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„Applicable Law in International Commercial Arbitration with a Focus on Lex Mercatoria and Ex Aequo Et Bono "

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Abstract

Die Schiedsgerichtsbarkeit ist eine der beliebtesten Methoden der Streitbeilegung bei Geschäftsleuten, die an internationalen Transaktionen beteiligt sind. Die Frage des anwendbaren Rechts ist eines der am häufigsten auftretenden Probleme bei internationalen Handelsschiedsverfahren.
Die Bestimmung des anwendbaren Rechts ist ein wesentlicher Schritt in einem Schiedsgerichtsverfahren. Es werden verschiedene Lösungen angeboten, und es gibt unzählige Kommentare zu diesem Thema, so dass die Frage recht komplex ist. Bevor ein Schiedsspruch erlassen wird, müssen drei verschiedene Rechtsordnungen bestimmt werden. Dabei handelt es sich um das auf die Schiedsvereinbarung anwendbare Recht, das Verfahrensrecht und das auf die materiellen Streitfragen zwischen den Parteien anwendbare Recht. Es gibt eine Reihe von Möglichkeiten für die Parteien und die Schiedsrichter, das anwendbare Recht zu bestimmen.
In diesem Zusammenhang ist die lex mercatoria eine wertvolle Ressource. Sie ist ein Korpus von Handelsregeln und Handelsbräuchen. Das Konzept der lex mercatoria wird analysiert, und ihre Rolle wird in dieser Studie untersucht. Das Konzept ist umstritten und wird ständig kommentiert, da es für die internationale Handelsschiedsgerichtsbarkeit und die globale Geschäftswelt von entscheidender Bedeutung ist.
In ähnlicher Weise ist ex aequo et bono ein weiteres umstrittenes Konzept, das für internationale Handelsschiedsverfahren von Bedeutung ist. Eine Schiedsvereinbarung, die eine Entscheidung ex aequo et bono vorsieht, führt dazu, dass das eigene Gerechtigkeitsempfinden des Schiedsrichters als das für den Streitfall maßgebliche Recht gilt und nicht ein bestimmtes nationales Recht. Die allgemeine Auffassung davon ist wegen der damit verbundenen Unvorhersehbarkeit eher negativ. Eine Entscheidung ex aequo et bono in einem Schiedsverfahren kann nur selten zustande kommen.
In der heutigen Zeit gibt es unterschiedliche Lösungen, die von verschiedenen Gerichtsbarkeiten für diese Probleme entwickelt wurden. Vor diesem Hintergrund zielt diese Dissertation darauf ab, diese Konzepte zu erforschen und zu untersuchen. Durch die Analyse verschiedener Ansätze und Lösungen gibt die vorliegende Studie einen Überblick über das anwendbare Recht in der internationalen Handelsschiedsgerichtsbarkeit, um ein besseres Verständnis der aktuellen Situation zu ermöglichen.

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List of Abbreviations

CISG	The United Nations Convention on Contracts for the International Sale of Goods
ICC	International Chamber of Commerce
UCP	The Uniform Customs and Practice for Documentary Credits
UNCITRAL	The United Nations Commission on International Trade Law
UNIDROIT	The International Institute for the Unification of Private Law

Chapter 1: Introduction

International commercial arbitration is “a method of resolving disputes through an arbitration proceeding heard by one or more arbitrators, instead of pursuing resolution of the dispute through an applicable court system.”[1] It is one of the cornerstones of international trade and business today. As a dispute resolution method that has been successfull for long years, it is not surprising that it is very popular especially among international traders.

Throughout ancient and modern times, merchants have always been reluctant about becoming involved in litigation.[2] According to literature “expense and delay are the usual reasons offered, but a stronger reason is that suits at law are contentious and seriously affect business good will, and the trader was, and still is, far more interested in continuing business relations than in preserving his legal rights.”[3]

International arbitration derives its authority from a agreements concluded by the parties in dispute. Unlike national courts, arbitration as a system does not has a dedicated set of rules and law which dictate the progression of the arbitration process. Consequently, the subject of ‘applicable law’ plays a crucial part in international commercial arbitration.

This dissertation is intended to explore the current status of the applicable law in international commercial arbitration and investigate the problems found that are faced in arbitration and the respective concepts concepts. The research aims at presenting the definition, grounds, and possible solutions to the issue.

Party autonomy is a fundamental principle in international commercial arbitration. In arbitration, parties are given total control over the dispute resolution process, therefore, they are enabled to maintain authority over the adjudicatory process.[4] Parties have the freedom to arrange their arbitration agreements in the way they see fit. They also may agree on the applicable law of their choice.

Parties generally decide on international commercial arbitration to resolve disputes while they are drafting their contracts. However, in a number of cases, parties do not include a choice of law clause in their agreements. Naturally, this leads to the discussions around the question of

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[1] ‘International Commercial Arbitration’ (*Columbia Law School*) <https://guides.law.columbia.edu/ica> accessed 27 July 2023.
[2] Earl S. Wolaver, ‘The Historical Background of Commercial Arbitration’ (1934) 83(2) UPaLRev 132, 144.
[3] Ibid.
[4] Jan Dalhuisen, Dalhuisen on Transnational Comparative, Commercial, Financial and Trade Law Volume 1 (6th edn, Hart Publishing 2016) 401.

applicable law in arbitration. The question has been discussed through decades and finding different solutions and explanations to the problem is possible now. Especially, since it is possible for the arbitration to be governed by more than one legislation, the confusion grows.

The 1985 UNCITRAL Model Law helped in many ways in creating harmonization between the different legal systems. Nevertheless, there are still different approaches and views around the world.

The fact that there are several different laws that may be applied to an international commercial arbitration does not help eliminate the confusion. Besides, these laws may all be different from one another. These are:

(i) The law applicable to the arbitration agreement,
(ii) The law applicable to the arbitration proceedings,
(iii) The law applicable to the substantive matters,
(iv) The law of the place of enforcement of the arbitral award.

The law applicable to the arbitration agreement is a rather complex matter. As the arbitration agreement is autonomous there is discussion which method should be used in determining the law applicable to it. It is worth taking some care in drafting the arbitration clause. However, in most cases, it features as a boilerplate clause without regard to the particular parties and their circumstance.[5] Parties often do not include a choice of law clause determining the law applicable to their arbitration agreement. Consequently, it is of high importance to answer how the applicable law should be determined.

Subsequently, determining the procedural law is a stepping stone for the process of arbitration. The traditional approach to deem the law of the seat as the procedural is now losing its importance and more countries are turning to the contemporary approach which gives more emphasis to the party autnomy. The law governing the arbitral procedure is not necessarily the law of the seat or the governing law of the substantive issues. When there's an absence of agreement between the parties, the parties and the arbitrators have a signifacnt amount of freedom in this respect.[6]

The applicable law to the merits of the dispute is usually selected by the parties, although there are some cases where the choice of law clause is absent. It is generally accepted that parties

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[5] Ewan McKendrick (ed), Goode and McKendrick on Commercial Law (6th edn, 2020 Penguin Books Ltd.) 1351-1352.
[6] Emmanuel Gaillard & John Savage (eds.), Fouchard, Gaillard, Goldman on International Commercial Arbitration (Kluwer Law International 1999) 633.

have the freedom on selecting the law deemed appropriate and in some jurisdictions arbitrators enjoy the same freedom.

For the course of the dispute, determining the content of the governing law is of utmost importance. The governing law will effect parties' rights and obligations and to reach a fair result the proper law must be determined. Transnational rules may be the governing law of the contract as well. Parties have the freedom to select lex mercatoria as their applicable law to the substantive issue and in some cases arbitrators enjoy the same freedom.

The medieval lex mercatoria is the body of law used by the merchants during the Medieval Ages. This merchant law was mainly used in Europe for the disputes that involved international transactions. In the 20th century, the idea started to evaluate into the concept we now as the new lex mercatoria today. It was beginning to use in international arbitrations in certain cases. In modern days, parties generally have the freedom to govern their contracts by the transantional rules and principles.

The concept of lex mercatoria has been a highly contentious subject in commercial law. In this dissertation, the history of *lex mercatoria* and the arguments around the subject will be discussed to shed some light on the issue. It is a rather complex matter, therefore, the beginnings of the argument must be discussed in order to understand different approaches.

Another concept that is usually found to be similar to *lex mercatoria* is '*ex aequo et bono'*. This legal concept which was found by the Swiss law means the arbitrators do not have to use any law at all and merely make a decision according to equity and conscience. According to most developed legislations and institutional rules, parties have the right to request a decision made *ex aequo et bono* on the condition that the choice is explicitly made.

In Chapter 2, the applicable law in international commercial arbitration will be discussed. The law applicable to the arbitration agreement, the law applicable to the arbitration proceedings, and the law applicable to the substantive matters will be discussed in this chapter as these are the laws that needs to be determined before an award is made. The cause of the complexity of the issue and different approaches will be mentioned as well as relevant legislation and case law.

In Chapter 3, the concept of *lex mercatoria* and its relationship with the international commercial arbitration will be explained. This entails the current situation in international commercial arbitration and the attitudes towards lex mercatoria. The history and the evolution of the concept will be shortly mentioned. In doing so, this chapter explores the cause of the need in lex mercatoria as well as the criticism of it.

In Chapter 4, the concept of *ex aequo et bono* and its effects will be analysed. This includes the definition, the reasons behind the skepticism, and its application. A brief comparision between *ex aequo et bono* and *amiable composition* will be included. Parties' right to refer to *ex aequo bono* and *amiable composition* will be discussed by analyzing different situations.

In Chapter 5, a general comparison will be made between the approaches mentioned thus far. The last part of this dissertation is devoted to analysing the different views around the problems discussed in the former chapters. The possible changes that are likely to take place in the near future for the international commercial arbitration will also be considered. Thereby, the conclusions of this dissertation will be presented.

Chapter 2: Applicable Law in International Commercial Arbitration

Perhaps the most important and often asked question regarding international commercial arbitration would be: What law governs the arbitration? Thus, the concept of "applicable law" is a crucial aspect of any arbitration. The applicable law is of utmost importance since it shapes the procedures and parties' rights and obligations. The issue covers not only the legal framework under which the arbitration agreement is established but also the rules governing the conduct of the arbitration proceedings and the rules of law by which the merits of the dispute are resolved.

Generally, there are three distinct applicable laws in international commercial arbitration that need to be determined until an award is made by the tribunal. These are (2.4) the applicable law to the arbitration agreement, (2.5) the procedural law, and (2.6) the applicable law to the substantive issues. Questions of formal validity, capacity to conclude an arbitration agreement, and arbitrability are generally governed by the law applicable to the arbitration agreement. However, these topics will be discussed separately in the first three parts of this chapter to give more light on the issue.

2.1. Formal Validity of International Arbitration Agreements

Like many types of contracts, international commercial arbitration agreements are frequently subjected to specific form requirements. An arbitration agreement needs to be formally valid in order to be an enforceable agreement. Naturally, the arbitration agreement must meet the legal requirements for formal validity in the relevant jurisdiction to be enforceable. In the context of international commercial arbitration, formal validity, therefore, is particularly important.

One of the most essential requirements for the formal validity of an arbitration agreement is that it must be in writing. In most arbitration laws, this requirement can be found.[7] According to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, an arbitration agreement has to be in writing in order to be enforceable.[8] Similarly, UNCITRAL

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[7] Emilia Onyema, International Commercial Arbitration and the Arbitrator's Contract (Routledge 2010) 17.

[8] United Nations Convention on the Recognition an Enforcement of Foreign Arbitral Awards (adopted 10 June 1958, entered into force 7 June 1959) 330 UNTS 38 (New York Convention) art 2(1).

Model Law on International Commercial Arbitration demands that "the arbitration agreement shall be in writing."[9]

There can also be a number of other factors that can impact an agreement's formal validity. Naturally, those factors depend upon the applicable law to the arbitration agreement, as the validity of the agreement itself is a question of it.

2.2. Capacity to Conclude International Arbitration Agreements

For the validity of the arbitration agreement, the parties must have the capacity to conclude it. This requirement takes place in all international arbitration conventions and national arbitration statutes.[10] It is crucial for the formation of the arbitration agreement and for its enforceability. The lack of capacity by one of the parties is a ground for setting aside the arbitral award or refusing the recognition and enforcement of it.

Generally, the capacity of the parties is governed by their own national law.[11] An individual's or an entity's legal capacity is "regulated under the personal law of the individual and the law of the place of incorporation or registration of the legal entity."[12] Although the specific requirements may vary depending on the applicable laws, there are generally recognized principles such as legal age, mental capacity, consent, and corporate authorization.

