Telefontnaya Kompaniya v Sony Ericsson Mobile Communication Rus*, judgment of 19 June 2012, N A40-49223/11-112-401

<sup>603</sup> Case No 11-26.022.

jurisdiction clause. However, the Court de Cassation<sup>604</sup> decided that the unilateral jurisdiction clause was contrary to French contract law principles and that it was a case of *potestative*, which is a contract term in favour of only one party and unfair to the other party.<sup>605</sup> The court also argued that this clause was against EU Regulation 44/2001, which requires certainty in jurisdiction clauses. This court was of the opinion that the fact that the bank had the choice to sue the French national in any jurisdiction it wished conflicted with the EU Regulation because of the lack of legal certainty.<sup>606</sup>

From the above examples, although it is clear that including unilateral option clauses into a loan agreement can be the best of two mechanisms for lenders, they have to take extra care when they are dealing with borrowers from jurisdictions where the courts do not regard unilateral option clauses to be enforceable as other clauses incorporated into the contracts. Failure to take care may result in the vulnerability of the arbitration award when it comes to enforcement.<sup>607</sup> It can be argued that such award is the result of the application of an option clause and option clauses are not regarded enforceable or valid in the country of enforcement.<sup>608</sup>

Banks and financial institutions find such clauses very appealing because the clauses combine the best of both worlds when banks and financial institutions have the option. Banks seem to have finally decided on the most attractive choice, arbitration, which replaces their traditional tendency towards litigation in New York and London courts. The option clause gives the bank the possibility of bringing an action in any court or tribunal, whereas their borrowers are limited to just one exclusive jurisdiction.<sup>609</sup> By adopting an optional arbitration clause, the banks have the liberty to choose either litigation or arbitration as they see fit. For instance, in matters in which they wish to preserve confidentiality, they can proceed with arbitration and, on the other hand, if there is higher chance of enforcing a court judgment they can exercise their litigation choice.

It is clear that considering the different approaches taken by courts throughout the globe makes the practicality of unilateral option clauses difficult in a sense that the

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<sup>604</sup> Final appeal court in France

<sup>605</sup> Fentiman (n 582), 24–27.

<sup>606</sup> *ibid.*

<sup>607</sup> See Article V(2)(b) of the New York Convention 1958.

<sup>608</sup> Gill and Freeman (n 585) 353.

<sup>609</sup> *ibid* 333

enforceability of such clauses can never be guaranteed. Overall, the number of jurisdictions that judge option clauses to be invalid is increasing; this is believed to be because they wish to promote certainty and predictability in contracts, which are fundamental principles in contract law. However there is no solution offered to the issue of leaving the parties with ‘only one avenue of redress’, which was the main reason for the creation of these terms.<sup>610</sup>

#### **6.4 Key arbitration options – including evaluating P.R.I.M.E.Finance’s efficiency and its current role in the market practice**

Parties that are willing to refer finance- and bank-related disputes to arbitration have to select an appropriate arbitral institution. The choice of a suitable arbitral body is of great importance. If one is looking for an institution that offers commercial arbitration services, many will be found. However, when it comes to bank and finance arbitration, the choices are limited or at least not as wide as the services available for commercial arbitration.

The competency of the arbitral tribunal is of great importance in disputes related to banks and financial institutions. Historically, banks have not regarded arbitral tribunals as proficient as courts in rendering a ‘predictable’ or ‘fair outcome’.<sup>611</sup> The presumption about arbitrators has always been that they follow King Solomon’s approach and use ‘split the baby’<sup>612</sup> reasoning in most of their decision-making processes.<sup>613</sup> Arguably, arbitrators do seem to be tolerant towards all the claims and counterclaims that both claimant and respondent may have during the course of arbitration, even if those claims lack the required merit.<sup>614</sup> For these reasons, banks and financial institutions have major concerns as to the certainty and competency of arbitral tribunals, as well as their calm and flexible treatment towards debtors. To address these concerns, the arbitration community has found practical solutions and among them are training and designing arbitral institutions to specifically deal with financial and banking cases. In terms of training, the arbitration community can provide training courses for arbitrators to familiarise them

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<sup>610</sup> Draguiev (n 579).

<sup>611</sup> Gill and Freeman (n 585) 314.

<sup>612</sup> Hebrew Bible at 1 Kings 3: 16–28.

<sup>613</sup> Gill and Freeman (n 585) 314.

<sup>614</sup> *ibid.*

with the market and give them the necessary level of knowledge of finance and banking to ensure a knowledgeable tribunal.

Consequently, in the past few years this trend has started to change and currently there are several viable options available for parties. In this section, some of the most frequently used institutions are illustrated. Some of these institutions are specifically designed to offer dispute settlement services to the banking and finance industry, and only deal with this type of disputes. Another group is the arbitral institutions that offer services for various types of disputes, including bank- and finance-related disputes. These types of institutions have special rules for financial and banking disputes.

#### 6.4.1 Panel of Recognised International Market Experts in Finance

The most recent development in international arbitration is the launch of the Panel of Recognised International Market Experts (P.R.I.M.E.) in Finance on 16 January 2012 in The Hague, Netherlands. This centre aims to provide a smooth dispute settlement for complex international finance and banking disputes. P.R.I.M.E. Finance is the only arbitral institution, that specifically deals with financial and banking disputes; no other types of disputes should be referred to this institution. P.R.I.M.E. Finance can be regarded as a unique arbitral institution that only deals with bank- and finance-related matters.<sup>615</sup>

This centre has a set of rules, the P.R.I.M.E. finance arbitration and mediation rules, that are used when dealing with cases referred to it. The rules of P.R.I.M.E. Finance are based on the United Nations Commission on International Trade Law (UNCITRAL) Arbitration Rules and are in fact a modified version of UNCITRAL rules.<sup>616</sup> This modification catered to the requirements of financial disputes.<sup>617</sup>

P.R.I.M.E. Finance lists a number of highly qualified finance and banking experts who are all professionals in dispute resolution. According to Articles 8 and 9 of P.R.I.M.E.

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<sup>615</sup> Abby Cohen Smutny and Petr Polasek, 'Arbitral Institutions' in Jeffrey Golden and Carolyn Lamm (eds), *International Financial Disputes* (Oxford University Press 2015) 21.

