Kluwer Arbitration Blog

Arbitration vs Litigation in Financial Agreements: A Policy Perspective

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Choice of dispute resolution mechanism is crucial in drafting and negotiation of financial transactions. Usually lenders insist on having their preference inserted into the financial agreement and this is why dispute resolution clauses in such transactions reflect primarily the interests of lenders, and lenders seek efficient settlement of disputes. Traditionally large international banks and other financing parties have preferred choice of court clauses. Recently the International Swaps and Derivatives Association ("ISDA") opted for arbitration in its Master Agreement for the sector.

Arbitration and litigation clauses in financial transactions are often compared in order to outline advantages/disadvantages. Instead, below is, first, an overview of the policy ends that lenders pursue in dispute resolution clauses and, afterwards, the arbitration vs litigation discussion is mapped against lenders' interests.

Stability and predictability. Lenders favour venues for settlement of disputes which are renowned for consistent case law and reliable decision making. This is why often London and New York courts are selected in choice of court clauses (also courts in Switzerland, Luxembourg and others).

Neutrality. Lenders are interested to choose venues which exhibit low risks of influence on dispute resolution. This is why it is common to choose jurisdictions where decision making is deemed as independent: lenders seek to avoid political interference, possible risks of corruption, etc. Moreover, often neither party to the transaction is comfortable with appearing in the courts of the home country of the other one but would like to take the dispute to a neutral territory.

Professionalism. Lenders prefer to have their disputes decided by experts in the field. This means that the umpire should be cognizant not only in the applicable law and the relevant procedural rules but to understand the various interests of the stakeholders in financial transactions; to be commercially minded and look for the business rationale of clauses and provisions beyond the black letter of the law, understanding the intricacies of international finance. It has become a highly complex and convoluted area and so lenders prefer to entrust their disputes to persons already versed in it.

Confidentiality; speed; cost. Lenders would like to keep information regarding their

disputes as private as possible and are known to seek cost-effective decision making.

Flexible enforceability. Lenders are usually very sensitive about tracing a debtor's assets. This is why they want to be able to bring suit in various jurisdictions depending on where assets of the debtor might be found, or, if the dispute is to be concentrated in one jurisdiction, to be able to enforce in other jurisdictions as well. This is why lenders value both the flexibility of decision making and its ultimate enforceability. The primary concern is to be able to enforce against the assets, no matter where located.

Most often large international financing parties select courts in major financial centres, e.g. London and New York but also Paris, Geneva, Zurich, Luxembourg, etc. It is deemed that such jurisdictions provide: neutrality due to the low risk of interference into courts' work; good professional training of judges and ability to understand commercial transactions; stable, consistent, predictable decision making, producing judgments that are highly respected and enforceable abroad.

However, the policy objectives outlined above seem to be better embraced by arbitration.

In terms of neutrality, arbitration is delocalized to a high level, although it remains within the framework of the law of the seat of the tribunal. Direct interference with arbitral process is seldom to be seen, especially if the seat is in a reliable jurisdiction. Moreover, risks with arbitration are lower as it entails a single procedure while court litigation may encompass two to three judicial instances. For the same reason arbitration takes less time, therefore costs less, too.

Professionalism is better catered for in arbitration as parties can choose renowned experts versed into the specific deals at stake instead of relying on the commercial understanding of judges. A recently established specialised institution, P.R.I.M.E. Finance, is premised on this. Court judgments within EU are enforced on basis of Regulation Brussels Ibis but there is no overarching international instrument for enforcement of judgments. The New York Convention is, however, universally accepted and implemented and can ensure enforcement in a wide array of instances. This gives awards better utility than judgments in terms of their enforcement.

In spite of this, arbitration's allure is faced with several pitfalls. Below are some key examples to be taken account.

Unilateral/hybrid clauses. Lenders usually insist on using the so called "unilateral", "hybrid", "asymmetrical" jurisdiction clause which are deemed to combine the best of both (or all) worlds so that the lender is entitled to bring suit in the jurisdiction where there is greatest opportunity to reach the assets of the debtor (see generally D. Draguiev, Unilateral Jurisdiction Clauses: The Case for Invalidity, Severability or Enforceability (2014) 31 Journal of International Arbitration Issue 1, pp. 19–45). However, the case law on interpreting this type of clauses is volatile and some jurisdictions disfavour unilateral clauses. Hence, the utility of unilateral clauses is at least disrupted and a lender is exposed to the risk that the clause is found invalid/unenforceable, or recognition of judgment or award based on such a clause –

refused.

Therefore, it is questionable whether a unilateral clause, which combines arbitration and litigation regarding a financial transaction, is as beneficial as it is usually deemed to be. It may turn to be more effective for a lender to choose between either courts or arbitration without combining them.

Complex disputes. Arbitration's beating heart is consent. If a dispute entails more than two parties, or a number of related agreements, it is difficult to compel all stakeholders to participate in a single procedure if some of the parties do not consent to this. In case of no consent, there is the risk of separate procedures and conflicting awards. In contrast, procedural laws in state court litigation normally provide rules on intervention, joinder, consolidation and bringing a number of parties into one case is not subject to free will.