2.3 Arbitrability

In order for a dispute to be resolved by arbitration the subject of the matter needs to be "arbitrable". According to related legislation from a number of states and case law, certain categories of disputes cannot be settled through arbitration.[13] These subject matters are "nonarbitrable". The nonarbitrability doctrine rests on the notion that some matters so pervasively involve either "public" rights and concerns or interests of third parties that agreements to resolve such disputes by "private" arbitration should not be given effect. For

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[9] United Nations Commission on International Trade Law Model Law on International Commercial Arbitration 1985 with amendments as adopted in 2006 (UNCITRAL Model Law) art 7(2).
[10] Gary Born, International Commercial Arbitration (3rd edn, Kluwer Law International BV 2021) 625.
[11] Isil Ozkan, 'Law Applicable in International Commercial Arbitration' (2020) 40(2) Public and Private International Law Bulletin 831, 836.
[12] Onyema (n 7) 14.
[13] Born (n 10) 853.

example, in most jurisdictions, issues relating to criminal law, family law, competition law, and bankruptcy are not arbitrable.

Article 1 of the Geneva Protocol provides that *"commercial matters or ... any other matter capable of settlement by arbitration"* can be recognized.[14] Similarly, Article II(1) of the New York Convention states that an international arbitration agreement which *"concerns a subject matter capable of settlement by arbitration"* shall be recognized.[15] Also Article V(2)(a) of the Convention states that an award shall not be recognized or enforced if *"the subject matter of the difference is not capable of settlement by arbitration under the law"* of the country where recognition is sought. [16]

There are different approaches to answering the question of choice of law regarding arbitrability. Generally, the parties' choice of the seat of arbitration governs the question of arbitrability.[17] Nevertheless, in order to determine the law applicable to it, first, at what stage of the proceedings the question of arbitrability appears of the arbitration should be looked into. If it arises while the case is still before the arbitral tribunal, the law governing the arbitration agreement or the law of the seat should be applied.[18] Another opinion on this is to apply the law governing the substantive issues of the dispute between the parties to the issue of arbitrability.[19] The law of the place where the enforcement is sought can also be applied to the issue at a later stage.

According to the UNCITRAL Model Law and New York Convention, if there is no choice of law agreement made by the parties, the law of the seat will govern arbitrability.[20] However, during the stage of recognition or enforcement of the arbitral award, the law of the state where the recognition and enforcement are sought shall be applied.[21]

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[14] United Nations Protocol on Arbitration Clauses (adopted 24 September 1923, entered into force 28 July 1924) 27 LNTS 157 (Geneva Protocol) art 1.
[15] New York Convention 1958 art 2.
[16] New York Convention 1958 art 5.
[17] Margaret L Moses, The Principles and Practices of International Commercial Arbitration (Cambridge University Press 2018) 68.
[18] Sibel Ozel, Milletlerarası Ticari Tahkimde Kanunlar İhtilafı Meseleleri (Legal 2008) 54.
[19] *See* Julian DM Lew, 'The Law Applicable to the Form and Substance of the Arbitration Clause', in Albert van den Berg (ed) *Improving the Efficiency of Arbitration Agreements and Awards: 40 Years of Application of the New York Convention* (Kluwer Law International 1999) 136.
[20] UNCITRAL Model Law 1985 art 34(2)(a)(i); New York Convention 1958 art 5(1)(a).
[21] UNCITRAL Model Law 1985 art 36(1)(b)(i); New York Convention 1958 art 5(2)(a).

2.4 The Law Applicable to the Arbitration Agreement

The arbitration agreement is the cornerstone of any arbitration. If there is no valid arbitration agreement, the arbitral proceedings cannot commence or continue, and any award made pursuant to such proceedings will be invalid and non-enforceable.

The law applicable to the arbitration agreement is primarily the law chosen by the parties. Nonetheless, parties usually do not make this choice of law. Coming across an ambiguous arbitration clause, one should begin their inquiry to ascertain the applicable law.[22] Unfortunately, determining the law applicable to the arbitration agreement is a highly complex subject. There is endless commentary regarding the issue, which leads to perplexity. This confusion around the subject mainly stems from the separability principle of arbitration agreements. However, there have been recent developments that suggest solutions for the uncertainties. These different approaches will be discussed below.

2.4.1 SEPARABILITY PRESUMPTION

The separability presumption is one of the cornerstones of international arbitration.[23] Today, separability can be considered a general principle of international commercial arbitration.[24] The autonomy of the arbitration agreement is recognized by the institutional arbitration rules[25] and arbitration statutes[26].

This principle means that the arbitration agreement, even when it is a clause of the main contract, is considered to be a separate agreement from the main contract of which it is a part. An arbitration agreement does not establish rights and obligations by itself. It insted provides "a machinery for settlement of disputes arising out of the rights and obligations."[27] With this approach, the arbitration agreement has its own legal destiny without being affected by the main contract.[28] Naturally, the arbitration agreement to be governed by a law different than the one governing the main agreement is possible. A consequence of this, for example, is that the

[22] Katharina Plavec, 'The Law Applicable to the Interpretation of Arbitration Agreements Revisited' (2020) 4 University of Vienna Law Review 82, 84.
[23] Born (n 10) 312.
[24] JF Poudret and S Besson, Comparative Law of International Arbitration (Sweet & Maxwell 2002) 258.
[25] *See* ICC Arbitration Rules 2021 art 6(9); LCIA Arbitration Rules 2020 art 23(2).
[26] *See* English Arbitration Act 1996 s 7; Swiss Private International Law Act 1987 art 178(3); Code of Civil Procedure of The Netherlands 1986 art 1053.
[27] VS Deshpande, 'The Applicable Law in International Commercial Arbitration' (1989) 31(2) Journal of the Indian Law Institute 127, 128.
[28] Dietmar Czernich, 'The Law Applicable to the Arbitration Agreement' [2015] Austrian Yearbook on International Arbitration 73, 74.

arbitration agreement may continue to be valid even when the main contract is invalid. Following that, determining the applicable law to the arbitration agreement arises if the same law does not automatically govern it as the main contract.

2.4.2 DETERMINING THE APPLICABLE LAW

As stated above, the arbitration agreement is regarded to be a separate contract from the main contract. Since it cannot automatically be assumed that the law governing the main contract between parties also applies to the arbitration agreement, a distinct examination is needed to determine the law applicable to the arbitration agreement. In most cases, however, it will be either the law of the place of arbitration or the substantive law chosen by the parties.[29]

The straightforward solution to all confusion around this topic would be for the parties to make an express choice of law. Such a choice would ensure predictability and provide parties with a sense of control over the arbitration process. However, parties rarely do this in practice. So how is the law applicable determined?

Different jurisdictions developed different solutions to the problem over the years. The principle of party autonomy, the seat of arbitration, the principle of separability, international conventions, national statutes, and case law collectively shape the way to identify the governing law. In this part, some possible solutions to the question of determining the applicable law will be presented and discussed.

A. Explicit Choice of Law

Parties have the freedom to select a governing law for their arbitration agreement. The most unambiguous indication as to which law shall be applied to the arbitration agreement would be given by an express choice of law clause.[30] The parties' explicit choice of law ends all discussion regarding the applicable law to the arbitration agreement and the arbitrators will be bound by the rules chosen by the parties. It establishes a clear framework for resolving any disputes arising from the agreement. Nevertheless, as mentioned above, an express choice-of-law clause is not seen in the contracts very often. Perhaps it is because the parties have the will to have more flexibility during the arbitration process.

[29] Moses (n 17) 65.
[30] Czernich (n 28) 78.

ArtV(1)(a) of the New York Convention does not set any limitations regarding which laws can be chosen by the parties. Parties are free to choose a law other than the law of the seat or the main contract.

B. Implicit Choice of Law

Considering the infrequent use of explicit choice of law clauses in arbitration agreements, it is of high importance to examine the conditions in which an implicit choice of law can be applied. Having said that, it is not very clear in the wording of the ArtV(1)(a) of the New York Convention whether the parties' choice of law must be explicit.

The Greek Court of First Instance held in a ruling that under the New York Convention, the law applicable to the typical or substantive validity of the arbitration agreement is the law determined by the contracting parties.[31] Moreover, it held that the contracting parties' choice of law can be explicit or implicit.[32]

It is a general rule that an implied choice of law may be presumed only in the circumstances that there is proof the parties had mutual intentions to agree on a law even if they did not stipulate this common will explicitly.[33] The implicit choice of law is in most cases (i) the law applicable to the main contract or (ii) the law of the seat. There are also other approaches, which are mentioned below.

1. The First Approach: The Law Applicable To The Main Contract (*lex causae*)

International commercial contracts usually contain a clause clarifying the law governing the substance of the dispute. When there is a choice of law clause in the main contract, it is entirely reasonable to question whether that choice of law applies exclusively to the main contract or if it extends to govern the arbitration agreement as well.[34]

It is possible to see many examples of case law where courts and arbitral tribunals decided that the law governing the underlying contract should also be applied to the arbitration agreement. In an ICC case, the tribunal decided that the choice of law applicable to the principal contract also tacitly governs the situation of the arbitration clause in the absence of a specific

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[31] *Consortium Member A v Concortium Member* B [2005] Greek Court of First Instance no 84.
[32] Ibid.
[33] Czernich (n 28) 79.
[34] Gaillard (n 6) 222.

provision.[35] Similarly, in a recent case, the Austrian Supreme Court held that the question of applicable law to the agreement should be examined on a case-by-case basis and decided that the governing law must be the law of the main contract.[36]

As once held in a Singaporean judicial decision, the parties' choice of law (for an arbitration agreement) is not necessarily the same law that is their choice to be the law of their substantive contract.[37] However, it also does not necessarily have to be different from the one governing the main contract. In this situation, how is it determined that there is an implied choice of law between the parties for the governing law of the main contract to be applicable also to their arbitration agreement?

Firstly, it should only be assumed that there might be an implied choice of law regarding the law of the main contract when the parties to the main contract actually include a choice of law clause in it. The lack of a choice-of-law provision in the main contract by itself indicates that the parties did not share a common intention to subject the main contract to a specific legal framework, and, as a result of this, such intention "cannot be substituted for the purposes of the arbitration agreement by extending the law of the contract also to the arbitration clause".[38]

There should also be indications that the parties commonly intended the arbitration agreement to be governed by the same law as the substantive contract. A choice of law should only be implied if the specific conditions of the case and the wording of the arbitration agreement permit such interpretation.[39]

In the case *Arsanovia Ltd & others v Cruz City 1 Mauritius Holdings*, the court decided that Indian Law shall be applied to the arbitration agreement, which was the *lex causae*.[40] In this case, the main agreement between the parties which was a shareholders' agreement was governed by Indian law. Further, under the arbitration clause, the application of specific provisions of the 1996 Indian Arbitration and Conciliation Act was specifically excluded from being applicable. The Court decided that these were strong indications of the parties' intentions for the arbitration agreement to be governed by *lex causae*.

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[35] ICC Case No 2626 (1977).
[36] *C v D* [2018] OGH 3 Ob 153/18y.
[37] *BNA v. BNB*, [2019] SGHC 142 17(e) (Singapore High Ct).
[38] Czernich (n 28) 80.
[39] Plavec (n 22) 104.
[40] *Arsanovia Ltd & others v Cruz City 1 Mauritius Holdings* [2012] EWHC 3732.

2. The Second Approach: The Law of the Seat

Another approach to determining the law applicable to the arbitration agreement is to deem the law of the seat as an implied choice of law. It can be argued that by way of choosing the seat, the parties choose a specific jurisdiction and thus, the law applicable to their arbitration agreement. Compared to the law of the main contract, the law of the seat usually has more connection to the arbitration agreement.[41]

In one case, C v D, the parties' main agreement stated that New York law was the governing law of the contract and London was the seat of arbitration.[42] The English Court of Appeal decided that there were strong indications in the arbitration clause against the New York law to be the governing law of the contract. This was deemed in favour of the law of the seat, and the court held it to be the applicable law to the arbitration agreement.