<sup>616</sup> Panel of Recognised International Market Experts in Finance <<http://www.primefinancedisputes.org/images/pdf/arbitration%20rules%20-%20prime%20format%20-.pdf>> accessed 15 January 2016. Also see Hanefeld (n 551) 917.

<sup>617</sup> Smutny and Polasek (n 614) 21.

Finance rules, parties are required to select their arbitrators from this list, which is available at the institute.<sup>618</sup> This emphasis on the use of P.R.I.M.E.-Finance-registered arbitrators is to safeguard the effectiveness of the arbitration procedure. As arbitrating complex finance and banking cases requires a deep and technical level of related knowledge of both practice and markets, P.R.I.M.E. Finance obliges the parties to choose their panel from its recognised list of arbitrators.

P.R.I.M.E. Finance also offers mediation services. Mediation, as an effective method of dispute settlement, is a suitable means of settlement for disputes in financial services. A panel of experts in P.R.I.M.E. Finance can assist the conflicting parties as mediators as well as arbitrators or advisers.<sup>619</sup>

One of the unique features of the P.R.I.M.E. Finance arbitration institution is an emergency arbitration procedure.<sup>620</sup> Parties that are in need of a speedy resolution can request emergency arbitration by submitting the required form to the institution. After the form and all the required documents are submitted to the institution, an emergency arbitrator will be appointed within 72 hours and they have to issue an award within 15 days of the transmission of the case.<sup>621</sup> The fact that such a mechanism exists and provides for extra-speedy dispute resolution can be very advantageous for disputant parties in bank- and finance-related cases.

Speed and efficiency are very valuable in the arbitration of these disputes and these advantages are addressed in P.R.I.M.E. Finance Rules. There are sections in the Rules that can ensure a prompt proceeding. For example, Article 17(1) requires arbitrators to handle the proceedings in such a way to ‘avoid unnecessary delay and expenses’ and to ‘provide a fair and efficient process’.

Another vital concern for bank and finance disputants is to keep the entire case confidential and private. P.R.I.M.E. Finance offers a mechanism to preserve this secrecy. Article 34 (5) of the Rules stipulates that the arbitration award is not to be made public

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<sup>618</sup> Article 8 and 9 P.R.I.M.E. Finance Arbitration Rules, Panel of Recognised International Market Experts in Finance <<http://primefinancedisputes.org/images/pdf/arbitration%20rules%20-%20prime%20format%20-.pdf>> accessed 12 July 2015.

<sup>619</sup> Tony Willis and William Wood, ‘Alternative Dispute Resolution’ in Jeffrey Golden and Carolyn Lamm (eds), *International Financial Disputes* (Oxford University Press 2015) 81.

<sup>620</sup> P.R.I.M.E. Finance Arbitration Rules, Article 26a, Emergency Arbitral Proceeding (n 617).

<sup>621</sup> Articles 4 and 9, Annex C Prime Finance Arbitration Rules (n 617).

unless all of the parties express their consent, or if the law requires it. It has to be noted that this provision in P.R.I.M.E. Finance Rules is common in other main arbitration rules, as confidentiality is one of the fundamental characteristics of the arbitration process.

To promote and expand precedent and custom in the finance and banking sectors and also to develop market practices, P.R.I.M.E. Finance Rules allow for excerpts of awards to be distributed, as long as they are in an anonymous format.<sup>622</sup>

If one wish scrutinise the function of P.R.I.M.E. Finance and assess the effectiveness of this institution in banking and finance sector disputes, it has to be remembered that it is a newly established body, meaning that a more reliable judgment on the function of this panel may require a longer period of time.

#### 6.4.2 China International Economic and Trade Arbitration Commission

P.R.I.M.E. Finance is not the only example of the use of alternative dispute resolution (ADR) in finance/banking disputes. There are other arbitral institutions that offer tailored arbitration services to the banking and finance industry. The China International Economic and Trade Arbitration Commission (hereinafter CIETAC) is one of them, and it has special rules for financial disputes the CIETAC Arbitration Rules for Commercial Financial Disputes. These arbitration rules are designed solely for disputes arising out of 'financial transactions'. CIETAC has defined and restricted the scope of 'financial transactions' to loans, letters of credit, deposit certificates, guarantees and negotiable instruments.<sup>623</sup>

Not surprisingly, the rules for commercial financial disputes contain provisions for an expeditious and speedy dispute settlement<sup>624</sup> process, as time is of the essence in this category of disputes. For instance, Article 22 provides for a strict deadline of parties'

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<sup>622</sup> Smutny and Polasek (n 614) 25 and see Article 35(5) PRIME Finance Arbitration Rules

<sup>623</sup> CIETAC, Financial Disputes Arbitration Rules, China International Economic and Trade Arbitration Commission <<http://www.cietac.org/index/rules.cms>> accessed 5 July 2015.

<sup>624</sup> Hanefeld (n 551) 917.



submissions, and provides that an award shall be issued within 45 days after the constitution of the tribunal.<sup>625</sup>

The use of an arbitration clause in banking and finance contracts is more common in South East Asia, according to some leading practitioners (Philip Wood). CIETAC introduced its rules for financial disputes in 2003. Since then, this centre has been a place for parties that wish to have access to the advantages of arbitration as a means of dispute resolution in their contracts.

#### 6.4.3 The Hong Kong International Arbitration Centre

This institution was established in 1985 in Hong Kong and is one of the most frequently used institutions in finance- and banking-related cases. The Hong Kong International Arbitration Centre (HKIAC) was established by a group of leading professionals and is currently governed by a panel of experts from all around the globe.<sup>626</sup> According to HKIAC's website, the centre offers various dispute resolution services, including arbitration and mediation, and all the activities of the centre are supervised by a secretary general, chief executive and registrar.<sup>627</sup>

In relation to financial arbitration, HKIAC is considered to be one of the more desirable options by parties in this sector, because of the existence of its special rules for an expeditious arbitration process. HKIAC, similar to some other arbitral institutions, offers rules that contain provisions designed for a speedy and swift resolution of disputes.<sup>628</sup> As time is of essence in financial and banking dispute settlements, the possibility of having an accelerated procedure seems appealing to parties in this sector. In addition to the expeditious arbitration rules, HKIAC also provides another desirable facility for

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<sup>625</sup> CIETAC, Financial Disputes Arbitration Rules, Article 22 (n 622).

