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Which Law Governs the Arbitration Agreement? An Analysis of Sulamérica CIA Nacional de Seguros S.A. and others v Enesa Engenharia S.A. and others

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When a commercial contract subject to the law of one country contains an arbitration clause specifying the seat for arbitration in a different country, is the validity of the arbitration agreement itself to be determined by reference to the law applicable to the substance of the dispute or to the law of the seat? The English courts have been grappling with this question for some time. Decisions have traditionally applied a presumption in favour of the proper law of the contract but more recently have tended toward the law of the seat. The Court of Appeal has recently rendered the latest view in Sulamérica CIA Nacional de Seguros S.A. and others v Enesa Engenharia S.A. and others, [2012] EWCA Civ 368. This case continues a recent trend in the English courts towards applying the law of the seat to the arbitration agreement on the basis that the law of the seat is most closely related to it although the court did accept that it is reasonable to start with the assumption that the parties intended the arbitration agreement to be determined by reference to the same law as the contract itself. This article reviews this latest decision and places it in the context of the evolution of the English courts' thinking on this issue.

It concludes that the decision went some way towards clarifying some of the confusion that has crept into the law on this issue but it does not ultimately create the certainty that is needed in the business community. The result in the case and the way that the court reached that result may in the event create more confusion by introducing a third competing presumption not consistent with the traditional or the recent approaches. If the case is appealed, it is hoped that the Supreme Court will take the opportunity to clarify the law in this area.

Background

The case arises out of the Jirau hydroelectric dam project in Brazil. The dispute – between Brazilian insurers and the consortium of Brazilian construction companies – arose over coverage for substantial damage caused during a workers' protest. The relevant policies,

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which were placed back to back with London reinsurance, contained clauses stating that they were to be "*governed exclusively by the laws of Brazil*" and contained exclusive jurisdiction clauses in favour of the Brazilian courts. There were also clauses providing for mediation and, if that failed, arbitration of disputes "*as to the amount to be paid under this policy*" in London under the ARIAS Rules. Insurers claimed that the coverage dispute was subject to arbitration in London under the ARIAS rules, whilst the consortium claimed that the arbitration agreement in the policy was unenforceable under Brazilian law against the consortium and that all claims must therefore be brought before the courts of Brazil. The parties secured competing anti-suit injunctions from the Brazilian and English courts. The law governing the arbitration agreement was important for determining whether the dispute should be subject to arbitration in London or litigation in Brazil because, according to the consortium, the arbitration agreement was only enforceable under Brazilian law with its consent.

On the application to continue the English anti-suit injunction, Cooke J held that the arbitration agreement was governed by English law on the grounds that it had its closest and most real connection with the law of the seat of the arbitration. [link to 26.03.2012 GAR article]. He did not engage in any substantive discussion as to whether the parties had made an express or implied choice of law for the arbitration agreement.

On appeal, the consortium argued that the parties had impliedly chosen the law of Brazil as the law governing the arbitration agreement. The consortium relied on a number of factors in favour of their interpretation: (i) the parties had subjected the policy to the law of Brazil; (ii) the parties had agreed that the courts of Brazil should have exclusive jurisdiction in respect of any disputes arising out of or in connection with the policy; (iii) the close commercial connection between the policy and Brazil; and (iv) the inclusion of a clause indisputably governed by the law of Brazil requiring the parties to attempt mediation as a pre-condition to arbitration. The consortium appeared to concede that the parties had not made an express choice of law governing the arbitration agreement. The insurers relied on the choice of London as the arbitral seat and the separability of the arbitration agreement.

The Decision

Lord Justice Moore-Bick reviewed the history of the case law on this subject starting with the observations of Lord Mustill in a number of early cases concerning the likelihood of the law governing the arbitration agreement to follow the laws chosen in other parts of the contract. In Black Clawson International Ltd v Papierwerke Walfhpof-Aschaffenburg AG, [1982] 2 Lloyd's Rep. 446, Mustill J. (as he then was) observed that "*Where the laws diverge at all, one will find in most instances that the law governing the continuous agreement [arbitration agreement] is the same as the substantive law of the contract in which it is embodied and that the law of the reference is the same as the lex fori.*" He further observed that "*In the ordinary way, [the proper law of the arbitration agreement] would be likely to follow the law of the substantive contract.*" In Channel Tunnel Group Ltd v Balfour Beatty Construction Ltd, [1993] A.C. 334, Lord Mustill stated:

> "*It is by now firmly established that more than one national system of law may bear upon an international arbitration. Thus, there is the proper law which regulates the substantive rights and duties of the parties to the contract from which the dispute has arisen. Exceptionally, this may differ from the national law governing the*

interpretation of the agreement to submit the dispute to arbitration. Less exceptionally it may also differ from the national law which the parties have expressly or by implication selected to govern the relationship between themselves and the arbitrator in the conduct of the arbitration: the "curial law" of the arbitration as it is often called."

Lord Justice Moore-Bick pointed to a number of other judgments and commentaries such as Dicey, Morris & Collins, The Conflict of Laws, 14th ed. and Mustill & Boyd, Commercial Arbitration, 2nd ed. to support the proposition that the parties to a contract are likely to intend that the whole of their relationship, including the agreement to arbitrate, is to be governed by the same system of law.

Lord Justice Moore-Bick then recognised that a shift had occurred recently in the English courts as represented by XL Insurance Ltd v Owens Corning, [2001] 1 All E.R. (Comm) 530, and C v D, [2007] EWCA Civ 1282, [2008] 1 All E.R. (Comm) 1001. He discussed in particular the speech of Lord Justice Longmore in C v D in which he referred to a different passage from Mustill J in Black Clawson that read:

"*It has I believe, been generally accepted that in an arbitration case with a foreign element, three systems of law are potentially relevant. Namely: (i) The law governing the substantive contract. (ii) The law governing the agreement to arbitrate. (iii) The law of the place where the reference is to be conducted: the lex fori.*

In the great majority of cases, these three laws will the same. But this will not always be so. It is by no means uncommon for the proper law of the substantive contract to be different from the lex fori; and it does happen, although much more rarely, that the law governing the arbitration agreement is also different from the lex fori."

Lord Justice Longmore concluded from this passage that it was rare for the law governing the arbitration agreement to differ from the law of the seat. This was so, he said, because an agreement to arbitrate will normally have its closer and more real connection with the law of the seat of the arbitration.

Similarly, Toulson J held in XL Insurance that the parties had impliedly agreed that the law of the seat (London) should govern the arbitration agreement which, had it been subject to the proper law of the contract (that of New York), might have been invalid. He held that by providing for arbitration in London specifically referring to the provisions of the Arbitration Act 1996, the parties had chosen English law to govern matters falling within the scope of the Act, including the formal validity of the arbitration agreement and the jurisdiction of the arbitrators, and by doing so had by implication chosen English law as the proper law of the arbitration agreement.

Lord Justice Moore-Bick recognised this shift in emphasis towards the law of the seat, observing that:

"*[t]he difference in emphasis between the views expressed in the earlier authorities and those to be found in the more recent cases is, I think, mainly due to the different degrees of importance that has been attached to the parties' expressed choice of proper law to govern the substantive contract, reinforced by a more acute awareness of the separable nature of the arbitration agreement*."

The more acute awareness of the separable nature of the arbitration agreement derives from Fiona Trust & Holding Corp v Privolov, [2007] UKHL 40, [2008] Lloyd's Rep. 254, where the House of Lords re-emphasised the principle of separability of arbitration agreements from the contracts in which they sit which means that disputes arising out of the contract are submitted to arbitration even where the existence of the contract itself is challenged. Lord Hoffman stated in paragraph 17 of the judgment that "*the arbitration agreement must be treated as a 'distinct agreement' and can be void or voidable only on grounds which relate directly to the arbitration agreement*." Emphasis by the House of Lords on the distinction between the contract and the arbitration agreement in the arbitration clause led to the distancing of the arbitration agreement from the proper law of the contract in later judgments of the lower courts in cases such as XL Insurance and C v D.