Finally, there should be no question of an implied choice of law regarding the law of the seat if the parties have not made a choice of seat. Where the choice of seat is entrusted to an arbitral institution or to the arbitral tribunal, it would not be very convincing to claim that the choice should be considered as an implied choice of law for the arbitration agreement.[43]

3. Other Approaches:

Reference to National Law

An explicit reference to any national legislation, as a general rule, gives rise to the presumption that parties had a will to subject the arbitration clause to that national law.[44]

Reference to Institutional Arbitration

When there is a referment to institutional arbitration in the parties' arbitration agreement, it can be argued that the parties have impliedly chosen the law of the country where the institutional organization has its seat as the governing law of their agreement. An example of this approach can be found in Chinese Law. The Laws Applicable to Foreign-Related Civil Relations provides that "Absent any choice by the parties, the law of the place where the arbitration

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[41] Piero Bernardini, 'Arbitration Clauses: Achieving Effectiveness in the Law Applicable to the Arbitration Clause' in Albert Jan van den Berg (ed), Improving the Efficiency of Arbitration Agreements and Awards: 40 Years of Application of the New York Convention (Kluwer Law International 1999) 201.
[42] *C v D* [2007] EWCA Civ 1282.
[43] Renato Nazzini, 'The Law Applicable to the Arbitration Agreement: Towards Transnational Principles' (2016) vol 65 ICLQ 681, 693.
[44] Cezrnich (n 22) 80.

institution locates or the law of the seat of arbitration shall be applied."[45] However, the parties' reference to institutional arbitration by itself does not seem to be a convincing reason to apply the law of the country where the institution is seated. Indeed, an arbitration may be conducted under an institution's rules while having its seat in another country than the one the institution is located in. For example, parties to an arbitration agreement are free to determine the arbitration to be conducted under ICC rules while choosing the seat as England. Applying French law to the agreement would not be very plausible in that case.

C. No Choice of Law

The method to determine the applicable law when there is no choice of law made by the parties in the arbitration agreement depends on the court or institution where the arbitration takes place.

If the parties do not make an express or implied choice of law in their arbitration agreement, according to Art. V(1)(a) of the New York Convention, the arbitration agreement is subject to the law where the arbitral tribunal has its seat.[46] It is not surprising, therefore, that most jurisdictions reach a decision based on the law of the seat of arbitration.

The English Court of Appeal laid down a guideline on the determination of the governing law in the case *Sulamérica v Enesa.*[47] According to these guidelines, when there is no express or implied choice of law can be found, an inquiry into the closest and most real connection should be made to determine which law governs the arbitration of the case at hand.

In another case, Enka v Chubb, the English Supreme Court found that no explicit or implicit choice of law had been made. [48] Thus, an inquiry was made to discover the law with the closest connection, and the court found it to be the law of the seat. Two judges, however, had contrary opinions and stated that the law of the main contract should be governing the agreement.

French case law has a different approach to the matter. In the groundbreaking Dalico case, the Cour de Cassation decided that there is no necessity to refer to any national law and that the validity of an arbitration agreement depends on the common will of the parties.[49] Nevertheless, upholding the validity of an arbitration agreement based on the French rule may jeopardize the

[45] Law of The People's Republic of China on the Laws Applicable to Foreign Related Civil Relations 2010 art 18.
[46] New York Convention 1958 art 5(1)(a).
[47] *Sulamerica CIA Nacional de Seguros SA and others v Enesa Engenharia SA and others* [2013] 1 WLR 102.
[48] *Enka Insaat ve Sanayi A.S. v. OOO Insurance Company Chubb* [2020] UKSC 38.
[49] *Dalico Contractors v Municipalite de Khoms El Mergeb* [1993] French Cour de Cassation…

enforceability of the arbitral award at a later stage, as it seems questionable how it would be reconcilable with the clear wording of Article V(1)(a) New York Convention.[50]

Some authors suggest that transnational principles may apply to the arbitration agreement in the absence of an express or implied choice of law and that this approach should be encouraged.[51] According to this approach, the application of any national law must be set aside and the transnational rules which are directly applicable must be used instead.

The decision made by the French Cour de Cassation in the above-mentioned case 'Dalico' can be an example of this approach. Indeed, there is no strong reason why the application of transnational rules should not take place for the arbitration agreement itself, where the tribunal or the court deems it appropriate. However, considering the hesitation shown by states even for the application of transnational rules to the substantive issues where the parties' choice of law is absent, this approach will not become popular anytime soon.

2.5 The Law Applicable to the Arbitration Proceedings

Unfortunately, there is no commonly accepted definition of the term "procedural law" (also called "*lex arbitri*"). According to a well-considered definition, the procedural law of arbitration is "the law governing all aspects of the conduct of the arbitral proceedings, including the internal procedures of the arbitration and the external relationship between the arbitration and the courts and the law of the arbitral seat."[52]

The law governing the merits of the dispute is not automatically applied to the arbitral procedure. There are different approaches when it comes to determining procedural law in international commercial arbitration. Different methods can be found in different jurisdictions' legislations. However, the law governing the procedures of international commercial arbitration is, in most cases, the law of the seat of arbitration.[53] Many national legislations for arbitration deem the law of the seat as the *lex arbitri*.

[50] Plavec (n 22) 96.
[51] *See* Nazzini (n 43) 701.
[52] Born (n 10) 1311.
[53] Moses (n 17) 64.

Traditionally, the law governing the procedure is the law of the seat. *Lex arbitri* is always the *lex loci arbitri*. Parties do not choose the law governing the arbitration procedure, except through the choice of the seat, they can indirectly determine the applicable law.[54]

As the traditional approach requires applying the law of the seat as the procedural law, it does not always have to be the case. It is widely accepted today that a choice made to determine the seat of the arbitration does not directly cause the *lex arbitri* to be the law of that jurisdiction.[55] According to the UNCITRAL Model Law, the parties are free to agree on the procedure to be followed by the arbitral tribunal in conducting the proceedings.[56] Even when the seat of arbitration is chosen by the parties, it does not automatically indicate that the law of the seat shall be procedural law. The modern view, in some jurisdictions, is to recognize the parties' autonomy to decide on the procedural law. It sometimes goes even to the point of allowing the parties to choose the procedural law of another state. Switzerland and France are two examples of countries taking a liberal approach to the issue. The Swiss Law states that "The parties may directly or by reference to rules of arbitration regulate the arbitral procedure; they may also subject the procedure to the procedural law of their choice." [57] The French Code of Civil Procedure provides a similar view.[58] It is evident that the parties' autonomy to choose a national law other than the law of the seat is implied by their freedom to select the applicable procedural law.[59]

Notwithstanding, according to the explanatory note on the UNCITRAL Model Law, "where the national law allows parties to choose the procedural law of a State other than that where the arbitration takes place, experience shows that parties rarely make use of that possibility."[60]

A U.S. court observed in one case that an agreement that provides one country as the seat of the arbitration but the procedural law would be another's law is "almost never used in practice" and "once in a blue moon set of circumstances."[61]

Although the freedom to select another state's procedural law is not much used in practice, they should be able to do so if they find it suitable for their case. As party autonomy is the

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[54] William W Park, 'The Lex Loci Arbitri and International Commercial Arbitration' (1983) 32(1) The International and Comparative Law Quarterly 21, 23.
[55] Gaillard (n 6) 635.
[56] UNCITRAL Model Law 1985 art 19.
[57] Swiss Private International Law Act 1987 art 182(1).
[58] French Code of Civil Procedure 2011 art 1509.
[59] Born (n 10) 1320.
[60] UNCITRAL Model Law 1985, Explanatory Note 14.
[61] *Karaha Bodas Co LLC v. Perusahaan Pertambangan Minyak Dan Gas Bumi Negara* [5th Cir. 2004] 364 F.3d 274.

critical principle in arbitration, parties have the freedom to design their proceeding according to their needs and wishes through their agreements. They should be able to use this freedom when it comes to the procedural rules as well.

2.5.1 Determining the Procedural Law

The parties are free to choose the law governing the arbitral procedure, and in the case of an absent choice of law, the arbitrators have the same freedom.[62] This choice can be made in the arbitration agreement or after the dispute has arisen. However, it is highly uncommon for the parties to agree explicitly in their primary contract or arbitration clause on the procedural law of an arbitration that will take place in the future.[63] Usually, the arbitrators determine the rules governing the procedure of the arbitration.

If the parties did not express a choice of procedural law for the arbitration the law of the arbitral seat may be regarded as the implicit choice of the parties. The English High Court held in one decision that "*If the parties do not make an express choice of procedural law to govern their arbitration, then the Court will consider whether they have made an implicit choice. In this circumstance, the fact that the parties have agreed to a place for the arbitration is a very strong pointer that implicitly they must have chosen the laws of that place to govern the procedures of the arbitration.*".[64] This approach is very reasonable since there is a close connection between the arbitral proceedings and the seat of choice of the parties.

Arbitrators also have the power to determine the procedural law. As they have the same freedom as parties to select a procedural law before the proceeding begins, arbitrators usually do not decide upon the procedural law before a dispute on the matter arises. Instead, they make their decisions depending on the arisen issue during the procedure. UNCITRAL Model Law provides that in the absence of an agreement made by the parties, the arbitral tribunal may conduct the arbitration in such a manner as it considers appropriate.[65] German Law [66] and English Law[67] have similar provisions. The ICC rules follow a similar approach, and it also

[62] Gaillard (n 6) 647.
[63] Born (n 10) 1318.
[64] *Union of India v. McDonnell Douglas Corp* [1993] 2 Lloyd's Rep. 48, 50 (QB) (English High Ct.).
[65] UNCITRAL Model Law 1985 art 19(2).
[66] German Code of Civil Procedure 2005 art 1042(4).
[67] English Arbitration Act 1996 art 34.

provides that the arbitral tribunal's power to determine the procedural laws/rules is not limited to be a national law. [68]

According to French Law, the arbitrators can quite liberally determine the procedural law or rules when there is no choice made by the parties. [69] In this light, the arbitrators may apply the laws of a place other than the seat of the arbitration as the procedural rules. The Swiss Law has a similar approach to the matter.[70]

In some jurisdictions, the national legislation automatically decides on its own procedural law as the applicable law when there is no agreement between the parties. In these jurisdictions, the arbitrators do not have the autonomy to determine a procedural law. Turkish Law can be an example of legislation taking such an approach.[71]

2.6 The Law Applicable to the Substantive Issues

The determination of the law applicable to the substantive issues (or to the contract) is of utmost importance in international commercial arbitration. It impacts the rights and obligations of the parties and the interpretations of the contracts between parties.

The law applicable is chosen by the parties and when there is an absence of the parties' choice of law by the arbitrators.

2.6.1 PARTIES' CHOICE OF LAW

International commercial arbitration agreements typically contain a choice of law provision that deals with the applicable law to the parties' contract. The choice of law agreement is usually a clause in the parties' main contract. Still, a choice of law can also be made subsequent to the formation of a contract, after a dispute has occurred, or even after an arbitration has been filed.[72] And when it comes to the question of formulation, no modern arbitration statute requires a form for the choice of law agreement to be binding.

Contemporary international arbitration practice does not give as much importance to the choice of the seat of arbitration.[73] The law applicable to the merits of the dispute is independent of the

[68] ICC Arbitration Rules 2021 art 19.
[69] French Code of Civil Procedure 2011 art 1494(2).
[70] Swiss Private International Law Act 1987 art 182(2).
[71] Turkish International Arbitration Law 2001 art 8(a).
[72] Born (n 10) 2240.
[73] Gaillard (n 6) 789.

choice of the seat. The law of the seat cannot automatically be considered the applicable law to the merits of the dispute.

National laws, international arbitration conventions, and the international arbitral institutions' rules all recognize the parties' autonomy to choose the law applicable to their contract. When the parties determine the law of a state, it does not refer to the conflict of laws rules of that state, unless otherwise expressed, but instead refers to the substantive law of that state.

The New York Convention does not specifically address the question of choice of substantive law, however, it mentions the parties' freedom in choosing the applicable law for the arbitration agreement and the arbitration agreement.[74] The European Convention, on the other hand, directly mentions that the parties are free to determine the law to be applied to the substance of the dispute.[75] The UNCITRAL Model Law is to the same effect.[76]

In almost all developed states, just like contemporary international conventions, the courts recognize and enforce agreements on the applicable choice of law to the merits of parties' contracts and disputes.[77]

The parties have different options regarding their choice of law for the applicable law to the substance of their relations. They can make a national or a non-national choice of law agreement. Over the last decades, it became quite clear that the parties are free to agree to decide which rules of law govern their contract. This approach was adopted by French law in 1981.[78]

A. National Law

Historically, the parties had to select a law that has an objective connection with the contract otherwise, the choice of law was not deemed valid under the private international law of contract.[79] The contemporary approach is on the contrary, and party autonomy is given more importance in today's world. Therefore, parties are free to choose any national law they deem appropriate.

