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Arbitration World

Highlighting developments and issues in international arbitration

July 2008

In this issue:

Welcome to the 6th Edition of K&L Gates' Arbitration World

Welcome to the Sixth Edition of Arbitration World, a publication from K&L Gates' Arbitration Group which aims to highlight significant developments and issues in international arbitration for executives and in-house counsel with responsibility for dispute resolution.

In this edition, our review of key case law includes reports on the keenly awaited U.S. Supreme Court decision in *Hall Street v. Mattel*, a U.S. appellate decision excluding class actions, and a recent case from the Court of Arbitration for Sport with potentially wide-ranging implications.

We look at investor-state arbitration in the NAFTA context and reasons to arbitrate disputes if enforcement in Russia is in prospect. We look at the growing area of e-disclosure in the arbitration context, and the controversial draft ABA disclosure guidelines for arbitrators on conflicts of interest.

Contributors from our Hong Kong office discuss developments in Chinese arbitration. We report on a worrying decision in the Indian courts on challenges to foreign-seated arbitration awards and a troubling Australian decision on the scope of application of an arbitration clause. Our Berlin colleagues highlight matters to be aware of when providing for arbitration in corporate transactions in Germany.

We also bring news of our latest office opening in Asia and look forward to our International Arbitration Event to be held at the New York Marriott East Side in September 2008.

As always, we also include a round-up of developments from around the world.

News from around the world

Middle East

United Arab Emirates

Two new pieces of arbitration law are expected for 2008. The federal government of the U.A.E. intends to pass a new federal arbitration act governing arbitrations seated in the Emirates, and the Dubai International Financial Centre aims to introduce a new law governing arbitrations seated in Dubai to replace the existing law from 2004. It is expected that both laws will be closely modelled on the UNCITRAL Model Law, with modifications based on international best practice.

Syria

Syria has passed its new arbitration law. The law is generally favourable to domestic and international arbitration, although doubts have been expressed about the practicality of bringing enforcement proceedings.

Asia

Russia

Russia has enacted a new federal law on enforcement proceedings, replacing the existing legislation from 1997. This step is expected to increase confidence in the practical prospect of the enforcement of arbitral awards and court judgments in Russia.

See page 14 of this edition for a report on the enforcement of foreign judgments in Russia.

China

The Hong Kong Department of Justice has published a consultation paper on the proposed reform of the Hong Kong arbitration law. The key proposed change is to abolish the distinction between domestic and international arbitrations

continued

and to adopt a unitary regime for both. The proposed Arbitration Bill is modelled on the UNCITRAL Model Law. By this reform, the Department of Justice hopes to make Hong Kong arbitration law more user-friendly and to promote Hong Kong as a regional arbitration centre.

The Hong Kong International Arbitration Centre has announced a revision of its arbitration rules and an agreement for closer co-operation with CIETAC and more recently with the Stockholm Chamber of Commerce (see page () for a full report).

Macao and mainland China have entered into an agreement on the mutual recognition and enforcement of arbitral awards made by the two territories' arbitration authorities.

Japan

The Japan Commercial Arbitration Association has recently made two important modifications to its rules. The first change requires arbitrators to disclose any circumstances giving rise to a doubt as to their impartiality. The second is an increase in the range of hourly rates for arbitrators' fees.

"The Hong Kong International Arbitration Centre has announced a revision of its arbitration rules "

North America

Canada

Canada's ratification of the ICSID Convention is now complete, following implementing legislation in all the states and territories. The ratification will improve the rights of investors under NAFTA and most of Canada's 22 BITs.

United States

The City of San Francisco has launched an action against the National Arbitration Forum, an organisation that resolves disputes between credit card companies and consumers. The claim follows statistics showing that fewer than 0.2% of the NAF's cases between 2003 and 2007 were won by consumers.

The action alleges pro-company bias by the NAF, inflated awards, and improper costs awards. The action takes place in the context of increasing controversy at state and national levels about the use of arbitration in the consumer context.

In March 2008 the Supreme Court handed down judgment in Hall Street v Mattel, an important decision on the scope for judicial review of arbitral awards. See page 21 for a full report.

Europe

England and Wales

The English High Court has held that general words of incorporation suffice to incorporate an arbitration clause into a contract save for exceptional cases. In Heifer v Helge, an issue arose as to the incorporation in several contracts between the parties of an arbitration clause in one contract. The Court held the clause was incorporated. Even if the contract containing the arbitration clause was intended to govern the parties' relationship only until a certain date, the arbitration clause still applied to disputes arising after that date.

In Braes of Doune Wind Farm v Alfred McAlpine, the parties stipulated that the English Arbitration Act 1996 should apply, but that the seat would be Glasgow, Scotland. The court held that due to the parties' express choice that the English Arbitration Act should apply, they had chosen England and Wales as the "juridical seat", and the reference to Glasgow was intended only to refer to the place of the hearings.

Latin America

Various countries in Latin America are considering withdrawing from ICSID and limiting access to international arbitration.

The draft Bolivian constitution will forbid recourse to a foreign arbitral tribunal or court for oil and gas disputes. There are also proposals to renegotiate treaties which contravene this prohibition, which would have a serious impact on BIT litigation. Bolivia has already withdrawn from the ICSID Convention.

The Ecuadorean parliament is proposing a reform to the constitution that would forbid the state from submitting disputes to international arbitration. Ecuador has already withdrawn from ICSID in respect of oil-related matters. The proposed reform would seriously affect any future litigation under the country's BITs.

Nicaragua's Attorney General has announced that the country is considering a partial withdrawal from ICSID.

Venezuela has denounced its BIT with the Netherlands. Due to the number of multinationals with head offices in the Netherlands, it is under this treaty that a majority of the ICSID proceedings involving Venezuela have been brought. The termination of the BIT is sure to give rise to disputes concerning the scope and application of its "survival clause".

Brazil

A Brazilian court has refused the enforcement of an ICC award on grounds that the parties had never signed a separate compromisso document (an arbitration agreement fulfilling certain formal requirements under Brazilian law). The decision has been criticised as overly technical and out of keeping with established Brazilian case law, and is subject to appeal to the Superior Court of Justice.

Oceania

New Zealand

New Zealand's Arbitration Act 1996 has been updated. The amendments bring New Zealand into line with recent amendments to the UNCITRAL Model Law. Changes include restrictions on arbitration agreements involving consumers, clarification of party obligations in relation to the use of confidential information, and a detailed new regime for tribunal-granted interim measures.

ICC

The President of the ICC Court of International Arbitration, Pierre Tercier, has announced his resignation. Mr Tercier's resignation will take effect at the end of June. No announcement has been made as to any replacement.

ICDR

The International Centre for Dispute Resolution has published new guidelines on the exchange of information in international arbitrations. The guidelines aim to enhance the efficiency of arbitration by discouraging excessive document production. They also contain provisions on electronic disclosure.

They will apply in all arbitrations administered by the ICDR commencing after 31 May 2008 unless the parties agree otherwise. In relation to pending cases, they may also be adopted at the discretion of the tribunal.

A revision of the ICDR Rules to take account of the guidelines is expected.

And finally…

Cyberspace

An arbitration forum has been launched in the virtual community Second Life. The e-Justice Centre, a joint venture between the Portuguese Ministry of Justice and the Universities of Lisbon and Aveiro, provides mediation and arbitration services for all "avatars" to assist them in resolving conflicts. ■

A Step in the Wrong Direction?
Court Interventionism in India

By: Marcus M. Birch, London

Many commentators perceive an increasing trend toward court intervention in arbitration in India. Since the enactment of the Indian Arbitration Act in 1996, Supreme Court decisions have, first, widened the scope of the public policy exception in relation to awards in Indian-seated arbitrations and, more recently, opened the door to the application of that wider interpretation to awards in foreign-seated arbitrations. These developments appear to fly in the face of the objectives of the Indian legislature and have raised concerns in the international arbitration community. This article examines the key cases and the lessons to be learned.

The Indian Arbitration Act

The Indian Arbitration and Conciliation Act 1996 (the "Act") was modelled on the UNCITRAL Model Law. It was enacted in order to modernise India's regime for both domestic and international arbitration, to bolster party autonomy, and to reduce court intervention in arbitration. Part I of the Act provides a regime for arbitrations seated in India and "domestic" awards. Any award in an Indian-seated arbitration is deemed to be "domestic", regardless of the nationality of the parties. Part II deals with the recognition and enforcement under the New York and Geneva Conventions of "foreign" awards, i.e., those rendered in arbitrations seated outside India.

SAW Pipes and the widening of the public policy exception

Both Parts of the Act contain a provision setting out the grounds for challenge of an award: section 34 in Part I and section 48 in Part II. In both cases, the list of grounds is notionally more restrictive than the English Arbitration Act, in that there is no right of appeal on a point of law. However, both provisions do contain the standard public policy ground and it is the interpretation of this ground that has given rise to concern in the Indian context.

First, other countries have generally taken a very restrictive approach to the interpretation of public policy, and many (e.g., France) have understood it as referring not to domestic policy concerns but international public policy. However, it is clear from the wording of the Act that it is "the public policy of India" that is important.

Second, the Supreme Court's decision in SAW Pipes (2003) set a precedent for a wide interpretation of "public policy" under section 34. In that case, involving a domestic award and thus Part I of the Act, the Court recognised a notion of "patent illegality" as being within the public policy ground, and accepted that a court could set aside an award if a party could demonstrate that the award violated an Indian statutory provision or suffered from an error of law. In practice, this decision opened the door for parties to use the public policy exception to appeal domestic awards to the courts on the merits. Although the Indian courts have refrained from applying SAW Pipes widely in such a way as to set aside a large number of awards, the case permits parties to bring a challenge and obtain a stay of enforcement of an award. The consequent delay, which can be several years, can be of considerable strategic value for the losing party and a source of frustration for the party seeking enforcement.

