LATHAM & WATKINS

Client Alert Commentary

Latham & Watkins International Arbitration Practice | Number 1548 | July 8, 2013

Litigation or Arbitration: How Best to Resolve Cross-Border Disputes in the Financial Sector?

A primer on decision-making for financial institutions considering arbitration and drafting arbitration clauses in their cross-border contracts

International arbitration is becoming an increasingly attractive means for the resolution of cross-border disputes in the financial sector, particularly in emerging markets. Financial institutions turn to international arbitration because it provides parties with access to a neutral decision-maker as well as the ability to effectively enforce against the assets of foreign counter-parties. Unlike most court proceedings, arbitrations are generally confidential, which can help protect reputation, proprietary information, and client identities. And because arbitrators are often specialists chosen by the parties on the basis of their industry experience, arbitrators may be better suited than generalist judges to resolving disputes involving complex business relationships or sophisticated investment products.

This guide provides an overview of international arbitration in the financial sector and describes the considerations that financial institutions should take into account when deciding whether to arbitrate and how to incorporate arbitration clauses into their contracts.

An Overview of International Arbitration[1]

Arbitration is a binding form of dispute resolution in which disputes are resolved privately rather than in court. Arbitration is founded in the consensual agreement of the parties, but is regulated and enforced by the state. National laws generally recognize arbitration as a mutually exclusive alternative to litigation, and the great majority of states require parties to honor contractual obligations to arbitrate and support the enforcement of arbitral awards.

The arbitrators, location (or seat), and the procedural and substantive rules of the arbitration are fixed by the agreement of the parties. For this reason, arbitration clauses must be drafted very carefully.

Arbitrations are typically conducted by a tribunal consisting of one or three arbitrators who serve as the functional equivalent of judges. In most cases, the parties select the arbitrators, who are often experienced lawyers or experts in the field in which the dispute arose. The parties choose which substantive law to use, and the arbitrators apply the substantive law to decide the merits of the dispute.

Parties are free to draft their own custom-made procedural rules for the arbitration, but usually adopt (and sometimes modify) a pre-existing set of arbitral rules and arbitration administered by an arbitral institution. arbitrations.

Latham & Watkins operates worldwide as a limited liability partnership organized under the laws of the State of Delaware (USA) with affiliated limited liability partnerships conducting the practice in the United Kingdom, France, Italy and Singapore and as affiliated partnerships conducting the practice in Hong Kong and Japan. The Law Office of Salman M. Al-Sudairi is Latham & Watkins associated office in the Kingdom of Saudi Arabia. In Qatar, Latham & Watkins LLP is licensed by the Qatar Financial Centre Authority. Under New York's Code of Professional Responsibility, portions of this communication contain attorney advertising. Prior results do not guarantee a similar outcome. Results depend upon a variety of factors unique to each representation. Please direct all inquiries regarding our conduct under New York's Disciplinary Rules to Latham & Watkins LLP, 885 Third Avenue, New York, NY 10022-4834, Phone: +1.212.906.1200. © Copyright 2013 Latham & Watkins. All Rights Reserved.

The best known arbitral institutions include:

- The American Arbitration Association's International Centre for Dispute Resolution (ICDR)
- The International Court of Arbitration at the International Chamber of Commerce (ICC)
- The London Court of International Arbitration (LCIA)
- Hong Kong International Arbitration Centre (HKIAC)
- Singapore International Arbitration Centre (SIAC)
- China International Economic and Trade Arbitration Commission (CIETAC)

The International Centre for the Settlement of Investment Disputes (ICSID), which is part of the World Bank, administers investor-state disputes.

In some cases, parties choose to use a set of institutional rules or an unaffiliated set of rules such as those promulgated by the United Nations Commission on International Trade Law (UNCITRAL) rather than have an arbitral institution administer their arbitration.

International Arbitration in the Financial Sector

The construction, energy, shipping and insurance industries have long embraced international arbitration as the standard method of dispute resolution. While financial institutions have in the past relied primarily on litigation — typically in New York and London — to enforce contracts, they are increasingly turning to international arbitration. In a 2013 survey by PwC and the University of London, for example, a significant majority of in-house counsel at financial services institutions expressed the belief that international arbitration was well-suited for disputes in their sector.[2]

Arbitration may provide an effective means for financial institutions to address cross-border disputes stemming from several areas, including:

- Sophisticated financial instruments, such as swaps or other derivatives contracts
- Relationships with vendors
- Investment relationships with foreign institutions, including sovereign wealth funds and state-owned enterprises
- M&A transactions
- D&O service contracts