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[74] New York Convention 1958 Art 5(1)(a)-(d).
[75] European Convention on International Commercial Arbitration (adopted 21 April 1961, entered into force 7 January 1964) 484 UNTS 349 (European Convention) art 7(1).
[76] UNCITRAL Model Law 1985 art 28(1).
[77] Born (n 10) 2156.
[78] French Code of Civil Procedure 2011 art 1512.
[79] Gaillard (n 6) 792.

In most choice of law agreements, a national substantive law is selected. Parties to a commercial contract usually want their relations to be governed by a legal system that is predictable and well-developed. They also most likely will want to determine a law that they are familiar with. Thus, the parties typically choose the national law of one of them when selecting the law governing the contract.[80] In a recent survey, it was found that 44% of the corporations would choose the law of their home jurisdiction if they were free to do so.[81] Other than that, the most favored law as the governing law of the substance was found to be English law, which is considered to be "predictable", "internationally accepted", and "well developed" by the respondents. [82]

Parties to a contract, if they feel the need to protect themselves, can use a stabilization clause to freeze the law applicable to their contract. This happens mostly in cases where one of the parties is a State.

Parties may also select the laws of two or more states to govern their contract. In that case, more than one state's law would govern the whole of their contractual provisions. This particular choice of law agreement between the parties may create confusion and future disputes; therefore, is not seen often.

B. Depeçage

Some choice of law agreements determine different national laws to govern different aspects of their main contract, which is known as depeçage. A split choice of law agreement such as this can be useful in cases where the law of one state is well suited to some particular issues between the parties but another law to the rest. According to the Rome Convention, parties shall be able to select the applicable law for a part of the contract.[83]

C. Transnational Principles (Conventions and Treaties)

As stated above, parties can select a non-national law as their applicable substantive law. Many states give this autonomy to them by the use of the words "rules of law." France[84],

[80] Moses (n 17) 69.
[81] Queen Mary University of London, 2010 International Arbitration Survey: Choices in International Arbitration 12.
[82] Ibid.
[83] Convention on the Law Applicable to Contractual Obligations [1980] OJ L266/1 (Rome Convention) art 3(1).
[84] French Code of Civil Procedure 2011 art 1496.

Switzerland[85], The Netherlands[86] are some examples to this. The parties can choose, for example, The United Nations Convention on Contracts for the International Sale of Goods (CISG) or the UNIDROIT Principles of International Commercial Contracts. Parties must be careful in such cases because some areas of their dispute might not be covered by an agreement like CISG.

D. *Lex Mercatoria*

Lex mercatoria (law of merchants) is a body of customary international commercial law, which the parties may refer to in their choice of law agreement. Partes might make a choice of lex mercatoria "parties escape peciluar formalities, brief cut-off periods, and some of the difficulties created by domestic laws."[87] It is generally accepted that the parties may choose lex mercatoria as their governing law. However, there is much discussion around the matter. *Lex Mercatoria* will be discussed in more detail below, under Chapter 3.

E. *Ex Aequo et Bono* and *Amiable Compositeur*

The parties may also require the arbitral tribunal to make a decision on the matter *ex aequo bono* or as *amiable compositeur*. Most arbitration rules and laws today allow arbitrators to make decisions this way, however, only if the parties expressly state them to do so. The European Convention states that "the arbitrators shall act as *amiable compositeurs* if the parties so decide".[88] The UNCITRAL Model Law has a similar provision for *ex aequo et bono* and *amiable compositeur*.[89] Parties seldom agree to this in their choice of law agreement. However, when they do, the arbitrators will not be obliged to make a decision by the application of legal rules. They will make a decision based on the general principles of fairness and equity. This gives arbitrators broad authority.

The matter of *ex aequo et bono* and *amiable composition* will be discussed in detail below, under Chapter 4.

2.6.2 LIMITS TO PARTIES' CHOICE

[85] Swiss Private International Law Act 1987 art 187.
[86] Netherlands Code of Civil Procedure 1986 art 1054.
[87] Ole Lando, 'The Lex Mercatoria in International Commercial Arbitration' (1985) 34(4) The International and Comparative Law Quarterly 747, 748.
[88] European Convention 1961 art 7(2).
[89] UNCITRAL Model Law 1985 art 28(3).

As stated in an ICC award, arbitration shall only be governed by the rules of arbitration chosen by the parties.[90] In the majority of cases, this happens. However, in some situations, there can be grounds to limit the effectiveness of the parties' choice of law.

Where they deem the law to be contrary to international public policy, arbitrators have the authority to disregard those provisions. According to the New York Convention, recognition and enforcement of an arbitral award may be refused if it is contrary to international public policy.[91] This should mean that the arbitral tribunal has the authority to set aside the provisions of a law chosen by the parties which would result in a contravention of a principle that is part of international public policy. [92]

2.6.3 DETERMINATION BY THE ARBITRATORS

As it is provided in all related legislation and arbitration rules, arbitrators will determine the governing law of the contract, usually with broad discretion, where the parties have no choice specifying it.[93] The UNCITRAL Model Law provides that "the arbitral tribunal shall apply the law determined by the conflict of laws rules which it considers applicable."[94] The European Convention contains a similar provision as it states that "Failing any indication by the parties as to the applicable law, the arbitrators shall apply the proper law under the rule of conflict that the arbitrators deem applicable.".[95]

Preliminarily, the arbitrators' role in selecting the applicable substantive law consists of a two-step process.[96] The arbitrators, at first, need to decide on a country's conflict of laws rules in order to determine the applicable law. After deciding on the conflict of laws rules, the arbitrators then need to determine which law must govern the contract by the application of the conflict of laws rules. An example of an act taking this approach is the English Arbitration Act.[97]

Some national arbitration legislations, French[98] law and Dutch[99] law as examples, have a similar approach to the matter and recognize the authority of the arbitral tribunal to select the

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[90] ICC Case No 1512 (1971).
[91] New York Convention 1985 art 5(2)(b).
[92] Gaillard (n 6) 861.
[93] Moses (n 17) 76.
[94] UNCITRAL Model Law 1985 art 28(2).
[95] European Convention 1961 art 7(1).
[96] Borne (n 10) 2109.
[97] English Arbitration Act 1996 s 46(3).
[98] French Code of Civil Procedure 2011 art 1511.
[99] Netherlands Code of Civil Procedure 1986 art 1054(2).

applicable law to the substantive issues. In the view of some scholars, "the fact that French and Dutch arbitration laws are less restrictive and do not require the arbitrators to apply a choice of law rule does not prevent them from doing so."[100]

This approach is obviously not very popular among state legislations. However, arbitrators should be able to determine the appropriate governing law themselves in cases. The law determined by the application of conflict of laws rules does not necessarily provide the most suitable rules for the parties' dispute. The tribunal is impartial and can examine the case thoroughly to detect which law would lead to the fairest result with the most suitable provisions that the case needs. Arbitrators should be given this autonomy as long as they do not override the parties'.

When the arbitral tribunal is given the authority to select the applicable law, they are not bound to choose a national law. In an ICC case, the arbitral tribunal decided to apply *lex mercatoria* to the substance of the dispute.[101] Afterward, when the case went to appeal, the Austrian Supreme Court supported the tribunal's decision. [102] In one case, the Paris Court of Appeals stated that the arbitral tribunal has the freedom to apply *lex mercatoria* as the governing law.[103]

Usually, institutional arbitration rules recognize the arbitral tribunal's autonomy. While some institutions[104] have an identical rule as the UNCITRAL Art 28/2, a greater number of institutions[105] directly give the arbitrators the authority to decide on the applicable law. According to the ICC Arbitration Rules, when the parties fail to reach an agreement, the arbitral tribunal has the power to apply the rules of law that it determines to be appropriate.[106] In that case, there would be no need for the use of a conflict of rules since the arbitrators can directly choose a law to be applied to the merits of the dispute.

There are also some institutional rules where the arbitrators are required to apply the law of the state with the closest connection to the parties' dispute.[107]

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[100] Gaillard (n 6) 871.
[101] *Pabalk Ticaret Sirketi SA v Norsolar SA* [1979] ICC Case No 3131.
[102] *Pabalk v Norsolor* [1982] OGH 8 Ob 520/82.
[103] *Compania Valenciana de Cementos Portland SA v Primary Coal Inc* [13 July 1989] Cour d'Appel Paris.
[104] CIDRA Arbitration Rules 2005 art 32(1).
[105] LCIA Arbitration Rules 2020 art 22(3); VIAC Rules of Arbitration 2021 art 27(2); ISTAC Arbitration Rules 2016 art 25(1).
[106] ICC Arbitration Rules 2021 art 21(1).
[107] Swiss Rules of International Arbitration 2004 art 35(1).

Chapter 3: *Lex Mercatoria* and its Role in International Commercial Arbitration

3.1 The Concept of *Lex Mercatoria*

Lex mercatoria, often referred to as the law merchant, "is a general body of European usages in commercial matters."[108] To be more precise, it is a body of customary international commercial law that has evolved over time through the practice of traders and merchants engaged in cross-border trade. *Lex mercatoria,* without reference to a particular national system of law, consists of a set of general principles and customary rules instinctively made reference to or developed in the structure of international trade.[109] It is possible to find various definitions of the term today.

Unlike national laws that are specific to one jurisdiction, *lex mercatoria* is a set of principles and rules that do not belong to a jurisdiction. This law emerged as a response to the need for a standard set of rules to govern trade between merchants from different legal systems.

3.1.1 Medieval *Lex Mercatoria*

Medieval *lex mercatoria* alludes to the historical origins of the law merchant during the Middle Ages. Medieval *lex mercatoria* was not, in fact, a non-state law. It was a combination of state and non-state regulations and practices, kept together by the merchants, which were its subject.[110] Reportedly, this law emerged in the area of maritime trade and in general commercial transactions, and it was based on the customary procedures of the merchants and traders of those days.[111]

During that time, there were challenges arising from cross-border trade between merchants. As a result, common norms and general principles emerged to govern these matters. It is assumed that dating back to the middle of the thirteenth century, disputes taking place between merchants were conducted according to a procedure that was quite different from that of traditional common law courts.[112] In the Middle Ages, commercial courts decided on cases

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[108] Jonathan Law (ed), *A Dictionary of Law* (10th edn, Oxford University Press 2022) 1696.
[109] Berthold Goldman, 'The Applicable Law: General Principles of Law – the Lex Mercatoria, in Cotemporary Problems in International Arbitration' in Julian DM Lew (ed), *Contemporary Problems in International Arbitration* (Springer Science+Business Media BV 1986) 116.
[110] Ralf Michaels, 'The True Lex Mercatoria: Law Beyond the State' (2007) 14(2) Ind.J.Global Legal Studies 447, 454.
[111] Klaus Peter Berger, 'History & Modern Evolution of Transnational Commercial Law' (Trans-Lex 2002) <trans-lex.org/the-lex-mercatoria-and-the-translex-principles_ID8#note_target_63> accessed 3 August 2023
[112] Francis M Burdick, 'What is the Law Merchant?' (1902) 2(7) CLR 470.

which involved foreigners not according to their domestic law but by the general law of nations that was based on customs and mercantile codes.[113]

It needs to be stated that *lex mercatoria* was not a transnational uniform law. A greater part of medieval literatüre consisted of rules of mercantile procedure from certain cities and towns.[114] There were many local variations of the *lex mercatoria*. It was far from being a universally recognized legal framework. Indeed, even today, *lex mercatoria* and the commercial principles can change from one region to another.

Moreover, before the 17th century, the conception of the *lex mercatoria* was totally different from the current vision.[115] After the 17th century, similar to the modern day, the concept was romanticized and thought to be different than what it truly was.[116] According to this view, *lex mercatoria* was a substantive law created by merchants for their use and had international recognition.[117] The new *lex mercatoria* doctrine is based on this view.

3.1.2 The New *Lex Mercatoria*

The origins of the modern *lex mercatoria* doctrine can be traced back to the early 1900s when foreign investors began seeking the right and ability to pursue their legal disputes independently against host states.[118] Naturally, when there is a contract between a private party and a State, the State will not want their contract to be governed by the laws of foreign national law. Similarly, the private party will not wish the laws of the foreign state to govern the contract, considering that the laws may be changed for the opposite party's advantage after they enter into an agreement.[119] Thus, the parties need neutral decision-makers in the case of a dispute. One example of these cases is the Rules of Qatar v. International Marine Oil Company Ltd.[120] The tribunal considered Islamic law to be insufficient and instead applied the principles of justice, equity, and good conscience.

