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# Rise of arbitration in the financial sector: breaking with tradition

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# Rise of arbitration in the financial sector: breaking with tradition

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*Prior to the 2008 financial crisis, the dispute resolution clauses in derivatives contracts were scarce. The trend is changing as the legal risk increases. The derivatives market has been hit by the tsunami of post-Lehman litigation as well as the 2012 eurozone crisis. More disputes may come out of the complex financial derivatives regulation in the making across the world. Clearing and margining requirements will not be easy to interpret for the derivative players, much less so for the national tribunals of general jurisdiction. The grand arbitration debate is also alive in Nordics, reports Silvia Devulder.*

The PwC 2013 International Arbitration Survey[1] confirms that "arbitration's popularity depends on the industry concerned, with financial services at one end of the spectrum." While 69 percent of financial services respondents agreed that arbitration is well suited to their industry, in practice only 23 percent indicated preference for arbitration compared to the other dispute resolution methods. "By contrast, litigation is the clear favorite for respondents in the financial services sector."

**The apparent hostility of the financial sector may however be justified by the overreliance on the market standard clauses, combined with a historical lack of interest in the dispute resolution arrangements in general.** The reliance on the "market standard" is often opposed as a sole argument for refusing arbitration. Whether the standard of litigation actually makes sense or is in the parties benefit may be often disregarded in the interest of a smooth negotiation. Indeed, since the International Swaps and Derivatives Association Inc. (ISDA) drafted the standard ISDA master agreement for derivatives in 1987, it has referred the disputes arising thereunder to litigation in English or New York

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1 The 2013 Survey, "Corporate choices in International Arbitration" with particular emphasis on companies in energy, construction and financial services sectors, by Gerry Lagerberg, PwC, and Loukas Mistelis, School of International Arbitration Queen Mary, University of London: http://www.pwc.com/gx/en/arbitration-dispute-resolution/.

courts.[2] The parties can amend the relevant provision (Section 13(b)), but the forum for disputes has not been the focus of the bilateral negotiations. And fairly so – the disputes in derivatives have been rare and the hassle not deemed worth the effort. Everybody has been happy to fall back on courts until forced to actually litigate.

**The 2008 crises resulted in a noticeable increase in disputes.**[3] And not any kind of disputes – the judges were suddenly confronted with the most complex topics of swaps valuation, their close-out methodology, mathematical modeling and other market mysteries never tested in courts. The novelty resulted in contradictory judgments, increasing the legal risk and reducing the business predictability.[4] To be fair, the judges coped quite well, considering the lack of precedent. But quite well is not good enough when millions are at stake. And while the businessmen know that time is money, the courts can afford spending time to forge their view. As a result, 6 years on the clock, some Lehman related litigation is still ongoing or have been settled out of court by disillusioned parties. Olle Flygt, a partner at the Stockholm based law firm Mannheimer Swartling shares his experience of counsel in a long lasting dispute in which he and his team represented Lehman Brothers bankruptcy estate against AB Svensk Exportkredit in Swedish courts: "Despite an exemplary case management by the Swedish judge, the proceedings involving more than 15 experts and 5 law firms as well as translators on both sides would have been dealt with more time- and cost-efficiently through an arbitration." The parties eventually settled out of court.

There is no doubt that derivatives and related disputes require expertise. It thus remains a mystery why the derivative counterparties put all their eggs in one basket of an unknown judge rather than cautiously selecting the arbitration experts to deal with their potential arguments. Beyond the interest of the parties, it also comes down to the stability of the financial markets – the new regulation will require a sensible interpretation in order to achieve its goals. "People make difference", claims Jeffrey Golden, a founding member of P.R.I.M.E. Finance Foundation[5] – an arbitration institute specialized in financial and derivatives disputes with a panel of more than 100 financial experts-arbitrators capable to understand the complex derivatives disputes. "Judges who understand finance

[2] Section 13(b) of the ISDA Master Agreement refers the disputes to litigation in English courts if governed by English law and courts of the State of New York and the United States District Court located in the Borough of Manhattan in New York City if governed by New York law. This remained unchanged in the 1992 and 2002 revisions.

[3] See the inventory of case law http://lehmansecuritieslitigation.com/.

[4] In re Lehman Brothers Holdings, Inc, et al (Case No 08-13555(JMP), Bankr SDNY, 15 September 2009 and Lomas v JFB Firth Rixson Inc. [2012] EWCA Civ 419 where the English and US courts reached conflicting rulings with respect to the same Section 2(a)(iii) of the ISDA Master Agreement.

[5] Panel of Recognized International Market Experts in Finance exists since 2012.

can intelligently interpret financial markets regulations in light of new facts. Therefore, the courts can potentially play an important role in the battle against financial market systemic risk. However, when it comes to the derivatives markets and complex product litigation, the courts can also be a source of systemic risk," writes Jeffrey Golden.[6]

Another practical point is the enforcement. A court decision has no value if it cannot be enforced in the jurisdiction where the assets of the counterparty are located. Unfortunately, court decisions are not universally enforceable and the system of recognition treaties is a patchy one – based on bilateral treaties or in the best case on the regional instruments.[7] By contrast, the 1958 New York Convention[8] would assist in enforcing an arbitral award in approximately 150 countries without challenging the merits of the case. Recent efforts have been made to improve enforcement of court decisions internationally.[9] One of the intentions behind the new Hague Convention on Choice of Court Agreements, as well as the ongoing Hague Judgments Project shall create an international instrument that eventually achieves mutual recognition of court judgments in parallel to what the New York Convention has achieved in the area of global recognition of arbitration awards.