Venture Global Engineering and the blurring of the domestic/foreign distinction

SAW Pipes quickly drew criticism from commentators, who hoped that it would be overruled, and that the Supreme Court would mandate a less interventionist approach in the Indian courts. However, the precedent remains untouched. Moreover, while the negative impact of the case was initially limited by its application only to Part I of the Act, and therefore only to domestic awards, that consolation appears to have been removed by a further case indicating a trend towards interventionism by the Indian courts in relation to arbitral awards. In January 2008, the Supreme Court held that Part I of the Act applies not only to all Indian-seated arbitrations, but also to any international commercial arbitration which does not expressly exclude its operation.

Venture Global Engineering v Satyam Computer Services Ltd (2008) concerned a London-seated arbitration and an LCIA arbitral award made in London. When the successful party sought enforcement of the award in the U.S., the losing party made an application to the City Civil Court in Secunderabad, India to set aside the award under the provisions of the Act. Pending a full hearing of the merits, the Civil Court granted an ex parte injunction restraining the U.S. enforcement action. That decision was appealed first to the High Court of Andra Pradesh and then to the Supreme Court of India.

In the Supreme Court, Tarun Chatterjee and P Sathasivam JJ followed Bhatia International v Bulk Trading (2002) and held that Part I of the Act applied to "all arbitrations including international commercial arbitrations and to all proceedings relating thereto." Where the arbitration was seated in India, the provisions of Part I were mandatory and the parties could only deviate from them to the extent expressly permitted in Part I. Where an arbitration was seated outside India, for example, in London, Part I still applied, unless the parties excluded any or all of its provisions by express or implied agreement.

The case is a worrying development for international parties involved in arbitration with Indian counterparties. In particular, it extends the scope of Part I, and therefore SAW Pipes, from domestic awards to foreign awards, and permits intervention by the Indian courts (particularly for the purposes of review) even where the parties have chosen a seat (and hence supervisory jurisdiction) in a place outside India. This is particularly concerning given the lack of predictability of the Indian courts' approach to the public policy exception.

One way out of this scenario is for the parties to agree expressly to exclude the operation of the Act. Parties should be advised to do this if they are contracting with Indian parties and they want to avoid arbitral awards being subject to review by the Indian courts as well as by the courts of the seat.

Reform of the Indian system

The Act is still relatively new but has generated more Supreme Court litigation than was expected or intended. It has given rise to considerable divergences of judicial opinion and a perhaps unexpected degree of judicial activism. These issues may ultimately be addressed by reform of the Act. As long ago as 2001, the Law Commission of India made various recommendations. It is to be expected that at least some of the judicial decisions of recent years will be overturned in future amending legislation, but in the meantime, parties to contracts with Indian parties considering arbitration clauses should tread very carefully indeed.

New HKIAC Rules and Co-operation Agreement

By: Wing L. Cheung, Yujing Shu and Paul Fan, Hong Kong

The Hong Kong International Arbitration Centre ("HKIAC") has announced a revision of its arbitration rules. The new rules are expected to come into force on June 1, 2008, superseding the existing HKIAC rules, save to the extent that the parties have already agreed to adopt the existing rules.

The new rules differ from the existing rules in two main ways. First, in line with the proposed reform to the Hong Kong Arbitration Act, the rules will apply to both domestic and international arbitration proceedings. Secondly, the new rules will no longer be intended merely to supplement the UNCITRAL Rules, but to operate as a complete procedural code. The new rules are thought to be modelled on the Swiss Rules Of Arbitration.

On 21 February 2008, the China International Economic and Trade Arbitration Commission (CIETAC) and the HKIAC signed the latest in a line of Co-operation Agreements. Under this agreement, CIETAC arbitrations may be conducted at the HKIAC in Hong Kong and HKIAC proceedings may be conducted at CIETAC's venues on the mainland. The host institution will provide administrative and other support for the conduct of the arbitrations, including recommendations of arbitrators and the exchange of secretariat members. The agreement also contemplates the joint administration of arbitrations by CIETAC and the HKIAC in the future.

The HKIAC has also announced a co-operation agreement with the Stockholm Chamber of Commerce involving joint promotion of ADR services, mutual recommendations of arbitrators and mediators, the sharing of hearing facilities, and research into co-operation over investor-state arbitrations involving Chinese parties.

U.S. Appellate Court Enforces Arbitration Provision that Precludes Class Actions

By: David R. Fine, Harrisburg

As Arbitration World reported in its Spring 2008 issue, courts in the United States have taken strikingly different positions on the enforceability of contractual arbitration provisions that preclude consumers from asserting their claims in class actions. Since that report, the divergence has only widened, and the issue seems primed for consideration by the Supreme Court.

In December 2007, the U.S. Court of Appeals for the Third Circuit (which reviews cases arising in Pennsylvania, Delaware, New Jersey and the U.S. Virgin Islands) issued the strongest judicial statement yet that such arbitration/class-action-waiver provisions are not inherently unconscionable. In *Gay v. CreditInform, 511 F.3d 369 (3d Cir. Dec. 19, 2007)*, the court considered an allegation that the defendant had sold what are known as credit-repair services without making certain disclosures required by federal and state law regarding such services. The plaintiff sought to pursue her claim as a class action involving all purchasers of the services throughout the United States. The defendant asserted, first, that it did not offer credit-repair services as defined by the statutes and, second, that in any event, the plaintiff had signed an agreement that she would arbitrate any dispute and do so individually (i.e., not as part of a class action).

K&L Gates represented the defendant from the outset of the suit. The federal district court in Philadelphia agreed with the defendant and ordered the plaintiff to pursue her claim individually in arbitration before the American Arbitration Association, the forum named in the agreement. On appeal, the plaintiff argued that enforcement of an individual arbitration provision pursuant to the agreement and the Federal Arbitration Act (the "FAA") was inconsistent with the rights granted by the credit-repair statutes and that the provisions were contractually unconscionable. Federal and state courts in the United States had split on the issue of whether such provisions are unconscionable. For example, as noted in a previous issue of this publication, state and federal courts in California have consistently held such clauses to be unenforceable.

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In *CreditInform*, the Third Circuit found no conflict between the FAA and enforcement of the credit-repair statutes. It likewise found no inherent unconscionability in requiring the plaintiff to pursue her claim individually in arbitration. The court also said that, to the extent state laws could render such clauses unconscionable, those laws would be preempted by the federal law established by the FAA. The plaintiff sought to have the entire court of appeals rehear the case, but the court refused the request in an order entered in February 2008.

While the *CreditInform* decision is a major one, it has in no sense resolved the issue. Since the Third Circuit entered its opinion, both the Ninth Circuit and the North Carolina Supreme Court have refused to follow the Third Circuit's holding. See *Lowden v. T-Mobile USA, Inc., 512 F.3d 1213 (9th Cir. 2008)*, and *Tillman v. Commercial Credit Loans, Inc., 655 S.E.2d 362 (N.C. 2008)*. It is likely that courts will remain divided on the issue and that the U.S. Supreme Court ultimately will have to step in to bring uniformity. There is already a petition for a writ of certiorari pending before the Court in a case from California raising essentially the same issue the Third Circuit addressed in CreditInform, and it appears almost certain that the Supreme Court will place the issue on its 2008-09 docket. ■

Pitfalls Down Under

By: Sean Kelsey, London

A recent Australian judgment giving a narrow construction to an arbitration clause is a reminder of the importance of the careful drafting of arbitration agreements.

In Seeley International, a distributor of air-conditioners sued their manufacturer in the Australian Federal Court for breach of contract, seeking summary judgment on a claim for declaratory relief. The manufacturer sought to restrain the proceedings on the basis of an agreement to arbitrate any issue between the parties. However, the relevant clause also provided that nothing in it "prevents a party from seeking injunctive or declaratory relief in the case of a material breach or threatened breach of this Agreement." On this basis, the judge concluded that, although the arbitration agreement was valid, the parties had intended that certain types of dispute and forms of relief were not to be settled by arbitration. He went on to grant summary judgment and declared the manufacturer in breach of contract.

This decision contrasts sharply with the decision of the English House of Lords in the Premium Nafta case, reported in the Spring 2008 edition of Arbitration World. In what their Lordships described as a "fresh start" for English arbitration, it was held that a valid arbitration clause should be construed on the presumption that the parties, as rational businessmen, intended any dispute arising out of their relationship to be decided by arbitration. Only express language to the contrary would rebut that presumption. As a result of Seeley, the approach of the Australian courts is not so clear. The case highlights the importance of ensuring that an agreement to arbitrate is drafted in such a way that the parties can be held to it, and limiting the risk of having to litigate disputes in the local courts of your opposing party.

Chapter 11 of NAFTA:
Dispute Resolution Mechanism or Threat to the U.S. Legal System?

By: Jerome J. Zaucha, Washington, D.C.

Chapter 11 of the North American Free Trade Agreement ("NAFTA") between the United States, Canada and Mexico, which came into effect in 1996, establishes an arbitral dispute resolution mechanism through which private investors may pursue claims against the signatory governments as a means of ensuring that the investors of each party are treated fairly and without regard to nationality within the free trade area. However, since the filing of the first investor arbitration claim in March 1996 alleging that a Canadian regulation deprived a Mexican company of sales in Canada, some U.S. legal commentators have warned that Chapter 11 of NAFTA may undermine the U.S. legal system. Indeed, such hyperbolic concerns have not been the sole province of legal scholars. Chapter 11 has even become a visible issue in the current U.S. Presidential race. In response to the Pennsylvania Fair Trade Coalition 2008 Presidential Candidate Questionnaire, both Barack Obama and Hillary Clinton committed to "renegotiate NAFTA to eliminate its investor rules that allow private enforcement by foreign investors of . . . investor privileges in foreign tribunals." As Hillary Clinton noted, "Under NAFTA, foreign companies can challenge American laws before special tribunals and outside our court system." The following provides a brief overview of Chapter 11 and an assessment of the arbitration outcomes to date.

