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WHAT'S THE DIFFERENCE? ARBITRATING DISPUTES UNDER THE ISDA MASTER

01 July 2016 | Global
Legal Briefings – By **Nick Peacock, Partner and Dr Mathias Wittinghofer, Partner**

It is over two and a half years since the International Swaps and Derivatives Association (ISDA) published its Arbitration Guide, which provides both general guidance on arbitration, and a selection of model arbitration clauses that can be incorporated into an ISDA Master Agreement. ISDA decided to publish the Arbitration Guide following consultation with its members and other stakeholders, which confirmed the increasing interest in using arbitration as a means of resolving disputes arising from derivatives transactions documented under a Master Agreement. ISDA had previously (in 2010 and 2012) included an arbitration clause in its Islamic finance Tahawwut (Hedging) Master Agreement and its Mubadalatul Arbaah (Profit Rate Swap) Agreement, which were the first official ISDA documents to provide for arbitration. ISDA's decision to provide for arbitration in its documentation reflects a broader trend towards greater acceptance of arbitration in the financial markets - for example, the Loan Market Association (LMA) also incorporated an option for parties to agree to LCIA arbitration in some of its standard facility agreements at a similar time as the ISDA Arbitration Guide.

This article will consider some of the pros and cons of arbitrating (rather than litigating) derivatives disputes arising under an ISDA Master Agreement. It will then move on to consider the future of the ISDA Arbitration Guide and some areas for potential future development.

IS ARBITRATION SUITABLE FOR DERIVATIVES DISPUTES?

Some of the key advantages and disadvantages of arbitrating derivatives disputes include the following.

Relative ease of enforcement:

The courts of London, New York, Paris, Frankfurt and other developed legal jurisdictions have historically been the preferred options for derivative disputes and for cross-border financial disputes in general, and remain popular forums. The English courts have recently sought to cement their position through the creation of a specialist Financial List that handles claims relating to the financial markets.

However, a major drawback in using any court to decide cross-border matters is that arrangements for cross-border enforcement of court judgments remain fragmented and piecemeal. This remains the case despite increasing uptake of the Hague Convention on Choice of Court Agreements, which provides for reciprocal enforcement of judgments rendered pursuant to an exclusive jurisdiction clause.

In contrast, arbitration awards benefit from the enforcement mechanisms available under the New York Convention, which has been signed by over 150 countries worldwide. Despite this, there remain practical difficulties in enforcing awards in some jurisdictions. In particular, the "public policy" defence to enforcement under the New York Convention is given a more expansive interpretation in some jurisdictions than in others. In the context of derivatives transactions, this may lend itself to an argument that the transaction violates bonos mores, such that enforcement of the resulting award would be contrary to public policy. Nonetheless, arbitration is typically the best available option in terms of ease of enforcement when operating in emerging markets.

This is particularly relevant given ISDA's increasingly diverse membership, both in terms of types of counterparty (including multi-national corporates and state entities), and in terms of jurisdictions (as membership has developed in the Middle East, Africa, Russia and the former CIS).

Suitability of arbitration for resolving derivatives disputes:

A review of reported decisions of the English courts in recent years indicates that the most commonly occurring disputes under the ISDA Master Agreement include disputes as to a party's capacity and authority to enter into transactions; mis-selling claims; disputes as to the suspension of payments; disputes as to close-out procedures and the calculation of early termination payments; and disputes in relation to notice provisions and the validity of termination and other notices.

These are issues that many commercial arbitrators are familiar with, and are equally capable of being addressed by commercial arbitrators as by judges.

In some respects arbitral tribunals can be better placed to decide these issues, given the scope for the parties to appoint arbitrators with particular qualifications or expertise. For example, disputes about a party's capacity to contract often raise issues relating to the law of that party's place of incorporation (which may be different to the governing law of the Master Agreement). Parties in arbitration may find it convenient to appoint an arbitrator qualified in the relevant law to assist in deciding such issues. Similarly, detailed issues of quantum may often arise in relation to netting and early termination payments, which may favour contributions from particularly numerate arbitrators or even non-lawyers on the tribunal.

The significance of this need for expertise has been recognised by the European Centre for Financial Dispute Resolution ("EuroArbitration") and by the Panel of Recognised International Market Experts in Finance ("P.R.I.M.E. Finance") (both specialist arbitration institutions targeting financial disputes), one of the key selling points of which is that the institutions maintain a list of arbitrators with specialist financial expertise.