<sup>626</sup> See HKIAC official website (About Us) <<http://www.hkiac.org/en/hkiac/about-us>> accessed 12 August 2015.

<sup>627</sup> *ibid.*

<sup>628</sup> HKIAC Administered Arbitration Rules 2013, Article 41 Expedited Procedure, <<http://www.hkiac.org/en/arbitration/arbitration-rules-guidelines/hkiac-administered-arbitration-rules-2013/10-domain-name-dispute-resolution-a-odr/14-hong-kong-international-arbitration-centre-administered-arbitration-rules-2013-3#41>> accessed 18 August 2015.

arbitration to disputant parties in the finance sector and that is tailoring arbitration rules for securities disputes in a set of rules called HKIAC Securities Arbitration Rules.<sup>629</sup>

The entire combination of the features noted above, in addition to the location of the institution one of the biggest financial centres in the world, has made this centre a very popular choice for parties that seek financial arbitration services.

The increased use of arbitration clauses that provide for HKIAC or CIETAC arbitration may indicate that there is a growing tendency among contracting parties in South Asia to arbitrate their disputes more locally.<sup>630</sup>

#### 6.4.4 American Arbitration Association

The AAA is an international centre for dispute resolution. It is located in the US and has offices throughout the country. The AAA is one of the predominant arbitral institutions in the world and provides arbitral services to various sectors, including the energy sector, communication sector, entertainment and sports sector, intellectual property sector and healthcare sector.<sup>631</sup> The areas of expertise in AAA cover commercial finance and securities. Moreover, it has a special set of rules for commercial financial disputes, which can be used to resolve banking and securities disputes.<sup>632</sup>

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<sup>629</sup> HKIAC Securities Arbitration Rules which came into force in 1993  
<<http://www.hkiac.org/images/stories/arbitration/Securities%20Arbitration%20Rules.pdf>> accessed 18 August 2015.

<sup>630</sup> Gill and Freeman (n 585) 318.

<sup>631</sup> The list includes other sectors. See American Arbitration Association.  
<[https://www.adr.org/aaa/faces/aoe?\\_afLoop=408633346088934&\\_afWindowMode=0&\\_afWindowId=djkgvsep8\\_198#%40%3F\\_afWindowId%3Ddjkgvsep8\\_198%26\\_afLoop%3D408633346088934%26\\_afWindowMode%3D0%26\\_adf.ctrl-state%3Ddjkgvsep8\\_311](https://www.adr.org/aaa/faces/aoe?_afLoop=408633346088934&_afWindowMode=0&_afWindowId=djkgvsep8_198#%40%3F_afWindowId%3Ddjkgvsep8_198%26_afLoop%3D408633346088934%26_afWindowMode%3D0%26_adf.ctrl-state%3Ddjkgvsep8_311)> accessed 15 August 2015.

<sup>632</sup> American Arbitration Association, Commercial Finance  
<[https://www.adr.org/aaa/faces/aoe/commercial/financialservices/commercialfinance?\\_afWindowId=djkgvsep8\\_84&\\_afLoop=408826595761858&\\_afWindowMode=0&\\_adf.ctrl-state=djkgvsep8\\_4](https://www.adr.org/aaa/faces/aoe/commercial/financialservices/commercialfinance?_afWindowId=djkgvsep8_84&_afLoop=408826595761858&_afWindowMode=0&_adf.ctrl-state=djkgvsep8_4)> accessed 14 August 2015.

#### 6.4.5 London Court of International Arbitration

The LCIA was established in 1883 and is one of the leading international arbitral institutions.<sup>633</sup> The LCIA is one of the predominant choices for commercial arbitration referrals and, according to LCIA reports, it has become popular recently for resolutions in banking and financial disputes.<sup>634</sup> This popularity can be explained by London being one of the world's leading financial centres and also English law's popularity as a governing law for finance and banking contracts.<sup>635</sup> The LCIA has benefited from its location, as well as its flexible arbitral rules. The LCIA offers expedited formation of an arbitral tribunal,<sup>636</sup> saving time, which can be of great importance for bank and financial institutions' claims.

#### 6.4.6 International Court of Arbitration of the International Chamber of Commerce

One of the leading arbitral institutions in the world is the International Court of Arbitration of the ICC, which is located in Paris. Although the headquarters is in Paris, it administers arbitral tribunals all around the world.

ICC differs from other arbitral institutions in that every ICC arbitral award is scrutinised by a court that is an independent body within the ICC, which administrates the dispute resolution procedure, but does not resolve the disputes.<sup>637</sup> Any the award is not available to parties until it has been reviewed by the court.<sup>638</sup>

As it was discussed in Chapter Five,<sup>639</sup> there is a special panel in ICC that offers ADR services, including arbitration of disputes arising out of documentary credit, which is

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<sup>633</sup> LCIA <<http://www.lcia.org/LCIA/introduction.aspx>> accessed 28 July 2015.

<sup>634</sup> LCIA report 2012 <<http://www.lcia.org/LCIA/reports.aspx>> accessed 27 July 2015.

<sup>635</sup> Smutny and Polasek (n 71) 35.

<sup>636</sup> Article 9A LCIA Arbitration Rules, <[http://www.lcia.org/Dispute\\_Resolution\\_Services/lcia-arbitration-rules-2014.aspx#Article%209](http://www.lcia.org/Dispute_Resolution_Services/lcia-arbitration-rules-2014.aspx#Article%209)> accessed 12 September 2015.

<sup>637</sup> See ICC Rules, Article 1 <[http://www.iccwbo.org/products-and-services/arbitration-and-adr/arbitration/icc-rules-of-arbitration/#article\\_2](http://www.iccwbo.org/products-and-services/arbitration-and-adr/arbitration/icc-rules-of-arbitration/#article_2)> accessed 12 January 2016

<sup>638</sup> See ICC Rules, Article 33 and 23, <[http://www.iccwbo.org/products-and-services/arbitration-and-adr/arbitration/icc-rules-of-arbitration/#article\\_2](http://www.iccwbo.org/products-and-services/arbitration-and-adr/arbitration/icc-rules-of-arbitration/#article_2)> accessed 16 January 2016 .