Investment Provisions

Chapter 11 of NAFTA incorporates a standard array of free trade agreement foreign investment provisions, including: National Treatment (each party is to accord the investors of another party treatment no less favorable than that accorded to its own investors) (Article 1102); Most-Favored-Nation Treatment (each party is to accord to the investors of another party treatment no less favorable than that accorded to investors of any other party or of a non-party) (Article 1103); Standard of Treatment (each party is to accord to the investors of another party the better of National and Most-Favored-Nation Treatments) (Article 1104); Minimum Standard of Treatment (each party is to accord to the investors of another party treatment in accordance with international law) (Article 1105); Performance Requirements (no party may establish export, local content or other like requirements for investments by the investors of another party) (Article 1106); and Expropriation and Compensation (no party may expropriate an investment of an investor of another party except as prescribed under, and any such expropriation must be compensated in accordance with the requirements of, Chapter 11) (Article 1110).

Arbitration Provision

To protect foreign investors and facilitate the resolution of investment disputes, Chapter 11 provides for the filing of investor arbitration claims directly against a host government in the event of treatment inconsistent with Chapter 11. Allegations of direct injury to an investor, or to an investor's firm in the host country, may be presented through filing a notice of intent to submit and submitting a claim to arbitration under the ICSID Convention, the ICSID Additional Facility Rules, or the UNCITRAL Rules. Awards may consist of monetary damages or restitution, but not punitive damages. A prevailing party may also be awarded their arbitration costs.

Number and Types of Claims to Date. As of January 1, 2008, investors had filed a total of 49 notices of intent to file arbitration claims against the Governments of Canada (18 cases), Mexico (17 cases) and the U.S. (14 cases) under Chapter 11. The NAFTA Articles most often cited as the basis for claims are: Article 1105 (minimum standard of treatment), approximately 43 claims; Article 1110 (expropriation), approximately 39 claims; and Article 1102 (national treatment), approximately 34 claims. Article 1103 (most-favored treatment), approximately 17 claims, and Article 1106 (performance requirements), approximately 16 claims, also are frequently stated as a basis for claims. Article 1104 (standard of treatment) is cited as the basis for only approximately eight claims.

The host government measures targeted include both national and regional/local measures in the following areas: environmental protection, natural resources, manufacturing, land use, import trade proceedings, postal services, court decisions, taxation, procurement, and other matters. Although the NAFTA expropriation provision, Article 1110, is cited as the basis for many claims, the measures alleged to constitute expropriations are not traditional government takings of businesses but rather more conventional government regulatory, tax, permitting, and other similar types of actions alleged to unfairly impinge on the business activities of an investor of another party to NAFTA.

Outcomes of Arbitrations under Chapter 11

Thirteen arbitrations are still in process, 13 are pending or inactive, 11 cases have been dismissed and only five have resulted in decisions with an award of damages against the host government. Six arbitrations have been settled or withdrawn. The successful investor claims include challenges to a Canadian ban on the export of toxic polychlorinated biphenyls (PCB) wastes and a Canadian lumber export quota system (to implement the U.S.-Canadian softwood lumber agreement) and challenges to the refusal by a Mexican local government to issue a permit to operate a hazardous waste landfill, the refusal by the Mexican government to rebate taxes on cigarette exports, and the implementation by the Mexican government of measures discouraging the import and production of high-fructose corn syrup.

Two of the most controversial arbitrations involving the U.S. were initiated by the Loewen Group Inc. and Methanex Corp., both Canadian companies, which claimed that state government-level actions, namely, a state court decision in the Loewen case and a state ban on the use of a chemical for health/safety reasons in the Methanex case, conflicted with the National Treatment (Loewen) and Minimum Standard of Treatment and Expropriation and Compensation (both Loewen and Methanex) Articles of Chapter 11. It is these two proceedings in particular that appear to have motivated many of the commentaries asserting that Chapter 11 undermines the U.S. legal system by allowing U.S. regulatory and judicial decisions to be reviewed by "foreign tribunals."

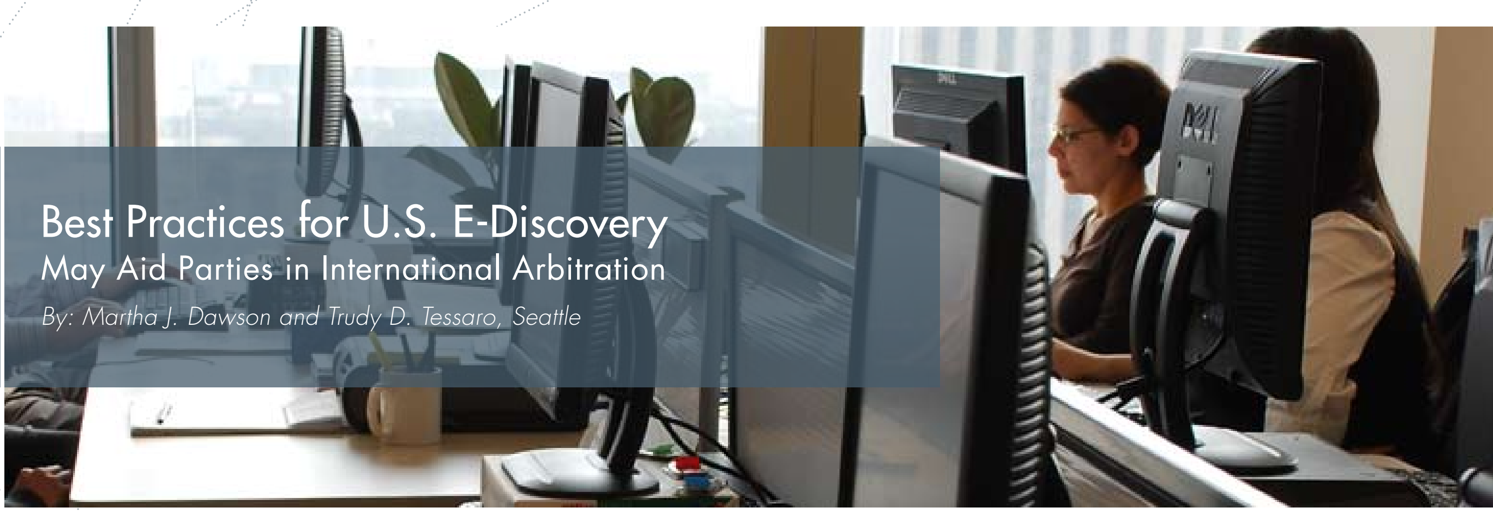
However, the arbitrators in both cases declined to undertake such reviews. As stated by the arbitrators in the Loewen case:

> Far from fulfilling the purposes of NAFTA, an intervention on our part would compromise them by obscuring the crucial separation between the international obligations of the State under NAFTA, of which the fair treatment of foreign investors in the judicial sphere is but one aspect, and the much broader domestic responsibilities of every nation towards litigants of whatever origin who appear before its national courts. . . . As we have sought to make clear, we find nothing in NAFTA to justify the exercise by this Tribunal of an appellate function parallel to that which belongs to the courts of the host nation. Too great a readiness to step from outside into the domestic arena, attributing the shape of an international wrong to what is really a local error (however serious), will damage both the integrity of the domestic judicial system and the viability of NAFTA itself. . . . [T]he interests of the international investing community demand that we must observe the principles which we have been appointed to apply, and stay our hands.

In the Methanex case, the arbitrators not only ruled that the tribunal lacked jurisdiction to determine the substantive Chapter 11 claims but awarded costs against Methanex in the amount of approximately $3 million. By determining to "stay" their hands, both the Loewen and Methanex tribunals likely bolstered the legitimacy and ongoing viability of Chapter 11 arbitrations.

Conclusion

U.S. anxieties over Chapter 11 likely were born from the relative newness of free trade arrangements to the U.S. and the Constitution-based belief that the U.S. legal system should not be subject to any external authority. Although the nature of certain of the claims brought to date may have fed those anxieties, the performance of the arbitration process under Chapter 11 over time should calm them. As Chapter 11 claims and the arbitration of those claims become normalized, arbitration under Chapter 11 likely will come to be viewed, even in the U.S., less as a threat to national legal systems and more as a conventional and appropriate mechanism for the resolution of trade agreement investment disputes. ■



Best Practices for U.S. E-Discovery
May Aid Parties in International Arbitration

By: Martha J. Dawson and Trudy D. Tessaro, Seattle

Advances in computer technology have changed the way individuals and organizations conduct business and maintain records. It is estimated that over 99 percent of new information is now created and stored electronically, and much of that information is never reduced to printed form.

Litigants, whether in court or in arbitration, have started to view the electronically-stored information (ESI) of opposing parties as potential treasure troves of records that can be searched to support their case or undermine the case of opposing parties. A party's own ESI may also be a valuable source of information to support its case. Electronic discovery – the pursuit of evidence existing in some electronic form – is not new to U.S. litigators. Over 38 years ago, Rule 34 of the Federal Rules of Civil Procedure was amended to "accord with changing technology" and include "data compilations" in its description of discoverable documents. Since that time, U.S. courts have consistently held that electronic evidence is discoverable. Electronic discovery has thus become a firmly established component of U.S. litigation. But it has also become a trap for the unwary. The consequences can be dire for parties who fail to appreciate the unique challenges posed by ESI or fail to ensure they are taking adequate steps to meet their discovery obligations. News headlines announcing multimillion-dollar verdicts awarded because of "smoking gun" electronic records, or detailing extreme sanctions imposed against parties (and/or their attorneys) for the failure to preserve and produce ESI, are not uncommon.

Rules and Other Sources for Guidance in the U.S.

E-discovery in the U.S. is only growing. At the same time, U.S. litigants have an increasing number of sources for guidance in this arena, including mandatory court rules, forms and protocols, and non-binding "best practices" proffered by a variety of groups and organizations.

Amendments to the Federal Rules of Civil Procedure addressing the discovery of ESI went into effect on December 1, 2006, and govern e-discovery practice in the federal courts. Primarily, these amendments:

- Require early attention to e-discovery issues (FRCP 16(b) and 26(f));
- Provide guidelines for limiting discovery of ESI that is not "reasonably accessible because of undue burden or cost" (FRCP 26(b)(2)(B));
- Address issues related to the format of production of ESI (FRCP 34(b));
- Establish "clawback" procedures for inadvertently produced privileged documents (FRCP 26(b)(5)); and
- Establish a "safe harbor" that protects a party, absent exceptional circumstances, from the imposition of sanctions for "failing to provide electronically stored information lost as a result of the routine, good-faith operation of an electronic information system" (FRCP 37(f)).

