

## Case Studies on the Application of PICC in International Commercial Arbitration\*

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### I. Introduction

In the past century, the modern *lex mercatoria* has had a resurrection from the business law of the Middle Ages (the *lex mercatoria*) with the spread of globalization. In international society, the modern *lex mercatoria* has played a more and more important role in international commercial practice by way of conventions and commercial customs.<sup>①</sup> Additionally, a new form of the *lex mercatoria*—restatement—has been promulgated. Business persons have realized that this modern *lex mercatoria* can govern their contracts and arbitration agreements. International tribunals and domestic courts have adopted the modern *lex mercatoria* to settle disputes in international commercial activities. The modern

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\* The author gratefully acknowledges generous financial support by the Research Project of the Ministry of Education of PRC; the Research Project of the Ministry of Justice of PRC; the Project of Science Foundation of Postdoctoral Research of PRC; Scholarship of the State Scholarship Fund of China; Scholarship of UNIDROIT. And the author also wishes to thank anonymous referees and Prof. Alber H. Kritzer for their enlightening suggestions.

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① In the broadest sense, commercial custom can include custom, usage and practices of the parties.

*lex mercatoria* has become especially popular in international commercial arbitration.

As the International Institute for the Unification of Private Law (hereafter UNIDROIT) states, the Principles of International Commercial Contracts (hereafter PICC, including the two editions of 1994 and 2004) is a body of international contract "restatement". According to the preamble to PICC and commercial practice, the main functions of PICC in international commercial arbitration include:

(a) PICC can be used to interpret or supplement international uniform legal documents (convention), especially the 1980 United Nations Convention on Contracts for the International Sale of Goods (hereafter CISG) (hereinafter function 1 of PICC).

(b) PICC can fill up the governing law of a contract or assist in the application of domestic governing law provisions to international transactions (as testified in commercial practice) (hereafter function 2 of PICC).

(c) PICC can be the governing law of a contract if the contract so states, or tribunals and courts can apply PICC based on conflict rules referring to application of law in arbitration and arbitration rules when there is no clear statement of the governing law in the contract<sup>①</sup> (hereafter function 3 of PICC).

<sup>①</sup> Moreover, PICC may serve as a model for national and international legislators and as teaching material. Additionally, the PICC can work as a guide for drafting contracts. In the ARB (AF)/98/1 (2000) case of International Centre for the Settlement of Investment Disputes (ICSID) — Joseph Charles Lemire v. Ukraine—A national company of the United States and the Government of the Ukraine entered into an investment agreement concerning the establishment by the former of broadcasting stations in the Ukraine. When a dispute arose as to the proper performance of the agreement, the parties submitted their dispute to the International Centre for the Settlement of Disputes (ICSID). After the commencement of the arbitral proceedings, the parties entered into negotiations with a view to settling their dispute, which they ultimately succeeded in doing. In their settlement agreement, which they requested the Arbitral Tribunal to record in form of an award, the parties, after having stated the terms of the settlement, added a separate section entitled "Principles of Interpretation and Implementation of the Agreement" containing provisions concerning the interpretation, validity and performance and non-performance of the settlement agreement. All the provisions of the section are taken literally, with a few minor adaptations, from the PICC, precisely, from Articles 1.7, 3.3 (1), 4.1, 4.2, 4.3, 4.5, 5.3, 5.4 (1) of PICC (1994 edition), [Arts. 5.1.3 and 5.1.4 (1) of PICC (2004 edition)], 6.2.1, 6.2.2, 6.2.3, 7.1.1, 7.1.4 and 7.1.5 (1)-(2)-(3), dealing with the principle of good faith and fair dealing in international trade, initial impossibility, the interpretation of contracts and unilateral statements, the duty to cooperate, the duty to achieve a certain result, hardship and its consequences, the definition of non-performance, the non-performing party's right to cure, and the setting of an additional period of time for performance, respectively. Further information about the case is contained in <http://www.unilex.info/dynasite.cfm?dssid=2377&dsmid=13621&x=1>, last visited on August 11, 2007.

Tribunals, courts, arbitrators and parties can make use of the above three functions of PICC to settle disputes in commercial practice in different meanings compared to other international legal documents, such as CISG. Considering its unique nature, the application of PICC in international commercial arbitration should be regarded as the application of modern *lex mercatoria* which is different from international conventions. Function 1 and function 2 of PICC do not belong to CISG and function 3 of PICC does not have equal power compared to CISG in commercial reality.

The practice of international commercial arbitration offers sufficient examples to demonstrate the new approach. Three approaches to applying PICC in international commercial arbitration will be analyzed:

—As interpreting and supplementing international uniform legal documents (convention) in the commercial field,

—As international interpretation of domestic law in commercial field, and

—As the governing law of international commercial contracts.

The author will then set forth concrete rules for the application of the PICC in international commercial arbitration.

## II. Definition of the Modern *Lex Mercatoria* and Its Three Resources: Conventions, Commercial Custom, and Restatement

In the article, the modern *lex mercatoria* (it also can be called the modern law merchant or modern business law)<sup>①</sup> means principles and rules widely accepted by persons undertaking international business transactions.

We learn from history that before the emergence of countries and the element of sovereignty in the modern sense, international trade relationships actually were dominated by a kind of business customary law with a self-controlling mechanism, rather than within the jurisdiction of the law of sovereign states.<sup>②</sup> This international business custom law, called the *lex mercatoria*, descended from the practice and usage of international traders in

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① In the article, the author uses three concepts with the same meaning.

② Medwig, *The New Merchant, Legal Rhetoric and Commercial Reality*, Law and Policy in International Business, 1993, Vol. 24, p. 590.

the Middle Ages of Europe.<sup>①</sup> Along with the significant changes in the political and economic systems of the countries of the world after the World War II, swift and violent developments took place in international business relationships, with the result that traditional domestic law has not been able to keep pace with the need for development in international commercial relationships, either in nature or in system. Such defects in domestic legal systems encouraged persons engaged in international trade to greatly desire a new legal system to regulate their legal relations. This gave birth to the modern *lex mercatoria*.<sup>②</sup>

Along with the sustaining development of international business law, we can find distinct appearance of the application of the business law in discussion. Scholars refer to the modern *lex mercatoria* in various terminologies: modern commercial law, the modern law merchant, the new business custom law, international trade law, international business law, modern law for business, international contract law, or transnational law, etc., in order to differentiate it from the *lex mercatoria* of the Middle Age.

Philip C. Jessup, Professor at Colombia University (U. S.), proposed the conception of *transnational law* for the first time, explaining that it refers to all legal regulations of transnational trade and behavior, including international law and private international law, and that other rules cannot be included in those regulations.<sup>③</sup> While Professor Goode adopted the term *transnational commercial law* to emphasize the connection with business behavior, for the consideration that the concept of transnational law is so inclusive that it almost includes all the domestic law and domestic conflict rules in international trade.<sup>④</sup> He considered *transnational commercial law* as a form of law and an aggregation of the common spirits abstracted from several systems, but not a certain legal system made up of the legal regulations in any certain legal systems. In this article,

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① Clive M. Schmitthoff, *Commercial Law in a Changing Economic Climate*, 2nd edition, Sweet & Maxwell, 1981, pp. 23-24. Besides, on the issue of historical resources of the *lex mercatoria*, scholars do not have a uniform understanding. Generally speaking, there are two viewpoints: (a) The *lex mercatoria* come from trade customs, primarily those of ancient Rome. (b) The *lex mercatoria* was born in Middle Ages, as a product of the city culture and business culture of the Middle Ages.

② Zheng Yuanmin, *The Theory of the Modern Lex Mercatoria and Its Influence upon International Arbitration Law*, Journal of Hunan University (Social Sciences), Vol. 16, No. 6, 2002, p. 94.

③ Philip C. Jessup, *Transnational Law*, Yale University Press, 1956, p. 2.