<sup>639</sup> See section 5.1.2.1 above.

called Documentary Instruments Dispute Resolution Expertise (DOCDEX).<sup>640</sup> It is worth mentioning that the ICC DOCDEX offers less flexibility to the parties in that there a panel of three experts deal with the dispute and the experts are selected from the list provided by ICC.<sup>641</sup>

ICC also has a division called ICC Banking Commission and it specifically deals with trade-finance-related disputes.<sup>642</sup> ICC has administrated several financial disputes that have encompassed 9.1% of all the arbitration cases referred to ICC in 2010, 11% in 2011, and 8% in 2012.<sup>643</sup>

## **6.5 Drafting the arbitration clause for the banking and finance sector**

The use of arbitration to resolve disputes, both nationally and internationally, is expanding and the issue of drafting an effective arbitration clause is a vital issue. For parties to benefit from arbitration, the clause needs to be drafted properly. Parties can enjoy a workable arbitration clause only if it has been drafted diligently otherwise they are faced with an unenforceable clause. It should be noted that a 'standard' arbitration clause is rather worthless as there is no standard contract or standard dispute, thus each arbitration clause has to be drafted in a way that particularly and precisely reflects the components of that particular contract.

It was discussed in Chapter Four that incorporating an arbitration clause in an agreement represents the parties' mutual consent to the use of arbitration services rather than courts in the event of a dispute. Therefore, any ambiguity as to the clause itself may invalidate the choice of arbitration and ultimately deprive parties of their wishes. Therefore, parties must ensure that the agreement is drafted with due diligence to avoid a 'pathological

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<sup>640</sup> For more see [International Chamber of Commerce] <<http://www.iccwbo.org/products-and-services/arbitration-and-adr/docdex/>> accessed 12 January 2016

<sup>641</sup> Introduction to ICC, <<http://www.iccwbo.org/products-and-services/arbitration-and-adr/docdex/>> accessed 30 August 2015.

<sup>642</sup> ICC Banking Policy Commission, <<http://www.iccwbo.org/about-icc/policy-commissions/banking/>>

<sup>643</sup> Smutny and Polasek (n 71) 27.

clause’<sup>644</sup> situation where the clause is defective and cannot be given effect and, therefore, the parties’ wish to arbitrate is not met.

An arbitration clause or arbitration agreement is the fundamental part of an arbitration process and, obviously, without establishing a valid and strong arbitration clause or arbitration agreement, there is no way to opt for arbitration after the execution of the contract. An arbitration clause can be a separate document or included in the main contract. Parties that are willing to benefit from arbitration as a means for dispute settlement have to ensure that the arbitration agreement is clear and effective enough according to the requirements set by the New York Convention.<sup>645</sup> One of the essential requirements specified in New York Convention, as well as many other national arbitration laws such as UNCITRAL Model Law, is the requirement that it be in writing.<sup>646</sup>

Therefore, first stage in recognising an arbitration agreement is to compare the clause or the agreement with the requirements set out in the New York Convention.<sup>647</sup> The New York Convention contains Articles that specifically relate to the validity of arbitration agreements. One of the key requirements of to the New York Convention is the requirement that the agreement be in ‘writing’. Article II(2) states that an arbitration agreement has to be in writing to be given effect. The same approach is taken in Arbitration Act 1996 (UK)<sup>648</sup> where, in section 5, it is stated that an arbitration agreement has to be in writing. This section has defined ‘in writing’ requirement as:

- (2) There is an agreement in writing—
  - (a) if the agreement is made in writing (whether or not it is signed by the parties),
  - (b) if the agreement is made by exchange of communications in writing, or

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<sup>644</sup> It is believed that the term ‘pathological clause’ was first used by Frederic Eisemann, former Secretary General of the ICC Court of Arbitration, see Margaret L. Moses, *The Principles and Practice of International Commercial Arbitration*, (first published 2008, Cambridge University Press 2012) 43.

<sup>645</sup> The New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958

<sup>646</sup> See Chapter Three, 3.1.5

<sup>647</sup> New York Convention 1958 (n 101).,

<sup>648</sup> Arbitration Act 1996 (UK) The national Archives,

<<http://www.legislation.gov.uk/ukpga/1996/23/contents>> accessed 19 August 2015.

(c) if the agreement is evidenced in writing.<sup>649</sup>

An arbitration clause can be in form, from a single paragraph to a lengthy document that covers several pages. Depending on the complexity of the main contract, parties may wish to vary the detail that is included in their arbitration clauses. As arbitration clauses often required validation by national courts, the drafting of an efficient and effective arbitration clause that can survive a court's validity testing by courts is a challenging but crucial task. This task may become even more critical when there is an unfamiliar foreign national court as the chosen jurisdiction.<sup>650</sup>

In some areas of commercial law, such as construction and trade, international arbitration is a common means for dispute settlement purposes. Parties that wish to incorporate an arbitration clause in their agreements in these sectors can use standard clauses that are readily available and usually only need some adjustments and tailoring to meet the specific requirements of the parties. It can be stated that the drafting of an arbitration clause in an area where arbitration has been practised for several decades is not a major obstacle for parties.

Conversely, using an arbitration clause in the banking and finance sector is a rather new phenomena and a recently emerged trend. As stated above in this research, the popularity of arbitration in commercial law has been transmitted to financial and banking disputes. Several factors are involved in the popularity of arbitration in this sector and the most important factors are the globalisation of banking and financial markets and the involvement of parties from emerging markets.<sup>651</sup>

The incorporation of arbitration clauses in agreements in the abovementioned sector is not considered to be a straightforward or common matter. Contracting parties should act diligently and attentively to minimise the risk of an arbitration clause being declared void by the courts. As was discussed above in this research, banks and financial institutions are willing to consider arbitration as a means of dispute resolution so as to benefit from the global enforcement and recognition of arbitration awards, which is one of the major

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<sup>649</sup> Arbitration Act 1996 <<http://www.legislation.gov.uk/ukpga/1996/23/section/5>> accessed 19 August 2015.