Like in investment contracts, the parties' wish to find neutral decision-makers is quite the same when there is an international commercial contract between a State and a private party. As a

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[113] McKendrick (n 5) 22.
[114] Mert Elcin, 'Lex Mercatoria in International Arbitration: Theory and Practice' (PhD thesis, European University Institute) 12.
[115] Ibid 11.
[116] Ibid.
[117] Ibid.
[118] Ibid 23.
[119] Lando (n 87) 748.
[120] *Ruler of Qatar v. International Marine Oil Co* [1953] 20 ILR.

result, as more and more case decisions were made according to principles such as good faith, the transnational theory of arbitration came up. It started to be accepted that arbitration can/should be detached from the law of the seat. As a result, in light of the medieval *lex mercatoria* and international arbitral practice experience, the doctrine of modern *lex mercatoria* was invented by European professors.[121] *Lex mercatoria*'s one function here is to overcome the legal diversities created by the division of many legislations.[122]

To give an example as to the content of the new lex mercatoria, it includes basic concepts like freedom of contract, good faith, and sanctity of contracts. These principles are vital examples of commercial principles recognized by most of the international business community.

3.1.3 Sources of *Lex Mercatoria*

Lex mercatoria has many sources. By means of trade usages and general principles, traders were creating their own regulatory framework independently from national law. As stated above, *lex mercatoria*'s content can show difference from region to region, and there are more than one view of *lex mercatoria*. Indeed, there is also no common opinion on what constitutes *lex mercatoria* and what its sources are. In this part, a brief list, not exhaustive, will be mentioned to create a general idea of the concept of the law merchant. These sources are trade usages, general principles, international conventions and model laws, model contracts and standard clauses, and arbitral awards.

Trade Usages

Trade usages are the cornerstone of *lex mercatoria*. A trade usage "is a practice or method of dealing having such regularity or observance in a place, vocation, or trade as to justify an expectation that it will be observed with respect to the transaction."[123] In short, these are practices generally followed in the commercial industry. Trade usages are binding without the need of being expressly consented to by the commercial parties, and they safeguard that distinctive characteristics and requirements of the global business community are recognized and incorporated into modern *lex mercatoria*.[124]

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121 Mert Elcin (n 114) 30.

122 Francesco Galgano, 'The New Lex Mercatoria' (1995) 2(1) Annual Survey of International and comparative Law 99, 108.

123 'Usage of Trade' (*Cornell Law School*) <https://www.law.cornell.edu/wex/usage_of_trade#:~:text=A%20usage%20of%20trade%20is,contracts> accessed 3 August 2023

124 Oliver Volckart and Antje Mangels, 'Are the Roots of the Modern Lex Mercatoria Really Medieval?' (1999) 65(3) Southern Economic Journal 427, 430.

General Principles

Although it is not always easy to determine what rules are accepted to be the "general principles", they can be defined as principles that are common to a number of legal systems. There is no exhaustive list of general principles. Arbitrators will need to engage in research to find the required general principles for the dispute. In order to do that, comparative law research is essential.

For example, Unidroit Principles of International Commercial Contracts are of high importance in international commercial law and these may be applied to the substantive issues if the parties refer to *lex mercatoria* as their governing law of the contract. The UNIDROIT Principles itself also provide that it can be applied when the parties have an agreement determining "*lex mercatoria*", "general principles of law", or similar concepts.[125] *Pacta sunt servanda* ("agreements must be kept") and good faith are also two examples of general principles.

International Conventions and Model Laws

International conventions are important essential for *lex mercatoria*. International conventions form rules of law of that have international aspects, and they contain widely recognized solutions of the comparative law as confirmed by the international legal community.[126]

Model laws are designed to guide states in reforming their laws and usually provide valuable solutions to challenges in international commercial law. Therefore, these are also quite valuable sources.

Model Contracts and Standard Clauses

Another vital element of *lex mercatoria* is the model contracts like Uniform Customs and Practice for Documentary Credits (UCP) of the International Chamber of Commerce. These model contracts decrease the risk of application of national provisions, which can lack rules for certain types of contracts.

Standard clauses, like the Incoterms, are additional components of the law merchant.

Arbitral Awards

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[125] UNIDROIT Principles of International Commercial Contracts Preamble 2016.

[126] Tolga Ayoğlu, 'Some Reflections on the Sources of Lex Mercatoria' in Ahmet Cemil Yildirim and Serhat Eskiyoruk (eds), Uluslararasi Ticari Tahkim ve Yeni Lex Mercatoria (Oniki Levha Yayinlari 2014) 33.

Unfortunately, most arbitral awards are not published because of confidentiality issues. Although the matter of confidentiality, previously issued arbitral awards may be used as compelling evidence in order to persuade the Arbitral Tribunal towards a particular solution, as they have a function to specify the general principles of international contract law, trade usages, and non-national rules of law.[127]

The arbitral tribunal, in many cases, refers to international commercial case law while examining the content of transnational rules, and naturally, arbitrators use precedents created by other arbitral awards rendered under similar conditions.[128]

3.2 Lex Mercatoria in International Commercial Arbitration

Because of its nature, *lex mercatoria* has limited applicability in general. In litigation, the national laws, rules, and procedures will always have priority. Therefore, the applicability of *lex mercatoria* depends on whether or not the parties choose arbitration as their dispute resolution mechanism.[129] So, the primary dispute resolution mechanism where the application of *lex mercatoria* can be come across is international commercial arbitration.

Although parties to commercial contracts today mostly prefer a national law as their governing law, in some of their choice of law clauses, they do refer to *lex mercatoria*. Today, it is generally accepted that the parties may refer to *lex mercatoria* in their choice of law agreements, however, there is still controversy around the subject.

3.2.1 Arguments Around *Lex Mercatoria*

The discussions made by Goldman and Schmitthoff during the 1960s started the argument around the concept of "the new *lex mercatoria*".[130] They played a pivotal role in the formation and shaping of the new *lex mercatoria* discussion from its beginnings until the late 1980s.[131] Berger states that "they shared the conviction that a transnational body of legal principles and rules was gradually emerging from the spontaneous activities of the international business

[127] Ibid 35.
[128] Emmanuel Gaillard (n 6) 817.
[129] Mert Elcin (n 114) 179.
[130] *See* Dave De ruysscher, 'Conceptualizing Lex Mercatoria: Malynes, Schmitthoff and Goldman Compared' (2020) 27(4) MJ 465-483.
[131] Nikitas E. Hatzimihail, 'The Many Lives and Faces of Lex Mercatoria: History as Genealogy in International Business Law' (2008) 71(3) LCP 169, 174.

community and the multiple activities of international formulating agencies in the harmonization and unification of the law of international trade and finance."[132]

The concept and application of *lex mercatoria* in international commercial law have been subject to endless criticism since it became relevant in the 1960s, and today, the same arguments are still going on. There are usually two types of criticism around *lex mercatoria*. The first kind is raised against *lex mercatoria* as a concept and denies it having an actual legal order. This criticism is, therefore, more conceptual. The second kind of criticism is on its practicality. It refers to the use and application of *lex mercatoria* and concerns the difficulty in discovering its content.

Interestingly, it is easy to notice that most critiques of *lex mercatoria* are from the common law systems while the proponents are from the civil law systems.

Criticism of Lex Mercatoria

Criticism of *lex mercatoria* is generally caused by its uncertain nature, and the fact that it has no legal order like national legislation does. Most arguments put forward against Goldman's and Schmitthoff's theories after the 1960s are still being repeated, and the content of the criticism is mostly the same today. The main arguments made by the scholars will be discussed here.

Mann stated that a choice of law agreement should not validly refer to transnational rules since "it is difficult to imagine a more dangerous, more undesirable and more ill-founded view which denies any measure of predictability and certainty and confers upon parties to an international commercial contract or their arbitrators powers that no system of law permits and no court could exercise".[133]

Lord Mustill was another scholar who raised important questions about the concept and application of *lex mercatoria*.[134] He stated that there is "no guarantee of homogeneity even within a single trade."[135] He thought there were other distinct problems such as "On what basis one should discover the substandard content of *lex mercatoria*?" and "How to predict, in a case where the relevant rule has not yet been firmly established by a consensus of opinion or by one

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[132] Berger (n 111).
[133] F A Mann, 'England Rejects "Delocalised" Contracts and Arbitration' (1984) 33(1) The International and Comparative Law Quarterly 193, 197.
[134] *See* Michael Mustill, The New Lex Mercatoria: The First Twenty-Five Years (1988) Arbitration International 86-109.
[135] Ibid 95.

or more arbitral awards, what sources a tribunal will deploy when addressing the new issue of principle, and what conclusions it will reach?"[136]

Born is also of the opinion that "even when they are enforceable, non-national choice of law formulations should be resisted in the drafting of contracts, save in relatively unusual cases".[137] He further states that it is "not advisable for private parties to expose themselves to the uncertainties that a non-national choice of law clause will entail."[138]

These arguments have been repeated in various ways by other authors and scholars. The essence of most arguments and questions is mostly the same. Other than practical difficulties created by *lex mercatoria* related to its sources, determination, and foreseeability, there are also philosophical objections to the *lex mercatoria*.[139] A frequently raised question is whether the *lex mercatoria* can be accepted as 'law'.

It is rightfully argued that creating a counterargument to the criticism is rather tricky since most contributions made in favor of *lex mercatoria* so far have "lacked an analytical approach".[140] Moreover, there is still misunderstandings about the terminology and the fact that the debate is isolated from other areas of the law makes it even harder.[141]

In Support of Lex Mercatoria

Lex mercatoria has its proponents as well as its opponents. As mentioned, Goldman and Schmitthof were the first advocates of *lex mercatoria*. The proponents mainly adopted two approaches in support of the existence of *lex mercatoria*: (i) They created proof of the *lex mercatoria* in the form of written compilations; (ii) and gestured to pre-existing arbitral awards, court decisions, and traditional wisdom about the medieval law merchant.[142] However, these were definitely not enough to answer the questions regarding the practicality of *lex mercatoria*. The criticism of the practicality of *lex mercatoria* and its uncertainty are the more critical arguments standing in its way. Rather than arguing about its nature and conceptual existence, its practicality should be the focus for the proponents as well.

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136 Ibid 114.
137 Born (n 10) 2229.
138 Ibid.
139 Michael Pryles, 'Application of The Lex Mercatoria in International Commercial Arbitration' (2003) 18(2) Maeley's International Arbitration Report 1, 12.
140 Orsolya Toth, The Lex Mercatoria in Theory and Practice (Oxford Academic 2017) 8.
141 Ibid 9.
142 Ibid 12.

According to Gaillard, "it is by no means evident that to be the object of a valid choice of governing law, the rules chosen must necessarily be organized in a distinct legal order."[143] Arguments stating that a choice of law referring to a transnational set of rules or *lex mercatoria* should not be deemed valid are already outdated. In many developed jurisdictions today, parties have the freedom to select *lex mercatoria* as their governing law.

When it comes to other arguments raised against the application of *lex mercatoria*, these fall short in today's world to provide reasons why it would not be useful and to the benefit of the parties. Of course, there are cases where the specific rules of a national legislation would be more suitable as its governing law. However, in general, criticism of *lex mercatoria* usually focuses on its legal nature and its a-nationality. These do not actually give a reason for the need to stick with "national" rules in international commercial situations. Frankly, in cases where the parties explicitly select *lex mercatoria* to be the law governing their contract or where the tribunal has the authority to choose 'rules of law' to apply to the parties' dispute, the argument if the *lex mercatoria* qualifies as an organized legal framework is merely academic.[144]

Why did we need the concept of *lex mercatoria* in the first place? Clearly, international commercial law was in need of a 'not so strictly organized set of rules' that do not belong to one legal system in order to have fairer judgments and flexibility. Claiming that *lex mercatoria* has a legal order just like a national law does would not give much fruit in trying to convince others of its application. On the contrary, *lex mercatoria* is vital because of the very thing that causes it to be questioned. Even if not as the sole governing law of a contract, *lex mercatoria* can be of great use applied together with a national law.

Indeed, it is hard to determine *lex mercatoria,* but it should be left to the parties and arbitrators to decide if they want to apply this set of rules to the contract. The abstract and uncertain nature of *lex mercatoria* might actually be helpful in certain cases. In short, there is no plausible reason why transnational rules should be dangerous for parties engaged in international commerce. *Lex mercatoria,* under the authority of the arbitrators, can operate "as an instrument for the selection of the most suitable legal rules and, therefore, contribute to the progress of law."[145]

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[143] Emmanuel Gaillard (n 6) 809.
[144] Michael Pryles (n 139) 13.
[145] Alfonso-Luis Calvo Caravaca and Javier Carrascosa Gonzalez, 'Lex Mercatoria and Private International Arbitration' (2020) 12(1) Cuadernos de Derecho Transnacional 66, 85.