④ Roy Goode, *Usage and Its Reception in Transnational Commercial Law*, International and Comparative Law Quarterly, Vol. 46, 1997, pp. 1-3.

the modern *lex mercatoria* refers to the principles and rules widely abided by persons undertaking international business transactions. ① Generally speaking, the main resources of the modern commercial law are international treaties, commercial custom and standard form contracts, etc. International treaties include CISG, the International Convention for the Unification of Certain Rules of Law Relating to Bills of Lading (hereafter 1924 Hague Rules), The Hague Rules as amended by the 1968 Brussels Protocol (hereafter 1968 Visby Rules), the United Nations Convention on the Carriage of Goods by Sea (hereafter 1978 Hamburg Rules). The most famous symbol of commercial custom is Incoterms 2000.

Within the scope of the modern *lex mercatoria*, some important conventions, e. g., CISG can play a more important role in international commercial arbitration than commercial custom in that the latter does not have formal legal status in international law and can not get a legal acceptance to govern contracts and arbitration agreements between parties.

Indeed, international treaties have strong legitimacy in international law and parties can choose them in contract and arbitration without concern. However, no treaties can get rid of the destiny of being a product of compromise after a game of national interests. Therefore, applying a convention can mean jumping into a pool with ambiguities, and tribunals and courts may find that they are confronted with a dilemma while they try to interpret the convention. Moreover, increasing focus on negation of the convention always results in failure in legislation technique, and hence the convention can not reflect the most advanced theories of contract law. Last but not least, as a product of compromise after a game of national interests, conventions can not be revised in time to keep up with the development of commercial reality. Hence, it is not surprising that conventions in the field of international commerce are not necessarily the most effective tool to resolve conflicts in international commercial practice.

On the other hand, commercial custom takes on a picture of mess and conflict each other. To avoid waste of time and money in negotiation of conventions and ambiguity of commercial custom, a so-called "third legal system" ② —international contract restatement containing developed theories and abundant commercial custom (it is referred

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① See Xu Guojian, *New Lex Mercatoria*, Social Sciences in China, Vol. 3, 1993, pp. 1-15.

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to as “restatement” in American Law—appeared. PICC has become a milestone restatement in modern *lex mercatoria*.

### III. The PICC as an Aid to Interpreting and Supplementing International Conventions

#### A. Whether PICC Has the Function of Interpreting and Supplementing CISG

The preamble to PICC calls attention to these Principles as an aid to interpreting and supplementing international uniform legal documents. Even in the absence of relevant provisions in contracts, this function of PICC can also be realized by tribunals and courts, and it makes special sense in the context of CISG, considering the consanguineous relationship between PICC and CISG. PICC can help the application of CISG by interpreting and supplementing the latter. ① Art. 7 of CISG provides that:

(a) In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade.

(b) Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law.

However, this function of PICC is not accepted by all scholars. PICC, as creativity and development of CISG and harmony of two legal families, reflects some new concepts and theories in contract law; it is different in scope of application, literal expression and structure compared to CISG. Some scholars hold the viewpoint that, CISG and PICC apply to different objects and adjust different legal issues, and thus the conclusion that PICC

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① Professor Michael Joachim Bonell made detailed illustrations on the issue. See Kritzer, General Observations on Use of the UNIDROIT Principles to Help Interpret the CISG, available at <http://cisgw3.law.pace.edu/cisg/text/matchup/general-observations.html>, last visited February 20, 2008.

interprets and supplements CISG can not be drawn.<sup>①</sup> These scholars are conservative, and ignore the fact that practice and theory of law must be renewed. From the perspective of change and development, we can see that ~~old-fashioned parts and ideas of CISG must~~ be renewed by the function of interpreting and supplementing PICC. In practice, PICC has become a good assistant to CISG step by step by interpreting and supplementing the latter.

### B. Interpreting CISG

PICC can help the interpreters of CISG to get a clearer result if CISG is the governing law of international commercial contracts. The PICC absorbed a series of advanced theories of contract law that can facilitate the interpretation of CISG. For instance, under Art. 7.3.1 of PICC (right to terminate the contract), an avoidance regime is similarly distinguished from termination based on fundamental nonperformance.<sup>②</sup> These somewhat clearer standards for judging whether a failure to perform an obligation amounts to fundamental nonperformance can help tribunals and courts understand in interpreting Art. 25 of CISG which is to some extent ambiguous. Similar circumstances apply to Art. 7.1.4 of PICC (cure by non-performing party) which provides that the non-performing party may, at its own expense, cure any nonperformance. As Bertram Keller noted in his editorial remarks on Art. 37 of CISG, the civil law tradition has been generally less familiar with the notion of a right to cure, and its inclusion in UNIDROIT does indeed "encourage the world wide acceptance of a general right to cure"<sup>③</sup>. At the same time, Art. 48 of CISG is in many ways an unremarkable article. The basic premise of the provision is simple—a seller can remedy any of its obligations even after the time of

<sup>①</sup> Whether PICC can become a good assistant to the CISG by interpreting and supplementing the latter remains a question. These questions can be found in John Felemegas (ed.), *An International Approach to the Interpretation of the United Nations Convention on Contracts for the International Sale of Goods (1980) as Uniform Sales Law*, Cambridge University Press, 2007. In the book, after discussion and analyses on many articles of PICC and CISG, many scholars thought that it was not convinced that PICC could interpret and supplement CISG. Of course, in the same book, many scholars are discommender.

<sup>②</sup> Robert Koch, *Commentary on Whether the UNIDROIT Principles of International Commercial Contracts May Be Used to Interpret or Supplement Articles 63 and 64 of the CISG*, available at <http://cisgw3.law.pace.edu/cisg/biblio/koch1.html>, last visited February 20, 2008.

<sup>③</sup> See B. Keller, *Editorial Remarks*, in guide to CISG Article 37, para. (b), available at <http://www.cisg.law.pace.edu/cisg/principles/uni37.html#er>, last visited February 20, 2008.

delivery provided that he does so without unreasonable delay or inconvenience to the buyer. Considering the complexity of cure by non-performing party, Art. 48 of CISG does not establish a widely accepted standard. Therefore, generally PICC can eliminate uncertainty on the issue under Art. 48 of CISG. ① Additionally, the intent of Art. 11 of CISG is reproduced in Art. 1.2 read in conjunction with Art. 3.2 of PICC. Thus, the Official Comments on Art. 1.2 and Art. 3.2 of the PICC support the interpretation of Art. 11 of CISG. In addition, Art. 2.12 and Art. 2.13 of the PICC assist the further interpretation of freedom of form under Art. 11 CISG. ②

### C. Supplementing CISG

PICC can fill the gaps in CISG. In practice, tribunals and courts always follow some reasoning rules that try to provide a certain answer after confirming a general principle. Quoting PICC can facilitate this work as long as related provisions of PICC indicate that they can form the basis of related provisions of CISG. Art. 75 of CISG and its counterpart, Art. 7.4.5 of PICC, apply to both contracting parties and consequently give a general guarantee of the proper performance of the contractual obligations of both the buyer and the seller under an international contract for the sale of goods. More importantly, both articles, along with the possibility for the innocent party to declare the contract avoided, stipulate an additional method of protection for the injured party by providing for the possibility to claim damages. ③ Therefore, this right might be executed only after avoidance of the contract is finally defined and the strict requirements outlined in Art. 75

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① However, considering there exist some important structural differences between PICC and CISG, whether PICC can eliminate uncertainty on the issue under Article 48 of CISG are worthy of further debate. See Christopher Kee, Remarks on the Manner in which the UNIDROIT Principles May Be Used to Interpret or Supplement Article 48 of the CISG, available at <http://cisgw3.law.pace.edu/cisg/biblio/kee1.html>, last visited on February 20, 2008.

