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Welcome to the club: ISDA publishes model arbitration clauses

*On 9 September 2013, ISDA published a set of model arbitration clauses for use with the 1992 and 2002 ISDA Master Agreements (the **Master Agreements**). This was accompanied by the publication of the 2013 ISDA Arbitration Guide (the **Guide**). ISDA's publication of these documents ended a consultation period with its members lasting more than two years. This article considers the background to ISDA's consultation, provides an overview of ISDA's response and raises some thoughts and issues to be considered by anybody looking to adopt the model clauses.*

KEY POINTS

- ISDA has now published a set of model arbitration clauses for use with the 1992 and 2002 ISDA Master Agreements (the **Master Agreements**).
- The PRIME Finance Arbitration Rules have been included as an option.
- The model clauses are not intended as boilerplate clauses.
- The challenge for parties to the ISDA Master Agreement will be to tailor the model clauses for their transaction without falling into any of the potential pitfalls that the model clauses have been carefully drafted to avoid.

BACKGROUND TO THE ISDA CONSULTATION

Publication of the Guide followed a period of consultation with ISDA's members by way of two memoranda dated 19 January 2011 and 10 November 2011 (the **Memoranda**) and a number of meetings with members and interested stakeholders from financial centres worldwide. The consultation was prompted by ISDA's awareness of a growing trend towards using arbitration as a means of resolving disputes in the financial sector, including for disputes arising in connection with derivative transactions under the ISDA Master Agreements. Members' views were sought as to the ways in which ISDA might respond to this development and the steps which it might take to assist members in their use of arbitration.

AN INCREASING INTEREST IN ARBITRATION

The Memoranda noted that the growth in the use of arbitration was particularly apparent in relation to ISDA Master Agreements involving parties established in, or operating from, emerging market jurisdictions. The ISDA Master Agreements, at s13, currently only provide for a choice of English or New York governing law and for the jurisdiction of the English or New York courts. However, increasingly parties to derivatives contracts and international financial transactions are based in emerging markets in which it is difficult (or sometimes impossible) to enforce judgments from the English or New York courts. In these circumstances, and given the alternative of agreeing to litigate disputes in the emerging jurisdiction's local courts, it has become increasingly common for parties to agree to disputes being resolved by way of arbitration.

The primary attraction of arbitration is the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the **Convention**), which provides a regime for the enforcement and recognition of arbitral awards within the 149 contracting states. Notwithstanding a certain degree of disparity in compliance with the

Convention, many regard arbitration as reducing the enforcement risk in relation to emerging market parties. Other attractions are the confidential nature of arbitral proceedings, and the finality of arbitral decisions as compared to litigation.

WHY DID ISDA GET INVOLVED?

This preference for arbitration had manifested itself in parties including arbitration clauses in the Schedule to the ISDA Master Agreements or the transaction confirmation. However, as noted in the Memoranda, these arbitration clauses were sometimes drafted poorly and some have even been found to be invalid. In particular, ISDA highlighted the failure to delete the jurisdiction clause from the ISDA Master Agreements, to make clear which arbitral rules applied and to make a clear choice of seat as well as unclear provisions for exercising an optional arbitration agreement.

The responses to the Memoranda indicated that the Members felt that ISDA could usefully assist in providing guidance as to the use of arbitration in the derivatives market and also to publish model arbitration clauses. The Guide and model clauses together address both of these requests.

THE MODEL CLAUSES

Each model clause specifies the governing law of the Master Agreement and the arbitration clause and, where the seat of the arbitration is not the same as the parties' choice of governing law, a governing law of the separable arbitration clause has been included. The options are set out in Table 1 below.

TABLE 1: THE MODEL CLAUSES

Rules	Seat	Governing law	Governing law of arbitration clause (if different to governing law)
ICC	London	English	
	New York	New York	
	Paris	English or New York	"*substantive principles of international law*" as developed by the French courts
LCIA	London	English	
AAA-ICDR	New York	New York	
HKIAC	Hong Kong	English or New York	Hong Kong
SIAC	Singapore	English or New York	Singapore
Swiss Rules of International Arbitration	Determined by the parties, the court, or the tribunal	English or New York	As chosen by the parties, the law applicable to the substance of the dispute, or Swiss law
PRIME Finance	London	English	
	New York	New York	
	The Hague	English or New York	Dutch

The Guide acknowledges that the choices of seats and arbitral institutions have been determined on the basis of members' comments as to which to prioritise. However, it notes that parties can choose other seats and rules, if desired.