3.2.2 Parties' Choice of *Lex Mercatoria*

Sometimes, parties choose their contract to be governed by *lex mercatoria*. In modern international commercial arbitration, the expression 'rules of law' as opposed to 'the law' to specify the rules that can be selected by the parties to govern their contract indicates the freedom of the parties to apply such rules such as *lex mercatoria*.[146] Where the expression "rules of law" can be found, arbitrators are allowed to select a set of nonlegal rules to the extent they deem it suitable.[147] This includes *lex mercatoria* and the general principles of law.

Explicit Reference to Lex Mercatoria

Parties may directly refer to *lex mercatoria* in their arbitration agreement or clause as the applicable law. In this light, the parties' freedom to select 'rules of law' to apply to their contract enables them to refer to any of the components of *lex mercatoria*.[148] They may, for example, only refer to general principles leaving the other sources of *lex mercatoria* out of their agreement. In such a situation, the arbitrators must establish the parties' intention in using a specific expression to decide on the rules applicable to the dispute. Therefore, the first step must be the examination of the choice of law clause made by the parties. On the other hand, in some situations, parties may only use a phrase like "general principles", "common principles", or "trade usages" while they actually mean the whole of *lex mercatoria*. Under those circumstances, the phrasing of the parties must be accepted as a reference to *lex mercatoria*.

The parties may determine a national law together with the *lex mercatoria* to be the governing law of their contract. This choice, which is common in state contracts, "indicates the parties' intention to prevent the arbitrator from treating the rules of the national law as incorporated into the agreed bargain under the contract and considering them as the articulated rules to the extent that they reflect the isolated position of the relevant legal system in the order of international commerce."[149] In the case *LIAMCO v Libya*, parties agreements provided that the governing law was 'common principles of Libyan and International law', and in the absence of such common principles, 'general principles of law'.[150] Thus, Libyan domestic law was found to be the principal governing law, as long as there was no conflict between it and the international principles of law.

[146] Gaillard (n 6) 802.
[147] Moses (n 17) 78.
[148] Gaillard (n 6) 807.
[149] Elcin (n 114) 262.
[150] *Libyan American Oil Co v The Government of Libyan Arabic Republic* [1977].

There are also some clauses that determine the principles of several legal systems as applicable law. In that case, the arbitrators must conduct a comparative analysis staying within those legal systems.

The parties may decide on the application of *lex mercatoria* or its components in many different ways and in different circumstances. As is emphasized many times in this chapter, the arbitrators should very carefully analyze the intention of the parties in each case. Since the *lex mercatoria* has limited legal material and thus the application of it can become a "creative process".[151] As a result, the arbitrators might need to look for guidance elsewhere. This leads to arguments that the application of *lex mercatoria* is exceedingly difficult since there is not a readily identifiable body of rules composing it.[152]

As stated above in Chapter 2, according to the international arbitration survey made in 2010, national laws are preferred over transnational rules.[153] This can be explained by the participants' wish to choose a governing law that is "predictable", "certain", and "foreseeable".[154] While drafting their contract, the parties wish to choose a law that is "accessible", "clear", and "has an established jurisprudence that can provide some amount of certainty".[155] However, this should not mean that choosing *lex mercatoria* as the governing law does not have its own advantages. In a case where the arbitrators are applying the *lex mercatoria*, they have the autonomy to choose the more appropriate and better rules of law for the case at hand. On the other hand, when a national law is chosen by the parties the tribunal would not have the freedom to do so.

Moreover, there may be a situation where the chosen national does not include the foreign elements needed, leaving the arbitrator in a dilemma between law and equity. In such cases, the *lex mercatoria* may, in fact, provide more certainty.[156]

Implied Reference to Lex Mercatoria

The fact that parties did not make any choice of national law does not, by itself, mean that they had an intention of transnational rules to be applied to their contract. Nevertheless, in certain cases, an implication to the *lex mercatoria* can be found. The contract needs to be evaluated to

[151] Lando (n 87) 753.
[152] Monica Kilian, 'CISG and The Problem With Common Law Jurisdictions' (2001) 10(2) Journal of Transnational Law and Policy 217, 222.
[153] (n 81) 13.
[154] Ibid.
[155] Moses (n 17) 62.
[156] Ole Lando (n 87) 754.

reach the decision that the parties made an implicit choice of law referring to *lex mercatoria* and that they had a common intention in doing so. It might be considered that there is an implied reference to *lex mercatoria* in cases where the parties grant the arbitrator the power to act as an *amiable compositeur*.[157] Nevertheless, it is dangerous to think that parties decision for the arbitrators to act as *amiable compositeurs* to give way for the application of *lex mercatoria* directly. There must be a strong indication in their agreement that parties have a wish for them to do so. Otherwise, it would not be fair to apply *lex mercatoria* to their contract. In all cases, arbitrators must give effect to the intentions of the parties.

In an ICC case, where the arbitrators were authorized to act as *amiable compositeurs*, they stated that they may make the decision based on the contract provisions and the general principles.[158] They reached the decision that *lex mercatoria* can be applied to the case.

In the case Sapphire v. National Iranian Oil Company, there was no choice of law agreement between the parties on the law applicable to the substance of the case.[159] The court found that there was a negative intention of the parties to reject the application of Iranian law. Thus, the court held that "It is quite clear from the above that the parties intended to exclude the application of Iranian law. But, they have not chosen another positive legal system, and this omission is on all the evidence deliberate. All the connecting factors cited above point to the fact that parties, therefore, intended to submit the interpretation and performance of their contract to the principles of law generally recognized by civilized nations…". So, in this case, the parties' intention to exclude Iranian law was a factor in determining that they had an intention for the general principles to be applied.

There was an international investment agreement between the parties in the above-mentioned case, however, it stands as an example for international commercial arbitration too. In an ICC case, the contract between an Italian company and a government agency of a Middle Eastern country did not contain a choice of law clause.[160] According to the tribunal, the facts that the parties refused one of their national law to be applied and chose a third country as the seat were signs of the parties' intentions to select general principles as their governing law. The arbitral tribunal made the decision that the applicable law shall be the general principles of trade as embodied in the *lex mercatoria* and referred to the provisions of the UNIDROT Principles.

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[157] Sulun Gucer, 'Lex Mercatoria in International Commercial Arbitration' (2009) 2(1) Ankara Bar Review 30, 37.

[158] ICC Case no 3540 (1980).

[159] *Sapphire v National Iranian Oil Company* [15 March 1963] ILR.

[160] ICC Case No 8261 (1996).

No Choice of Law

Sometimes, parties' agreements do not contain any choice of applicable law. When there is an absence of choice by the parties, *lex mercatoria* can be applied to the contract if the arbitrators deem it appropriate. For example, a situation can arise where the legal nature of the contract and dispute between the parties might be more suitable to be resolved by the transnational rules rather than a national law.

According to a number of institutional rules and legislations, arbitrators may choose to apply *lex mercatoria* to the substance of the dispute. Namely, France[161] and The Netherlands[162] are countries with such legislation. They give the arbitrators the same freedom they give to the parties.

On the other hand, as mentioned above under Chapter 2, many legislations only allow the arbitrators to find out the governing law to the contract by using a set of conflict of laws rules. In such situations, arbitrators cannot directly determine the *lex mercatoria* as the governing law of the substantive issues.

Binding the arbitrators with a set of conflict of laws rules to determine the applicable is not always plausible, as discussed above under Chapter 2. The tribunal should be given the autonomy to determine any "rules of law" they deem to be suitable for a case of international commercial arbitration. Nevertheless, they may apply conflict of laws rules if it would result in the best possible solution for the dispute before the tribunal. International disputes, in specific cases, require principles and rules that are of a global nature. Similar to the parties, the tribunal should indeed have the freedom to select lex mercatoria as the governing law. In this context, the autonomy of the arbitrators should be encouraged as long as it does not override the parties' autonomy.

The application of *lex mercatoria* by the arbitrators when the parties do not authorize them to do so happens rarely in practice. One example is the case *Pabalk Limited Sirketi v. Norsolor*.[163] In the agreement between the parties, there was no determined applicable law to the substance. While Norsolor claimed that Turkish law needed to be applied, Pabalk claimed French law should be the applicable law. The arbitral tribunal found it unfair to select a national law for the case and, therefore, decided on *lex mercatoria* as the governing law. The Austrian Supreme

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[161] French Code of Civil Procedure 1981 art 1496(1).

[162] Dutch Code of Civil Procedure 1986 art 1054(2).

[163] Pabalk Limited Sirketi v Norsolor (1979) ICC Case No 3131.

Court later found the arbitral award, which was made based on the application of *lex mercatoria,* to be justified.[164]

In another case where there was an absence of choice of law in the agreement between a Spanish and a Danish company, while one argued that the applicable law must be Spanish law, the other argued that it was Danish law.[165] Considering the business relationship of the parties, the tribunal decided to apply the CISG to the dispute between the parties. The arbitrator stated that the CISG and its general principles, as elaborated in the UNIDROIT Principles, were suited to the settlement of the present dispute.

The arbitrators may also decide to apply *lex mercatoria* together with a national law. *Lex mercatoria* can be used to fill the gaps left by the national law or to confirm the reached decision based on the national law.[166]

In some cases, although rare, where parties have no agreement on the choice of law, they might agree on the application of *lex mercatoria* during the proceedings. During proceedings, the arbitrators should suggest to the parties this option and invite them to contemplate a possible agreement on *transnational rules* as the governing law of the dispute when the arbitrators are inclined to apply the law merchant.[167]

3.2.3 Limits and Transnational Public Policy

Another controversial aspect of *lex mercatoria* is its limits. It is generally said that *lex mercatoria* cannot go beyond international public policy and an award should not contain anything to the contrary. While the statement argument is correct in the sense that a decision should not go against international mandatory policy, it is perfectly natural to question the use of transnational public policy here.

When a mandatory public policy can be found in a number of state legislations, it can be stated that there is an international aspect to it. Therefore, this rule is a part of the international public policy.

It can be argued that there is no reason to apply a mandatory public policy of one state to a matter that is of an international nature. Thus, there is a need for a policy that goes beyond one state's. However, it does not make much sense to think this way if the arbitrator knows where

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[164] *Pabalk v Norsolor* [1982] OGH 8 Ob 520/82.
[165] ICC Case No 8817 (1997).
[166] Tolga Ayoglu, Uluslararasi Ticari Sozlesmelere Uygulanan Genel Prensipler, Maddi Hukumler ve Ticari Adet-Teamuller Olarak Lex Mercatoria (Vedat Kitapcilik 2011) 94-95.
[167] Elcin (n 114) 272.

the parties will seek recognition and enforcement of an award. If the tribunal is aware of the fact that a decision they make will be taken to a Swiss court for enforcement, for example, they must take Swiss public policies into consideration. According to the New York Convention, an arbitral award may be refused of recognition and enforcement if "the recognition and enforcement of the award would be contrary to the public policy of that country."[168] Thus, at the end of the day, while seeking recognition and enforcement of an award, one always faces the authority of a state. If a decision goes against the mandatory provisions of that state it would not matter what the parties or the arbitrators wish for.

According to some, transnational public policy challenges state sovereignty[169]. This is not possible, however, as long as the countries have the ground of refusal for any matter that goes against their mandatory provisions.

It is true indeed that the application of *lex mercatoria* in some instances can become a 'creative process'. Yet, an arbitrator's creation of a solution that would suit a specific case cannot be compared to law making or regulatory processes of a state. The rules, which are an arbitrator's invention, will not be binding in another case as long as parties express their wish to the contrary.

Although the concept of transnational public policy would not likely ever go so far as to threaten the sovereignity of states, there is not much use of the concept except in cases where the place of recognition and enforcement is unknown to the arbitrator. In this context, transnational public policy does not have much practicality and "could not be anything more than a functional tool of comparative law for arbitrators who are uncertain of where in the world their award will be enforced."[170]

3.2.4 Attitudes Towards *Lex Mercatoria*'s Application in International Commercial Arbitration

A. Conventions

The New York Convention does not have a particular provision regarding the recognition and enforcement of awards based on *lex mercatoria* or transnational rules. However, the application

[168] New York Convention 1958 art 5(2)(b).
[169] Jan Kleinheisterkamp, 'The Myth of Transnational Public Policy in International Arbitration' (2023) 71(1) The American Journal of Comparative Law 98, 127.
[170] Ibid 139.

of *lex mercatoria* by the arbitrators to the dispute is not listed under the reasons for refusal in Article V of the Convention.[171]

The 1961 European Convention provides that the parties have the freedom to determine the law applicable to the substance of their dispute.[172] It further states that the arbitrators shall act as *amiable compositeurs* if the parties so decide.[173] This provision assumes that the applicable law for the substantive issues is a national law, however, considering that acting as an *amiable compositeur* gives much broader authority to the arbitrators than the application of *lex mercatoria*, permitting the arbitrators to act as *amiable compositeurs* is close to allowing them to decide the dispute by the application of *lex mercatoria* where the parties made an agreement accordingly.[174]

B. National Legislations

Lex mercatoria is subject to different views, as mentioned above. While some authorities consider the concept to be primarily negative, some believe it to be an essential development for modern arbitration. Although most legislation around the globe contains similar provisions, it is even possible to gather an overview of the conception taking place in a legal system by looking at the different wordings and phrases used.