② ~~Christa Niggemann, Remarks on the Manner in which the UNIDROIT Principles of International Commercial Contracts May Be Used to Interpret or Supplement Article 11 of the CISG, available at <http://cisgw3.law.pace.edu/cisg/biblio/niggemann.html>, last visited February 20, 2008.~~

③ See Jelena Vilus, Provisions Common to the Seller and the Buyer, available at <http://cisgw3.law.pace.edu/cisg/biblio/vilus.html>, last visited February 20, 2008.

of CISG and its counterpart Art. 7. 4. 5 of PICC are fulfilled. ①

In the practice, the Netherlands Arbitration Institute (*Nederlands Arbitrage Instituut* - NAI) interim award of 28 February 2005 provides an example of this issue. ② In the case, between 5 June 2002 and 25 March 2003, the Dutch seller and the Italian buyer entered into seven contracts for the sale of certain goods through confirmations of order followed by an invoice after delivery of the goods. The standard confirmation of order, which was sent in all cases both by fax and regular mail to the buyer, contained on the front page a reference to seller's General Conditions of Contract printed on the reverse. A reference to the General Conditions was also included on the invoice. The General Conditions of Contract provided for the application of Dutch law and arbitration of disputes in Rotterdam, The Netherlands, in accordance with the rules of the NAI. A dispute arose between the parties when the buyer refused to pay under the last three contracts (contracts No. 5, No. 6 and No. 7), alleging defects in the goods. NAI arbitration proceedings ensued before a sole arbitrator. The arbitrator first examined the law applicable to the disputed contracts. This question must be answered in accordance with the substantive law applicable to the contracts between the seller and the buyer (the contracts). In that respect the Arbitral Tribunal held:

"All the contracts, including the disputed contracts, are international contracts for the sale of goods. The parties are established in the Netherlands and Italy, which are both party to CISG. CISG applies to the contracts pursuant to Art. 1 (1) of CISG. According to Art. 22 of the EEC Convention on the Law Applicable to Contractual Obligations, [done at Rome on] 19 June 1980 (Pb EG 1980, L 266/1-19 Convention on Contracts) CISG

① Bojidara Borisova, Remarks on the Manner in which the UNIDROIT Principles May Be Used to Interpret or Supplement Article 75 of the CISG, available at <http://cisgw3.law.pace.edu/cisg/biblio/borisova1.html>, last visited February 20, 2008. Besides, the following case decisions can be proof about the issue: Austria 6 February 1996 Supreme Court, available at <http://cisgw3.law.pace.edu/cases/960206a3.html>; Russia 24 January 2000 Arbitration Proceeding 54/1999, available at <http://cisgw3.law.pace.edu/cases/000124r1.html>; Austria 9 March 2000 Supreme Court, available at <http://cisgw3.law.pace.edu/cases/000309a3.html>; Germany 6 April 2000 District Court München, available at <http://cisgw3.law.pace.edu/cases/000406g1.html>; Germany 13 January 1999 Appellate Court Bamberg, available at <http://cisgw3.law.pace.edu/cases/990113g1.html>.

② Available at <http://cisgw3.law.pace.edu/cases/050210n1.html>, last visited February 28, 2008.

prevails over the EC Convention on Contracts.”

“It is a matter of interpretation of CISG to answer the question how and when the buyer should have been informed about the General Conditions. Art. 7 (1) of CISG reads as follows: ‘In the interpretation of the CISG, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade.’ If CISG governs a matter but its provisions do not directly answer a particular question, Art. 7 (2) of CISG provides the following: ‘Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law’.”

The conclusion of the Arbitral Tribunal was that, the PICC also gave limited guidance on the issue of general conditions, and “the Principles are principles in the sense of Art. 7 (2) of CISG”<sup>①</sup>. Of course, in the case, the Tribunal did not think that PICC can fill all the gaps in CISG. The Tribunal held that, PICC only answer the question whether explicit acceptance of a certain clause was necessary, but not whether the accepting party had a reasonable possibility to know the content of the conditions and whether good faith required that the user of the general conditions take the initiative to offer such a possibility to the accepting party. In order to answer this question, the Tribunal stated that support might be found in the Principles of European Contract Law (hereafter PECL) prepared by the Commission on European Contract Law of the European Union, which commission included lawyers from the Netherlands and Italy.<sup>②</sup>

Case No. 8128 (1995) of the ICC Arbitration Court is another important ruling on the issue. In this case, in order to perform a contract with a third party, a Swiss buyer entered into a contract with an Austrian seller for the supply of chemical fertilizer. After termination of the contract by agreement, the question arose as to how to regulate the buying back of the inventories.

The claimant (buyer) had avoided the sales contract due to a fundamental breach by the defendant (seller) and sought to recover his costs incurred for the buying of replacement goods as damages under Art. 75 of the CISG. The arbitrators granted this claim and decided that the claimant was also entitled to interest under Art. 78 of the CISG.

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① Netherlands Arbitration Institute, Interim Award of 10 February 2005, para. 26.

② Netherlands Arbitration Institute, Interim Award of 10 February 2005, para. 28.

The tribunal was faced with the complicated problem that, unlike its predecessor—the 1964 Uniform Law on the International Sale of Goods, CISG does not indicate the rate of interest. During the deliberations on CISG, the drafters could not agree on the applicable interest rate due to the diverging views on the economic function of interest, and on possible limitations on interest contained in Islamic Shari'a laws. There was also disagreement as to whether the interest rate, however defined, should be that of the debtor's or the creditor's country. Art. 78 of CISG therefore constitutes the "lowest common denominator".<sup>①</sup> CISG provides that gaps in the Convention shall be closed in conformity with general principles on which CISG is based or, absent such principles, in conformity with the law applicable by virtue of the relevant conflict-of-laws rules.

Since CISG does not determine the rate of interest, the Arbitral Tribunal applied the average bank short term lending rate for prime borrowers, which is the solution adopted by Art. 7.4.9 of PICC and by Art. 4.507 of PECL. The Arbitral Tribunal considered that such rules were applicable, regarding them as general principles on which CISG is based. In the case at hand, the London International Bank Offered Rate (LIBOR) plus 2% required by the buyer corresponded to the bank short term lending rate to enterprises. The buyer was therefore awarded interest at the required rate.<sup>②</sup>

<sup>①</sup> Klaus Peter Berger, *International Arbitral Practice and the UNIDROIT Principles of International Commercial Contracts*, American Journal of Comparative Law, Vol. 46, 1988, p. 134.

<sup>②</sup> See also Case No. 100/2002 of the International Arbitration Court at the Chamber of Commerce and Industry of the Russian Federation. A Russian Buyer (Claimant) claimed from Indian Seller (Respondent) damages for non-delivery of the goods. Among others, Claimant asked for the interest on the amount of the price paid in advance in Indian currency. The CISG was the law applicable to the contract. Since the parties disputed the applicable rate of interest, the Arbitration Court, noting that the issue is not addressed in CISG, referred to Article 395 of the Russian Civil Code which provides that the rate of interest is to be determined according to the rate of bank interest on the day of performance of the monetary obligation at the place where the creditor is located. However, since in the Russian Federation, i. e., the place where the creditor was located, there is no rate of bank interest for Indian currency, the Arbitration Court decided to apply the international trade practice adopted in such cases as reflected in PICC. And since Article 7.4.9 (paragraph 2) of PICC provides that the rate of interest shall be the average bank short-term lending rate to prime borrowers prevailing for the currency of payment at the place for payment, or where no such rate exists at that place, then the same rate in the State of the currency of payment, the Arbitration Court applied the corresponding rate of interest used by the Reserve Bank of India. Further information about the case is available at <http://www.unilex.info/dynasite.cfm?dssid=2377&dsmid=13621&x=1>, last visited November 11, 2007.

#### IV. The PICC an Aid to Interpreting and Supplementing Domestic Commercial Laws

To realize the second function of PICC, tribunals and arbitrators have on occasion utilized articles of these Principles to help interpret and supplement domestic commercial laws to make them more meaningful. Two examples are provided.

##### A. PICC Award No. 8240 (1995)

Parties from Switzerland, Singapore and Belgium concluded a contract of distributorship. After termination of the contract by agreement, the question arose as to how to regulate the buying back of the inventories.

The determination of the exchange rate applied in a claim under Art. 1 of the Termination Agreement required interpretation of this under the applicable law.

The parties agreed that the choice-of-law clause contained in Art. 36 of the Distribution Agreement which refers to the laws of Switzerland as the governing law of their contract should also be applicable to the Termination Agreement. This was a valid choice of law clause and, according to the wording of Art. 36 of the Distribution Agreement, also applied in the interpretation of the contract.

Although the parties had indicated Swiss law as the law governing their contract, the Arbitral Tribunal, in deciding the rate of exchange to be chosen for the payment in the local currency, referred to Art. 6.1.9 (3) of PICC for a confirmation at an international level of a similar rule of Swiss law.

