

FINANCE AGREEMENTS: A PRACTICAL APPROACH TO OPTIONS TO ARBITRATE

Philip Clifford, partner, and Oliver Browne, associate, at Latham & Watkins in London explain the pitfalls of unilateral options to arbitrate, and how to avoid them

Dispute resolution clauses that give one party the right to choose whether to resolve an existing dispute through arbitration or litigation are frequently included in finance agreements. Like many parties, banks enjoy selecting whichever method of dispute resolution they consider to be best for them, depending on the type of dispute that has actually arisen. But these clauses can create significant pitfalls and so require careful consideration.

Arbitration or litigation?

International arbitration boasts several features that provide advantages over litigation. One advantage, of primary importance in many cases, is the wider scope for the enforcement of arbitral awards (as compared with court judgments) around the world, thanks primarily to the 1958 New York Convention, to which 139 states are party. There is generally little point in providing for litigation if the resulting judgment could not be enforced against the other side's assets. It is therefore often prudent, and sometimes essential, to provide for arbitration as the means of dispute resolution if the need for enforcement might arise.

That said, with certain disputes, litigation can also provide important advantages. For example, in English litigation, it is possible to obtain a default judgment where a defence is not filed. The availability of this procedure, which has no equivalent in arbitration, might be very attractive to a party, such as a bank, whose dispute concerns a simple debt that it wants to recover as quickly and as easily as possible.

As a result, parties sometimes wish to have the best of both worlds – a choice between litigation and arbitration depending upon the type of dispute that arises and the location of the assets against which enforcement might be required. Although options are sometimes provided to all the parties, it is common – particularly in finance agreements – for such an option to be given only to one party (for example, the bank). This is a so-called unilateral option to arbitrate (or to litigate, depending upon how the clause is drafted).

Drafting pitfalls

In some circumstances, the party with the benefit of a unilateral option will indeed have the best of both worlds. When a dispute arises, that party can ascertain whether arbitration or litigation is the better path. But as mentioned,

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potentially there are substantial pitfalls for the unwary.

As a practical matter, unilateral options require careful drafting. Consideration should be given – but very often is not – to precisely how and when the option may be exercised, and the consequences of such exercise. For example, provision might be made for a party wishing to exercise its option to give notice in writing to the other parties of the exercise before commencing court proceedings (or if another party has commenced such proceedings, before taking a specified step in them). Consideration should also be given as to how to deal with the costs of any aborted proceedings that arise as a result of using a unilateral option.

In some cases, a failure to draft the option clearly and precisely might cause confusion and unnecessary delay and expense. In other cases, the consequences might be more serious. The two main concerns, which have arisen together and independently as matters of legal principle in various jurisdictions, are a lack of certainty and mutuality. Table 1 gives examples.

Legal pitfalls – certainty

The need for certainty can arise on different levels. In some jurisdictions, courts have been reluctant to relinquish jurisdiction in favour of arbitration in the absence of very clear words requiring them to do so. In these circumstances, there could be a concern that an option might not be considered a clear enough submission to arbitration.

Even in more ‘arbitration friendly’ jurisdictions, parties are generally required, either as a matter of legal policy or through legal interpretation, to make their election at a relatively early stage of any dispute resolution process or else they risk being deemed to have consented to one particular form of dispute resolution over another. For example, in the English case *NB Three Shipping v Harebell Shipping Limited* (2004), the court warned that the option in question was not “open-ended” and that it “would cease to be available if [the party with the option] took a step in the action or they otherwise led the [party without the option] to believe on reasonable grounds that the option [...] would not be exercised.”

In other words, parties with the benefit of an option to arbitrate must appreciate that any substantive steps they take in arbitration or litigation before seeking to exercise their option may well deny them the benefit of their option.