It was already mentioned that contemporary legislations generally give parties permission to choose *lex mercatoria* as their governing law. Some legislations even give the arbitrators the freedom to decide on the *lex mercatoria* as the governing law of the dispute.

In 1981, the French Code of Civil Procedure addressed the transnational choice of law clauses and stated that parties may freely select the "rules of law" governing their contract.[175] The reference to "rules of law" was used first by French law. Clearly, this phrasing was designed to recognize parties' choice of transnational rules such as *lex mercatoria*.

Afterward, the same expression was used by other legal systems to imply the same meaning. 1986 Netherland Code of Civil Procedure is an example of that.[176] The 1987 Swiss Private International Law Statute addressed the situation similarly.[177]

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[171] New York Convention 1958 art 5.
[172] European Convention 1961 art 7(1).
[173] Ibid art 7(2).
[174] Lando (n 87) 756.
[175] French Code of Civil Procedure 1981 art 1496
[176] Dutch Code of Civil Procedure 1986 art 1054.
[177] Swiss Private International Law 1987 art 187.

Many countries then followed the trend and adopted similar provisions. This is largely due to the fact that, in 1985, the UNCITRAL Model Law embraced the trend.[178] It provided that "the tribunal shall decide the dispute in accordance with such rules of law as are chosen by the parties as applicable to the substance of the dispute." [179]

The 1996 Arbitration Act establishes that the arbitrators shall decide the dispute "if the parties so agree, in accordance with such other considerations as are agreed by them or determined by the tribunal".[180] The phrase 'other considerations' includes *lex mercatoria*. Still, it does not give as much importance to transnational rules as the wording of 'rules of law'. This provision does not prohibit parties from resolving disputes in accordance with alternatives to a national law, still; the preferred wording assigns these an inferior status.[181] Nevertheless, considering skepticism around *lex mercatoria* in the English legal system, this act was clearly an improvement.

When there is no choice of law made by the parties, the French Code of Civil Procedure even allows the arbitrators to apply the law they consider appropriate.[182] The Dutch Code of Civil Procedure adopts the same approach as it states that "the arbitral tribunal shall decide in accordance with the rules of law which it considers appropriate."[183] Spanish Arbitration Act has a similar provision.[184]

Swiss law provides that in the absence of the parties' choice of law, the dispute must be decided according to the rules of law that have the closest connection to the dispute.[185] This provision requires a connection to be found in order to determine the governing law. However, the legislation still uses the phrase "rules of law," which gives the arbitrators the freedom to resort to transnational rules if they can find a link between the case and these rules.

Nevertheless, most national legislations would not give the arbitrators the freedom to select *lex mercatoria* directly. Most legislations allow the parties to make a choice of law referring to *lex mercatoria*, however, they deem arbitrators to use the appropriate conflict of laws rules to determine the governing law of the contract.

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[178] Gaillard (n 6) 803.
[179] UNCITRAL Model Law 1985 art 28.
[180] The Arbitration Act 1996 sec 46(1)(b).
[181] Stewart R Shackleton, 'The Applicable Law in International Arbitration Under the New English Arbitration Act 1996' (1997) 13(4) Arbitration International 375, 378.
[182] French Code of Civil Procedure 1981 art 1496(1).
[183] Dutch Code of Civil Procedure 1986 art 1054(2).
[184] Spanish Arbitration Act 2004 art 34(2).
[185] Swiss Private International Law 1987 art 187.

Overall, there seems to be a diversion on the subject between common law countries and civil law countries. As common law countries are usually more conservative in this context and on the side of supporting more traditional views, civil law countries adopt contemporary approaches and allow parties more freedom. This view, supported by civil law countries like France, is becoming more popular in the modern days as the autonomy of the parties takes more and more importance in international arbitration. The provisions adopted by France and The Netherlands will likely be present in similar ways in more legislations.

Chapter 4: *Ex Aequo Et Bono*

4.1 The Concept of *Ex Aequo Et Bono*

Ex aequo et bono means "according to what is equitable and good" in Latin.[186] The phrase refers to "the way in which an international tribunal can base its decision not upon conventional law but on what is just and fair to the parties before it."[187] Where parties have an *ex aequo et bono* clause, the arbitrators can reach a decision that is based on fairness and reasonableness without having to apply the law precisely.[188] Adversarial proceedings and hearings will still take place although the decision will not be rendered based on law.[189]

In all cases, the concepts of arbitration *ex aequo et bono* or *amiable compositeur* give the arbitrator the freedom to decide the dispute without being under the obligation to apply any law or rules of law, and thus, a broad authority.[190] As held by the arbitral tribunal in an ICC case, "Considering that having the power of *amiable compositeurs*, the arbitrators should look even closer at the circumstances of each specific case, and accompany their partial decision with measures to safeguard the legitimate rights of each party, since 'they have been given the opportunity to put the principles of equity above the strictness of law, deciding in accordance with their conscience, *ex aequo et bono*, or 'in equity'; that the *amiable compositeur* is thus authorized to set aside the application of the law within the limits set by the mandatory provisions of the applicable legal system, as the French case law has stated with regard to set-off."[191]

Similar to the evaluation of "new *lex mercatoria*", the concept of *ex aequo et bono* was brought into focus by the transformation in international relations, typified by the growing international investment disputes.[192]

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[186] 'Ex Aequo Et Bono' (*Merriam-Webster Dictionary*) <https://www.merriam-webster.com/legal/ex%20aequo%20et%20bono> accessed 10 August 2023
[187] Law (n 108) 1324.
[188] Moses (n 17) 74.
[189] Dalhuisen (n 4) 404.
[190] Born (n 10) 2242.
[191] ICC Award no 3540 (1980).
[192] Leon Trakman, 'Ex Aequo et Bono: Demystifying an Ancient Concept' (2008) 8(2) Chicago Journal of International Law 621, 623.

4.2 *Ex Aequo Et Bono* and *Amiable Composition*

Amiable composition is a power given by the parties to the arbitrators to find "an equitable solution to their dispute, by setting aside, if necessary, the rule of law which would otherwise be applicable or the strict application of the contract."[193]

The 1961 European Convention provides that "the arbitrators shall act as *amiable compositeurs* if the parties so decide and if they may do so under the law applicable to the arbitration."[194] The *amiable compositeur* is still an arbitrator who will decide the matter, according to all legislations and international conventions that allow the parties to choose the arbitrator to act as an *amiable compositeur*.[195]

The variety of the expressions used in the arbitration legislations and clauses, which gives the arbitrators the autonomy to act as *amiable compositeurs* or to decide ex aqua et bono, has led to the distinction of the concepts between *amiable composition* and ex aqua et bono.[196] The separation of the concepts also stems from their origins since *ex aequo et bono* was found in Switzerland while *amiable composition* in France.[197]

Generally, the difference between the two concepts is that while an arbitrator acting as an *amiable compositeur* is deciding the dispute before him according to law and legal principles, the arbitrator still has the autonomy to modify the effect of specific legal provisions; *ex aequo et bono* is a dispute settlement entirely out of law, merely going according to moral principles.[198]

However, the distinction between *amiable composition* and *ex aequo et bono* seems artificial in light of the fact that, in both scenarios, the arbitrators have the authority to choose to have their sense of what equity and fairness demand overcome any other consideration.[199] In practice, the distinctions have mostly lost their significance, and *ex aequo et bono* and *amiable composition* are usually treated as synonyms.[200]

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193 'Amiable Composition' (*Paris Arbitration*) <http://parisarbitration.com/en/glossaire/amiable-composition/#:~:text=Power%20given%20by%20the%20parties,strict%20application%20of%20the%20contract.> accessed 10 August 2023
194 European Convention 1961 art 7(2).
195 Gaillard (n 6) 23.
196 Elcin (n 114) 319.
197 Gaillard (n 6) 836.
198 Ahmet Cemil Yildirim, 'Amiable Composition in International Commercial Arbitration' (2014) 24(3) Journal of Arbitration Studies 33, 40.
199 Gaillard (n 6) 836.
200 Elcin (n 114) 320.

4.3 Skepticism Towards *Ex Aequo Et Bono*

Ex aequo et bono and *amiable composition* clauses are very rare in contracts. There is criticism that a decision *ex aequo et bono* does not give certainty and predictability the way a national law does. Also, it is a reason for concern that a decision *ex aequo et bono* involves the arbitrator taking a subjective approach.[201]

Only a minimal amount of international commercial arbitration agreements request for an arbitration *'ex aequo et bono'*.[202] Lawyers and in-house counsels have been reluctant to allow the arbitrators to reach a decision ex aqua et bono as a consequence of concerns around unpredictability, uncertainty and the excessive discretion conferred upon arbitrators.[203]

It is true indeed that parties considering to use ex aequo et bono or *amiable composition* must be careful. It needs to be considered if they indeed want the arbitrators to reach a decision based on equity rather than applying a national law. Above all, they must check whether the laws of the states that are connected with the dispute permit such choices and agreements. If the award will not be recognized and enforceable, there would be no use in having such arbitration.

However, the 'flexibility' of the process might be what parties are looking for in some cases. Indeed, the most valuable advantage of *ex aequo et bono* is in flexibility, "especially (i) in long-term contracts where the rights and obligations of the parties cannot always be determined from the beginning, (ii) where unforeseen circumstances may occur throughout the duration of the contract, and (iii) where the parties involved are more like joint ventures than adversaries with conflicting interests."[204]

Moreover, arbitration *ex aequo et bono* may be an alternative to soft dispute resolution mechanisms like mediation and conciliation.[205] A reason for parties to choose these dispute resolution mechanisms is that their interests would be balanced, leading to a more well-considered decision.[206] Usually this aspect is seen as a huge benefit for long-term business partners that are involved in complex transactions. An arbitration process conducted *ex aequo et bono* may also be fruitful in such a situation as it could lead to a similar result.

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[201] Milan Lazic, Giulio Palermo and Srdan Dragicevic, 'Ex Aequo Et Bono in International Arbitration' (2020) 2(1) Revija Kopaonicke Skole Prirodnog Prava 47, 50.
[202] Born (n 10) 2242.
[203] Lazic (n 201) 64.
[204] Jana Herboczkova, 'Amiable Composition in the International Commercial Arbitration' (Law Faculty of the Masaryk University 2007) <https://www.law.muni.cz/sborniky/cofola2008/files/pdf/mps/herboczkova_jana.pdf> accessed 10 August 2023.
[205] Catharine Titi, The Function of Equity in International Law (Oxford University Press, 2021) 156.
[206] Ibid.

While it would not be suitable for all cases to conduct a process ex aequo et bono, it offers numerous advantages that should be considered by parties, especially if they are seeking a more equitable and case-specific resolution.

4.4 *Ex Aequo Bono* in International Commercial Arbitration

The UNCITRAL Model Law provides that "The arbitral tribunal shall decide *ex aequo et bono* or as *amiable compositeur* if the parties have expressly authorized it to do so."[207] In most developed jurisdictions today, national laws have similar provisions and recognize the parties' choice to give the arbitrators the power to reach a decision *ex aequo et bono* or as *amiable compositeur*.

According to the French Code of Civil Procedure, "the arbitrator shall decide as *amiable compositeur* if he is so authorized in the arbitration agreement."[208] The Swiss Private International Law Act holds that "the parties may authorize the arbitral tribunal to rule according to equity."[209] It is possible to find similar provisions in most of the developed national legislations today.

Despite the early skepticism shown by the English Court, even English law allows arbitration *ex aequo et bono*. According to the English Arbitration Act, the parties may agree that the tribunal should decide the dispute in accordance with other considerations.[210] This would include decisions by the tribunal that made *ex aequo et bono* or acting as *amiable compositeur*, which English law did not previously recognize.[211] As a result of this provision, parties may invite the arbitrators to decide the dispute *ex aequo et bono*.