##### B. PICC Award No. 8486 (1996)

A Dutch and a Turkish party concluded a contract for the installation of a machine for the production of lump sugar. The law applicable to the contract was Dutch law. After the conclusion of the contract, the Turkish buyer refused to pay the agreed amount of the advance payment, invoking financial difficulties due to a sudden drop in the market demand for lump sugar. After the parties' failure to agree on a revision of the contract, the Dutch seller declared the contract terminated and claimed damages from the Turkish buyer. In its defense, the latter invoked hardship under Art. 6.258 of the new Dutch Civil Code as grounds for relief.

In rejecting this argument, the Arbitral Tribunal stressed the exceptional character of

hardship which required a fundamental alteration in the original contractual equilibrium, not a mere increase in the cost of performance as in the instant case. In confirmation of this conclusion, the Arbitral Tribunal referred not only to Art. 6.258 of the new Dutch Civil Code, which was the applicable law, but also to Art. 6.2.1 of PICC.<sup>①</sup> The reference to the latter was justified by the argument that in applying Dutch law in an international context, attention should be given to the prevailing view in the field of international commercial contracts.

### V. Direct and Indirect Application of the PICC as the Governing Law in International Commercial Arbitration

To illustrate the third function of PICC, we find that some tribunals and arbitrators have overlooked the fact that PICC was not a mandatory binding law and directly or indirectly applied PICC as the governing law of the contract. Up to September 11, 2007, according to the statistical data compiled by the Centre of Comparative Law and Foreign Law study of UNIDROIT, there have been 57 cases in which PICC was applied directly and/or indirectly.<sup>②</sup> In practice, PICC can be expressly chosen by the parties, and when the expression "*lex mercatoria*" or "general principles of law" is referred to in the contract. These are direct applications of PICC. Arbitrators have also applied PICC in the absence of any choice-of-law clause, where words such as "the rules of law" or "relevant trade usages" appear in the contract. In addition, PICC has received attention in arbitrations conducted *ex aequo et bono*.

#### A. Direct and Indirect Application of PICC by Choice by the Parties

The practice of international commercial arbitration generally accepts that, international commercial arbitration institutions should respect and conform to the choice by parties in international commercial arbitration to apply the modern *lex mercatoria*. Parties can choose to apply the modern *lex mercatoria* in international commercial

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<sup>①</sup> Article 6.2.1 of PICC provides: "Where the performance of a contract becomes more onerous for one of the parties, that party is nevertheless bound to perform its obligations subject to the following provisions on hardship."

<sup>②</sup> Available at <http://www.unilex.info/dynasite.cfm?dssid=2377&dsmid=13621&x=1>, last visited September 11, 2007.

arbitration based on the principle of party autonomy. On the one hand, parties may choose to directly apply substantive law of some country; on the other hand, parties also can let the conflict law of a country determine the law to apply. In addition, international custom has acquired universal acceptance and application in international business practice, such as Incoterms 2000 of the ICC, Uniform Customs and Practice for Documentary Credits (ICC Publication No. 600), and arbitration tribunals can decide disputes between parties based on them whenever parties choose them.

In a similar vein, if a contract between the parties provides for the application of the modern *lex mercatoria*, arbitration tribunals can apply the modern *lex mercatoria* based on the contract. Then, other approaches to deciding how to choose the applicable law will be subsidiary. Many arbitration rules contain provisions on this subject, e. g., Art. 29 of the International Arbitration Rules of American Arbitration Association of 1997, Art. 13 of the Rules of Arbitration of ICC of 1998, Art. 33 of the United Nations Model Law on International Commercial Arbitration of 1985.<sup>①</sup>

1. *PICC as a Parameter of the Principles and Usages of International Trade*

A 1996 *ad hoc* arbitration of Rome is illustrative.<sup>②</sup> An English company and an Italian company concluded a contract for the sale of fuel oil. The contract contained an express reference to Italian law as the law governing the contract.

Considering the fact that, according to Art. 834 of the Italian Code of Civil Procedure, in an international arbitration the Arbitral Tribunal is required to take into account the terms of the contract and trade usages, the Arbitral Tribunal repeatedly referred to PICC, which it defined as a parameter of the principles and usages of international trade in order to prove that the solutions provided by Italian law were in conformity with international standards.

Particularly, Arts. 1. 2, 2. 1, 2. 6 and 2. 12 of PICC (1994 edition) [ Arts. 2. 1. 1, 2. 1. 6 and 2. 1. 12 of PICC (2004 edition) ] were cited to demonstrate the possibility of the valid conclusion of a contract even without an ascertainable sequence of offer and acceptance; Arts. 3. 4, 3. 5 and 3. 8 to decide the extent to which a party may avoid the contract for mistake or fraud; Art. 1. 7 to demonstrate the duty of the parties to act in

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① See Guo Guoting, *On Several Legal Issues of International Commercial Arbitration from a Case of International Commercial Arbitration*, Communication of Arbitration and Law, Vol. 3, 1993, p. 31.

② Available at <http://www.unilex.info/dynasite.cfm?dssid=2377&dsmid=13621&x=1>, last visited September 19, 2007.

good faith throughout the life of the contract; and Arts. 7.4.1, 7.4.5, 7.4.7, 7.4.9 and 7.4.12 to determine damages.

2. *PICC as Expression of the Lex Mercatoria Referred to in the Contract*

Case No. 12111 (2003) of the ICC Arbitration Court illustrates this. A sales contract between a Romanian seller and an English buyer contained the following choice of law clause and arbitration agreement:

“This contract is governed by international law; any dispute arising in connection with this contract shall be settled amicably, and failing that, by arbitration under the ICC International Court of Arbitration.”

When arose a dispute which the parties were unable to settle amicably, the Romanian seller commenced arbitration. The parties disagreed as to the law applicable to the dispute. Claimant argued that by referring to “international law” the parties had in mind the general principles of law and the *lex mercatoria* and, in accordance with Art. 1.101 (3) of PECL and paragraph 3 of the Preamble of the PICC, concluded that the dispute should be governed by PECL. Respondent objected by invoking the application of English law.

The arbitral tribunal held that by referring to “international law” the parties had made it clear that they did not want the application of any domestic law; the term “international law” was to be understood as reference to the *lex mercatoria* and general principles of law applicable to international contracts, and since such general principles are reflected in PICC it concluded that the dispute should be governed by PICC. As to PECL, the arbitral tribunal stated that “they constitute an academic research, at this stage not largely well-known to the international business community and are a preliminary step to the drafting of a future European Code of Contracts, not enacted yet” and therefore excluded their application in the case at hand.

3. *PICC as Expression of General Principles of Law Referred to in the Contract*

a. *PICC Award No. 82 (1997)*

Case No. 8264 (1997) of the ICC Arbitration Court illustrates this application. A U.S. manufacturer and an Algerian industrial development corporation entered into an agreement for the supply of industrial equipment and transfer of know-how. In a contract annexed thereto, the manufacturer agreed to provide the licensee with any information relating to changes and improvements in the equipment.

The contract contained a choice of law clause in favor of a particular domestic law (Algerian law) and authorized the Arbitral Tribunal to consider the general principles of law and the usages of trade.

The Tribunal held that Claimant's failure to provide Respondent with information relating to the equipment caused the latter the loss of an opportunity to develop and adapt its industrial production to the demands of the market. In the Tribunal's view, the PICC constitutes rules "... broadly recognised throughout the world and the practice of international contracts". In support of its decision, it referred to Art. 7.4.3 (2) of the PICC, according to which "compensation may be due for the loss of a chance in proportion to the probability of its occurrence".

*b. PICC Award No. 7365 (1997)*

Case No. 7365 IFMS (1997) of the ICC Arbitration Court concerned two contracts for the sale and installation of sophisticated military equipment, entered into in 1977 between a U. S. corporation (Cubic) and the Iranian Air Force (Iran). The contracts were duly performed until the advent of the Islamic Revolution in early 1979. Iran claimed reimbursement of payments made to Cubic in addition to damages, whereas Cubic, objecting that it was Iran which, by not paying the remainder of the price, had breached its contractual obligations, presented a counterclaim for damages. The contracts contained a choice of law clause designating the law of Iran, but parties eventually agreed to the complementary and supplementary application of general principles of international law.