Legal pitfalls – mutuality

In some jurisdictions, unilateral option clauses are unenforceable for lack of mutual consent. That is, the law requires all parties to agree to submit to arbitration and the fact that all parties agreed to the option before the dispute arose is considered insufficient. As the court explained in

Table 1

Argentina	Owing to a lack of legal authority, it is unclear how unilateral option clauses would be treated under Argentine law.
Australia	The Australian courts have upheld the validity of unilateral option clauses (See <i>PMT Partners Pty Ltd v Australian National Parks & Wildlife Service</i> (1995)).
Brazil	Owing to a lack of legal authority, it is unclear how unilateral option clauses would be treated. Nevertheless, as Brazilian law requires the consent of all parties to submit a dispute to arbitration, there is concern that Brazilian courts might well not recognise the validity of unilateral option clauses.
China	Article 16 of the Arbitration Law of the People's Republic of China of 1994 requires that an arbitration agreement, among other things, contains an expression of intention to apply for arbitration. There is concern that Chinese courts might well not recognise the validity of unilateral option clauses on the basis that they lack the requisite agreed intention to resolve disputes by arbitration. There is very little case law on this point, although in 1999 a local court in Beijing ruled that a unilateral option clause was invalid, deeming such clauses "unconscionable" or "unfair". Note that, in China, cases do not have any precedential value, so the same court or lower court might reach a different verdict.
England	As noted in the main text, unilateral option clauses have been upheld as valid.
France	On the basis of a widely reported case (Cour d'Appel d'Angers, 25 September 1972, Cour de Cassation, Première Chambre Civile, 15 May 1974) dealing with unilateral option clauses, there appears to be no general prohibition on such clauses in principle.
Germany	According to the German Federal Supreme Court, unilateral option clauses are valid in principle (BGH, <i>Urteil vom 26.01.1989 – X ZR 23/87</i> (Zweibrücken)). However, such clauses may, depending on their entire content, or the circumstances in which they were agreed, violate 'boni more' and become invalid (BGH, <i>Urteil vom 10.10.1991 – III ZR 141/90</i> (Bremen)). If the option operates for the benefit of a defendant, the unilateral option clause must provide that the defendant has to exercise its option before the claimant officially launches proceedings, to avoid a costly and time-consuming "back and forth" (BGH, <i>Beschluß vom 24.09.1998 – III ZR 133-97</i> (Jena)).
Italy	Unilateral option clauses have been upheld as valid. See Corte di Cassazione, Judgment No 2096 of 22 October 1970.
Japan	There is no case law directly on the point. Nevertheless, as a general principle of Japanese law is that contracts will be enforced according to their terms, it is believed that Japanese courts might recognise the validity of unilateral option clauses.
Mexico	Due to a lack of legal authority, it remains unclear how such clauses would be treated under Mexican law.
Russia	There is little case law on the point. Academic commentary (according to which unilateral option clauses might be invalid) and legal practice (where such clauses have been found to be valid) currently differ.
South Africa	A South African court might hold that a unilateral option clause is a valid and enforceable 'arbitration agreement' within the meaning of the South African Arbitration Act of 1965. The South African Law Commission, in its May 2001 report dealing with proposed reforms to the existing Arbitration Act, expressed the view that 'option-to-arbitrate' clauses, in the realm of consumer contracts, can result in unfairness. The commission has recommended that consideration should be given to the inclusion of consumer protection provisions in an arbitration statute of general application.
Sweden	Unilateral option clauses are generally considered to be valid, unless the option has been implemented by a party with stronger leverage in negotiations.
United States	It remains uncertain whether unilateral option clauses would be considered valid. In some cases, the principle of mutuality has been invoked to invalidate such clauses (<i>Hull v Norcom Inc</i> (1985)). And yet other decisions have reached an opposite conclusion (<i>Sablosky v Gordon Co</i> (1989)). Courts may find such clauses to be unconscionable (see <i>Armendariz v Found Health Psychcare Servs Inc</i> (2000), where the arbitration agreement contains several one-sided provisions). Equality of bargaining power may also be a factor.

the English case *Baron v Sunderland Corp* (1966), the issue is whether “it is an essential ingredient of an arbitration clause that either party may, in the event of a dispute arising, refer it, in the provided manner, to arbitration.” Mutuality is not an ‘essential ingredient’ under English law, but it is in some jurisdictions.

supportive of options to litigate or arbitrate. For example, in *NB Three Shipping*, the court upheld a unilateral option to arbitrate, and in *Law Debenture Trust Corp plc v Elektrim Finance BV and others* (2005), relying on *NB Three Shipping*, the court upheld the validity of a clause that provided for arbitration but with a unilateral option to litigate instead.