<sup>650</sup> Neil Aitken and Charles Spragge, 'Drafting the Arbitration Agreement' [1998] 1 (4) Int A L R 145.

<sup>651</sup> Gerard J Meijer and Richard H Hansen, 'Arbitration Clauses for International Financial Disputes' in Jeffrey Golden and Carolyn Lamm (eds), *International Financial Disputes* (Oxford University Press 2015) 145.

advantages of international arbitration. One of the most common grounds for refusal to recognise and enforce a foreign arbitral awards is the validity of the arbitration agreement.<sup>652</sup>

Drafting a valid and effective arbitration clause is one of the main practical concerns for parties in banking and finance, as it is in other areas of commerce. It has been claimed that although arbitration offers advantages to bank and finance parties, the drafting of an effective and recognisable arbitration agreement in this sector may require considerable work.<sup>653</sup>

An arbitration clause in this area could say anything the parties require. The standard rules for a valid and enforceable arbitration agreement are more or less applicable to financial arbitration agreements.<sup>654</sup> There are some key questions that need to be considered in each arbitration clause, including: first, the arbitration rules to be used in the arbitration process (both substantial and procedural rules); second, the seat of arbitration; third, the number of arbitrators or perhaps the name of the arbitrators who will serve on the tribunal.

There are many issues that need to be addressed in a valid arbitration agreement, such as the scope of clause, cost, language, seat, governing law and many others. Some of these issues have to be decided at the time of drafting the arbitration clause and some can be left until parties are engaging in the actual arbitration process. For instance, parties have to decide on the scope of arbitration at the time of drafting the arbitration clause, as this is a critical matter in the arbitration process. The scope determines which disputes can be brought before an arbitral tribunal.

Some of the world's leading arbitral institutions have model arbitration clauses for financial disputes. The unique nature of financial and banking transactions, compared to other commercial transactions, explains the need for a model arbitration clause tailored

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<sup>652</sup> Ibid 146.

<sup>653</sup> Michael Young, Andrew Pullen and James Freeman, 'Demystifying the Use of Arbitration Clauses in International Finance Documents' (2012) 27 *Butterworths Journal of International Banking and Financial Law*, 357.

<sup>654</sup> Gill and Freeman (n 585) 322.

for banking and financial disputes. The following arbitral institutions offer model clauses that are recommended for use in financial disputes:<sup>655</sup>

- AAA in New York
- CIETAC in Beijing
- the City Disputes Panel in London
- the European Centre for Financial Dispute Resolution in Paris (EuroArbitration)
- P.R.I.M.E Finance in The Hague.

If disputant parties in the financial and banking world are willing to use arbitration, they can adopt a model clause from any of the abovementioned arbitral institutions. Clearly, parties can draft their own arbitration clause, but this is not recommended as it increases the probability of the courts holding the arbitration clause invalid or ineffective.

One of the challenges in drafting an appropriate arbitration clause is the issue of multiparty disputes and arbitration.<sup>656</sup> Disputes arising in the banking and finance sector tend to involve more than two parties and can, therefore, include complex multiparty issues.

Drafting a valid arbitration clause for international banking and financial disputes is no different from drafting an arbitration clause for commercial disputes in that in both areas there are fundamental elements that have to be addressed by drafting parties. Among these issues are place of arbitration, number of arbitrators, appointment of arbitrators, and choice of law and language of arbitration. Although decisions on some of the issues such as language of the arbitration or number of the arbitrators may be straightforward matters for parties, other issues such as choice of law as to the applicable and substantive law are rather complex. The substantive law in disputes dealing with banks and finance is normally the law of England or New York because of the long-standing reputation of these laws in the mentioned sectors.<sup>657</sup> It should be noted that the application of English law or New York law can be a sensible option where parties have no affiliation with

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<sup>655</sup> Meijer and Hansen (n 650) 148.

<sup>656</sup> Hanefeld (n 551) 917.

<sup>657</sup> Meijer and Hansen (n 650) 162.



either of these countries. Here the choice of, for instance, English law can be still an interesting choice as it promotes the ultimate neutrality of the arbitration process.<sup>658</sup>

It must be mentioned that, in practice, parties frequently neglect the crucial task of drafting the arbitration clause for various reasons. In some cases, at the time of drafting the main contract parties do not believe that they may have a need for arbitration and do not spend time (and costs) on researching and incorporating an appropriate arbitration clause.<sup>659</sup>

## 6.6 Conclusion

Arbitration is becoming increasingly complex and more and more actors are attracted to arbitration. According to Gaillard, the most significant evolution of arbitration is its transformation from a solidaristic field to a polarised field.<sup>660</sup> A solidaristic model is where there are only a few actors, including parties and arbitrators and experts, involved in the arbitration process. On the other hand, polarised arbitration refers to the great expansion in the field of arbitration in that there are a greater number of players in arbitration.<sup>661</sup>

To conclude this chapter, it should be stated that arbitration and, to a lesser extent, ADR mechanisms have recently gained greater recognition in the banking and finance sector and contributed to the settlement of a considerable number of disputes in relation to certain transactions. Arbitration can be regarded as a viable option for both domestic and, more importantly, cross-border transactions in the finance and banking area.

When using arbitration, parties have a wider choice of adjudicators, and therefore have the autonomy to decide upon the seat for the hearing, as well as other procedural issues,

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<sup>658</sup> *ibid* 163.

<sup>659</sup> Moses (n 100) 44.

<sup>660</sup> Emmanuel Gaillard, 'Sociology of International Arbitration' (2015) 31 *Arbitration International* 1 [Shearman & Sterling LLP] <<http://www.shearman.com/~/media/Files/NewsInsights/Publications/2015/04/Emmanuel-Gaillard--Sociology-of-international-arbitration-042715-IA.pdf>> accessed 12 December 2015.