Regarding the issue of the substantive law applicable to the dispute, the Arbitral Tribunal held that:

"Since both Parties eventually agreed to the complementary and supplementary application of general principles of international law and trade usages, and based on article 13 (5) of the ICC Rules, the Tribunal shall, to the extent necessary, take into account such principles and usages as well. As to the contents of such rules, the Tribunal shall be guided by PICC, published in 1994 by the UNIDROIT Institute, Rome."

Thus, in finding that, as a result of the chaotic events preceding and following the Islamic Revolution in February 1979, each party was entitled to unilaterally request termination of the contracts or adaptation of their terms, the Tribunal expressly referred to Art. 6.2.3 (4) of PICC, pointing out that:

“... from the covenant of good faith and fair dealing which is implied in each contract follows that in a case in which the circumstances to a contract undergo ... fundamental changes in an unforeseeable way, a party is precluded from invoking the binding effect of the contract ... In such restrictive and narrow form this concept [ of hardship or *clausula rebus sic stantibus* ] has been incorporated into so many legal systems that it is widely regarded as a general principle of law. As such, it would be applicable in the instant arbitration even if it did not form part of the Iranian law.”

Furthermore, in order to justify the application by analogy of a “termination for convenience clause”, contained in the contracts, to the termination of the contract as a result of changed circumstances, the Tribunal applied Arts. 5. 1 and 5. 2 of PICC (1994 edition) [ Arts. 5. 1. 1 and 5. 1. 2 of PICC (2004 edition) ] and the “widely accepted principles therein set forth regarding implied obligations”.

#### **B. A Tribunal Can Also Apply PICC According to the Arbitrators' Understanding of the Nature of PICC in Circumstances in Which the Parties Have Not Clearly Expressed Their Intent to Apply PICC**

Another path to choice of PICC in international commercial arbitration is realized by tribunal based on arbitrators' understanding of the nature of PICC. Whenever parties abandon their “autonomy right” to choose applicable law, and there are no rules of law identified in the contract, arbitration tribunals should take into account all elements of contract, and assist parties to decide what kinds of law can be used. Here using PICC mainly includes two forms in international commercial arbitration.

The Preamble of PICC provides that, the Principles may be applied when the parties have agreed that their contract will be governed by general principles of law, the *lex mercatoria*, or the like. In practice, on the issue of application of the law of the contract, parties often used follow words: “general principles”, the “*lex mercatoria*”, “principles of international law” and so on, which has resulted in arbitration tribunals choosing to apply PICC according to their different understandings of the nature of PICC under circumstances where parties have not clearly expressed their intent to apply PICC in international commercial arbitration.

1. *PICC as the Rules of Law Arbitrators Consider as Appropriate*<sup>①</sup>

A 2005 case of the Arbitration Institute of the Stockholm Chamber of Commerce illustrates this. The Plaintiff, a trading company registered in Gibraltar, entered into a contract with State-owned Company X of a Central Asian Republic for the supply of gas condensate over the course of a certain period of time on a monthly basis. While Plaintiff regularly fulfilled its obligations under the contract, Company X, after paying the first invoices, stopped making payments. A few months later, the Government of the Central Asian Republic set up a new State-owned Company Y to replace Company X for the domestic supply of gas and transferred to Company Y the assets but not the debts of Company X. Plaintiff brought an action against the Central Asian Republic for the payment of the outstanding invoices and damages. According to the Plaintiff, the Defendant, by depriving Company X of its assets and thereby causing that company's insolvency had violated its obligation under the 1994 Energy Charter Treaty to ensure foreign investors fair and equitable treatment.

The Arbitral Tribunal ruled in favor of Plaintiff and awarded damages to compensate the loss suffered by Plaintiff by not being able to receive payment from Company X of its outstanding invoices. The Tribunal also awarded interest which it held should be calculated on the basis of international rather than national rules: in this respect, the Tribunal referred to Art. 7.4.9 of PICC which, with no further explanation, it considered was "an appropriate basis for determining the interest".

2. *PICC as Expression of Relevant Trade Usages to Be Taken into Account by Arbitrators*<sup>②</sup>

Case No. 302/1997 (1999) of the International Arbitration Court of the Chamber of Commerce and Industry of the Russian Federation illustrates this application of PICC. A Russian seller and a Swedish buyer entered into a sales contract. Since the seller delivered only the first lot of the goods (20% of the total), the buyer commenced legal proceedings requesting the seller to deliver the missing part of the goods or alternatively to pay damages for its failure to perform. The seller objected by invoking the invalidity of the contract due

<sup>①</sup> Cases are cited at UNILEX ([www.unilex.info](http://www.unilex.info)). More cases and analysis can be found in Ole Lando, *Assessing the Role of the UNIDROIT Principles in the Harmonization of Arbitration Law*, Tulane Journal of International Law and Comparative Law, Vol. 3, 1995, p. 129.

<sup>②</sup> Cases are cited at UNILEX ([www.unilex.info](http://www.unilex.info)). More cases and analysis can be found in Ole Lando, *Assessing the Role of the UNIDROIT Principles in the Harmonization of Arbitration Law*, Tulane Journal of International Law and Comparative Law, Vol. 3, 1995, p. 129.

to the lack of authority of the company's director who signed the contract. The Arbitral Tribunal applied the PICC which in its view are gradually gaining the status of internationally recognized trade usages.

As to the merit of the case, the Tribunal decided in favor of the Swedish buyer. In rejecting the seller's objection concerning the invalidity of the contract, it referred in particular to Art. 3.15 of the PICC, according to which notice of avoidance must be given to the other party within a reasonable time after the avoiding party knew or could not have been unaware of the relevant facts. In the case at hand, the Russian seller had clearly failed to do so, since in the course of the performance it had never raised the issue of the alleged lack of authority of the company's director and only during the arbitral proceedings, i. e., years after the conclusion of the contract, for the first time declared its avoidance. This is a case in which the arbitrators acknowledged the status of PICC as relevant trade usages.

## VI. Analysis of the Application of the Modern *Lex Mercatoria* in Arbitration Proceedings Involving PICC

Except where parties clearly provide for the use of PICC, the application of the modern *lex mercatoria* represented by PICC in international commercial arbitration must follow some rules. On this issue, the arbitration award in No. 7375 (1996) of the ICC Arbitration Court is a typical case.

### A. PICC Award No. 7375 (1996) ①

A U. S. seller (Defendant) and a Middle Eastern buyer (Claimant) entered into a contract for the supply of goods. The buyer, a governmental agency, claimed damages and interest in connection with a delay in the delivery of the goods. The contract contained no choice of law clause. The Defendant, invoking the application of the law of Maryland as the place where the significant contractual obligations, i. e., the manufacture of the goods, had been performed, deemed the claim to be time-barred. The Claimant relied on its own domestic law under which the action would not be time-barred, and, subsidiarily, invoked the application of general principles of law.

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① Available at <http://www.unilex.info/dynasite.cfm?dssid=2377&dsmid=13621&x=1>, last visited September 21, 2007.

In investigating the intent of the parties, the Arbitral Tribunal found that the absence of a choice of law clause in the contract demonstrated that neither party was prepared to accept the other's domestic law. Given such an implied negative choice, the Tribunal was faced with three alternatives: to apply a neutral law, to adopt the *trunc commun* doctrine, or to choose a denationalised solution and apply generally accepted principles of law. After rejecting the first two solutions—the first because it considered it artificial and arbitrary; the second because it would require lengthy comparative law research and might not lead to any conclusion—the Tribunal decided in favor of the third solution which it considered would fully maintain the equilibrium between the parties and respond to both parties' reasonable expectations. With express reference to ICC Award No. 7110, it decided to apply those general principles and rules of law applicable to international contractual obligations which are qualified as rules of law and which have earned a wide acceptance and international consensus in the international business community, including notions which are said to form part of the *lex mercatoria*, also taking into account any relevant trade usages as well as PICC, as far as they can be considered to reflect generally accepted principles and rules.

In the Arbitral Tribunal's view, PICC contain in essence restatement of those principles that have enjoyed universal acceptance and, moreover, are at the heart of those most fundamental notions which have consistently been applied in arbitral practice.

However, it also pointed out that PICC have not as yet stood the test of detailed scrutiny in all their aspects so that some of their individual provisions might not reflect international consensus. It was for this reason that the Arbitral Tribunal was prepared to apply PICC only to the extent that they actually reflect generally accepted principles and rules.