But questions have been raised over the validity of unilateral option clauses in a number of other jurisdictions (see Table 1).

Practical Steps

So, a properly drafted unilateral option to arbitrate (or litigate) provides significant advantages in certain circumstances. Yet the same option can also carry considerable risks. Minimising the risks in any given case might require advice on the law of several jurisdictions. The following practical steps should be considered:

- Take specialist advice about any option to arbitrate. In some cases this might require taking advice in relation to several potentially applicable laws (such as the law of the jurisdictions in which enforcement of any award might be sought and the law of the seat of the arbitration). Consider, too, whether the potential advantages of keeping the options open (rather than making a definitive choice to arbitrate or litigate) are worth the cost, as well as any ultimate risks.
- Always draft the option clearly and precisely, setting out how and when it can be exercised. Consider how to deal with any proceedings that have already been commenced before the option is exercised (as well as the costs of those proceedings).
- In each instance, draft both the litigation and the arbitration aspects of the unilateral option clause as though they were individual clauses, so that each is fully capable of operating independently.
- If there is a risk that the unilateral option clause may fail (which will arise, in particular, in instances where there is a concern about the treatment of such clauses under the laws which may be applicable to the arbitration, any award, or the enforcement of such award), ensure that the default position is satisfactory.
- The party with the benefit of the option should refrain from any substantive steps in litigation or arbitration proceedings before exercising its option (otherwise the option might become unenforceable).

A model clause

In light of the risks identified above, it would be unwise to rely on any model unilateral option clause without seeking specialist advice in each case. The following clause is offered merely as an illustration:

- 1.1 Subject to paragraph 1.2 below, any dispute, controversy or claim arising out of, relating to or in connection with this Agreement (including regarding its existence, validity, interpretation, performance, termination or the consequences of its nullity) (a “Dispute”) shall be referred exclusively to the courts of [England and Wales]. [Insert further desired court jurisdiction provisions, for example, dealing with process agents.]
- 1.2 Notwithstanding paragraph 1.1 above, if the [party with option] so elects by way of written notice to [the other party/parties] specifying the Dispute in question, that Dispute shall be referred to and finally resolved by arbitration under the [LCIA Arbitration Rules] (the “Rules”), which Rules are deemed to be incorporated by reference into this clause. The arbitral tribunal shall consist of [one/three] arbitrators. The seat (or legal place) of arbitration shall be [London, England] and the language of the arbitration shall be [English].
- 1.3 Any election pursuant to paragraph 1.2 above must be made before [party with option] institutes (and instead of instituting) court proceedings (other than proceedings solely for interim relief) in relation to the Dispute, or at any time before [party with option] takes a substantive step in any court proceedings in relation to the Dispute which have been commenced by [the other party/parties]. [Insert provision dealing with the costs of aborted proceedings if appropriate.]

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English law has proved to be generally supportive of options to litigate or arbitrate

The consequences of these potential pitfalls can be severe. If an option to arbitrate is deemed invalid or unenforceable at an early stage, the party thinking it would have an option might have to pursue its rights through the appropriate courts instead – possibly leading to a judgment that cannot be enforced where the assets are located. On the other hand, if an option to arbitrate is successfully challenged at a later stage, for example when a party is seeking to enforce its arbitral award, that award could be considered invalid and unenforceable, making the entire proceedings a waste of time and money. Furthermore by that stage there might even be limitation issues preventing any further proceedings.

It is therefore essential that parties think carefully about these issues before including a unilateral option to arbitrate. Doing so might require consideration of the laws of several jurisdictions, such as the law governing the arbitration agreement, the law of the seat of the arbitration and the law of any states in which enforcement might be sought. Moreover, as can be seen from Table 1, it might be impossible to reach firm conclusions about the validity of a proposed option because the legal position is unclear in one or more of the relevant jurisdictions.

A review of selected jurisdictions

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