<sup>661</sup> *ibid*.

although a potential challenge is finding the appropriate arbitrator who is free and not overloaded adjudicating other disputes.<sup>662</sup>

Another significant issue, which might require debate in future discussions, is the issue of arbitrability of financial disputes. This is a simple question of which types of financial disputes are appropriate for referral to an arbitration tribunal and which are not. As a general rule, there are areas in the law in which related disputes cannot be subject to arbitration, because of public policy. However, in the past years, because of the commercial nature of banking and financial transactions, the majority of disputes in this field are accepted as arbitrable.<sup>663</sup>

This chapter discussed that the allocation of unilateral dispute resolution clauses can work for the benefit of one party by offering a flexibility to sue the counterparty by way of their choice of arbitration or litigation. Commonly, it is the lender who has the power to decide on the process of the dispute resolution.

In the case of a loan agreement, the clause is drafted in a way that gives the lender the ability to opt for either arbitration or litigation depending on the interests that they wish to protect under the loan agreement. Lenders have this flexibility, and after a dispute has arisen they can assess the consequences of bringing an action against the other party by way of arbitration or litigation and then elect the most appropriate mechanism. Where substantial disclosure of documents and discovery in the dispute is not in the lender's interest, it can simply opt for arbitration where the dispute management procedure is confidential and the rules on disclosure are rather limited.<sup>664</sup>

It is evident that arbitration can be a more viable option than litigation for resolving banking-related disputes as a result of the advantages of this process, but one should not neglect the possibilities of delays occurring as a result of the prior engagements of the arbitrators in one specific sector. This is one of the problems that has appeared in practice and needs further consideration.<sup>665</sup>

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<sup>662</sup> Stephen Rosen, 'Increasing Use of Arbitration in Financial Markets Disputes' (2015) [ Global, Lexology] <<http://www.lexology.com/library/detail.aspx?g=a968dfcb-071e-4c9a-b3de-cc470b741623>> accessed 11 August 2015.

<sup>663</sup> Gill and Freeman (n 585) 326.

<sup>664</sup> Maria Davies, 'The Use of Arbitration in Loan Agreements in International Project Finance: Opening Pandora's Box or an Unexpected Panacea?' (2015) 32(2) *Journal of International Arbitration* 143.

<sup>665</sup> Rosen (n 118).

In relation to unilateral jurisdiction clauses, it can be summarised that although the use of such clauses is common practice because of the strong business logic behind using such clauses in international contracts, they are still subject to review and court scrutiny.<sup>666</sup>

In terms of drafting an arbitration clause, although there are many model clauses available at arbitral institutions, such as P.R.I.M.E. Finance and AAA, parties have to ensure that they draft the clause based on the specifics and requirements of the transaction in question to avoid possible pitfalls.<sup>667</sup>

Overall, although relatively new to this sector, the growing use of arbitration and ADR mechanisms means that these mechanisms have the potential to evolve into the primary means for resolving banking and finance disputes.

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<sup>666</sup> Draguiev (n 579). ,

<sup>667</sup> Meijer and Hansen (n 650) 168.

## Chapter Seven

### Conclusion

It is widely accepted that adopting a suitable dispute resolution in international transactions is not a straightforward task. A dispute resolution mechanism has to be considered by the contracting parties at early stages of drafting the main contract and should not be neglected or dismissed as this might create serious challenges and adversarial contacts between parties. The dispute resolution clause is itself an agreement that represents the parties' agreement on the way they wish to settle any disputes arising out of the main contract.

It has to be noted that there is a difference between a governing law clause and a dispute resolution clause. While most parties to an international transaction protect their contract by agreeing the jurisdiction governing the contract, they may overlook any agreement on a process for dispute handling.

There are number of considerations that should be taken into account when dealing with the issue of choosing between forum selection clauses and arbitration clauses. Issues such as procedural flexibility, confidentiality of the dispute matter, interests of the parties and enforcement elements are among the factors that will affect the dispute resolution decision.<sup>668</sup> In terms of enforceability, practitioners have a tendency to prioritise an arbitration clause over a litigation clause when dealing with non-EU parties This is because the vast majority of industrialised nations signed the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958<sup>669</sup> and therefore are obliged to validate and enforce foreign awards within their territories. It should be noted that only a few countries have adopted measures adopted to enforce court decisions made

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<sup>668</sup> Gary B. Born, *International Arbitration and Forum Selection Agreements: Drafting and Enforcing* (Kluwer Arbitration, 2013) 4

<sup>669</sup> The Convention on the Recognition and Enforcement of Foreign Arbitral Awards, also known as the "New York Arbitration Convention" or the "New York Convention" is one of the key elements in universal execution of foreign arbitral awards. The Convention was adopted by United Nations Commission on International Trade Law and entered into force on 7 June 1959 and is consist of 156 signatory parties.

in other jurisdictions and there is no harmonised approach towards the enforcement and recognition of foreign court judgements in home jurisdictions.

The choice between a panel of arbitrators and a judge (or perhaps in some cases, judges) is one of the crucial decisions that parties have to make when choosing between an arbitration clause and a litigation clause. There are several factors that each party has to take into consideration when drafting an effective dispute resolution clause. Depending on the relevant considerations in the main contract, parties may opt for an arbitration clause or a litigation clause. For instance, in contracts where the parties prefer to keep the dispute matter and the whole nature of the conflict confidential, perhaps arbitration as a private means of dispute resolution is the more appropriate choice. Alternatively, in circumstances where conflicting parties intend to benefit from certain and established case law, they would be likely to prefer litigation and to refer the dispute matter to the allocated national court.

Moreover, in situations where a technical and/or scientific issue is part of the dispute and needs expert knowledge to assist in its resolution, parties may favour arbitration over litigation as they can benefit from a specialised arbitral tribunal rather than a judge who may not have the relevant industry knowledge.

The issue of agreeing on an appropriate dispute resolution clause in international contracts is of such great importance that it might affect the entire nature of the main contract. Moreover, if contracting parties cannot reach an agreement on the means of conflict resolution they might decline to enter into the main contract. It is very important that dispute resolution clauses are drafted clearly and expressly, and reflect the true intention of parties, whether it is a forum clause or an arbitration clause.

Recent years have seen a turning point in views about the use of arbitration and mediation in financial and banking disputes. The reasons behind this change of attitude vary from globalisation of banking services and financial products to foreign investors' lack of trust in domestic litigation.