Lord Justice Moore-Bick recognised that the separability of the arbitration agreement did not in all cases mean that there was no implicit agreement that the proper law of the contract should also govern the arbitration agreement. He stated:

> "*The concept of separability itself, however, simply reflects the parties' presumed intention that their agreed procedure for resolving disputes should remain effective in circumstances that would render the substantive contract ineffective. Its purpose is to give legal effect to that intention, not to insulate the arbitration agreement from the substantive contract for all purposes."*

He then went on to analyse the case at hand. He first set out explicitly the sequence of analysis: (i) express choice; (ii) implied choice; and (iii) closest and most real connection. Each of these stages must be embarked upon separately and in that order although he recognised that stage (ii) often merged into stage (iii) because the system of law with the closest and most real connection with the arbitration agreement was a factor to be taken into consideration in determining whether the parties had made an implied choice.

Lord Justice Moore-Bick started from the premise that the agreement that the policy would be governed exclusively by Brazilian law was a strong indicator towards an implied choice of Brazilian law for the arbitration agreement as well. However, he noted two significant factors weighing against this. First, the parties would have been aware that their choice of London as the seat of the arbitration would bring with it the application of English law, including the Arbitration Act 1996, to the conduct and supervision of the arbitral proceedings. This tended to suggest that the parties intended English law to govern all aspects of the arbitration agreement, including its validity or enforceability. The second factor was the consortium's argument that the arbitration agreement was not enforceable against them without their consent. Lord Justice Moore-Bick found it unlikely that the parties would have entered into such a one-sided arrangement. He therefore determined that there was insufficient evidence to conclude that the parties had made an implicit choice of Brazilian law to govern the arbitration agreement. He then analysed which system of law had the closest and most real connection with the arbitration agreement and concluded that it was the law of England. Even though the underlying policy had deep and obvious commercial connections to Brazil, the arbitration agreement is concerned only with the procedure for dispute resolution which is most closely connected with the law of the seat.

The Master of the Rolls, Lord Justice Neuberger, concurred in the judgment of Lord Justice Moore-Bick but added some observations about the law applicable to the arbitration agreement. He noted the prevailing tendency of the courts prior to Fiona Trust to focus on the proper law of the contract "*on the basis that the arbitration agreement is an 'adjunct' to, or part of, the contract of which the proper law has been specifically agreed between the parties*." He then noted the different approach exemplified by Lord Justice Longmore in C v D to focus on the law of the seat on the basis that the law of the seat has the closest and most real connection to the arbitration agreement. He summed it up this way:

> "*Accordingly, (i) there are a number of cases which support the contention that it is rare for the law of the arbitration to be that of the seat of the arbitration rather than that of the chosen contractual law, as the arbitration clause is part of the contract, but (ii) the most recent authority is a decision of this court which contains clear dicta (albeit obiter) to the opposite effect, on the basis that the arbitration clause is severable from the rest of the contract and plainly has a very close connection with the law of the seat of the arbitration*."

Ultimately, the Master of the Rolls determined that it was unnecessary to choose between following C v D or reverting to the earlier course because the result would have been the same under either approach. Like Lord Justice Moore-Bick he was persuaded by the argument that English law should apply because it may not be possible to give effect to the arbitration agreement unless the insureds were willing to consent to arbitration.

Analysis

The line of cases exemplified by C v D has introduced an element of uncertainty into this issue in English law which naturally leads to difficulties for commercial parties. The Master of the Rolls was right to describe in paragraph 57 the current state of affairs as one of "*unsatisfactory tension*" between the approach in the earlier cases and the approach in C v D. The question is a fairly stark and binary one: should the court begin its analysis with an assumption that the arbitration agreement is governed by the proper law of the contract (as in the earlier cases) or by the law of the seat (as in the more recent cases)? Both attempt to establish a fairly bright line but since both are arguably good law, the law is currently anything but clear.

In the face of this problem, one would expect parties to provide for an express choice of law for the arbitration agreement in the arbitration clause itself. This has not happened to a great degree in practice. This may be because it is rare for there to be a distinction between the proper law of the contract and the law of the seat such to make the choice of law sufficiently material to litigate. Or it may be because most lay parties would assume that a clause stating that the contract is to be exclusively governed by a given law would be surprised to find that one of the clauses within that contract is actually a separate and distinct agreement that is subject to an entirely different law.

