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"Floating" Choice-of-Law Clauses and Their Enforceability

I. Background

Choice-of-law clauses in international agreements generally rely for their enforceability on the principle of party autonomy. In a standard choice-of-law clause parties provide for a single legal system to govern their contract. Choice-of-law clauses in loan agreements between Mexican borrowers and U.S. lenders, however, often provide that loan agreements shall be governed by the laws of a specified U.S. jurisdiction unless the lender brings a suit in a Mexican court, in which event they shall be governed by Mexican law.[1] Because the question of the enforceability of choice-of-law clauses of this type has never been addressed by the United States courts, some U.S. lawyers express doubts as to the legal effect of these provisions.

As a general rule, party autonomy with regard to the choice-of-law governing contracts is recognized in U.S. jurisprudence. This autonomy is subject to two major limitations: (1) the chosen law must bear some relationship to the parties or to the transaction; (2) the chosen law must not offend any of the fundamental policies of the forum or of the state which would otherwise be applicable.[2] In the case of Mexican contracts there can be no doubt that both the law of Mexico and the law of the U.S. jurisdiction chosen by the parties are significantly related to the parties and to the transaction. It appears also that no question of fundamental public policy would be involved. Consequently, there should be

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1. Provisions of this kind are usually inserted into the contracts on the insistence of Mexican counsels of United States lenders. According to Mexican lawyers, such provisions significantly facilitate potential future litigation in Mexico.

2. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAW § 187; UNIFORM COMMERCIAL CODE § 105 (1977).

no legal impediment to the enforcement by a U.S. court of the choice-of-law provisions used in loan agreements with Mexican borrowers.

II. The *Armar*

The issue of the validity of a choice-of-law clause similar to that used in loan agreements with Mexican borrowers has been recently analyzed in a series of English decisions starting with the case of *Armar Shipping Co., Ltd. v. Caisse Algerienne d'Assurance et Reassurance*.[3] In this case the plaintiffs, Cypriot ship owners, had chartered a vessel to a Cuban company. The charter party provided for arbitration in London, and the general average would be settled and adjusted in London according to York-Antwerp Rules, 1950.[4]

Under the charter party, a cargo of sugar was shipped from Cuba to Spain and Algeria. The bills of lading did not incorporate the charter party terms. During the voyage, the vessel grounded off the coast of Spain. Before the cargo destined for Algeria was delivered, a Lloyd average bond was signed by the master of the vessel on behalf of the plaintiffs.

The plaintiffs brought action against the cargo owners for contribution alleging that they had incurred sacrifices and expenditures of general average. Clause 10 of the bills of lading provided that:

> general average shall be adjusted, stated and settled according to York-Antwerp Rules 1950, except the rule XXII thereof, at such port or place as may be selected by the carrier. Matters not provided for by these rules to be adjusted, stated and settled according to the laws and usages at such port or place as may be selected by the carrier.

Similarly to the choice-of-law clause used in loan agreements with Mexican borrowers, the governing law in *Armar* depended upon the choice of the forum by one of the parties. The English court refused to give effect to this clause. According to the court, the governing law of the bond was "floating" and became "fixed" only at the moment the place of adjustment had been selected:

> If . . . at the time when the contract was made, the question remained undecided whether the average adjustment was to be in England or in the United States or in Germany or somewhere else, the fact that it was subsequently decided by one of the parties that the venue should be England cannot be a relevant factor in the ascertainment of the proper law at an earlier date. As a matter of legal logic, I find insuperable difficulty in seeing by what system of

3. [1980] 2 Lloyd's Rep. 450.

4. *See* International Maritime Committee, Bulletin No. 104 ("Amsterdam Conference 1949") (1951); for the text of the rules, see also 2 R. COLINVAUX, CARRIER'S CARRIAGE BY SEA, app. at 1275 (T. Carver 12th ed. 1971); and R. LOWNDES, THE LAW OF GENERAL AVERAGE, at appendix (1964).

law one is to decide what, if any, is the legal effect of an event which occurs when a contract is already in existence with no proper law: but, instead, with a "floating" non-law.

But in my opinion the difficulty goes beyond mere technicality or legal logic. Under the terms of this Lloyd's average bond contract, things had to be done by the parties forthwith and disputes under the contract might well, as a matter of commercial reality, arise forthwith. . . . It cannot be that the contract has to be treated as being anarchic: as having no governing law which the court . . . would apply in deciding the dispute. There must be a governing law from the outset: not a floating absence of law, continuing to float until the carrier, unilaterally, makes a decision.

The governing law cannot fall to be decided, retrospectively, by reference to an event which was an uncertain event in the future at the time when obligations under the contract had already been undertaken, had fallen to be performed and had been performed.