In addition, disputes between financial institutions and states that involve overseas investments may be subject to arbitration under bilateral investment treaties (BITs) or multilateral trade agreements (such as the North American Free Trade Agreement). At present, there are more than 2500 BITs in place throughout the world. The protections that they offer vary from agreement to agreement, but generally provide for arbitration to resolve disputes related to state appropriation of investments or other types of severe interference with property rights. Investors are subject to the protection of relevant BITs even if they are not party to a contract with the host state. Several recent disputes demonstrate the extent to which BITs can protect financial institutions. For example, ICSID tribunals (which, unlike tribunals constituted at most other arbitral institutions, publicize their awards) have held in two recent cases that BITs projected both sovereign debt purchased on the secondary market by an investor, and a commodity hedging agreement entered into by an investment bank.[3]

Trade organizations in the financial sector are taking note of the rising use of arbitration. For example, after a two-year consultation process, the International Swaps and Derivatives Association (ISDA) released several draft model arbitration clauses for use in the ISDA 2002 Master Agreement and the ISDA 1992 Master Agreement (Multicurrency – Cross Border), both of which are standardized documents commonly used in derivatives transactions. These draft model clauses likely will be finalized in mid-2013 and will apply to various combinations of arbitral rules, arbitral seats, and New York and English and law, or any other law applicable to the relevant seat (*e.g.*, Hong Kong or Singapore law).

In recent years, arbitral institutions have developed their capacity to deal with the types of disputes typical in the financial sector. For example, the newly-established Panel of Recognised Market Experts in Finance (PRIME), based in The Hague, focuses on financial disputes. PRIME's procedural rules — which provide for certain types of expedited proceedings — and experienced panel of approved arbitrators may prove appealing as a venue for financial institutions. At least one generalist arbitral institution, CIETAC, has a specialized, streamlined set of procedural rules for arbitrating financial disputes. In addition, many arbitral institutions and rule-making bodies, including the ICC, UNCITRAL and the LCIA, have begun to revise their process rules to deal with the increasing complexity of modern disputes. These revisions include new provisions related to joinder and consolidation. While not specific to the financial sector, the updated rules may be useful for addressing the complexity of financial sector disputes involving multiple parties and transactions.

When to Provide for Arbitration?

Financial institutions should consider the following factors when deciding whether to incorporate arbitration clauses in their business dealings.

Enforceability. Arbitral awards are often much easier to enforce against assets in foreign countries than court judgments. The 1958 United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention) stands out among several enforcement conventions, with more than 145 party countries agreeing to enforce arbitral awards (subject to very limited grounds for objection). Court judgments are not recognized by a similar enforcement regime and enforcing a domestic judgment in a foreign country (or converting a domestic judgment into a foreign judgment) can be a difficult task. For that reason, the enforceability of arbitral awards is an important consideration for financial institutions doing business with foreign counterparties that lack significant assets in the financial institutions' home jurisdiction.

Technical expertise. Arbitration almost always provides parties with some degree of choice over the decision-maker (or decision-makers), so parties can choose arbitrators with expertise or experience relevant to the dispute at hand. While some jurisdictions, including New York and the UK, have specialist courts for business disputes, in other instances parties run the risk of judges with little or no relevant experience deciding their disputes. For complex financial products and transactions, a sophisticated decision-maker can be particularly important. The 2013 PwC arbitration survey underlines this point: respondents in the financial services sector described the expertise of the decision-maker as "the number one benefit" of arbitration.[4]

Confidentiality. Arbitrations are generally conducted in private and therefore provide greater confidentiality than litigation, which is usually public. Different sets of arbitral rules provide for varying degrees of confidentiality, but parties can also expressly contract for confidentiality. Financial institutions that seek to protect their reputations, their clients' identity, and the terms and structure of their financial products might find confidential arbitration appealing. However, one potential downside of confidentiality is that arbitral tribunals generally do not rely on precedent, so helpful decisions often cannot be used to prevent future disputes from developing into full-blow arbitration or litigation. On the other hand, adverse decisions will not create negative precedent and a party's arguments in one arbitration cannot be used against it in another.

Neutrality. Parties to international contracts may often wish to avoid resolving disputes in the local courts of their counterparties. This concern may be of particular significance where one party is based, or holds the majority of its assets, in a country without a strong legal system or where a party is closely associated with the government of its home country. In these instances, arbitration often provides a forum acceptable to both parties.

Finality. Most arbitrations do not provide a procedure for appeal. While arbitral awards can be subject to limited judicial review based on the laws of the seat of the arbitration, the grounds for this review are usually very narrow. Thus parties may avoid some of the costs of a protracted appellate process.

Cost. Arbitration may not be definitively cheaper than litigation. As in litigation, legal fees generally account for the majority of costs, which vary depending on the complexity of the dispute and the nature and length of the proceedings. While arbitrators charge for their services and parties may have to pay for the venue and any administering institution, parties will not incur court fees and may agree to a "fast-track" or tailored process to streamline legal costs. In some instances, arbitral tribunals are authorized to award the successful party some portion of its costs.