In addition to the FRCP e-discovery amendments, many United States District Courts have enacted special local rules, forms or guidelines addressing the discovery of ESI, which litigants in those federal courts must follow (further details can be found on the "Resources" page of www.ediscoverylaw.com, the Electronic Discovery Law Blog of the e-Discovery Analysis and Technology Group at K&L Gates). Although similar to the FRCP amendments that encourage early attention to electronic discovery issues, these local rules tend to go much further and impose affirmative obligations on counsel to investigate and become knowledgeable about their clients' computer systems.

And, even where a federal district has no local rules or court-mandated forms, individual judges have created their own forms or set out their own preferred protocols for e-discovery.

More and more states are adopting statutes and court rules addressing the discovery of ESI, and others are actively considering whether to follow suit. Many of these mirror the FRCP amendments, but some were in place years before and are unique unto themselves.

> "More and more states are adopting statutes and court rules addressing the discovery of ESI..."

Non-Binding "Best Practices" and Guidelines

In addition to mandatory federal and state court rules, other groups and organizations have come forward to offer their suggested best practices and guidelines for parties and litigators involved in e-discovery disputes.

Probably the most well recognized of these is The Sedona Conference, a nonprofit research and educational institute which has authored several publications that are highly regarded in the field of e-discovery and which have been cited in court decisions as offering helpful analyses of e-discovery issues. These publications (all of which are available for free download at www.thesedonaconference.org) include:

- The Sedona Principles, Second Edition, Best Practices Recommendations and Principles for Addressing Electronic Document Production (June 2007). The language of The Sedona Principles, which first appeared in January 2004, has been modified to accommodate the language of the 2006 FRCP amendments, and the comments under each of the 14 principles have been significantly updated to reflect the new rules, a wave of recent court decisions, advances in electronic discovery technology, and a deeper appreciation among judges and lawyers for the unique qualities of ESI.

- The Sedona Guidelines: Best Practice Guidelines & Commentary for Managing Information & Records in the Electronic Age (September 2005). The second publication of The Sedona Conference, this document addresses questions related to the management of electronic information in organizations as a result of business, statutory, regulatory and legal needs.

- The Sedona Conference® Glossary: E-Discovery & Digital Information Management (Second Edition).

- The Sedona Conference® Commentary on ESI Evidence & Admissibility (March 2008). This document provides a brief survey of existing evidentiary rules and case law, addresses new issues and pitfalls that are looming on the horizon, and provides practical guidance on the use of ESI in depositions and in court.

- The Sedona Conference® Commentary on E-mail Management (August 2007). This Sedona Conference® Commentary suggests guidelines for determining the core elements of an e-mail retention policy suitable for public and private entities.

- The Sedona Conference® Best Practices Commentary on Search & Retrieval Methods (August 2007). This Commentary discusses the existing and evolutionary methods by which a party may choose to search unprecedented volumes of information.

- The Sedona Conference® Commentary on Legal Holds, August 2007 Public Comment Version. This Article provides guidance on the issue of when the duty to preserve is triggered and, once triggered, what the scope of the obligation is.

Another source for best practices guidelines is the Uniform Rules Relating to the Discovery of Electronically Stored Information, which were published by the National Conference of Commissioners on Uniform State Laws (also known as the Uniform Law Commission) in October 2007. The Uniform Rules mirror the spirit and direction of the FRCP e-discovery amendments, and in some cases freely adopt, often verbatim, language from both the FRCP and advisory committee comments the drafters deemed especially valuable.

In addition, the American Bar Association has included provisions addressing e-discovery in its Civil Discovery Standards (August 2004). The ABA has drafted standards relating to the identification and discovery of ESI (Standard 29), the use of technology to facilitate e-discovery (Standard 30), discovery conferences, privilege and technological advances (Standards 31-33). The Civil Discovery Standards offer suggestions for litigators and judges on these issues.

E-Discovery and International Arbitration

The "Digital Age" has not passed by parties involved in international arbitration. It is hard to imagine a commercial enterprise today that does not use computers to conduct its business. Widely available software allows users to create office documents, slide presentations, spreadsheets and databases, manage finances, and communicate electronically through e-mail or instant messaging. As storage of electronic information has become virtually effortless for computer users and continually less expensive, many organizations are finding that they possess

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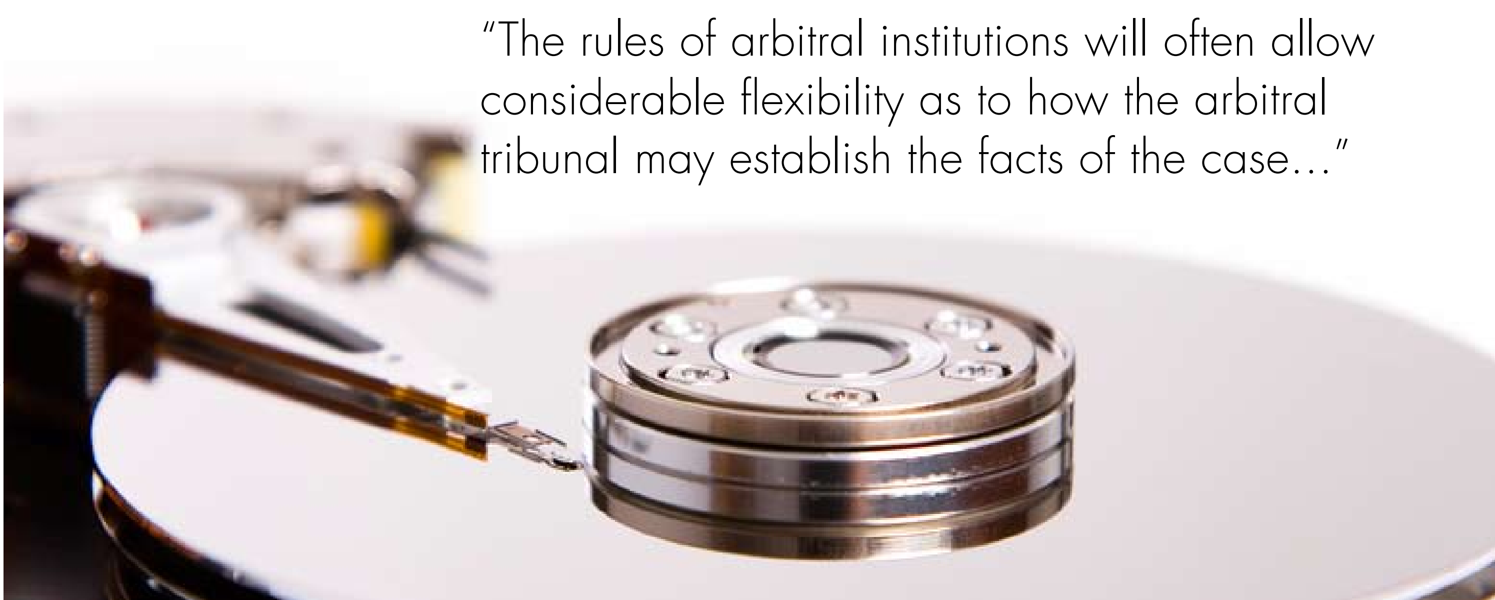
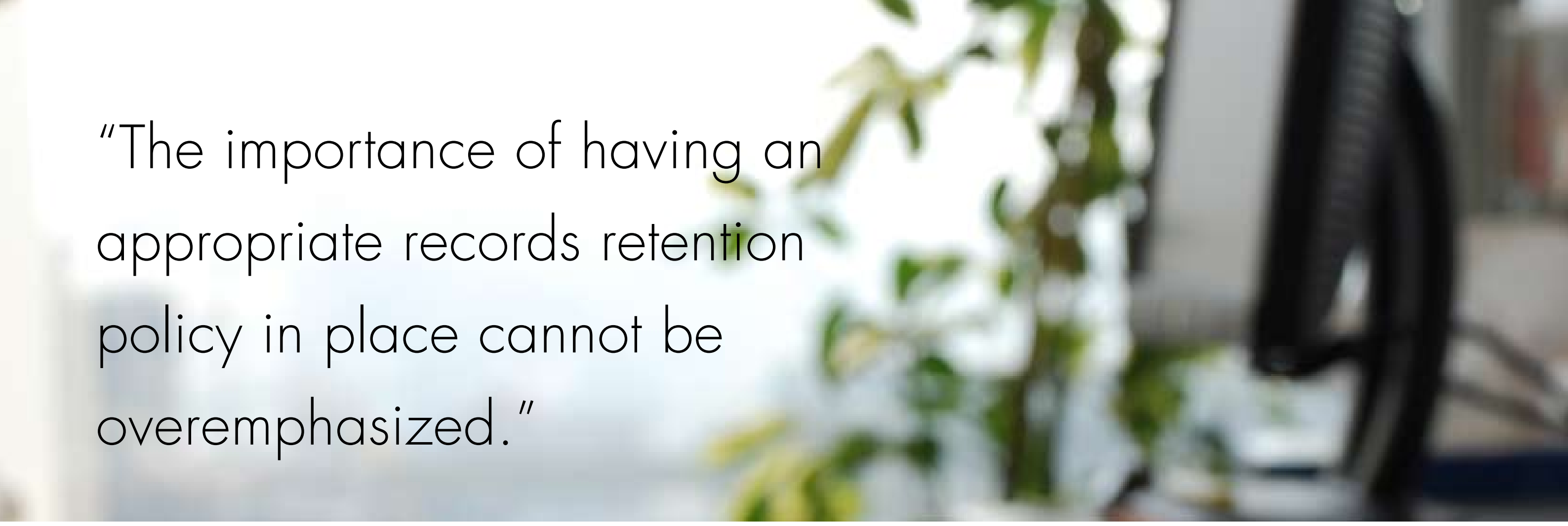




> "The importance of having an appropriate records retention policy in place cannot be overemphasized."

vast quantities of electronic documents unlike anything they would have accumulated in the paper world. It should come as no surprise that, increasingly, the evidence submitted by parties to a tribunal is electronic, whether the dispute is pending in court or in arbitration.