In the international sphere, banks as the main lenders have several concerns when it comes to bringing actions against defaulted overseas borrowers. The possibility of recovering debts from assets, which are located in foreign territories, is one of the main

concerns for lenders. Therefore, the recognition and enforcement of the achieved outcome, whether it is a court judgment or arbitration award, is one of the vital considerations for both parties.

Another main issue for both borrowers and lenders is the intelligence and professionalism of the dispute handling body. Arguably, expert arbitrators can be regarded as holding a wider technical knowledge and greater familiarity with banking practices compared to judges. Arbitrators are normally appointed from well-known experts in the area who have a long-standing and respected reputation in the sector. The panel's knowledge can become more important when dealing with complicated technical financial products. This could be situation where the extensive legal knowledge of the judges may be insufficient to resolve the matter and where there is a need for a deep knowledge of financial products and industry practices.

As well as the knowledge of the tribunal, neutrality of the tribunal is another important consideration for parties to an international lending contract. There is no doubt that an independent arbitral tribunal can appear to be a more neutral forum when one compares it to a national court. National courts can be frequently used in international claims, for example the courts of England or a national court in a less-known jurisdiction. In either case, a national court is part of that country's legal system and the judges are part of the legal structure of that country.

In light of the recent shift towards arbitration in banking and finance sector and the increasing willingness of legal practitioners to persuade parties to resolve their disputes through international arbitration, it can be concluded that the international community is moving towards a more global acceptance of arbitration in the banking and finance sector.

Although the use of international arbitration has grown in recent years, banks and the financial sector are still reluctant to fully endorse arbitration in some instances.<sup>670</sup> The main reason for this more conservative approach is the difficulties that are inherent in the

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<sup>670</sup> Maria Karampelias, 'Cross-border Disputes in the Financial Sector: A Trend Towards Arbitration and the Release of the ISDA Arbitration Guide', (Kluwer Arbitration Blog, 24 October 2013) <<http://kluwerarbitrationblog.com/blog/2013/10/24/cross-border-disputes-in-the-financial-sector-a-trend-towards-arbitration-and-the-release-of-the-isd-a-arbitration-guide/>> accessed 8 August 2015

arbitration process, such as the lack of summary judgment and/or default judgment. Undoubtedly, banks still prefer to use litigation over arbitration, mainly because of the stability and consistency of case law that is present in recognised jurisdictions, such as London, New York, Luxemburg and Switzerland.<sup>671</sup>

It seems that banks and other financial institutes are willing to opt for arbitration where their home jurisdiction clause is not available. In the case of unilateral clauses, they wish to have the control of the dispute settlement choice and use arbitration clause when they see such clauses as an appropriate option and not as something they are forced to accept.

It is suggested that the future for unilateral clauses may be challenging as currently there are presumptions that these clauses show the intention of parties to a contract to 'mould their relationship in the best (lawful) manner that suits their interests'.<sup>672</sup> Therefore, some jurisdictions are hesitant to validate these clauses because of the parties lack equality in the contract.

According to Sir Ronald Davison,<sup>673</sup> it would be foolish to deny the fact that arbitration procedure entails disadvantages as well as advantages. There is a need for regular and constant improvement of arbitration techniques, as well as the to identify the weaknesses and downsides.<sup>674</sup> International banking arbitration and international financial arbitration are in great need of improvement and reform, presumably to a greater extent than other areas as they are sectors new to the world of arbitration.

Arbitration is becoming increasingly widespread in the financial and banking sector. Considering the current large volume of global banking transactions, as well as the use of cross-border contracts, banks have no reason to reject out of hand international arbitration as a private dispute settlement mechanism. One of the most significant features of arbitration is its global enforceability in signatory countries. International arbitration enjoys a widespread global enforceability as a result of the application of the New York Convention. This particular characteristic of arbitral awards is referred to as being

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<sup>671</sup> Deyan Draguiev, 'Arbitration vs Litigation in Financial Agreements: A Policy Perspective' (Kluwer Arbitration Blog, 10 September 2015) <<http://kluwarbitrationblog.com/blog/2015/09/10/arbitration-vs-litigation-in-financial-agreements-a-policy-perspective/>> accessed 15 September 2015

<sup>672</sup> *ibid.*

<sup>673</sup> Sir Ronald Davison GBE CMG QC was the tenth Chief Justice of New Zealand from 1978 to 1989.

<sup>674</sup> Sir Ronald Davison, 'Arbitration – Its Future – Its Purposes' in Julio Cesar Betancourt and Jason A Crook (eds) *ADR, Arbitration, and Mediation, A Collection of Essays* (Author House 2014) 337.

‘portable awards’, in the sense that arbitral awards are portable, which makes enforcement and execution against assets possible in other states.<sup>675</sup>

Although the use of international arbitration has grown in the past few years, banks and the financial sector are still reluctant to fully adopt this practice.<sup>676</sup> The main reason for this more conservative approach is the difficulties that are inherent in the arbitration process, such as the lack of summary judgment and default judgment. Undoubtedly, banks are still keen to use litigation over arbitration, mainly because of the stability and consistency of the case law in recognised jurisdictions such as London, New York, Luxembourg and Switzerland.<sup>677</sup>

One can argue that the acceptance of arbitration clauses by the banking and finance sector is not entirely because of the appealing features of arbitration, but because of the non-availability of their favoured jurisdiction clause. In fact, banks, alongside financial institutions, are still in favour of a forum clause as long as it is their customary forum.<sup>678</sup> However, whenever the other party wishes to include a different forum or perhaps their own national jurisdiction in a choice of forum clause, banks will consider arbitration. It seems that banks are not yet ready to wave goodbye to the privileges that are present in national courts, such as summary judgment and the use of precedent, and not available in other methods of dispute settlement, including arbitration.

The number of arbitration referrals to the London Court of International Arbitration (LCIA) in disputes involving standard financial documents increased from 11.5 percent of all the reported cases to this institute in 2010 to 17 percent in 2011.<sup>679</sup> To conclude, it can be declared that banking and finance arbitration is on the rise. As the financial products and banking activities become increasingly globalised, the need for a neutral

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<sup>675</sup> Sam Luttrell, ‘Opportunities for Australian Arbitration Practitioners in the “Global Financial Crisis”’, (2009) *Arbitration* 415–416

<sup>676</sup> Karampelias (n 669).