III. After *Armar*

After the *Armar* decision, English courts were confronted with floating choice-of-law clauses in several other cases. In the first such case, *Black Clawson Int'l Ltd. v. Papierwerke Waldhof-Aschaffenburg A.G.*,[5] the court analyzed a sales contract containing the following clause:

> The arbitration . . . shall take place in Zurich and any question as to the construction or effect of this contract shall be decided according to the laws of England if the reference to arbitration shall have been made by the Purchasers and according to the laws of the Federal Republic of Germany if such reference shall have been made by the Sellers.

Clearly, the above quoted provision did not provide for a legal system governing the contract from the outset. Consequently, the clause came within the *Armar* doctrine. The court suggested, however, an alternative to striking the choice-of-law clause down as repugnant to *Armar*. According to the court, it could be assumed that a "provisional proper law, liable to be changed retrospectively when a claim is made" existed.

Unfortunately, the court did not elaborate on that point, and, in particular, did not indicate how such "provisional proper law" should be determined. One might theorize that until the law governing the contract is determined pursuant to the choice-of-law clause, the contract is governed by the law most closely related to the contractual relationship. The significance of the *Black Clawson* court's pronouncement on that point is diminished by the fact that its analysis of the *Armar* problem was only dictum.

The cases decided after *Black Clawson* returned to the *Armar* doctrine and did not consider the alternative suggested by the *Black Clawson* court.

5. [1981] 2 Lloyd's Rep. 446.

Thus, a choice-of-law clause in a bill of lading providing that the proper law would be, at the option of the carrier, either Iranian law, or German law, or English law, was struck down in *Dubai Electricity Co. v. Islamic Republic of Iran Shipping Lines (The "Iran Voidan")*.[6] *The Iran Voidan* court strongly reaffirmed the validity of the *Armar* doctrine:

> The proper law is something so fundamental to questions relating to the formation, validity, interpretation and performance of a contract that it must, in my judgment, be built into the fabric of the contract from the start and cannot float in an indeterminate way until finally determined at the option of one party.

In yet another case involving a floating choice-of-law clause, *Cantieri Navali Riuniti SpA v. NV Omne Justitia (The Stolt Marmaro)*, the insurance contract conferred on the assured an option to decide whether the insurance policy would be governed by the law of New York.[7] In analyzing this provision, the court observed that the option to choose the application of New York law was conferred on one party only. In *dictum*, the court expressed the view that such a contractual provision may not be effective under English law.

Despite the fact that none of the cases decided after *Black Clawson* referred to the alternative approach to the floating choice-of-law problem suggested in that case, it could be argued that this alternative has not been abandoned or forgotten. The choice-of-law clauses in *Armar, The Iran Voidan* and *The Stolt Marmaro* were similar in that each granted a power to choose the governing law to one party only. In *Black Clawson*, on the other hand, the applicable law could have been determined by either of the parties. Under the *Armar* rationale, such a factual distinction should be of no importance since in all the cases, including *Black Clawson*, there was no single legal system governing the legal relationship between the parties prior to litigation or arbitration. Nevertheless, it remains to be seen whether in the future English courts would narrow the application of the *Armar* doctrine and reach for the *Black Clawson* alternative.

IV. Saving Clauses

Another important issue raised by *Armar* and its progeny concerns the use of so-called "saving clauses" in a choice-of-law provision. An example of such a clause can be found in the bill of lading involved in *Astro Venturoso Compania Naviera v. Hellenic Shipyards S.A. (The "Mariannina")*.[8] After stipulating the application of English arbitration law, the contract provided:

6. [1984] 2 Lloyd's Rep. 380.
7. [1985] 2 Lloyd's Rep. 428.
8. [1983] 1 Lloyd's Rep. 12.

> [B]ut if for any reason it is ruled by a competent authority that the . . . arbitration provision is unenforceable then any claim and/or dispute . . . shall be governed by Greek Law and solely decided by the competent Greek Courts of Piraeus where the Carrier has his principal place of business and to which both parties . . . submit themselves, to the exclusion of the jurisdiction of any [other] competent Court.

The appellants argued that because the law governing the contract would change at the time the choice of English arbitration law was refused recognition by a court, the choice-of-law clause in the bill of lading was of a floating character, and as such invalid under the *Armar* doctrine.

The court, however, found the *Armar* decision to be inapplicable, commenting:

> I accept that it is unusual for a clause to provide expressly or by implication for two proper laws—one to be applied in one event and another to be applied if that event is negativated, but I cannot see why there cannot be sound commercial sense in a fall-back provision of the kind which this clause seems to represent.