On the merit of the case, the Tribunal declared that it was not ready to make a final decision. Admitting that general principles of law and the *lex mercatoria* were by their very nature too vague to provide precise answers to the statute of limitations and that PICC did not contain any specific provisions dealing with the issue, the Tribunal nevertheless invited the parties to submit their memorials on substance having regard to applicable general principles of law rather than to their sole domestic laws.

## B. Method Used by Tribunal to Apply PICC

### 1. Objective Approach

In this case, one of the important issues was the determination of the law (or rules)

applicable to the first contract. The general method is the objective approach. The objective approach includes using the usual standard to determine the substantive rules applicable to contracts.

Under the objective approach, the first step is to identify the conflict rules. There is no doubt that the conflict rule which is supported most widely is the "closest connection rule". It is the common rule in most countries' conflicts law. Most private international law provisions and most arbitration decisions will first consider the business and habitual residence of the so-called party who is to effect "characteristic performance", in the process of identifying the closest connection with contract in question. A few countries first consider the place of the "characteristic performance". This method is widely known in continental law countries influenced by the French legal tradition. Only a few continental law countries, such as Spain and Italy (before the law of 1994 came into effect), still first consider the place of the creation of the contract. Moreover, it seems to be the mainstream view of the Iranian Civil Code.

Demonstrated by the above analysis, it is very clear that the widely supported solution in international arbitration is to apply the "closest connection rule" as the relevant conflict law stipulated in Art. 13 (2) of the ICC rules. Furthermore, applying this rule to the case in question, a tribunal should identify the characteristic performance of one party of the other according to the articles of the first contract. In addition, the arbitration tribunal should also take other relevant elements into account.

The second step is to find out how to apply the closest connection test.

The first contract did not specify the place of signature. The claimant claimed that the contract was signed in Teheran, but there is no evidence to support his claim. The respondent argued that the contract was not signed in Teheran, but he could not prove a more exact place of signature. The obligation of producing the equipment of the respondent will be accomplished at his factory in Maryland. Moreover, all the important elements occurred in Maryland, which is in America. For example, the transfer of the goods occurred in the harbor in America selected by the respondent. In addition, the acceptance of the goods should be regarded as being completed in America. The above analysis indicates that the first contract did not contain any important obligations to be completed outside Maryland.

However, even if the first contract contained any element of the obligation that should be completed in Iran, the consideration on the element should be compared with the consideration on the elements to be completed in America. Only if the performance in Iran

should be considered first in the overall evaluation can we reasonably conclude that the most closely connected place of the first contract (or its center) is Iran.

The tribunal held that, all of these elements very clearly indicate in the opinion of the Majority Arbitrators that under the objective approach and the closest connection test, having regard to the characteristic performance and all other connecting factors, the center of gravity of Contract No. 1 is, beyond doubt, located in Maryland, and therefore the proper law of the Contract would be Defendant's national law, i. e., Maryland law.

## 2. Subjective Approach

However, in fact, the Tribunal just discussed the objective approach in Excursus of the Award. In practice, tribunals adopt the subjective approach: implied negative choice.

The reasons are very interesting and developmental.

Firstly, objective approach is not only "proper rule" in commercial arbitration, especially in present case. Considering the specialties of the present case,<sup>①</sup> the Tribunal held that it did not have the obligation to identify any conflict law of a specific state; on the contrary, it is invited to choose one (or more) "proper" conflict law. If a contract such as Contract No. 1 does not contain a choice of law provision, then this must be viewed as a "shouting silence", at least an "alarming silence", "*un silence inquiétant*"; thus, a silence which must ring a bell and requires the tribunal to look "behind" so as to understand why the Parties have failed to include "the obvious".

In this situation, research on the history of Contract No. 1 could easily have clarified the situation if, for instance, the Parties had been able to produce earlier drafts, working papers and internal memoranda on the contract negotiations, or the live witnesses had been available to testify those negotiations in 1971. Most civil law countries accept that such materials can serve interpretation purposes. However, apparently due to the Iranian Revolution that material has either disappeared, or was destroyed, or has otherwise become unavailable to either one of the Parties. Thus, the Tribunal was left with the scarce evidence before it.

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<sup>①</sup> As the Tribunal stated, "it was not a contract between parties operating within the same environment and legal culture..., not a contract between parties that had a long history of dealing and cooperating together; it cannot be assumed that a very particular mutual confidence had already been in place while entering into Contract No. 1..., not a contract concluded between equal parties (e. g. both being common city traders accustomed to respect the rules of their common trade) ..., not a contract containing extensive provisions, addressing all possible eventualities as could occur in the 'runway' of performance under the contract..."

Against this background, the absence of a choice of law clause must be understood as a so-called "implied negative choice" by the Parties "... in the sense that none of the Parties' national laws should be imposed on any of the Parties." The non-explicit—but implied—rejection by one Party of submitting itself to the other Party's national law (as the governing law of contract) is thus—in the opinion of the Majority Arbitrators—an implied term of the contract.

In this sense, an interpretation of what had been agreed and what, perhaps even more significantly, had not been agreed upon in the Contract, provides a clear answer, although only a negative one in the above sense: the Contract should not, according to the implied negative choice of the Parties, be governed by any of the Parties' national laws.

All in all, the Majority Arbitrators got a conclusion that Contract No. 1 should not be subject to either Party's national law. Thus, the Tribunal will not apply Iranian law, nor will it apply US law or the law of Maryland.

The next question is what law or rules of law should be applied. Should the Tribunal apply the substantive law of a neutral country, or follow the *trunc commun doctrine* which, essentially, proposes that the relationship should be governed at least by the part of the other and of his own legislation which is common to them, or fully denationalize Contract No. 1 and determine that a-national or transnational rules of law and general principles of law will be applied, including rules that are said to form part of the *lex mercatoria*, and taking into account PICC, and trade usage?

Ardent debates never stop over the above three questions. Finally, The Majority Arbitrators' decisions were: (a) it would be entirely artificial and arbitrary to rule that a third neutral (national) law should apply. Any choice would be extremely critical; (b) must discard it here, because it would not provide the solution in respect of the statute of limitations and provides no direct answer to the legal regime that should control in case of divergent answers found in the two national laws; (c) despite the difficulty referred to above under "contra", with which it would have to cope, the denationalization of the Contract No. 1 is the solution which the Tribunal, in the opinion of the Majority Arbitrators, owes to both Parties. It is at the same time the only solution which fully maintains the equilibrium between the Parties and responds to both Parties' objectively fair and subjectively justified and reasonable expectations, discarding any *pro domo* arguments of the Parties in support of their respective cases. Additionally, the Tribunal did not wish to refer extensively to other cases, because no other case would qualify as a "precedent". The tribunal must reach, and in actual fact has reached, its decision independently of

what other tribunals in the past may have considered and decided in somehow comparable situations.

Logically, the Majority Arbitrators were aware that various terms should be used, such as general principles of law, generally accepted principles of private law, a-national rules of law, transnational law rules, *lex mercatoria*, principles of international law, etc. The practice of the Tribunal is to apply those general principles and rules of law applicable to international contractual obligations which are qualified as rules of law and which have earned a wide acceptance and international consensus in the international business community, including notions which are said to form part of a *lex mercatoria*, also taking into account any relevant trade usages as well as PICC, as far as it can be considered as reflecting generally accepted principles and rules. ①

It is worth noting that, as regards the reference to PICC, the Tribunal analyzed that, these Principles contain in essence restatement of those "*principes directeurs*" that have enjoyed universal acceptance and, moreover, are at the heart of those most fundamental notions which have consistently been applied in arbitral practice. On the other hand, PICC, as now laid down, has not yet, in all its details, stood the test of detailed scrutiny in all its aspects, and thus it is at least conceivable that a particular rule would not seem to reflect the international consensus. Because of this concern, the Tribunal has added the condition "as far as they can be considered to reflect generally accepted principles and rules" ②.