The plethora of rules, standards and firmly established case law available in U.S. e-discovery practice stands in stark contrast to the international arbitration arena. Most rules of arbitration limit discovery, and parties involved in international arbitration may never see the same scale and breadth of electronic discovery as that found in U.S. litigation.

In general, the discovery obligations of parties who have selected arbitration as a means to resolve a dispute are typically set by the parties themselves, often by reference to the rules of a particular arbitral body and sometimes explicitly in the arbitration clause itself. The rules of arbitral institutions will often allow considerable flexibility as to how the arbitral tribunal may establish the facts of the case, including the document disclosure process. The position commonly arrived at in international arbitrations is that parties are required to produce the documents on which they intend to rely, and the arbitral tribunal may (at the request of a party) order a party to produce any documents or other evidence which may be relevant to the outcome of the case. While rules of international arbitration do not generally deal explicitly with electronic discovery, there is no reason to think that electronic evidence should be beyond a tribunal's reach simply by virtue of its being electronic. Indeed, the IBA Rules on the Taking of Evidence in International Commercial Arbitration define a "document" as "a writing of any kind, whether recorded on paper, electronic means, audio or visual recordings or any other mechanical or electronic means of storing or recording information." Article 3 of the IBA Rules deals with document production and sets in place a mechanism by which (i) particular described documents or (ii) narrow and specific categories of documents reasonably believed to exist can be secured even if the adverse party holding that documentation chooses not to volunteer it in support of their own case. The crucial test (set out at Article 3.3(b) and Article 6) is that the documents must be "relevant and material to the outcome of the case". In practice, they must be identified with a higher level of precision than tends to be the norm in many common law jurisdictions including, in particular, the U.S. Possible grounds of objection to document production requests under the IBA Rules are set out at Article 9(2), and these include where producing the requested document(s) would constitute an "unreasonable burden" (Article 9(2)(c)).

Thus, electronic discovery is an emerging issue that will need to be addressed. In fact, a number of authors have already raised the issue of whether e-discovery guidelines might be helpful in international arbitration.

Universal E-Discovery Best Practices

The state of e-discovery in the U.S. may be viewed as a vast and confusing nightmare scenario by those not accustomed to the broad pretrial discovery available in U.S. litigation. However, there are some best practices that may be helpful beyond just the U.S. civil litigation context. As e-discovery becomes more prevalent in international arbitration (as it almost inevitably will), many of these tips will help parties better prepare for it and avoid some of the common pitfalls that can occur.

1. Adopt a records management policy that retains records only for as long as they are needed for business or legal compliance.

Businesses need not save everything. Instead, adopt a records management policy, supported by a retention schedule that preserves documents and ESI only for as long as required for legal needs and business compliance.

The importance of having an appropriate records retention policy in place cannot be overemphasized. While such policies have a purpose well beyond litigation and discovery concerns, they can be invaluable in controlling the cost and complexity of discovery. An effective records management policy can help curb the tendency of employees to retain all their electronic documents when there is no business or legal reason to do so and create a system in which an organization is better able to identify and isolate potentially relevant documents when faced with the possibility of a dispute.

Train employees to set up folders (preferably on shared servers where records are regularly backed up and easily accessible) for storing e-mail that needs to be saved longer than the standard period.

2. Ensure that backup media are used solely for disaster recovery purposes.

Disaster recovery media are a matter of particular concern, both because of the volume of information and the potential cost of restoring and searching backup tapes or disks. Backup media should be used solely for disaster recovery and kept for the shortest period of time necessary to achieve that goal. For example, if an organization periodically backs up its systems on a weekly or monthly basis, typically there is no reason to retain tapes that are older than the most recent one or two rounds of backups. The reason is simple – if a catastrophic loss of data occurred and an organization needed to restore as much information as possible, last week's backup tapes would most effectively accomplish that goal.

Many do not appreciate the difference between disaster recovery systems and proper archives or long-term records retention. Organizations may hold onto backup tapes for years, treating them as ad hoc corporate archives. Do not use backup tapes as archives. While an arbitral tribunal can excuse the production of evidence if it would be an "unreasonable burden" to produce it, you may undermine such arguments if you use backup tapes for archival purposes instead of for disaster recovery.

3. Train staff to use e-mail properly.
A single ill-considered, cynical or sarcastic e-mail or instant message generated by one employee can be used against an entire company in litigation or arbitration. You should sensitize employees to the dangers of electronic communications and adopt an acceptable use policy. The policy should include notice that no right of privacy exists in information sent or received using company resources and that the use of e-mail, instant messaging, the Internet and other IT resources will be monitored.

4. Become familiar with the information systems and likely sources of relevant evidence.
Counsel should meet with the client soon after an arbitrable dispute arises to talk about basic background information necessary to locate relevant evidence and to respond intelligently to possible requests for ESI. Proper communication between counsel and client will ensure that all sources of relevant ESI are identified – including those that are not reasonably accessible because of undue burden or cost – and that relevant evidence is retained on a continuing basis. Counsel should learn about the client's computer systems, including the hardware and software used, how files are saved, what e-mail system is used, and what backup protocols are in place, if any. Counsel should become fully familiar with the client's document retention policies, as well as the client's data retention architecture. To obtain the best information possible, it may be advisable for counsel to meet directly with the client's information technology personnel.

5. Be ready to roll out a "legal hold."
The duty to preserve evidence begins as soon as a company becomes involved in litigation or a regulatory investigation, or reasonably anticipates such action. Even where the destruction or deletion of relevant evidence is not willful, a party may be accused of "spoliation of evidence" if relevant information is lost as a result of automatic-deletion protocols after the duty to preserve is triggered. To avoid possible repercussions, think through such a situation in advance. What, if any, steps should you take to preserve documents for the arbitration?

6. Raise and discuss potential issues relating to ESI with the opposing party early in the proceedings.
Early on, consider discussing issues related to ESI and the role it will play in the arbitration. The particular issues regarding ESI that will deserve attention depend upon the specifics of the given case, but examples include: (1) issues related to the preservation of relevant ESI; (2) identification of the various sources of such information within a party's control that should be searched for ESI; (3) whether the ESI is reasonably accessible to the party that has it, including the burden or cost of retrieving and reviewing the information; and (4) the form or forms of producing ESI to the other party and to the tribunal.

Conclusion
One way or another, in the vast majority of international arbitrations, some degree of document production will be required, and this increasingly will extend to ESI. Best practices and guidelines do exist to help companies work through the maze of ESI and document production in the international arbitration setting. ■

Developments in New York for Bad Faith Claims Against Insurers

Two recent judgments of the New York Court of Appeals may prove to be a significant weapon for policyholders trying to cope with bad faith insurer conduct such as the low-balling of and/or the delay in claims payments. In Bi-Economy Market, Inc. v. Harleysville Ins. Co. and Panasia Estates, Inc. v. Hudson Ins. Co., the Court recognized that policyholders may assert claims for consequential damages against their insurers for bad faith claims handling, apart from the policy limit, in accordance with the usual principles applying to consequential damages claims for breach of contract.

More Reasons to Arbitrate:

The Enforcement of Foreign Judgements in Russia

By: Margaret T. Korgul, Newark

Foreign litigants are generally suspicious of the Russian judicial system. Due to years of corruption within the court system, the enforcement of commercial obligations by Russian parties and the resolution of commercial disputes involving such parties are perceived by foreign businesses as presenting a challenge. Many foreign litigants do not believe that enforcement proceedings in Russia will result in any actual recovery. Moreover, the Russian judiciary has little experience in enforcing foreign judgments and virtually no uniform procedures and practices for such enforcement. All these factors discourage foreign parties from bringing enforcement actions in the courts of the Russian Federation, and encourage the use of arbitration as a simpler and more effective route to enforcement in Russia. This article explores the difficulties facing parties who choose the litigation route and explains the preference for the arbitration route.

Enforcement Based on an International Treaty

In order to secure the execution of a judgment rendered by a foreign court on assets within the Federation, the foreign judgment must be formally recognized by a Russian court and an execution order issued. In many cases, the procedure for execution will be determined by an international treaty between the Russian Federation and the relevant country.

Russia is a signatory to a number of mutual legal assistance treaties which include provisions concerning the mutual recognition and enforcement of court judgments with former Warsaw Pact countries, Cyprus, Greece, Spain, Finland and Italy. Russia has also signed treaties with non-European countries such as Argentina, Egypt, Mali, Iran, Cuba, China and Turkey. Although Russia is not party to either the Brussels Regulation or the Lugano Convention, it is a signatory to the Hague Convention on Civil Procedure (1954), the Rome Convention on Damage Caused by Foreign Aircraft to Third Parties on the Surface (1952), and the International Convention on Civil Liability for Oil Pollution Damage (1969). All of these agreements provide for the formal recognition by a Russian court of the foreign judgments and its execution on the basis of an order of such court.

Enforcement Based on Judicial Comity and Reciprocity

When parties cannot rely on a treaty between Russia and the jurisdiction where their judgment was rendered, they may attempt to rely on the principles of judicial comity and reciprocity in support of their enforcement actions. Comity is a broad principle designed to help courts to resolve disputes that implicate laws of many jurisdictions. Although the Russian Civil Code provides that courts should presume the existence of reciprocity, it is for the party seeking enforcement to prove that the judgment-originating court respects the principles of comity and reciprocity. This is typically accomplished by the use of diplomatic channels and involves a long and difficult process. Also, because Russian courts have broad discretion in their rulings on enforcement actions, there is no uniformity among them on how to approach the procedure. It is therefore undisputed that enforcement of foreign judgments based on international comity and reciprocity is far more cumbersome than enforcement based on international treaties.

Procedure for Enforcement of Judgments

Every application for enforcement of a foreign judgment must comply with all the formalities required by Chapter 45 of the Civil Procedure Code. It is unclear whether enforcement actions should be brought before the specialized arbitrazh courts or whether they should be heard by the courts of general jurisdiction. The limitation period for filing an action to enforce a foreign judgment is three years from the entry into force of that judgment.