Speed. Arbitration may be faster or slower than litigation. Arbitration may not involve the same amount of discovery/disclosure or appellate review as litigation and can be streamlined with the agreement of the parties, but the complications of coordinating the schedules of the parties and arbitrators can cause delays. As with litigation, speed will generally depend on the size and complexity of the claims and the strategies the parties adopt. Because arbitrations usually lack the summary judgment procedure available in litigation, they may be less attractive for some financial sector disputes, such as straightforward claims based on the breach of a loan covenant. If speed, limited disclosure or summary disposition is important, provisions can be included in the dispute resolution clause to address these issues.

Pre-emptive remedies. Parties can empower arbitral tribunals to grant preliminary relief, such as an order freezing assets, but tribunals cannot impose sanctions on a defaulting party. To address this issue, arbitral rules commonly allow parties to apply to courts for interim relief (pending the arbitration on the merits of the case). However, parties anticipating the need for preliminary relief may find litigation easier and more straightforward.

Joinder of parties and related disputes. Unlike court proceedings, generally all parties to an arbitration must consent before additional parties or related disputes can be joined. An arbitration clause that includes the parties' consent to joinder and sets out the procedure for joinder can be drafted at the time of contracting to address the joinder issue. These types of provisions can be complicated, however, and require considerable care in drafting.

The Agreement to Arbitrate

Drafting an arbitration agreement requires careful attention. Ambiguous arbitration clauses can lead to litigation in national courts over proper interpretation and an arbitration clause that fails to meet the legal requirements of the laws of the seat of arbitration may be unenforceable. Given their importance, arbitration agreements should be crafted with the advice of counsel. The following are just a few of many issues to consider.

Hybrid or split clauses. Some arbitration agreements include clauses that allow one or both parties to choose whether to resolve disputes through either litigation or arbitration. The flexibility these clauses provide can make them appealing, particularly where one party has sufficient leverage to enjoy the sole right to select the most appropriate dispute resolution mechanism — a feature sometimes described as a "unilateral" or "asymmetrical" clause. National courts, however, have rejected these clauses as unenforceable in certain jurisdictions, these clauses should therefore be drafted and adopted with caution.[5]

Scope. Should all disputes arising from a contract or business relationship be handled through arbitration, or just certain types of disputes? For most business relationships in the financial sector, an arbitration agreement which expressly encompasses all types of disputes is advisable. Otherwise, the scope of the clause may become a matter for litigation in national courts.

Arbitral rules. The rules under which the arbitration will take place should be clearly set forth. There are many advantages to using an arbitral institution to administer an arbitration, but in some circumstances ad hoc arbitrations can be appropriate.

Arbitrators. The number of arbitrators (either one or three) and the manner of their appointment should be set forth in the arbitration agreement. Parties should also consider whether to specify certain qualifications for the arbitrator or arbitrators.

Seat. The arbitration venue is of particular importance, because parties may bring suit in the domestic courts to attempt to obstruct the arbitration or to attempt to vacate an award. The primary consideration here is to choose a seat that is a recognized center for arbitration where financial institutions can be certain that courts will respect the arbitration process. The most common venues include New York, London, Paris, Zurich, Geneva, Hong Kong, Singapore and Dubai.

By carefully drafting the arbitration agreement, financial institutions can strategically tailor the dispute resolution process to meet their objectives.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Claudia T. Salomon
claudia.salomon@lw.com
+1.212.906.1230
New York

Philip Clifford
philip.clifford@lw.com
+44.20.7710.1861
London

Simon D. Powell
simon.powell@lw.com
+852.2912.2693
Hong Kong

Sebastian Seelmann-Eggebert
sebastian.seelmann@lw.com
+49.40.4140.3259
Hamburg

Client Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the lawyer with whom you normally consult. A complete list of Latham's *Client Alerts* can be found at www.lw.com. If you wish to update your contact details or customize the information you receive from Latham & Watkins, visit http://events.lw.com/reaction/subscriptionpage.html to subscribe to the firm's global client mailings program.

Endnotes

[1] The Latham & Watkins Guide to International Arbitration (2013), which can be downloaded at http://www.lw.com/thoughtLeadership/guide-to-international-arbitration-2013, describes international arbitration in further detail.

[2] PwC and Queen Mary, University of London, Corporate Choices in International Arbitration: Industry Practices, at 8 (2013) (2013 PwC Survey).

[3] *See, e.g.*, *Abclat and Others v. The Argentine Republic*, ICSID Case No. ARB/07/5, Decision on Jurisdiction and Admissibility (Aug. 4, 2011); *Deutsche Bank AG v. Democratic Socialist Republic of Sri Lanka*, ICSID Case No. ARB/09/02, Award.

[4] 2013 PwC Survey, at 8.

[5] For more information on unilateral clauses, *see* P. Clifford and O. Browne, Finance Agreements: A practical approach to options to arbitrate, *Global Arbitration Review*, Vol. 1, Issue 6, 2007.