With reference to Art. 26 of the PICC Rules, it may be stated that the Majority Arbitrators were not aware that, in connection with a potential enforcement of the Final Award against Defendant in the U. S. (or in European countries, where assets might exist), the *exequatur* could be refused on the ground that this Tribunal applied general principles of law and a-national rules of law, instead of applying a particular national law. In other words, the Tribunal did not interpret the implied negative choice by the Parties in the sense that they would, by their silence, have tacitly empowered this Tribunal to rule

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① The Majority Arbitrators are of the opinion that "these General Principles of Law" (in the wide understanding as described above) are established in sufficiently concrete fashion so as to enable the Tribunal to adjudicate any and all issues as may arise in the framework of this arbitration.

② See Hilmar Raeschke-Kessler, *PICC for International Commercial Contracts: A New Lex Mercatoria?* in: ICC/Dossier or the Institute of International Business Law and Practice, 1995, p. 167 et seq.

merely on the basis of natural justice, or on an *ex aequo et bono* basis; nor would the Arbitrators consider themselves authorized to act as *amiables compositeurs* (unless such further powers would, in the further course of the proceedings, be conferred to them explicitly with the consent of both Parties).

### C. Rules Enabling Tribunals to Apply PICC

In the respect of application of law in international commercial arbitration, we can see that, traditional method is to choose the conflict rule first, and then identify the substantive rules according to the conflict rule. This can be called Method I.

According to Method I, the first step is to choose the conflict rule of a country; the second step is to specify the substantive rule according to the conflict rule. ① The second step is called upon to address the conflict of the substantive rules (*au premier degre*), which is different from the way of choosing applicable law in courts. A judge is only concerned with the conflict of the substantive rules. When it comes to the conflict rules, he has no choice but to apply the conflict rules of the forum state, and there is no room for him to choose the conflict rules of other states.

In Method I, there are various opinions and practice on choosing and applying the conflict rules. It mainly includes: (a) applying the conflict rules of the place of arbitration; (b) applying the conflict rules of the arbitrator's state; (c) applying the conflict rules of the state most closely associated with the issue; (d) applying the conflict rules of the state which possibly enforces the decision; (e) applying the conflict rules relevant to the issue comprehensively; (f) applying the international conflict rules recognized widely by the legislation in various states or the international conflict rules stipulated in international treaties; ② (g) applying the conflict rules of the state which has jurisdiction over the issue, if there are no arbitration articles. The theory is that the arbitration clause only excludes the jurisdiction of the domestic court over the issue, but the method of identifying applicable law should refer to the method of the court on the assumption that there is jurisdiction of the domestic court. Those who object to the theory argue that, this view means that the arbitrator should identify the court that has the jurisdiction, before choosing the conflict rules. And the identification of the jurisdiction

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① The first step was called *au deuxieme degre* in the application of law in arbitration.

② For further analyses, see Vitek Danilowicz, *Choice of Law in International Arbitration*, Hastings International and Comparative Law Review, Vol. 9, 1986, pp. 258-267.

will also lead to a series of conflict of rules. Thus this theory is not applied in practice any more; and applying the conflict rules that the arbitrator considers proper. ①

Among above approaches, approach (8) is a new theory and practice in respect of applying substantive rules in arbitration. This theory breaks the deadlock of sticking to a specified conflict rule in tradition, gives the arbitrator a chance to choose the conflict rules flexibly in accordance with the situation of the case, and leads to a more fair and reasonable result of identifying substantial rules finally. However, the above approaches will have the same ending: application of domestic law.

The truth undoubtedly destroys the application of the modern *lex mercatoria* (including PICC) directly or indirectly in international commercial arbitration. Therefore, if the modern *lex mercatoria* hopes to survive in international commercial arbitration, an adequate method adopted by arbitrators and tribunals would be to identify the substantive rules directly without applying the conflict rules, which can be called Method II.

Undoubtedly, the choice of modern *lex mercatoria* as substantive rules in arbitration can decrease unpredictability of judgment and difficulty by choice of laws arising from Method I, and merchants can get a stable prediction in arbitration. Consequently, the trend of the legislation on and practice of arbitration is to expand the authority of the arbitral tribunals, simplify the process of choosing substantive rules, and allow arbitration tribunals to choose directly the proper or substantive rules most closely connected with the issue. In this way, if the parties did not have any agreement on choosing substantive rules, the arbitral tribunal should apply the law that the tribunal considers applicable. To support the above viewpoint, Art. 28 (2) of the 1985 United Nations Model Law on International Commercial Arbitration is a typical reflection of this theory. In addition, Art. 7 (1) of the 1961 European Convention on International Commercial Arbitration and Art. 33 (1) of the Arbitration Rules of UNCITRAL have adopted the same article as has the United Nations Model Law on International Commercial Arbitration. Additionally, the laws of the U. K., France, Germany, Italy, Switzerland, the Netherlands and other countries have abandoned Method II, and have adopted the method of choosing the substantive rules directly by the arbitrators. For example, Art. 1496 of the French Civil Procedure Code stipulates that, arbitrators should settle the dispute according to the rules

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① See Huang Yaying, *On the Application of Law on the Merits of the Parties Dispute in International Commercial Arbitration and Its News Development*, Political Science and Law, Vol. 3, 1999, pp. 1-15.

selected by the parties; when there is no choice of the rules by parties, an arbitrator could make decision according to the proper rules. ① Art. 187 (1) of the Swiss Statute of International Private Law stipulates that, an arbitral tribunal should settle the dispute according to the rules chosen by the parties. If there is no such choice, the dispute should be settled according to the most associated rules to the case. ② Art. 46 (3) of the 1966 Britain Arbitration Law, section 1051 of the Germany Civil Procedure Code, Art. 834 of the Italian Civil Procedure Code, ③ and Art. 1054 (2) of the Netherlands Civil Procedure Code ④ have also adopted Method II. In the theory of international arbitration, Method II has become the leading approach. ⑤ Many scholars hold that if the arbitrator or the arbitration tribunal has been accredited to settle the dispute, then we can suppose that they are authorized to identify the rules that should be applied to the dispute. Obviously, Method II extends the application of modern *lex mercatoria* in international commercial arbitration as much as possible.

## VII. Further Thoughts: Limitations on the Application of PICC and Overcoming Limitations

The application of PICC in international commercial arbitration is not absolute; there are limitations to it. In the case of choosing rules, once PICC, characterized by internationalism and autonomy has been chosen, it does not mean the exclusion of the mandatory rules of the forum. Consequently, the French scholar Goldman maintains that the application of the merchant law cannot contradict the international public policies and the "good custom" of the forum. ⑥ Certainly, in the institutions of international

① Alan Redfern and Martin Hunter, *Law and Practice of International Commercial Arbitration*, 2nd ed., Sweet Maxwell, 1991, pp. 126-127.

② Alan Redfern and Martin Hunter, *Law and Practice of International Commercial Arbitration*, 2nd ed., Sweet Maxwell, 1991, p. 787.

③ Gian Battista, *Choice of Substantive Law: The 1994 Italian Reform*, *International Business Lawyer*, Vol. 25, 1997, p. 962.

④ Alan Redfern and Martin Hunter, *Law and Practice of International Commercial Arbitration*, 2nd ed., Sweet Maxwell, 1991, pp. 126-127.

⑤ Wolfgang Kühn, *Choice of Substantive Law in the Practice of International Arbitration*, *International Business Lawyer*, Vol. 25, 1997, p. 151.

⑥ Zheng Yuanmin, *Research on the Modern Lex Mercatoria*, Law Press, 2001, p. 47.

commercial arbitration, modern *lex mercatoria* represented by PICC can only be denied its application in the case of breaking the transnational public policy. When the transnational public policy is contradicted by the international public policy of one state, the latter has priority.