**The industry seems to have finally understood.** Several indicators points toward brighter prospects for the arbitration of the future derivatives disputes. ISDA's consultation in 2011 showed interest of the industry members in using arbitration for disputes arising in connection with derivatives transactions docu-

[6] Jeffrey Golden, "Judges and Systemic Risk in the Financial Markets", Fordham Journal of Corporate & Financial Law, Volume XVIII 2013 number 2.

[7] Within EU countries based on EU Brussels I Regulation (44/2001) on Jurisdiction and the Recognition of Judgments in Civil and Commercial Matters, revised ("recast") in force on 10 January 2015; extended to Norway, Switzerland and Iceland by the 2007 Lugano Convention on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters.

[8] United Nations Convention on Recognition and Enforcement of Foreign Arbitral Awards done at New York on June 10, 1958. The text and list of Contracting States is available at http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention.html.

[9] The Hague Convention of 30 June 2005 on Choice of Court Agreements may at some time in the future provide an effective regime for enforcing judgments made pursuant to exclusive jurisdiction clauses. At the date this article was submitted to the editor, only Mexico and Singapore have ratified. The EU has started the ratification process: The Council´s approval of 4th December 2014 on behalf of the EU shall be deposited by July 2015 and the date of the entry into force for EU of the Convention published in the EU´s Official Journal. It is anticipated that the entry into force of this Convention will occur in June once the latest instrument of ratification will be deposited. At the Hague Conference on Private International law in March 2015 it was mentioned that a number of other states are considering signing the Convention as well. The text and list of Contracting States is available at http://www.hcch.net/index_en.php?act=text.display&tid=134.

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mented under the ISDA master agreement. The resulting 2013 ISDA Arbitration Guide[10] provides a helpful analysis of the key factors in driving the choice of dispute resolution method and key points to consider when drafting the arbitration clauses. Currently, the parties may choose from 11 "ISDAfied" model clauses combining various governing laws, seats and arbitral rules.

This is a clear sign that litigation will not anymore be perceived as a unique market standard for derivatives. The ISDA Arbitration Guide recognizes the good reasons for selecting the arbitration in certain context. At the same time, the one size fits all approach would not be a sensible one – there may still be situations where court litigation is more appropriate. To give the full legitimacy to arbitration in derivatives, it is desirable that ISDA hardwires the arbitration clause in the body of the agreement itself alongside with litigation. Moving the arbitration from the category of "amendments" into the standard options selected by the parties in their bilateral negotiations would help leveling the playing field.

Some reputed arbitration institutes have not made it into the ISDA Arbitration Guide. In preparing model arbitration clauses, ISDA has been led by the responses it has received from its members. At that time, not enough support was voiced in favor of the Nordic arbitral institutions such as the Arbitration Institute of the Stockholm Chamber of Commerce, explains ISDA.

**The Nordic reality is however different.** The Roschier Dispute Index reveals throughout the years that arbitration remains the preferred dispute resolution method in Nordics.[11] The SCC Rules rang as the most popular choice among the arbitration rules. SCC has an excellent reputation internationally, as a neutral, cost and time efficient arbitral institution. This makes it a good candidate also for the derivatives markets.

In this context, an "ISDAfied" SCC model clause has been drafted by the Swedish law firms Mannheimer Swartling and Gernandt & Danielsson in consultation with the local derivatives industry. "We will announce the new model clause on our website soon", confirms Natalia Petrik, legal counsel at the Arbitration Institute of the Stockholm Chamber of Commerce.[12] In parallel, the Swedish model clause has been submitted to ISDA and supported by the large Swedish members. "Amendments are being considered based on demand expressed by market participants", says Peter Werner, the senior director at ISDA. "Initial proposals for expanding the suite of ISDAfied arbitration clauses in the ISDA Arbitration Guide have been made at the December 1, 2014 ISDA Arbitration

[10] 2013 ISDA Arbitration Guide, version 1.0, 9 September 2013.

[11] Roschier Disputes Index 2014, A Biennial Survey on Facts and Trends in International Dispute Resolution from a Nordic Perspective Link to survey:http://roschier.com/news-and-media/articles-surveys/survey-roschier-disputes-index-2014-9-april-2014.

[12] The clauses were not yet released at the time this article was submitted to the editor.

Committee meeting. Further discussions will take place throughout 2015", clarifies Peter Werner.

**In reality, all choices seem wrong when it comes to a dispute.** It is interesting to note the gap between the parties' voiced preference for arbitration and the actual use of arbitration clauses. The 2014 Roschier Disputes Index reveals the contradiction in Sweden, where the disputes are mostly litigated (according to 77 percent of the respondents) while 62 percent of the respondents reported preference for arbitration.[13] The great debate – litigation versus arbitration – continues. The paradox is the universal perception of each camp that the resolution method of their preference is cheaper and more efficient than the other camp's alternative (see 2014 Roschier Disputes Index, decisive factors for choice of arbitration and litigation, p. 8–9). The individual experience (usually bad, whatever method is involved) is the most determining factor in taking the side.

No consensus may ever be reached. But the disputes in derivatives are certain not to decrease. The financial products may have been simplified after the last financial crisis, but this time the source of disputes may come from the complexity of the financial regulation. It is far from clear how the markets will implement the upcoming clearing, margining and other post-Lehman measures to regulate derivatives. Something the judges may have difficulties to understand. "It makes no sense to spend a fortune on a better regulation but not a penny to judges' education", means Jeffrey Golden. While P.R.I.M.E. Finance educates judges, the safest option for the derivatives firms is to start looking for competent arbitrators.

[13] See http://roschier.com/news-and-media/articles-surveys/survey-roschier-disputes-index-2014-9-april-2014.