This is the sound basis upon which the historical approach reflected in the earlier judgments of Lord Mustill was based. The law has always been that the court should look to determine whether there was an express or implied choice of law before applying conflicts of law principles to determine the applicable law. These are separate and distinct phases of analysis that should be undertaken in succession and not together. The law prior to C v D

was essentially that there was a presumption that the parties had intended that the arbitration agreement be governed by the same law as the substantive contract but that this could be rebutted on contrary evidence. The courts moved away from this approach for two reasons both of which might legitimately be questioned: (i) that the separability of the arbitration agreement meant that it was a separate and distinct contract removed from the underlying contract; and (ii) that the law of the seat has the closest and most real connection with the arbitration agreement.

With regard to separability, this concept is to preserve the dispute resolution mechanism in the face of a challenge to the validity of the contract not directed specifically to the arbitration agreement. Even if an arbitration clause is to be considered to constitute a separate contract for technical purposes, we should not lose sight of the fact that the arbitration clause is contained within a larger contract to which reference should be had in its interpretation. Whilst they may be separate contracts, they are most often contained within the same document and it is rare indeed to see a choice of law provision in the contract itself that is said expressly not to apply to the arbitration clause. There is thus an undeniable connection between the choice of law in the contract and the arbitration agreement.

With regard to the connection between the law of the seat and the arbitration agreement, it is important not to put the cart before the horse. This factor is relevant for two reasons that must be kept separate. Whilst it may be one of a number of factors going to the question of whether the parties had made an implied choice of law for the arbitration agreement, it has never been expressly held to be sufficient in itself to overturn the presumption that the parties wished the arbitration agreement within the contract to be governed by the proper law of the contract. It is only once it is determined that there is no implied choice of law that the connection with the law of the seat becomes relevant to determine the applicable law as a conflicts of law principle. Something more express or substantial than the mere choice of a seat and the reference to the arbitration law of that jurisdiction should be necessary to rebut the presumption that the proper law of the contract also applies to the arbitration agreement.

The question following the Sulamérica decision is whether it sufficiently clarifies the uncertainties that have crept into the law in this area. Lord Justice Moore-Bick correctly stated the sequence of analysis: (i) express choice; (ii) implied choice; then (iii) the law with the closest and most real connection with the arbitration agreement. Whilst he observed that it had been said that stages (ii) and (iii) above often merge together, he quite rightly moved away from this overlap in keeping his analysis separate. He went on to correctly state the proper starting point for question (ii) in paragraph 26:

> "*A search for an implied choice of proper law to govern the arbitration agreement is therefore likely (as the dicta in the earlier cases indicate) to lead to the conclusion that the parties intended the arbitration agreement to be governed by the same system of law as the substantive contract, unless there are other factors present which point to a different conclusion*."

The Court of Appeal therefore seemed to apply the proper structure of analysis.

The Result

The result reached, however, arguably threw the state of the law back into confusion as to the level of contrary evidence sufficient to overturn the presumption in favour of the proper law of the contract. The factors that the court pointed to in discounting an implied choice of law and ultimately favouring the law of the seat may be questionable at best and at worst would introduce a new competing presumption leading to further confusion.

The first factor was that the parties must have been aware that the provisions of the Arbitration Act 1996, including provisions which are more substantive in nature such as sections 5, 7, 8, 12 and 13, would be applicable to the conduct and supervision of the arbitration. Lord Justice Moore-Bick found in paragraph 29 that this inherently indicates that the parties intended English law to govern the arbitration agreement. There are a number of potential problems with this analysis. The first is that the reference to the seat without more is little more than an acknowledgement that the law of the seat applies to the conduct and supervision of the arbitration. It is well recognised that issues relating to the conduct and supervision of the arbitration and the validity or interpretation of the arbitration agreement can be determined according to different laws. In other words, it does not take one much further forward beyond the observation that the parties have chosen a seat for their arbitration where they are comfortable with the procedures. It does not in itself indicate that the parties did not wish to subject the arbitration agreement to the law chosen as the proper law of the contract.