PRIME FINANCE

An interesting development which occurred contemporaneously with ISDA's consultation was the launch of the Panel of Recognised International Market Experts in Finance (**PRIME Finance**) in January 2012. PRIME Finance was established to help resolve, and to assist judicial systems in the resolution of, disputes concerning complex financial transactions. Most relevant for these purposes is its role as a new arbitral institution with its own set of arbitration rules, which are based on a modified version of the 2010 UNCITRAL Rules.

It was only the final version of ISDA's model clauses which included the PRIME Finance arbitration rules as an option (although in June 2013 PRIME Finance had published its own "*PRIME Arbitration Amendment Agreement*" for use with both the 1992 and 2002 ISDA Master Agreements).

During the consultation process, the Memoranda had recorded various areas in response to which initiative by ISDA might be helpful. These included a lack of appropriately qualified arbitrators. However, the launch of PRIME Finance purported to address this issue, with PRIME compiling a list of dispute resolution and finance experts and requiring, as part of the PRIME Finance Rules, that an arbitrator be selected from that list unless the parties agreed to deviate from this requirement.

Further, the Memoranda highlighted the potential problem in the context of an industry-standard contract of the absence of precedent in the case of arbitral awards given their private (and usually confidential) nature. Again, the launch of PRIME Finance went some way to addressing this issue, with the PRIME Finance Rules permitting PRIME Finance to publish anonymised excerpts from arbitral awards subject to the agreement of all parties.

It remains to be seen how many of the parties which elect to include an arbitration clause also choose the PRIME Finance arbitration rules, or whether they remain with the more established institutions, such as the ICC or LCIA.

MODEL CLAUSES, NOT BOILERPLATE CLAUSES

The Guide notes that the model clauses "*are provided to assist parties with the framework of their dispute resolution clauses. These clauses are not boilerplate clauses and may have to be tailored specifically to the transaction concerned*". In particular, the Guide advises that "[a]*mong the matters that parties may wish to take into account are the location of the counterparty and its assets, and whether any amendment or addition to the clause is helpful for the purpose of obtaining recognition, or the agreement to arbitrate, or enforcement of an award in these particular jurisdictions*".

This is undoubtedly correct. However, the challenge for parties to the ISDA Master Agreement will be to depart from the model clauses without falling into any of the potential pitfalls which the model clauses have been carefully drafted to avoid.

Some amendments should be relatively straightforward. For example, if the parties wish to specify certain criteria, qualifications or experience which the arbitrators should possess, or if the parties wish to provide expressly for hearings to take place in a location other than the arbitral seat or by telephone.

However, the key battleground when negotiating the arbitration agreement — in particular for the purpose of obtaining recognition, agreement to arbitrate or enforcement of an award — is likely to centre on the seat of the arbitration. As touched upon by the Guide, it will be important for anyone negotiating an arbitration clause which departs from the model clause to understand the effect of both the decision regarding the seat of the arbitration and the amendments made to the model clause, and the interplay between the law of the seat and the arbitral rules selected. A failure to check these points carefully could result in an arbitration which looks quite different from that which the parties had envisaged when agreeing to arbitrate.

As addressed by the Guide, the seat of the arbitration will determine the arbitral procedure, the powers of the local courts in relation to the arbitration, and the jurisdiction in which the award will be treated as having been made.

Taking these points in reverse order, in many cases the assets of the counterparty are likely to be located within one of the 149 signatories to the New York Convention. However, note that there are a number of jurisdictions, in particular in Africa, which are not signatories. Further, and as alluded to earlier, it should be noted that although the New York Convention imposes an obligation on signatory nations to treat awards which fall under the Convention "*no less favourably than domestic awards*", there are 149 procedural regimes and varying approaches which can create hurdles to enforcement. For example, even in the US there is a line of reasoning which imposes a jurisdiction "*relatedness requirement*" upon a party seeking to confirm and enforce a foreign arbitral award against the assets of a debtor which sits within the United States. Although in practice the vast majority of arbitral awards are complied with and require no steps towards enforcement, to avoid the risk of a Pyrrhic victory this is a matter which should not be overlooked, especially in circumstances where the main driver for selecting arbitration is the desire to enforce the decision more readily in a particular emerging market jurisdiction.

The powers of the courts to intervene, and the extent to which they are likely to have a pro-arbitration approach in circumstances where they do intervene, are factors critical to the efficiency, effectiveness and ultimate success of the arbitral process. Last minute concessions to agree a seat of an unknown jurisdiction can be costly in circumstances where, for example, the courts of the seat have power under local law to hear an application to annul an arbitral award rendered in their jurisdiction or to challenge an arbitrator alleged to be biased. A not infrequent concern is that courts in a particular jurisdiction might be more likely to favour one of the parties; alternatively, and of equal concern, is a court system where such applications will get bogged down for many years, thereby delaying the arbitral process.