Procedural flexibility:

Arbitration typically affords greater autonomy for the parties to determine what procedures will be adopted to resolve the dispute. For example, the approach to disclosure tends to be more flexible (and less onerous) in arbitration. This can be a significant advantage for financial institutions that face the burden of extracting, reviewing and disclosing large volumes of documents.

The autonomy afforded by arbitration means that parties that are considering including an arbitration clause in their ISDA Master Agreement must be aware of the different options that are available when drafting the clause and the pros and cons of each. For example:

- Some arbitral institutions (such as the London Court of International Arbitration (**LCIA**)) provide for arbitrators to be remunerated based on hourly rates, while other institutions (such as the International Chamber of Commerce (**ICC**) or the Singapore International Arbitration Centre (**SIAC**)) tend to charge on an ad valorem basis (ie, based on the sum in dispute). Hourly rates can prove an advantage for disputes that are high value but do

not raise particularly complex factual or legal issues (eg, a straightforward default scenario), although the ICC and other institutions that charge ad valorem fees are alive to the need to provide value for money in such circumstances.

- The model arbitration clauses in the Arbitration Guide require the parties to choose whether their disputes will be resolved by a tribunal of three arbitrators or by a sole arbitrator. Appointing a sole arbitrator can make the arbitration proceedings quicker, but on the other hand a three member tribunal may be preferable where complex issues arise, or where a blend of expertise or backgrounds is required on the tribunal (particularly given the limited scope for challenging/appealing an arbitration award – see further below).

Limited grounds of appeal/challenge:

In most jurisdictions, arbitration awards can only be challenged on very limited grounds, and appeals on the merits are typically not available. This promotes speed and finality. On the other hand, however, it means that a party that is aggrieved by the tribunal's decision is unlikely to have any avenues for redress. The potential significance of a lack of appeal is illustrated by the high profile case of Lomas v JFB Firth Rixson [2012] EWCA Civ 419, where In most jurisdictions, arbitration awards can only be challenged on very limited grounds, and appeals on the merits are typically not available. This promotes speed and finality. On the other hand, however, it means that a party that is aggrieved by the tribunal's decision is unlikely to have any avenues for redress. The potential significance of a lack of appeal is illustrated by the high profile case of *Lomas v JFB Firth Rixson* [2012] EWCA Civ 419, where the English Court of Appeal was able to resolve uncertainty arising from conflicting first instance decisions, some of which were at odds with market expectations as to how the relevant provisions of the Master Agreement should work. This might not be possible in arbitration. However, one way of mitigating this potential drawback of arbitration is to provide for a three member tribunal, thereby lessening the risk of a "rogue" decision by an individual decision-maker.

Availability of summary and expedited procedures:

An often cited disadvantage of arbitration compared with some court procedures is that there are no summary and default judgment mechanisms available. In a summary procedure, the case is resolved without a full hearing on the merits on the basis that there is no credible claim or defence to the claim. Under a default procedure, judgment can be granted where the defendant to a claim does not appear to contest its validity. Such mechanisms can be useful ways of obtaining judgment more quickly against a defendant who does not participate in the proceedings or raises only very weak defences.

The recent English case of *Travis Coal Restructured Holdings v Essar Global Fund* [2014] EWHC 2510 (Comm) suggests that arbitral tribunals and supervisory courts may be more willing than in the past to support the use of summary procedures. In that case, an arbitral tribunal in New York dismissed certain fraud-based defences to a claim on a guarantee, adopting a summary procedure that fell short of a full hearing on the merits. In enforcement proceedings in England, the English court concluded that there was no realistic prospect of resisting enforcement of the award based on the summary procedure adopted by the tribunal. Further, the Singapore International Arbitration Centre (**SIAC**) has recently released its new rules, in force on 1 August 2016, which provide for an early dismissal procedure (at Article 29). The Arbitration Institute of the Stockholm Chamber of Commerce (**SCC**) is also considering including provision for summary procedures in its 2017 rules.

"WERE A BIFURCATED DISPUTE RESOLUTION CLAUSE TO BE INCLUDED IN FUTURE EDITIONS OF THE ARBITRATION GUIDE, THIS COULD PROVIDE FOR DIFFICULT TECHNICAL QUESTIONS TO BE RESOLVED BY AN INDIVIDUAL WITH RELEVANT EXPERTISE, IN SOME CASES AVOIDING THE COST AND DELAY OF PRESENTING EXPERT EVIDENCE"

This is, however, a somewhat controversial area and there remain concerns in some quarters about the use of summary procedures in arbitration, given arbitrators' obligations to observe due process and the scope for awards to be challenged on the basis that that duty has not been complied with. There is a tension between that duty and the need for arbitrators to be prepared to use robustly the procedural tools available to them to serve the needs of the parties for an efficient and effective dispute resolution process.