This is further revealed when we look more closely at the cited provisions of the Arbitration Act 1996. There appears in the judgment to be a suggestion that there is something inherent in the substantive provisions in the English arbitration law that makes it more likely that parties choosing a seat in England understood that English law would govern the arbitration agreement. This is presumably because the Arbitration Act contains provisions that bear upon the validity or interpretation of the arbitration agreement. However, upon closer inspection we see that the provisions that relate to the interpretation or validity of the arbitration agreement (sections 5-8) are not mandatory provisions. See Schedule 1 to the Arbitration Act 1996. Section 4 makes clear that the parties can derogate from such non-mandatory provisions by agreement and that a choice of law other than that of England & Wales in respect of any matter provided for in a non-mandatory provision is equivalent to an agreement making provision about that matter. Since an implied choice of law in relation to the arbitration agreement would be the equivalent of a derogation in relation to the matters referred to in sections 5 to 8 of the Arbitration Act, these matters would not necessarily have been understood by the parties to be subject to English law and would not therefore tell us anything about whether they had made an implied choice of law in favour of the proper law of the contract. The sections of the Act referred to by Lord Justice Moore-Bick that are mandatory (sections 12 and 13) do not concern the validity or interpretation of the arbitration agreement but rather give the court the power to extend the time to commence proceedings and provide that the Limitation Acts apply to arbitral proceedings as they do for litigation proceedings. Again, this tells us nothing further about which law the parties had intended to apply to issues of interpretation or validity of the arbitration agreement.

Both XL Insurance and C v D can be distinguished on this point because in those cases there was an express reference to the Arbitration Act 1996 in the arbitration clause which could be read as displacing any implied agreement to derogate from the non-mandatory provisions of the Arbitration Act relating to the validity or interpretation of the arbitration agreement. In Sulamérica, there was no such express reference.

The court in Sulamérica also found persuasive the argument that the parties must not have intended that Brazilian law applied to the arbitration agreement because, on the consortium's case, under Brazilian law it would only have been enforceable with the consortium's consent. The court found it unlikely that the parties would have entered into such a one-sided arbitration agreement that might have been undermined if it was governed by Brazilian law.

The difficulty with this result is that it has the potential to turn the analysis on its head. It is only where the application of the law would favour one side or the other that the issue ever arises. In virtually every case that comes before the court where the choice of law of the arbitration agreement is at issue, the arbitration agreement will on one or the other party's case be weakened, invalid or unenforceable depending on the applicable law. Taken to its logical conclusion therefore the approach in Sulamérica would always favour the application of the law under which the arbitration agreement is most likely to be enforceable equally as against both parties. This in effect creates a third competing presumption (in favour of the law that most effectively upholds the jurisdiction of the arbitration) that accords with neither the traditional nor the recent approaches. However, parties often agree that their agreements will be subject to a certain law knowing or perhaps not knowing that such law (as opposed to the alternatives) might in future favour the position of one party over another. Indeed, it is not uncommon for the subject agreement to be not only weakened but entirely invalid under the law that the parties have chosen for it. Such a presumption therefore is not entirely justified without additional facts suggesting that the parties had not understood the proper law of the contract to also apply to the arbitration agreement.

Conclusion

The discussion of the analytical steps in the Sulamérica decision has added some useful clarity to the confusion that has crept into the question of which law governs the arbitration agreement in a contract where the choice of law for the contract and the seat for the arbitration refer to different jurisdictions. Lord Justice Moore-Bick correctly set out the proper analysis to be undertaken and the Master of the Rolls properly identified the unsatisfactory tension between the traditional approach (focused on the proper law of the contract) and the recent approach (focused on the law of the seat). As Lord Justice Moore-Bick observed the starting point for the analysis should be a presumption that the parties intended the arbitration agreement to be governed by the law specified to govern the contract as a whole. The author agrees.

However, the analysis that led the court to conclude in the end that there was no implied choice of law for the arbitration agreement and that it should therefore be governed by the law of the seat, arguably undid much of the clarity that the case might otherwise have provided. The factors that the court relied upon to override the presumption in favour of the proper law were not entirely persuasive and could even be said to establish a competing

presumption in favour of the law under which the arbitration agreement is most likely to be mutually enforceable to the exclusion of other factors.

Given the uncertainty that remains in this area of law, if the consortium seeks leave to appeal, the Supreme Court should review the case so that it can make a more unequivocal endorsement of the traditional approach to this issue and re-establish the effective presumption in favour of the proper law of the contract. This will provide the maximum level of certainty to commercial parties when negotiating their contracts.