Finally, the seat of the arbitration will determine the arbitral procedure. If a London seat is selected, the arbitration will be subject to the Arbitration Act 1996 (the **Act**). In addition to identifying the circumstances in which the courts have power to intervene, the Act imposes default rules which will apply unless the parties have agreed otherwise, as well as a number of mandatory provisions which parties are not permitted to contract out of. There are two principal means of "*contracting out*" at the outset: either by expressly addressing the point in the arbitration agreement, or by adopting arbitral rules (eg, ICC, LCIA) which address the matter.

Care is required to ensure that the arbitration is correctly structured from the outset, and that any matters which are not addressed satisfactorily by the arbitral rules are addressed expressly in the arbitration agreement. Although the arbitration agreement is theoretically always capable of agreement between the parties at a later date, once a dispute has arisen the parties' interests have invariably diverged, and the amendments required by one party will not be agreed by the other.

To take one example, although confidentiality is often presented as one of the key reasons for preferring arbitration over litigation, as flagged in the Guide, there is no automatic duty of confidentiality in arbitration proceedings which have their seat in certain jurisdictions, including New York and France. Some arbitration rules (eg, LCIA) contain provisions addressing confidentiality, but not all do, and not all are in terms on which you would necessarily want to rely. In particular, the ICC 2012 Rules provide that "[u]*pon the request of any party, the arbitral tribunal may make orders concerning the confidentiality of the arbitration proceedings…*"; however, this is a matter for the

Tribunal to determine. As such, a party which strongly values the confidentiality of the arbitration proceedings, but which has selected, for example, a Paris seat and ICC Rules, should ensure that robust confidentiality obligations are included within the arbitration agreement. Conversely, if the parties have an interest in the award being made public, thus expanding the body of jurisprudence, this should be addressed expressly. In relation to this point, it should be noted that ISDA's "*model clause for ICC Rules (Paris seat)*" does not contain any additional confidentiality obligation or undertaking. This should therefore be considered by parties selecting a Paris seat and the ICC Rules.

A final word on departing from the model clauses. Unilateral arbitration clauses, which allow one party to the agreement the option of pursuing a dispute via either arbitration or litigation in the courts, might appear to be an attractive option. However, as we addressed in our article *Unilateral jurisdiction clauses — Navigating the minefield (IFLR, September 2013)*, although the English courts will uphold such agreements, a number of jurisdictions (eg, Russia, Romania, Poland, Bulgaria) have refused to recognise their validity, and many more (eg, Japan, Singapore, Sweden, US, Brazil, China, Kazakhstan) have raised doubts. Given these concerns, unilateral arbitration clauses should generally be avoided where the parties and their assets are located internationally.

A FURTHER THOUGHT ON COSTS

Section 11 of the 2002 ISDA Master Agreement provides:

> *"11. Expenses*
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> *A Defaulting Party will on demand indemnify and hold harmless the other party for and against all reasonable out-of-pocket expenses, including legal fees … incurred by such other party by reason of the enforcement and protection of its rights under this Agreement… including, but not limited to, costs of collection."*

A "*Defaulting Party*" is a party which has committed an "*Event of Default*", namely an event which can trigger close-out of all the transactions by a "*non-Defaulting Party*" under the Agreement. Section 6 provides for the payment of a "*Close-Out Amount*" in the event of early termination. However, the expenses referred to in s11 are different and broader than this payment, and concern the costs of enforcement and protection, including the legal fees, once the Close-Out Amount has been calculated.

In practice, s11 is not dissimilar to the clauses frequently found in other contracts that are subject to arbitration, which provide that the party which is found to be in default will be liable for the costs of the arbitration and, if necessary, for the enforcement of the arbitral award. It is unclear from the consultation whether s11 was intended to operate in this manner. However, regardless of what was intended, there would certainly appear to be an argument that s11 has the effect that the parties to the ISDA arbitration agreement have contracted that where there is a "*Defaulting Party*", it will pay all the costs of any arbitration and other associated out of pocket expenses "*on demand*". As such, it might be argued that the arbitrator should be invited to give an award on costs which is consistent with s11 (in circumstances where the Defaulting Party does not make payment pursuant to the indemnity). (Of course, if the seat of the arbitration was London, it would be necessary to consider the enforceability of any such provision in light of s60 of the Arbitration Act, which provides that an agreement which has the effect that a party (ie, the Defaulting Party) is to pay the whole or part of the costs of the arbitration in any event is only valid if made after the dispute in question has arisen.)

CONCLUSION

ISDA's introduction of arbitration model clauses is a helpful development which should be applauded and embraced. However, if users are to agree an arbitral process which works for them then, particularly in circumstances where negotiations cause them to depart from the model clauses, care will be required to understand the impact of such departures at the time the arbitration agreement is entered into.

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