> "Foreign parties … in a commercial relationship with a Russian party in which a dispute has arisen, would be well advised to look to international arbitration…"

Russian courts recognize six grounds for refusing to enforce a foreign judgment: (i) lack of a legally binding judgment in the court of original jurisdiction; (ii) expiration of the three-year limitation period; (iii) exclusive jurisdiction of Russian Federation courts over the dispute; (iv) procedural violations during trial in the original jurisdiction; (v) where the enforcement of the judgment would jeopardize national security or contradict fundamental principles of public law; and (vi) res judicata or lis pendens.

Conclusion

Overall, the international perception of the difficulty of enforcing foreign judgments in Russia is correct. The likelihood of successfully enforcing a foreign judgment in Russia is low. In contrast, foreign arbitral awards are generally enforced under both the New York Convention and Russian law irrespective of the country in which the award was rendered. All commercial disputes fall within the jurisdiction of the Russian Civil Courts, and those courts take the position that the merits of a foreign award may not be reviewed by the court during confirmation proceedings. As a result, foreign parties who are either considering contracting with Russian parties, or are already in a commercial relationship with a Russian party in which a dispute has arisen, would be well advised to look to international arbitration and other forms of alternative dispute resolution as a preferable means of protecting their interests. In both circumstances, parties should endeavor to reach creative resolutions to avoid the cost and unpredictability of litigation and enforcement proceedings. ■

K&L Gates Merger News

K&L Gates has announced its merger with the North Carolina firm Kennedy Covington Lobdell & Hickman, LLP. The combination creates a firm of more than 1,700 lawyers in 28 offices located throughout the United States, Europe and Asia, including the largest Carolinas presence of any global law firm. The firm will maintain offices in Charlotte, Raleigh and Research Triangle Park, North Carolina.

The merged firm will have an unparalleled presence in the Carolinas region of the U.S. among all global firms, and will offer its Carolinas business clients access to global financial and commercial centres and world capitals. The legacy Kennedy Covington practice areas, including dispute resolution and private equity, will complement and strengthen K&L Gates' existing capabilities in these and other practices and enable the firm's lawyers to offer truly comprehensive and seamless representation to clients across the entire spectrum of legal disciplines.

Arbitration Clauses in Transactional and Corporate Documents Governed by German Law

By: Dr. Eberhardt Kühne and Dr. Moritz Dietel, Berlin

In the majority of international M&A transactions involving German companies, it is the norm to include an arbitration clause in the transaction documentation. This is because foreign investors prefer to arbitrate rather than to litigate in German courts. In spite of this, it is not uncommon for disputes between foreign investors and either a company's management or its shareholders to end up in the German courts. Just as in common law jurisdictions, this can happen even where a carefully-drafted arbitration clause is present in the transactional and corporate documents. Why is this?

Public companies

The German Stock Corporations Act, which governs all publicly listed corporations, does not allow for arbitration clauses in a stock corporation's charter. As a result, arbitration clauses in transactional documents such as share purchase or shareholders' agreements may fail if a dispute arising out of such documents involves shareholders' interests which are simultaneously governed by the corporation's charter. In such case, any party may dispute arbitrability or challenge the applicability of the arbitration clause.

Private companies

In contrast, under the German Limited Liability Companies Act, which governs most private companies, disputes among shareholders or between management and shareholders are arbitrable. However, based on the concept of the inter omnes effect of shareholder resolutions, the German Federal Court of Justice has ruled that disputes involving the validity of shareholder resolutions are only arbitrable if all shareholders will be bound by the arbitration award. This raises the question of how to ensure that an award will be binding on all shareholders. One important matter in ensuring a binding award is establishing an appropriate mechanism for the appointment of the arbitrators. The problem is that certain formulas commonly used in the corporate context, such as that one arbitrator will be appointed by the company and the other arbitrator by the shareholder claimant, do not fulfil the requirements set by the Federal Court, since there is a possibility of the claimant and the defendant agreeing on the choice of arbitrators without having regard to the interests of shareholders not directly involved in the dispute. Those shareholders might then challenge the validity of the arbitration clause and any award issued pursuant to that clause. The most frequent solution to this problem is to include an arbitration clause in the articles of association and to make provision in that clause for the appointment of arbitrators. Three methods are commonly used. First, the arbitrators may be named directly in the articles. Second, in the case of ad hoc arbitration clauses, the clause may name a public authority (typically a chamber of commerce or the president of a regional court of appeals) with the power to appoint the arbitrators. Third, in the case of institutional arbitration clauses, an arbitration institution such as the DIS may be given the power to appoint.

Conclusion

Where the articles do not contain an arbitration clause, the Federal Court requires that all shareholders expressly consent to the implementing of an arbitration clause, because the core area of shareholder membership will be affected. Where shareholders acquire shares in a company whose articles already contain an arbitration clause, that clause will be binding on the new shareholders without the need for their express consent.

Parties negotiating arbitration clauses in deals involving German companies should be aware of the difference between public stock corporations and private limited liability companies. In the former case, there is a risk of the arbitration clause being held to be inapplicable if a dispute involves interests protected by the charter. In the latter case, it is important to verify how an existing arbitration clause is implemented in the articles, whether all shareholders will be bound by it, and that the method chosen for the appointment of arbitrators is fair and does not prejudice those shareholders that are not party to the dispute but whose interests may nevertheless be affected by an award. ■

ABA Draft Best Practices for Arbitrator Disclosures

By: Philippe A. Toudic, Palo Alto

On January 10, 2008, the Dispute Resolution section of the American Bar Association issued a "Draft for Comment" of proposed best practices for meeting arbitrator disclosure requirements under U.S. law. In its current form, the document contemplates extensive disclosures even when the facts do not suggest partiality or a potential conflict of interest.

The U.S. Federal Arbitration Act and arbitration statutes enacted by several U.S. states provide that arbitration awards may be overturned in court on the basis of "evident partiality" by the arbitrator. Failure to disclose potential conflicts may give rise to a presumption of partiality.

The bulk of domestic arbitration in the U.S. involves consumer credit and employment disputes under "adhesive" (i.e., non-negotiated) contracts. Many plaintiffs' lawyers are thus eager to obtain court review of a process perceived as biased towards employers and business interests. The same dynamic is less prevalent in business disputes – in which the parties have bargained for an arbitral forum. The proposed disclosure requirements, however, would apply to all types of arbitration.

The Draft establishes an affirmative, ongoing duty to discover and disclose facts that a "reasonable person" would consider likely to affect impartiality. The Draft encompasses three categories of relationships: business, social, and familial.

Business relationships are essentially subject to the equivalent of a law firm's "conflicts check," in which parties, counsel, and witnesses are checked against a database of prior representations. The drafters also consider direct e-mail inquiry within the arbitrator's firm to be "prudent."

Social relationships present a greater challenge. The Draft mandates detailed disclosure of the arbitrator's personal contacts (including the type of contacts and the frequency of meetings), whether or not the arbitrator is aware of a potential effect on partiality. The arbitrator may also be required to inquire of social contacts whether they are aware of a potential conflict. As the drafters note, the affirmative duty to inquire may conflict with confidentiality requirements.

In the arena of international arbitration, disclosure of social relationships presents special challenges. There is a small pool of arbitrators and subject matter experts, who may also appear as counsel in arbitrations, who tend to meet regularly, dramatically increasing the disclosure burden.

Familial relationships are the final subject of the Draft. Disclosure is generally limited to the arbitrator's immediate family (e.g., spouse, siblings, parents, and children) and may be satisfied without affirmative inquiry. Actual knowledge of a potential conflict would, however, trigger an affirmative duty to inquire.

The co-chair of the drafting subcommittee has confirmed receipt of "many comments" to the initial draft. We understand the international arbitration community has been particularly vocal in its opposition to it. The comments are to be incorporated into a revised draft which will be presented at the annual convention of the ABA in August 2008.

One possible result is the appointment of a working group to further develop the disclosure guidelines. Alternatively, the effort may go no further. In either event, the effort to expand disclosure requirements bears continued attention. ■

> "Failure to disclose potential conflicts may give rise to a presumption of partiality."

The CAS decision in Webster:

All change in the European football transfer market?

By: Martin King, London

The decision of the Court of Arbitration for Sport ("CAS") in Heart of Midlothian Plc v (1) Andrew Webster (2) Wigan Athletic AFC Limited (CAS 2007/A/1298, CAS 2007/A/1299, CAS 2007/A/1300) has been hailed as a landmark decision affecting player contracts with the potential to match Bosman in terms of its impact on the European football transfer system. This article discusses the potential legal and sporting fallout.

The Facts

Andrew Webster is a professional footballer currently on loan to Glasgow Rangers from Wigan Athletic. In 2001, at the age of 18, he signed for Heart of Midlothian FC ("Hearts") for £75,000 on a four-year contract (later extended a further two years to June 2007). During his time with Hearts, Webster was a regular first-team player and made over 20 international appearances for Scotland. During contract negotiations in 2005/2006, the relationship between Webster and Hearts deteriorated. Hearts' offers did not meet Webster's expectations and Webster found himself not being selected. In May 2006, Webster unilaterally terminated his contract with Hearts and months later signed a three-year contract with Wigan Athletic. Hearts subsequently filed a claim against Webster and Wigan before the FIFA Dispute Resolution Chamber ("DRC") for breach of contract. In April 2007, the FIFA DRC ordered Webster and Wigan (on a joint and several basis) to pay Hearts compensation of £625,000. Webster, Wigan and Hearts all cross-appealed and the case came before a three-person tribunal of the Court of Arbitration for Sport in October 2007.

The central dispute involved Article 17 of the FIFA Regulations for the Status and Transfer of Players (also known as the Players' Status Regulations or "PSR"), which sets out the consequences of unilaterally terminating a playing contract without just cause (see side panel). It was undisputed that Webster had unilaterally terminated his contract without just cause and that compensation had to be calculated in accordance with Article 17 PSR. The essence of the parties' positions on compensation were:

Hearts - the FIFA DRC failed to explain how it calculated the award of £625,000, which sum was inadequate in any event; the maintenance of contractual stability through Section IV of the PSR is of paramount importance; the FIFA DRC should have considered Hearts' lost chance to agree to a transfer fee and Hearts' costs of purchasing a replacement; the residual value of the contract was just one element of the assessment of compensation; Webster deliberately engineered the situation to secure a personal financial gain at Hearts' expense, constituting an aggravating factor affecting the assessment of compensation; and Hearts should be compensated over £4m (being the estimated market value of Webster).