<sup>677</sup> Draguiev (n 670).

<sup>678</sup> London or New York jurisdictions.

<sup>679</sup> Michael Brown and Claire Morel de Westgaver ‘Banking and Finance Arbitration on the Rise – A Trend to Follow?’ (Financier Worldwide, April 2013) <<http://www.financierworldwide.com/banking-and-finance-arbitration-on-the-rise-a-trend-to-follow/#.VaUkK5NUWB0>> accessed 7 June 2015



forum to resolve possible disputes arising out of these activities is more and more evident.

When the developments in the arbitration field are considered, along with arbitration's growing global popularity, on the one hand, and on the other hand, the expansion in the number of banking activities and financial transactions, which entail large sums and vital financial issues is considered, it is clear that there is a need for a more comprehensive view on the use of arbitration in banking and finance sector.

Clearly arbitration as a private dispute settlement procedure could conflict with public interests especially when manipulated in a regulated sector like banking. When using arbitration and alternative dispute resolution (ADR), banks must be aware of their implications on contracts and the interests of society. Overall, though relatively new to the banking scene, arbitration and ADR mechanisms have the potential to evolve into premiere dispute resolutions, provided that the relevant societal perspective changes.

Furthermore, the way that arbitration is applied and used in international banking and financial disputes needs to be harmonised to promote its efficiency. It appears that there is no country or state that could serve as a model country for applying (approving) international arbitration in banking and financial sector. One way of enhancing and promoting international financial arbitration is to facilitate the arbitration of banking and financial disputes by the provision of special arbitration rules that are specifically designed for disputes in this sector. One of the arbitration institutions that has adopted facilitating measures for the use of arbitration in banking industry is the International Chamber of Commerce (ICC), which has a division called ICC Banking Commission that specifically deals with trade and finance related disputes.<sup>680</sup>

Perhaps, so as to address the incompetence of international arbitration in banking sector, there is a need for a codification of the existing soft law in international arbitration, in a sense that provides for stronger measures and greater encouragement towards international arbitration in this sector. Also, the lack of summary judgment and legal precedent in arbitration, which are regarded as main limitations of arbitration, could be fixed by delegating more powers to arbitrators to issue summary judgments and

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<sup>680</sup> ICC Banking Policy Commission, <<http://www.iccwbo.org/about-icc/policy-commissions/banking/>> accessed 2 January 2016

providing a special mechanism to record arbitration awards and make them accessible to arbitrators, thereby creating legal precedent in arbitration similar to that in national courts.

In the light of these advantages and disadvantages, as well as other factors, it is argued that there is no dispute resolution mechanism that is perfect and without faults. International arbitration has proved its efficiency in international commercial transactions and has become the leading method of settling disputes. One could possibly conclude that as banking- and finance-related contracts are also considered to be commercial, international arbitration is, in fact, the most appropriate dispute settlement mechanism for case arising from cross-border transactions.

However, the existence of regulatory frameworks in the banking and finance sector and the intervention of states in this sector may limit the parties' choice of their favoured dispute resolution clause and, therefore, the practicality of arbitration in banking and financial disputes. Although securities transactions and other financial transactions are subject to contract law, there are some restrictions imposed on these transactions as a result of the securities and financial regulation regime. For instance, regulators may exempt particular banking and finance disputes from arbitration and make specific disputes in this sector not arbitrable. These limitations are thought to protect consumers or the public at large in financial transactions due to the sensitivity of financial markets and the fact that there are vulnerable investors involved in the market as well as strong investors. In other situation, where there is no need of consumer protection and the transaction in question is concerning banks, state, financial institutes, corporations and other powerful parties, states and regulators can vary the rules in a way that gives more scope for party autonomy and widen parties' authority to have their favoured dispute settlement method provided for in the underlying contract. This might result in a regulatory competition, which would be beneficial and help the further development of arbitration practices. A regulatory competition between regulators could enhance the transnationalism of the issue of arbitrability of banking and financial disputes and could result in the formulation of soft laws that encourage arbitration in this sector.

Perhaps emphasising the contractual nature of transactions in this sector, as well as other commercial sectors, would enhance the idea that arbitration is indeed a creature of party

autonomy<sup>681</sup> and sovereign states should not control it as long as the contracting parties have consented to the incorporation of arbitration clause in their main agreement.

Arbitrability of disputes in banking and other financial institutions is a relatively unaddressed issue by academics and practitioners and there is a need for further clarification as to whether banking and financial disputes can be arbitrated. In the absence of rules prohibiting the arbitration of such disputes, the presumption is that there is no legal restrictions on taking the dispute matter to the arbitration having followed the required steps of arbitration process.

In terms of foreign investment and the protection of banks and lenders as investors, countries can attract investors by offering an arbitration-friendly environment for all types of investors, including banks and financial institutions, thereby providing safety and security for lenders who invest in their territories.

Now is the time to leave behind the traditional rhetoric about banks' reluctance to engage in arbitration and welcome the recent trend in banking and finance sector towards the wider use of international arbitration. However, it has to be noted that contracting parties in the banking and financial sector come from various backgrounds, and although some may be leading lenders or powerful investors, some may be vulnerable consumers. Therefore, there should be different rules and regulations for different contracts. Adopting a liberal approach and allowing parties to decide on their favoured choice of dispute settlement process is efficient and appropriate only where parties are of equal bargaining power and no party is forcing its choice of terms on the other party.

In the case of consumer contracts, and where in general one party is in a weaker position, it may be possible for a state to declare regulatory frameworks that ensure the protection of consumers and lead to better justice.

It was demonstrated in this research that arbitration can indeed be considered as equally effective in banking as litigation and in fact there are unique features offered in arbitration which can be very advantageous for parties. Most importantly, global enforceability and cross-border recognition of arbitral awards as well as access to expert

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<sup>681</sup> Loukas A. Mistelis, 'Is Arbitrability a National or an International Law Issue?' in Loukas A Mistelis and Stavros L Brekoulakis (eds) *Arbitrability, International & Comparative Perspectives* (Kluwer Law International 2009) 7

arbitrators are the key elements of supporting arbitration versus litigation as a dispute settlement choice.

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