Actually, the mandatory rules and public policy have the effect of restrictions on the issues of court, arbitrator, and the application of rules in international commercial arbitration.<sup>①</sup> Currently, almost all arbitration laws choose to review judicially foreign arbitration decisions on procedure, and the practice of judicial procedural review is a limitation for the parties to choose the arbitral procedure law except the *lex loci arbitri*. Due to the consideration on state interest or public order, countries are inclined to incorporate some limitation articles into the arbitration law. For example, Art. 1042 (1) and (2) of the 1998 Germany Civil Procedure Code stipulates that the parties should be treated equally and provided the chance to state the case, and that lawyers should not be excluded from serving as authorized agent. If an arbitral tribunal applies an arbitration law chosen by the parties other than the German Arbitration Law, and the arbitration law that is applied contradicts one of the two mandatory articles above, the parties could seek to revoke the decision. Another examples are Art. 258 of the Civil Procedure Law of People's Republic of China, Art. 68 of the Arbitration Law of People's Republic of China, and Art. 23 of the Arbitration Rules of Chinese International Economic Trade Arbitration Commission stipulate that decisions on interim measures can only be made by the People's Court that has jurisdiction. In this way, arbitration tribunals are excluded from exerting this authority. If one arbitration agreement chooses the Chinese International Economic Trade Arbitration Commission, and chooses to apply the UNCITRAL Arbitration Rules or other procedural law or arbitration rules,<sup>②</sup> the arbitration tribunal is authorized to take property protection measures or the evidence protection measures upon the application by one party. However, if the other party seeks to revoke the decision in court for the reason that the rules applied by the arbitration tribunal are contrary to mandatory provisions of

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<sup>①</sup> See Xiao Yongping and Zhu Kepeng, *On the Impact of Mandatory Rules and Public Policy to International Commercial Arbitration*, International Trade Journal, Vol. 9, 1997, pp. 1-10.

<sup>②</sup> Article 17 of the UNCITRAL Model Law on International Commercial Arbitration of 1985, Article 38 (4) of the Britain Arbitration Act of 1997, Article 183 (1) of the Swiss Private International Law, Article 26 of the UNCITRAL Arbitration Rules of 1975, Article 23 of the Arbitration Rules of ICC of 1997, etc.

Art. 68 of the Arbitration Law, the decision will probably face the risk of being revoked. ①

In detail, the application of PICC in international commercial arbitration is limited in two aspects. The first is the limitation of mandatory rules, and the second is the limitation of public order. The substantive rules chosen by the parties can not contradict the public order and the mandatory rules of the arbitration state. The choice by the parties should fall within the scope of the arbitrary law. For example, Art. 6 of the French Civil Code stipulates that individuals can not violate the law related to French public order and good custom by the way of making special agreements among themselves. This is the common method of various countries. ②

The so-called mandatory rule is the law whose application cannot be excluded by the agreement of the parties. ③ It can be tracked back to ancient Roman law. This kind of mandatory rule is limited to the conflict law on contracts, specifically domestic rules used to exclude the application of the analogous contract law by a court. The mandatory rules in private international law have been pointed out in the 19th century, and have been created along with the strengthening of governmental intervention in economic activities. Mandatory rules can not be derogated from or excluded by the agreement of the parties. All states have specific regulations on mandatory rules. ④ Mandatory rules of a state have the legal force of excluding the autonomy of the parties and the application of foreign rules, and they are significant for maintaining the fundamental interest, public interest and good customs of a state. ⑤

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① Shen Muzhu, *Research on International Trade Law*, Law Press, 2002, p. 400.

② Xu Weigong, *On the Application of Law to Substantive Issues of International Commercial Arbitration*, Studies on Law and Business, Vol. 1, 2001, p. 95.

③ Fu Jingkun, *On Contracts in the Conflict Law of Laws*, Law Press, 1999, p. 57.

④ For example, Article 6 of the French Civil Code stipulates that the law related to the public order and good customs can not be deviated by agreements of individuals.

⑤ However, the mandatory rules themselves are indefinite and flexible. It is doubtful to apply the mandatory rules without any difference in both the international commercial arbitration characterized by autonomy of the parties and the international civil procedure characterized by the judicial sovereignty. See Zhang Jiangmin, *Some Legal Issues in Application International Arbitration*, Journal of Wuhan University of Hydraulic and Electrical Engineering (Social Sciences Edition), Vol. 56, No. 6, 2003, p. 740.

A 1998 decision of the ICC Arbitration Court<sup>①</sup> has demonstrated this issue. In that case, an Italian company as the Claimant and an Austrian company as the Respondent entered into a shareholder contract for financing an aviation plan. The Italian company terminated the contract after the nonperformance by the Austrian Company. The contract included a choice-of-law clause for the application of Italian law. The Respondent applied an article of PICC in his reply. His view is that since Art. 834 of the Italian Civil Procedure Code invites consideration of trade usage in international arbitration, the merchant law is an integral part of Italian law, and PICC should be considered as the authoritative source of proving international trade usages. The Arbitral Tribunal rejected the applicability of PICC. In this case, first, the Tribunal considered that PICC was not equal to international trade usages, and that there was a difference between applying PICC and applying the existing international commercial usages. Second, the Tribunal indicated that even if PICC could be applied as international trade usages, it could only be used to fill the gaps of domestic legislation, and could not contradict the Italian law. The provisions of Italian law on invalid contracts are considered as a part of public policy, and therefore they are mandatory. The Tribunal excluded the application of PICC. However, it discussed the relevant provisions of PICC from the perspective of interpretation and explanation.

Consequently, as a third body of rules independent of international law and domestic law,<sup>②</sup> the application of modern *lex mercatoria* represented by PICC in international commercial arbitration should avoid inconsistencies with the *jus cogens* at the level of public international law and the mandatory rules in private international law. This is a noteworthy issue in the application of PICC.

It has to be indicated that international commercial arbitration has a large extent of liberty and decisive power, and the autonomy of the parties runs through the whole procedure of international commercial arbitration. The current trend is that the limitations on choosing applicable rules by the arbitration tribunal are getting less and less. The related practice has shown that, although mandatory rules of a state have limited party autonomy, tribunals have nevertheless bypassed the related regulations and applied the law

<sup>①</sup> Available at <http://www.unilex.info/dynasite.cfm?dssid=2377&dsmid=13621&x=1>, last visited November 27, 2007.

<sup>②</sup> See Xu Guojian, *On the Modern Lex Mercatoria*, Social Science of China, Vol. 3, 1993, pp. 1-15.

chosen by the parties. For example, a 1989 ICC arbitration proceeding in Cologne involved a dispute over a wholesale contract between an Italian company and a Belgium company. The parties chose Italian law as the proper law of the contract. With regard to the mandatory rules of Belgium on terminating a "wholesale contract", the Tribunal held that the Belgium law had no legal effect on the rules chosen by the parties.<sup>①</sup>

### VIII. Conclusion

The application of PICC as the modern *lex mercatoria* and its potential role in international commercial arbitration is an interesting topic. In the above discussion, the author tries to offer a cogent and optimistic argument, which is supported by references to and analysis of selected arbitral awards.

Currently, sources of modern *lex mercatoria* are controversial. In addition to international conventions and commercial custom, international contract restatement appears in international commercial practice. Theories adopted by PICC and its application in international commercial arbitration accelerate the development of the modern *lex mercatoria*.

According to the Preamble of PICC (2004 Edition), PICC can be used to interpret or supplement international uniform legal documents, fill up the governing law of a contract or assist in the application of domestic governing law provisions to international transactions, and act as the governing law of a contract if the contract so states. Tribunals and courts can apply PICC based on conflict rules in arbitration and arbitration rules when there is no clear statement of the governing law in the contract. Compared to international conventions in international commercial transactions, function 1 and function 2 of PICC are its merits. The functions of PICC can be realized by direct and indirect application dependent on parties and arbitrators.

Furthermore, a new method by which a tribunal can apply the law specified by the conflict rules that the tribunal considers applicable breaks the deadlock of sticking to a specified conflict rule in tradition, gives the arbitrator a chance to choose the conflict rules flexibly in accordance with the situation of the case, and leads to a more fair and reasonable result of identifying substantial rules finally, which extends the application of

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<sup>①</sup> See Zhao Xiuwen (ed.), *Comment on Cases of International Commercial Arbitration*, China Legal Publishing House, 1999, pp. 168-177.

the modern *lex mercatoria* in international commercial arbitration as much as possible.

Although PICC was applied widely in international commercial arbitration, its application is not absolute. Application of the modern *lex mercatoria* represented by PICC in international commercial arbitration should avoid inconsistencies with the *jus cogens* at the level of public international law and mandatory rules in private international law. This is a noteworthy issue in the application of PICC.

In sum, PICC is currently a source of international commercial law. However, it will become customary law on international commercial transactions as it is gradually accepted by international society. The application of the modern *lex mercatoria* represented by PICC in international commercial arbitration will have a bright future.