In the meantime, the use of expedited procedures in arbitration has gained greater acceptance. Some arbitration rules contain specific expedited procedures (eg, the SIAC arbitration rules). These can be a useful way of achieving a quick result, although unlike summary procedures it is still necessary to have a full hearing of the issues.

Lack of binding precedents:

Unlike litigation, arbitration does not give rise to binding precedents or even generally to publicly available decisions that can be relied upon as persuasive authority. This can be a significant issue for parties (eg, banks and other market participants) that enter into a large number of ISDA Master Agreements, and who could potentially have to arbitrate the same point multiple times against different counterparties. The ability to decide disputed provisions or scenarios for the benefit of the wider market has been one of the benefits of public court decisions in this area. P.R.I.M.E. Finance has sought to address this by making provision in its rules for publication of anonymised abstracts of awards. It will take some time for a substantial body of such decisions to be available, and such an approach can only ever be mitigation for the absence of full public decisions and binding precedent in arbitration.

On the other hand, many commercial parties see the confidentiality of arbitration (where applicable) as a positive attribute and see no advantage in fighting their disputes in public, particularly where the dispute involves a counterparty default or otherwise raises sensitive issues.

WHERE NEXT FOR THE ISDA ARBITRATION GUIDE?

ISDA is well aware of the need for the Arbitration Guide to keep pace with developments in arbitration, and the evolving needs of ISDA's members both in terms of arbitral processes, and also the choice of institutions favoured by members.

Additional seats/institutions:

The selection of arbitral seats and institutions in the Arbitration Guide has been driven by ISDA members' preferences. It is therefore likely that further draft arbitration clauses will be included in the Guide in coming years, covering additional arbitral institutions and seats for which there is demand. Once the principle and practice of international arbitration for financial disputes is accepted, it can only be beneficial to ensure that users have standard-form drafting that they can use to opt for the process with which they are most comfortable. In the meantime, it is of course open to parties entering into a Master Agreement to opt for other arbitral institutions and seats that are not yet included in the ISDA Arbitration Guide, albeit that this will require bespoke drafting.

For example, further options that may appear in future editions of the Arbitration Guide include the **DIFC-LCIA** Arbitration Centre (an arbitration centre in the Dubai International Financial Centre that is affiliated with the London Court of International Arbitration) and the German Institution of Arbitration (**DIS**). Another option is the Arbitration Institute of the Stockholm Chamber of Commerce (**SCC**) – although the SCC has already issued its own "ISDA-fied" arbitration clause for use with the Master Agreement, at present there is no SCC clause in the ISDA Arbitration Guide.

Experts:

Disputes under the ISDA Master Agreement often raise difficult questions of quantum which require expert evidence to be decided by an arbitral tribunal, or a court. Even where a quantum expert might be appointed to an arbitral tribunal, it would remain the case that they would act as an arbitrator deciding cases based on submissions and evidence presented by the parties, rather than by applying their own expertise.

Query whether such disputes might be more suitable for resolution as an expert determination as an alternative to court or arbitration (albeit one of the two fall-back jurisdictions would still need to apply to disputes regarding, for example, the remit of the expert). In the recent case of *Credit Suisse International v Stichting Vestia Groep* [2014] EWHC 3103 (Comm), Andrew Smith J in the English High Court recognised this and encouraged the parties to consider whether issues about the amount of an early termination payment could be more efficiently and satisfactorily resolved by an arbitrator or expert than by the court.

Were a bifurcated dispute resolution clause to be included in future editions of the Arbitration Guide, this could provide for difficult technical questions to be resolved by an individual with relevant expertise, in some cases avoiding the cost and delay of presenting expert evidence to an arbitral tribunal. Bifurcated clauses can however create their own complications in terms of delimiting the expert's and arbitral tribunal's respective jurisdictions. For this reason, such clauses must be carefully drafted and should only be used after careful consideration of the pros and cons.

Overall, the ISDA Arbitration Guide has been a notable success in meeting a need among ISDA members for market-standard drafting as international arbitration is increasingly used. The Guide has also sparked discussion around the choice of seat and arbitration institution in increasingly diverse cross-border deals which, in turn, has led to consideration of dispute resolution options beyond traditional court litigation, and even beyond standard arbitration options.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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