Wigan and Webster - the FIFA DRC's decision was flawed in failing to give reasons for its findings; Hearts contributed to the breach by treating Webster unfairly; compensation was not appropriately calculated and should be reduced; Wigan was not guilty of wrongdoing and should not be jointly and severally liable; the interests of contractual stability are preserved by the Protected Period and compensation awarded for a termination outside the Protected Period should not restrict the player's right of freedom of movement in the EU by being punitive in nature; and it is inappropriate to consider the replacement costs of acquiring a new player and/or the loss of a chance of receiving a transfer fee in calculating compensation under Article 17 PSR.

The Decision

Merits of the Appeals: Article 13.4 of the FIFA Rules Governing the Procedures of the Players' Status Committee and the DRC ("the FIFA Rules") provides that decisions of the DRC must contain reasons for its findings. The CAS Panel found that the DRC had failed to meet the requirements of Article 13.4 of the FIFA Rules since there was no indication of the method or figures used by the DRC to get to £625,000. The CAS Panel would thus render its own substitute decision.

Compensation: The parties agreed at the hearing before the CAS Panel that the residual value of Webster's contract remaining after termination was £150,000. The CAS Panel found no sufficient evidence that either party had ill intentions or misbehaved to engineer the situation and thus no aggravating factors were present. Having done so, and since it did not have to consider the point, the CAS Panel left open the question of whether the concepts of aggravating factors or contributory negligence are legally relevant or applicable to the calculation of compensation under Article 17 PSR.

The CAS Panel found that "specificity of sport" (under Article 17 PSR) refers to finding solutions for the football world which allow a reasonable balance between the needs of contractual stability and the needs of free movement of players. PSR Article 17's reference to "other criteria" for determining compensation leaves a discretion to the deciding authority to account for the individual circumstances of each case. The CAS Panel deemed that, in seeking to balance the interests of clubs and players for the good of the game, the system of compensation provided by Article 17 PSR must be interpreted and applied in a manner which avoids favouring clubs over players and vice versa. The Panel considered that the football club's need for contractual stability is specifically addressed by the Protected Period and the severe sanctions (i.e., lengthy bans and high levels of compensation) that can be imposed in cases of disrespect for the Protected Period. The clubs' interests are further protected by Article 16 PSR, which prohibits unilateral termination during the course of a season.

Hearts' claim for £4m (reflecting a lost profit or replacement cost) was not taken into consideration by the CAS Panel because such form of compensation was not agreed upon contractually and to impose it by regulation would be punitive on the player and enrich the club. The CAS Panel found there to be no economic, moral or legal justification for a club to be able to claim the market value of a player as lost profit. The CAS Panel felt that, in light of the potentially high amounts of compensation that could be involved, giving clubs a regulatory right to the market value of players and allowing lost profits to be claimed in such a manner would bring the transfer system partially back to the pre-Bosman days when players' freedom of movement could be hindered by transfer fees.

Since the parties had agreed that the residual value of Webster's contract after termination was £150,000, that would be the amount due to Hearts as full compensation under Article 17 PSR for the termination of his contract. The Panel additionally found that Article 17(2) PSR (stating that the player and his new club shall be jointly and severally liable for payment of compensation) is a form of strict liability aimed at avoiding any difficulties of proving the involvement of a new club in a player's decision to terminate his former contract and to better guarantee payment to the former club.

The key elements of Article 17 are:

- the party in breach must pay compensation;
- compensation is calculated with due consideration for the law of the country concerned, the specificity of sport and other objective criteria (such as remuneration/benefits due to player under an existing and/or new contract; the time remaining on the contract; any fees and expenses incurred by the former club; and whether the contractual breach falls within a "Protected Period");
- a Protected Period is: 3 years from the effective date of the contract (if player is under 28 as at the date of contract); or 2 years from the effective date of the contract (if player is over 28 as at the date of contract);
- where a player is required to pay compensation, the player and his new club are jointly and severally liable;
- sporting sanctions (i.e. bans from playing or registering players) may be imposed on: any player in breach of contract during a Protected Period; and/ or on any club found to be in breach of contract or found to be inducing a breach of contract.

Implications of the CAS's decision

The decision has attracted both criticism and praise; criticism from clubs and regulatory bodies and praise from players and their representatives. The balance of power, previously with the clubs pre-Bosman, has been gradually shifting towards players, and it seems that the Webster decision is another step in that direction.

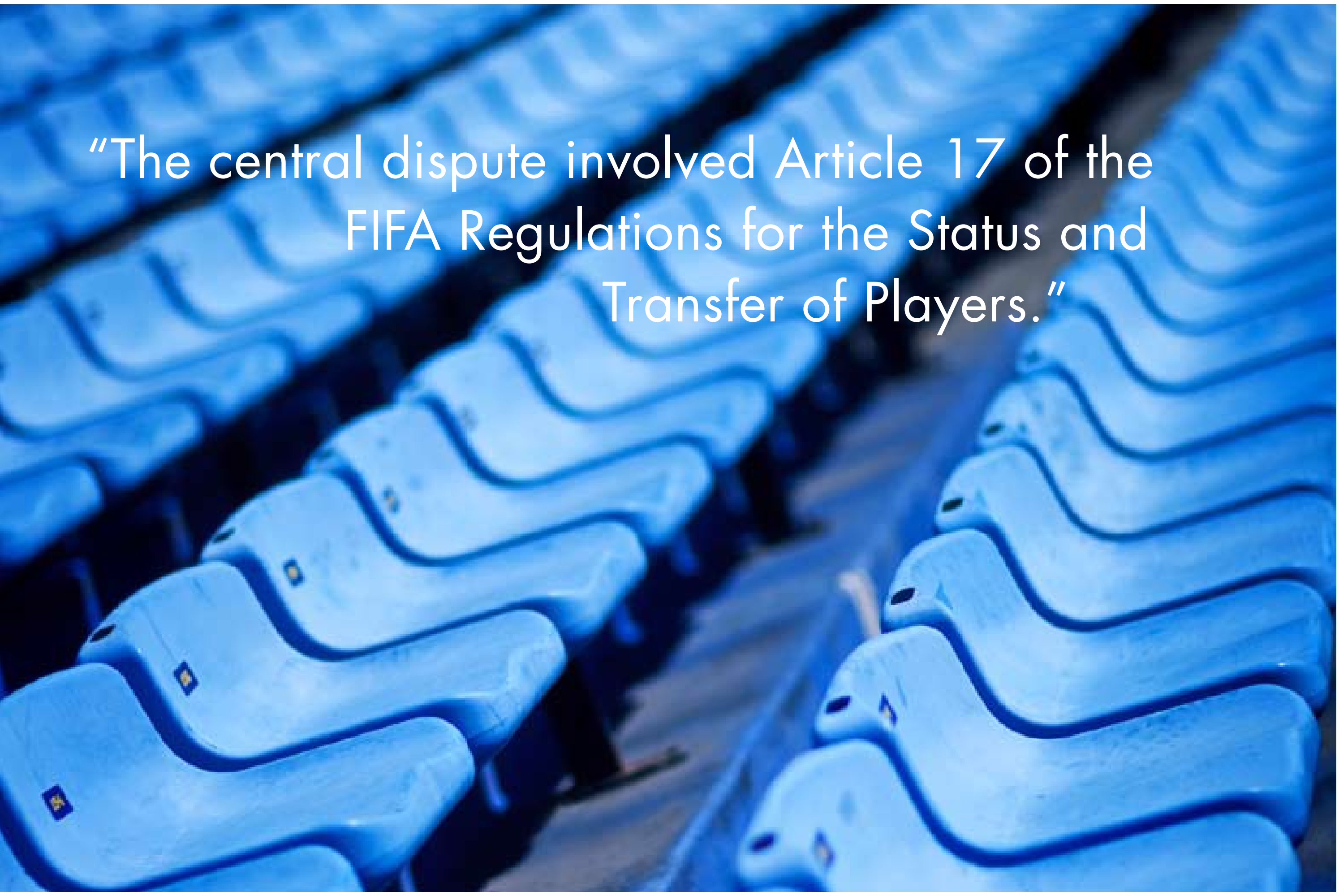
FIFA were "dismayed with the CAS decision". FIFA President Joseph S. Blatter commented "the decision which CAS took on 30 January 2008 is very damaging for football and a Pyrrhic victory for those players and their agents, who toy with the idea of rescinding contracts before they have been fulfilled … CAS did not properly take into consideration the specificity of sport as required by Art.17(1) of the Regulations on the Status and Transfer of Players. Because of this unfortunate decision, the principle of contractual stability, as agreed in 2001 with the European Commission as part of the new transfer regulations and which restored order to the transfer system, has been deemed less important than the short-term interests of the player involved. " FIFA's concerns have been echoed by Premiership managers who consider the application of the so-called "Webster Clause" likely to cause player salary inflation and add instability and uncertainty as players move earlier and quicker. Clubs with a focus on youth-team development feel the ruling could be detrimental as players are trained and educated but leave freely or cheaply when mature.

On the other hand, players' representatives have welcomed the decision which is seen to further promote the freedom of employment for footballers. FIFPro, the international professional footballers association, supported Webster and commented that, "this decision is perfectly in line with FIFA Regulations and the FIFA-EU Agreement. It respects labour law as well as the specific nature of sport. It is a further normalisation in the relationship between a professional player and a club. From now on, the market is more transparent and all parties will know where they stand at the end of a protected period".