There are clear differences between the choice-of-law clause in *The Mariannina* and the choice-of-law clauses in the cases discussed above. For example, it is significant that in *The Mariannina* the law governing the contract was fixed from the outset and remained certain until the occurrence of an event unrelated to the actions of the parties. Still, if such event occurred the law governing the contract would change. However, since it was the lack of a single legal system governing the contract prior to litigation that was the keystone in the *Armar* rationale, *The Mariannina* cannot be viewed as an important modification of the *Armar* doctrine.

The next step in the analysis of the saving clauses in this context deals with the enforceability of a saving clause in a floating choice-of-law provision. The argument that such clause is valid and enforceable was advanced in *The Iran Voidan*. There, the floating choice-of law clause was accompanied by the following provision:

> In case the law of the country in which a suit is filed does not recognize this agreement . . . on the exclusive application of Iranian, German or English law respectively, then the Hague rules enacted in that country shall apply or, if no such enactment is enforced in that country, the terms of said Convention shall compulsorily apply.

The court decided that it was not necessary for it to pass on the validity of the above-quoted provision. The judge writing the opinion expressed his doubts, however, as to the viability of any argument based on it. In light of the earlier reaffirmations of the *Armar* doctrine by the *The Iran Voidan* court this view is not surprising. The existence of a saving clause does not cure any of the defects found by the *Armar* court in floating choice-of-law clauses. In particular, since its operation begins only after

the commencement of litigation, a saving clause does not contribute to the certainty of the law governing the contract at the time prior to litigation.

V. Should the *Armar* Decision Be Followed by the U.S. Courts?

In anticipation of the "floating" choice-of-law issue arising in the U.S. courts, one should analyze the reasons which led the English judges to the rejection of the "floating" choice-of-law clause. The main concern of the English judges was that until the moment the action was instituted, and the forum was selected by the plaintiff, the contract was "anarchic," meaning that there was no law governing the contract until this point. The same situation exists, however, when parties stipulate that the choice of the governing law will be made at a point of time later than the time of contracting. For example, parties quite frequently stipulate for governing law during the course of the proceedings.

The question of whether the parties should be allowed to change applicable law during the proceedings was discussed in the Swiss case, *Kunzle v. Bayrische Hypotheken und Wechselbank*.[9] This case involved an international commercial contract which contained no stipulation of applicable law. The plaintiff relied on Swiss law while indicating the possibility that German law might also be applicable. The defendant stated that it had no objections to the application of Swiss law. The Swiss court concluded that a subsequent choice of law, i.e., in this case during the proceedings was possible:

> If the choice of law thus results from a specific selecting process, there is no reason why it could not be made after the event [i.e., the making of the contract], namely for the first time during the proceedings. The principle of contractual freedom is applicable to the selecting agreement because of its contractual nature. From which it follows that the parties are permitted to change its content in the future by substituting for the legal system originally chosen another system which is relevant under the circumstances, and this possibly with retrospective effect, to the extent that the principal contract has not yet . . . been performed.
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> If it is possible for the parties to pass from one selected legal system to another, it must be permissible also, by means of a subsequent agreement, to change the system of law which would be applicable in the absence of a choice. . . . So much the more since, on the basis of experience [it is a fact that] the parties do not usually consider the choice-of-law issue. Rather this issue arises at some later time when difficulties occur in the implementation of the contract. If at that time the parties agree upon the applicable legal system, in a situation of private international law, there is no cogent reason to advance against such a [selecting] process.

9. Swiss Federal Tribunal (TF.), August 31, 1953; R.O. 79 II. 295, J.D. 1954, I, 528.

Many countries authorize the parties to select the law applicable to their relationship after the making of the contract.[10]

Also, it is quite frequent that international contracts do not contain provisions governing the question of the applicable law. It would not seem accurate to conclude that all these contracts are "anarchic," and not governed by any legal system. Should a dispute regarding the interpretation or construction of such contract arise, the parties would, in the first instance, attempt to resolve it by negotiation. At this stage, they would not need to rely on any particular legal system. When the dispute could not be resolved in such a manner, one of the parties would then resort to litigation. The judge would decide, by using the applicable conflict of laws rules, which legal system governed the contract. Such a decision would in effect, have a retroactive effect and relates back to the time of contracting. By the same token, when the parties stipulated in their agreement that the applicable law would be determined at the time the lawsuit was instituted the determination of the applicable law then must be deemed to have a retroactive effect as well. Consequently, in determining whether a contract is "anarchic" or not, there appears to be no difference between the situation when the parties fail to provide for the governing law and the situation when the governing law is determined by the parties (or one of them) at the time the legal action is brought.

There is another reason why the reasoning of the *Armar* court should not be followed by U.S. courts in actions involving the typical choice-of-law provision used in loan agreements with Mexican borrowers: choice-of-law provisions in such agreements differ substantially from the choice-of-law clause involved in the *Armar* case.