This is a point on which arbitration clearly loses the edge compared to arbitration. However, some major arbitration rules, e.g. ICC Rules, have express provisions on joinder/consolidation so this drawback can be overcome. Nevertheless, it is important to have this complication in mind when making up strategy for drafting dispute resolution clauses in complex multiparty/multicontract scenarios. Hence, arbitration may still cater for these, but they require careful thought and consideration.

Arbitrators out of control. A lender is entitled to appoint one of the arbitrators (granted the panel should consist of three or more) but the other party should make an appointment, too. Even though the lender can opt for a high quality arbitrator, this does not prevent the other party from appointing a dubious figure, which may have impact on the quality of the award. Moreover, a panel may be more prone to land at a compromise in the award while a single judge in London or New York court might be more willing to render a clear cut judgment.

Very costly arbitrations. When arbitrators, experts and party representatives have to be drawn from different places, this often brings higher costs and results in a complicated schedule of proceedings, which may slow down the process significantly. Furthermore, awards can be challenged at the seat of arbitration or at enforcement, so the rendering of the award does not end the dispute.

Then, does litigation serve better the policy ends of lenders in financial transactions, or arbitration? Litigation is more institutionalised and instils financing parties with the belief that they are safe when turning to courts of countries where it is deemed that procedure is predictable; judges are not under political or other influence, and are versed in large scale commercial disputes. This is why lenders traditionally prefer courts in New York, London, Switzerland, etc. However, arbitration seems to meet all policy objectives as well – being more flexible and confidential; providing options to choose experts in the field; not being subordinated to state scrutiny/involvement; with better opportunity to be enforced.

The last point is of extreme importance, demonstrates a clear edge of arbitration over state litigation and ultimately tips the scales. Arbitral awards enforceable under the New York Convention are reliable tools for reaching assets in situations where they

may be scattered in different jurisdictions (and this is increasingly relevant in a world of global transactions). Also, arbitration provides more flexibility and greater expertise of decision-makers. Procedure in arbitration may become slow and expensive but this is relevant for litigation, too, where there can be several instances and can take even longer. On this point, litigation and arbitration can arrive at par. Although arbitration in complex disputes is difficult, it can be catered for by well-wrought clauses. Hence, litigation does not seem to provide an overwhelming plus to lenders while arbitration meets interests of financing parties at least to the same level, if not to a greater one.

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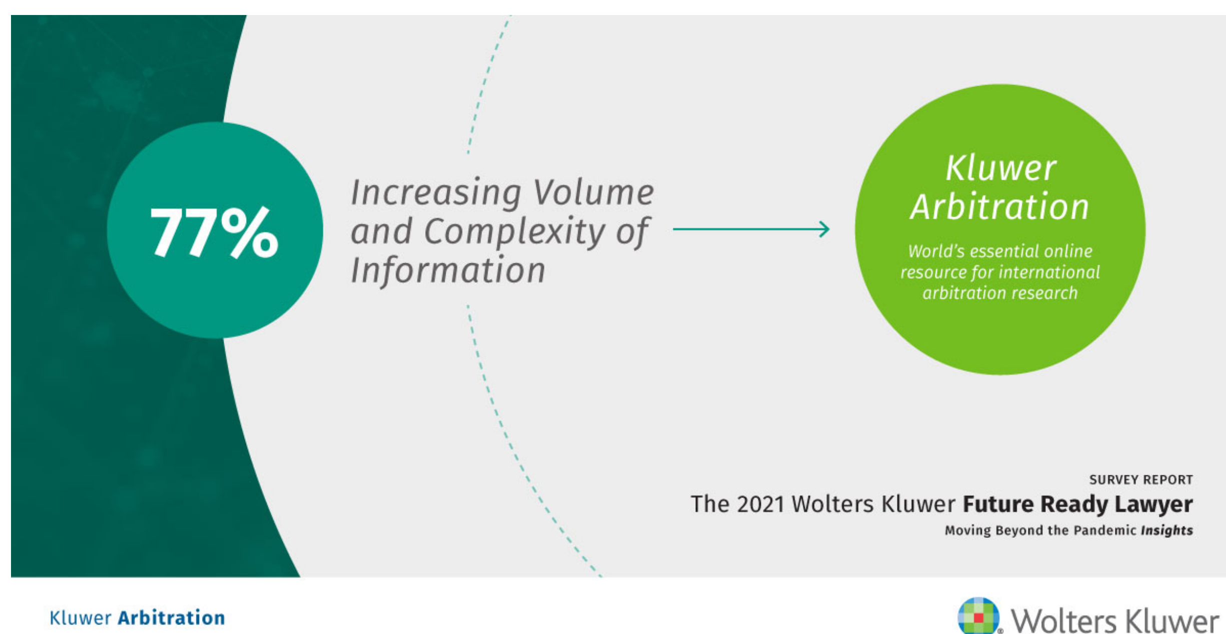

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