Objectively, it would appear to be a reasoned legal decision: interpreting the relevant regulations in accordance with the applicable law and taking into account the stipulated criteria in an attempt to balance interests within the sport. It protects the rights of players to move freely in their employment. It brings footballers' contractual rights more in line with standard employment contracts. It could have the effect of reducing player transfer fees by formalising the method of calculation and bringing about certainty and predictability in the cost of footballers. However, the more sceptical (and perhaps those with a vested interest in the business of football) might wonder whether the balance of power is shifting too far in the direction of the players. The aftermath of Bosman has seen top players get richer and smaller clubs get poorer as money appears to go into players' pockets rather than back into the game. Whilst on paper, the decision might be correct legally, is it good news for a sport which has seen allegations of corruption, particularly involving players' agents, as more and more money becomes available to the players?

Clubs may begin to enter shorter-term player contracts (to coincide with the Protected Period) so that players and other clubs are sufficiently deterred from breaching the existing playing contract by sanctions. This may lead to frequent contract negotiations and players' agents using the threat of the end of a Protected Period as a bargaining tool for higher wages. Higher wages could, in turn, provide a greater deterrent to players from breaching their contracts if the compensation they will have to pay will be a multiple of their annual remuneration package (depending on how long there is to run on the contract). Such a scenario would point towards an upward pressure on player salaries and the diversion of money out of the game. Alternatively, Clubs may need to be careful in the drafting of player contracts to prepare for the possibility of players buying out their longer-term contracts after the Protected Period. In an age of increasing player power, it remains to be seen whether clubs will be able to negotiate and enforce satisfactory terms. Such changes may serve to erode the contractual stability that Article 17 PSR was intended to create.

Andrew Webster was the first footballer to trigger an assessment of compensation under Article 17 PSR, and it is widely anticipated that further cases may follow. If they do, it will be interesting to see whether CAS' method of calculating the compensation is followed in the DRC and, if not, whether appeals flow through to CAS. This further intervention of the law into the football transfer market continues to make both the market and the CAS an interesting ground for sporting disputes and their resolution through arbitral panels. ■



U.S. Supreme Court Rejects Expanded Judicial Review Options Under Federal Arbitration Act

By: Jeremy A. Mercer, Pittsburgh

In its March 25, 2008 decision in *Hall Street Assocs., L.L.C. v. Mattel, Inc.*, the U.S. Supreme Court held to a literal reading of the Federal Arbitration Act ("FAA") when faced with a question as to whether parties to an arbitration agreement can supplement the statutory grounds for court review and vacatur or modification of an arbitration award. According to the Supreme Court, sections 10 and 11 of the FAA provide the exclusive means for modifying or vacating an arbitral award under the FAA.

Factual Background

Hall Street had sued Mattel in connection with a lease, claiming that Mattel, the tenant, was required to indemnify Hall Street, the landlord, for certain environmental cleanup costs and seeking to prevent Mattel from vacating the premises on the date Mattel had given. During the litigation in federal court in Oregon, the parties agreed to submit the issue of indemnification to an arbitrator. The District Court agreed and entered an Order submitting the issue to arbitration and providing the following as to the Court's review of any arbitral award:

> "[t]he United States District Court for the District of Oregon may enter judgment upon any award, either by confirming the award or by vacating, modifying or correcting the award. The court shall vacate, modify or correct any award: (i) where the arbitrator's findings of fact are not supported by substantial evidence, or (ii) where the arbitrator's conclusions of law are erroneous."

The arbitrator found for Mattel, but the District Court, invoking the standard of review cited above, concluded the arbitrator had made an error of law and remanded to the arbitrator, who then found for Hall Street. After another round in the District Court, which resulted in only a minor modification of the awarded interest, both parties appealed to the Court of Appeals for the Ninth Circuit.

Previously, in *LaPine Tech. Corp. v. Kyocera Corp. (1997)*, the Ninth Circuit had held that the FAA did not establish the exclusive means for modifying or vacating an arbitral award but that the parties were free to establish alternative standards of judicial review. However, the Ninth Circuit had then overruled that decision and concluded that parties were not free to establish alternative standards for judicial review; and the FAA standards could not be expanded (*Kyocera Corp. v. Prudential-Bache Trade Servs., Inc. (2003)*).

On the basis of its 2003 Kyocera Corp. decision, the Court of Appeals in Hall Street reversed the District Court's decision and remanded, instructing the District Court to confirm the arbitrator's decision unless the FAA's provisions permitting modification or vacatur were applicable. The District Court did just that, finding the decision exceeded the arbitrator's powers (because it rested on an implausible interpretation of the lease). On appeal again, the Ninth Circuit again reversed the District Court, finding implausibility of interpretation not to be a basis for invocation of any of the FAA's provisions. Hall Street then appealed to the Supreme Court.

The Supreme Court's Decision

The Supreme Court began by looking at the history of the FAA and the reason for its enactment, noting that "Congress enacted the FAA to replace judicial indisposition to arbitration with a 'national policy favoring [it] and plac[ing] arbitration agreements on equal footing with all other contracts.'" And while the FAA does not create federal jurisdiction, when a case falls within a court's jurisdiction, the FAA ensures that the agreement to arbitrate is enforceable. In those cases under the FAA, a court is required to "confirm" an arbitration award unless the award is vacated, modified, or corrected as "prescribed" in Sections 10 and 11 of the FAA. Despite this language, the various Courts of Appeal across the U.S. had reached differing conclusions as to whether the parties could expand the judicial review options – two courts concluding that parties could not, five courts concluding that parties could, and one court expressing an opinion, in dicta, that parties could not. The Supreme Court took this opportunity to resolve the Circuit split.

Expanded judicial review options are not judicially accepted

Hall Street's first argument was that the Supreme Court's own precedent accepted or permitted the parties to expand judicial review. Citing *Wilko v. Swan (1953)*, Hall Street argued that the Supreme Court had extended judicial review by concluding that arbitration awards could be modified or vacated on the basis of "manifest disregard of the law", a ground not set out in the FAA.

The Supreme Court swept this argument aside on several grounds. First, it had overruled Wilko in 1989. Second, there was a difference between judicial "expansion" of the FAA and an expansion of the statute by the parties to a contract. Third, the Court, in a bit of possible judicial legerdemain, explained that the Wilko "manifest disregard of the law" standard may have been nothing more than a shorthand reference to the grounds for vacatur in Section 10 of the FAA.

The Court did not take the opportunity to actually explain the Wilko language or overrule it. Instead, it merely concluded that it could not attach the significance to the Wilko "manifest disregard of the law" language that Hall Street sought.

Enforcement of the parties' agreement cannot require an expansion of judicial review options

The Court then turned to Hall Street's second argument on appeal, that because arbitration agreements are contracts and the FAA is motivated by a desire to enforce agreements to arbitrate, the parties should be free to agree to an expansion of the judicial review options.

Again, the Court dismissed this argument. Recognizing that the FAA permits the parties some freedom over the structuring of the arbitration process, the Court concluded that the text of the statute left no such freedom in respect of judicial review and enforcement. The text of the statute overrode any amorphous policy argument.

To reach that conclusion, the Court looked at the terms used in Sections 10 and 11 of the FAA defining the grounds that permit a court to vacate or modify an arbitral award. Both sections "address egregious departures from the parties' agreed-upon arbitration: 'corruption,' 'fraud,' 'evident partiality,' 'misconduct,' 'misbehavior,' 'exceed[ing] . . . powers,' 'evident material miscalculation,' 'evident material mistake,' [and] 'award[s] upon a matter not submitted.'" Applying the canon of construction "ejusdem generis," the Court concluded that a mistake of law did not fit easily with the statutorily listed examples of "extreme arbitral conduct" permitting the vacatur or modification of an arbitral award.

The Court found that an expansion of judicial review options would "rub too much against the grain" of the mandatory language in Section 9 of the FAA which requires a court to confirm an arbitral award unless Sections 10 or 11 prescribe otherwise.

Literal reading of the FAA is required, whatever the consequences

The Court warned that any interpretation of the FAA that fights the actual text would lead to arbitration becoming a mere dress rehearsal for the judicial review process:

Instead of fighting the text, it makes more sense to see the three provisions, paragraphs 9-11, as substantiating a national policy favoring arbitration with just the limited review needed to maintain arbitration's essential virtue of resolving disputes straightaway. Any other reading opens the door to the full-bore legal and evidentiary appeals that can 'rende[r] informal arbitration merely a prelude to a more cumbersome and time-consuming judicial review process' … and bring arbitration theory to grief in post-arbitration process.

The Court noted that each party to the appeal and their respective amici predicted that a decision adverse to that party would result in either a flight away from arbitration or a flight from the courts. Admitting it did not know which side was correct, the Court concluded that such a consideration could not sway it from the strict literal reading of the FAA. "But whatever the consequences of our holding, the statutory text gives us no business to expand the statutory grounds."

Alternative Ways to Achieve Expanded Judicial Review?

The Court opined that there may be non-FAA authority to permit a more expansive judicial review of arbitral decisions. Possible other grounds for an expanded judicial review include state statutory law, state common law, contracts that do not involve "commerce," and, as in this case, a federal court's inherent authority to manage its cases under the Federal Rules of Civil Procedure.

The Court did not explain how this latter ground could ever be relied upon given the Court's imposition of the FAA on a court order that apparently was entered as a means of docket management.

Implications for Arbitration in the U.S.

This decision has significant implications for U.S.-seated arbitrations. Anyone engaged in commerce within the United States and desiring to include an arbitration provision requiring U.S.-based arbitration should be aware that judicial review of the arbitral award is limited to the scope of review provided in the FAA.

While some questions were left unanswered by the Court, what is clear from this decision is that if a party to a commercial contract desires a more expansive judicial review than that provided by the FAA, that party should either (i) provide for the desired review in a non-judicial or arbitral setting or (ii) provide for arbitration in a non-U.S. jurisdiction. ■

Forthcoming Events

On 10 September 2008, K&L Gates and co-sponsor Navigant will be holding an all-day conference entitled "International Arbitration: Managing Risk in High Growth/High Risk Markets". This conference, to be held at the New York Marriott East Side, will draw together arbitrators, in-house counsel, and representatives of the main arbitral institutions for discussions on risk management for parties doing business in emerging markets, current issues in investor-state arbitration, and practical ways of reducing costs and delay in arbitration.

The conference will also be broadcast by live webcast. To register for the conference or webcast, please email kathie.lowe@klgates.com.

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