In *Armar*, the carrier was not limited, in any way, in its choice of forum and, consequently, the applicable law. The choice-of-law provisions in loan agreements with Mexican borrowers, on the other hand, provide for the application of one of two specified legal systems only. Moreover, under such loan agreements, the law of a U.S. jurisdiction constitutes a "residual" category. In other words, Mexican law would apply in one situation only, i.e., when the lender decides to sue in Mexico. In all other cases, the law of a U.S. jurisdiction governs. Thus, no legal vacuum exists here as it did in the English cases discussed above. Until the forum has been selected, the loan agreement is governed by the law of the indicated U.S. jurisdiction. To be sure, the law which governs the agreement still "floats" since it will change when a Mexican forum is chosen by the lender. The sea on which it can float is far smaller, however, then the ocean on which the law governing the *Armar's* bill of lading was adrift.

10. *See, e.g.*, G. R. DELAUME, APPLICABLE LAW ON SETTLEMENT OF DISPUTES—LAW AND PRACTICE, Booklet 8, at 15 (1983).

The *Armar* decision should also be read in conjunction with the English Rules of the Supreme Court, Order 11, which authorizes English courts to assume jurisdiction when a contract is governed by English law. Thus, the resolution of the question of whether English law governed the contract in *Armar* also controlled the question of whether an English court had jurisdiction over the case. On the other hand, should an action on a loan agreement with a Mexican borrower be instituted in a U.S. court, the jurisdiction of that court would not depend upon the validity of the choice-of-law clause.

Finally, it should be noted that the English court in *Armar* did not have an independent basis for the application of English law. Having refused to give effect to the choice-of-law clause, the court concluded that:

> Nothing else, in the facts and circumstances of the present case appears to be sufficient [to make English law the governing law of the contract], or to make the English system of law the system with which this transaction has the closest and most real connection.[11]

In an action on a loan agreement with a Mexican borrower, a U.S. court would face a completely different situation. If the U.S. law chosen by the parties was that of a jurisdiction which was the domicile of the lender, where the payment was to be made, or where the negotiations between the parties took place, such jurisdiction would have enough contacts with that transaction to justify the application of its law even if the court were to refuse to enforce the choice-of-law provision in the agreement.[12]

VI. International Contracts in U.S. Courts

Some support for the expectation that a U.S. court would not refuse to enforce the choice-of-law provision of the type typically used in loan agreements with Mexican borrowers can be found in the language of the U.S. Supreme Court in two leading cases in the field of international contracts, *Bremen v. Zapata Off-Shore Co.*[13] and *Scherk v. Alberto Culver Co.*[14]

The *Bremen* case dealt with the issue of whether the forum selection clause providing for the adjudication in London of any dispute between a U.S. party and a foreign party could be enforced by a U.S. court. Although the case did not involve a choice-of-law issue, the opinion con-

11. *Supra* note 3, at 505.
12. Cf. Allied Bank Int'l v. Banco Credito Agricola de Cartago, 757 F.2d 516, 521 (2d Cir. 1985).
13. 407 U.S. 1 (1972).
14. 417 U.S. 506 (1974).

tains some general language indicating the attitude of the U.S. Supreme Court toward international contracts:

> For at least two decades we have witnessed an expansion of overseas commercial activities for business enterprises based in the United States. The barrier of distance that once tended to confine a business concern to a modest territory no longer does so. Here we see an American company with special expertise contracting with a foreign company. . . . The expansion of American business and industry will hardly be encouraged if, notwithstanding solemn contracts, we insist on the parochial concept that all disputes must be resolved under our laws and our courts.[15]

This language was quoted with approval by the Supreme Court two years later in *Scherk v. Alberto-Culver Co.*[16]

Both *Bremen* and *Scherk* indicate the Supreme Court's willingness to take into consideration the interests of the United States business community while passing on issues relating to international contracts. The quoted language tends to suggest that the Supreme Court would be willing to enforce the reasonable measures that encourage and propagate trade and commerce between U.S. and foreign companies. The choice-of-law clause used in foreign loan agreements with Mexican borrowers aims at maximizing the possibility of U.S. lenders having their loan agreements enforced. The last decision in the *Allied Bank* case[17] by the Second Circuit Court of Appeals indicates that at least some U.S. courts are willing to take this consideration into account when passing on issues related to contracts with foreign debtors.

15. *Supra* note 13 at 8–9.

16. *Supra* note 14, at 519. The principles of *Bremen* were most recently reaffirmed by the Supreme Court in Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 87 L. Ed. 2d 244 (516).

17. *Supra* note 12.