4.4.1 Parties' Agreement

The parties may instruct the arbitral tribunal to make a decision *ex aequo et bono* or as *amiable compositeurs*. Most legislations and arbitration rules require express authorization. So, a decision *ex aequo et bono* can only be made if the parties explicitly choose it. A decision might face annulment and non-recognition on the ground of excision of authority if the arbitrators have decided the dispute *ex aequo et bono* without the parties' agreement allowing them to do

[207] UNCITRAL Model Law 1985 art 28(3).
[208] French Code of Civil Procedure 1981 art 1497.
[209] Swiss Private International Law Act 1987 art 187(2).
[210] English Arbitration Act 1996 s 46(1)(b).
[211] McKendrick (n 5) 1364-1365.

so.[212] An ex aequo et bono mandate will most likely be granted prior to the dispute by the parties' agreement.[213]

In most legal systems, there are no time requirements in order for the parties to agree on arbitration ex aqua et bono. Nonetheless, the parties may empower the arbitrators to decide ex aqua et bono at any time until the award is made.

Usually, when the parties have an *ex aequo et bono* or an *amiable composition* contract, they do not make a choice of the applicable law. In these circumstances, the arbitrators do not have to apply a national law or *lex mercatoria* to the substantive issues.

On the other hand, parties may have a choice of law clause and an *ex aequo et bono* clause together in their agreement. In such cases, the tribunal must begin with the application of the determined law and then move away from it where they consider the law to cause an inequitable conclusion.[214]

In a case that took place in Milan where the arbitrator was to decide the matter *ex aequo et bono,* the parties made an agreement at the outset of the proceedings that the dispute should be settled according to the UNIDROIT Principles.[215] The sole arbitrator made a decision accordingly, through *ex aequo et bono* and applying the UNIDROIT Principles. The arbitrator held at the end of the award that "These conclusions, which are not to be modified or mitigated in equity, the application of which the parties wished to moderate possible excesses of the law. The application of the law appears to lead to a satisfying balance of interests so that the conclusions reached in law do not need to be mitigated in equity, also taking into account the agent's alternative work opportunities."

4.4.2 Application of Ex Aequo et Bono

According to one view, an arbitrator deciding *ex aequo bono* must have his sole concentration on the factual situation of the case, may take certain rules of law into consideration, and revise the conditions of the parties' agreements.[216]

However, the arbitrators, even when they have the authority to decide a matter *ex aequo et bono*, cannot ignore the contract between the parties. In a decision, the Canadian Court of

[212] Born (n 10) 2244.
[213] Titi (n 205) 141.
[214] Gaillard (n 6) 837.
[215] Chamber of National and International Arbitration of Milan (1 December 1996) Final award in case no 1795.
[216] Milan Lazic (n 201) 49.

Appeal held that "Although the arbitrator or the *amiable compositeur* can modulate the contractual provisions to ensure that they reflect the parties' factual situation and true intentions, he or she cannot create new rights or obligations, nor can he or she decide to eliminate such obligation from the agreement altogether. The arbitrator cannot modify or eliminate the parties' obligations or take into account new circumstances or additional agreements for equitable considerations unless he or she is specifically empowered to do so."[217] The UNCITRAL Model Law also provides that the arbitral tribunal shall decide in accordance with the terms of the contract in all cases.[218]

The prevailing view, supported by most authorities, is that arbitrators have the flexibility to depart from the terms of the parties' contract while crafting a just and equitable decision on the condition that they do not alter the fundamental structure or essential terms of the agreement.[219]

The application of *ex aequo et bono* is guided by the need to reach a result that is clear and impartial in the way they treat parties.[220] Each case needs to be evaluated in its own specific context rather than in an abstract way in order to reach a fair result.[221] The adjudicators should make a decision "according to a moral order that is expressed through practical reason."[222]

There is also a commonly asked question of whether or not the *lex mercatoria* would be applicable in an arbitration *ex aequo et bono*. An arbitration agreement permitting arbitrators to decide *ex aequo et bono* or act as *amiable compositeurs* does not necessarily imply a reference to the *law merchant*; nonetheless, it may come close.[223] On the other hand, it is beyond question that while acting as *amiable compositeur* or deciding *ex aequo et bono* the arbitral tribunal may apply the *lex mercatoria* and the general principles, or in that respect, any other law.[224] Arbitrators may also draw inspiration from the *lex mercatoria*; nonetheless, they do not have to apply it in order to decide the dispute.[225]

Finally, it needs to be emphasized that the arbitrators are still bound by the mandatory international rules and international public policy even if the parties' agreement includes a clause conferring them to act as *amiable compositeurs* or decide the matter *ex aequo et bono*

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[217] Nearctic Nickel Mines Inc. v. Canadian Royalties Inc [2012] QCCA 385, 13.
[218] UNCITRAL Model Law 1985 art 28(4).
[219] Born (n 10) 2245.
[220] Trakman (n 192) 640.
[221] Ibid.
[222] Ibid.
[223] Dalhuisen (n 4) 390.
[224] AFM Maniruzzaman, 'The Arbitrator's Prudence in Lex Mercatoria: Amiable Composition and Ex Aequo Et Bono in Decision Making' (2003) 18(12) 2.
[225] Elcin (n 114) 321.

and therefore freeing them from applying the rules which would lead to an unfair result.[226] Also, in a case that the arbitrators know where the recognition and enforcement will take place, they should consider the mandatory provisions of that legal system since it would not be plausible to reach a decision on the contrary to these rules.

[226] McKendrick (n 5) 1253.

Chapter 5: Conclusions

International arbitration is one of the most preferred methods of dispute resolution, and the number of choices made to resort to it will likely continue to grow.[227] International commercial arbitration will keep its popularity among traders. The discussions around the subject, too, will keep their importance.

As mentioned throughout this dissertation, determining the law applicable in the process of arbitration is of utmost importance and needs a separate investigation in each case. Several investigations might be needed to take place during the arbitration process as there are different applicable laws that must be specified.

An arbitration process cannot begin in the absence of an arbitration agreement. Although the agreement by itself does not create rights and obligations, it provides the structure parties need for their dispute resolution. It is reasonable to suppose that the governing law of the parties' main contract or the seat will be the law applicable to their arbitration agreement. However, that does not occur automatically. The arbitration agreement has legal autonomy, meaning that whether it is concluded as a separate agreement or as a clause in the main agreement, it is not affected by the invalidity of the main contract between the parties. Thus, a separate inquiry needs to be concluded to reach what law shall govern it. This is referred to as the "principle of separability", and it is fair to say that one of the reasons causing complexity around the matter of applicable law is this principle.

The obvious solution to the problem would be the parties' explicit choice of law clause. This clause should be encouraged to be put in the arbitration agreements of parties as it would eliminate the complexity arising from the absence of the choice. Adding a choice of law clause to the agreement is plausible also because parties would gain time by agreeing on the matter previous to the dispute. In the case of an absent choice of law clause, the most reasonable solution is to examine the agreement for an implicit choice of law, which is the last step before resorting to the law of the seat as the governing law of the arbitration agreement.

For the procedure of arbitration, the traditional approach has been to apply the law of the seat as well. In the current situation, nonetheless, the parties can make a choice of law for the

[227] *See* Queen Mary University of London, 2018 International Arbitration Survey: The Evolution of International Arbitration.

procedure in most developed jurisdictions. In the case where parties do not make a choice, the tribunal will determine the appropriate law to be the *lex arbitri*.

Furthermore, the parties can freely select the governing law of the merits of the case. Parties to an agreement can make this choice in many ways, as discussed above. In many jurisdictions nowadays, they can choose a body of rules other than a national law, as implied by the phrase 'rules of law'. Arbitrators in several legal systems enjoy this freedom to the same extent. The free determination by the arbitrators is a plausible way of determining the law governing the contract as the law determined by the application of a set of conflict of laws rules does not necessarily mean the most suitable law. Indeed, in any case, if parties think the arbitrators should not be able to select the law independently, it is enough for them to express so.

As explored by this dissertation, the contemporary approaches in international arbitration are primarily on the side of recognizing the autonomy of the parties rather than binding them to national law by strict legislation. This approach, in general, suits the idea of arbitration better than the traditional views. It is not surprising that the states, especially in the common law countries, question these views and find them threatening to their authority of national laws. However, this has been changing, especially in recent decades, and governments will, in one way or another, agree to allow the parties and arbitrators to resolve the disputes in the way they see fit freely. Progress does not always bring perfection, but in the case of international commercial arbitration, it seems that the progress made so far has had positive impacts in many ways.

The same can be said for the application of *lex mercatoria*, considering the fact that the concept became relevant in international arbitration in the early 20th century. There has been development in the ways the transnational rules are used. Still, the issue is somewhat controversial, and there is room for improvement.

The overview of the debate proves that most of the criticism and supporting arguments do not actually contribute to the progress of transnational rules. These arguments created more and more unnecessary discussions. A possible cause of the debate to have become complex to this extent is the claim by mercatorists that *lex mercatoria* has an autonomous legal order on its own.[228] As stated by the opponents, *lex mercatoria*'s sources do not have a distinct legal order and do not provide actual certainty.[229] *Lex mercatoria* becomes binding in a case as a result of

[228] Koray Guven, 'Lex Mercatoria ve Milletlerarasi Tahkim' (2014) 34(2) Public and Private International Law Bulletin 1, 53.
[229] Ibid.

the parties' choice or arbitrators' determination. The law merchant provides flexible and suitable solutions for specific international disputes.

Most developed nations already recognize the parties', and in some cases the arbitrators', freedom to choose transnational rules as the governing law of the dispute. The discussions around *lex mercatoria*'s nature and history do not contribute much to the practice. The focus should be the challenges of practicality since this issue is the leading cause for parties to doubt *lex mercatoria* and steer clear of applying transnational rules. Perhaps there might be an easier way to determine the contents of *lex mercatoria* to be found.

National laws, in certain instances, do not contribute much to the case before the tribunal since they lack some necessary provisions governing international commercial affairs. The application of transnational rules, including general principles, would be advantageous for the business community in such situations, especially where they choose to apply *lex mercatoria* together with a national law. Indeed, *lex mercatoria* can be used to "fill the gaps".

Similar to *lex mercatoria*, the concept of *ex aequo et bono* has been subject to debate and is still a rather contentious subject. Although, in the current times, parties can resort to ex aequo et bono freely, this seldom occurs. There is even less certainty compared to *lex mercatoria* in an arbitration *ex aequo et bono* since the tribunal is bound by no law by any means. Generally, the concept is perceived as negative as a consequence of possible unpredictable results and the broad authority allowed to arbitrators in the process.[230] As a matter of course, parties and their attorneys hesitate to include a clause for an arbitration *ex aequo et bono*.

However, the practice of international commercial arbitration might, in fact, be enhanced by the flexibility provided within the concept of *ex aequo et bono*.[231] As discussed in Chapter 4, flexibility is the most significant advantage offered by an arbitration *ex aequo et bono*. Parties might consider referring to *ex aequo bono* in their arbitration agreement if versatility is needed for their dispute. Moreover, they can resort to the application of this concept together with a national law of their choice, which would remove the uncertainty to some degree.

To conclude, the concepts of *lex mercatoria* and *ex aequo et bono* both have a negative reputation undeserved. Most criticism does not even concern the practicality of these issues

[230] Nobumichi Teramura, 'Ex Aequo et Bono: An Overlooked and Undervalued Opportunity for International Commercial Arbitration' (*Kluwer Arbitration Blog*, 18 November 2018) <https://arbitrationblog.kluwerarbitration.com/2018/11/18/ex-aequo-et-bono-an-overlooked-and-undervalued-opportunity-for-international-commercial-arbitration/> accessed 25 August 2023.
[231] Ibid.

and instead focuses on their nature. This type of criticism does not go far from being merely academic and does not contribute to the current situation in international arbitration. The two concepts receive misplaced commentary from the opponents. As previously stated, the application of both can be fruitful in certain situations.

With globalization, trends in international commerce are changing, and the resolve to transnational rules will most likely show an increase. The rate of globalization has increased in recent years and probably will continue to grow.[232] The rate of choices made to resort to transnational rules will presumably show similarity to this trend.

So far, there have been many changes in the way international commercial arbitration proceeds and in the rules establishing its principles. The views taken continually keep changing as well, and most likely, the approaches to 'the question of applicable law,' *'lex mercatoria,'* and 'decisions *ex aequo et bono*' will keep evolving, corresponding to the needs and wishes of the international commercial community.

[232] 'Effects of Economic Globalization' (*National Geographic: Education*, 8 August 2023) <https://education.nationalgeographic.org/resource/effects-economic-globalization/> accessed 25 August 2023.

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