

The Parties' Right to Choose the UNIDROIT Principles as the Law Governing their Contract

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ABSTRACT

Parties negotiating an international contract have to deal with a number of challenges that are unique to international transactions. The most challenging part of the negotiations is the determination of the applicable law since parties have certain requirements with regard to the law that will govern issues not expressly dealt with in their contract. When agreeing on the applicable law parties often look for a neutral solution that does not favor either party. In the context of international business transactions, the UNIDROIT Principles – as a set of rules reflecting the needs of international trade - are the most effective choice. However, parties' freedom to choose the UNIDROIT Principles as the governing law of their contract depends on whether they submit their dispute to arbitration or litigation. More specifically, parties' ability to choose the Principles to serve as a governing law of their contract is confined to arbitration. Since the UNIDROIT Principles, in contrast to domestic laws, offer significant advantages in the context of international business transactions, this paper will examine why parties submitting their dispute to litigation are unable to choose the Principles as the governing law of their contract and derive full benefit from them, and whether it is necessary to eliminate the present distinction, i.e. give parties the right to choose the UNIDROIT Principles as the governing law of their contract even when they decide to submit their dispute to courts.

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Introduction

When parties negotiate an international contract, it is very important that they make the ‘right’ choice of law.¹ Even though most conflict-of-laws rules allow parties to create their own contractual framework (*principle of party autonomy*²), it is practically impossible for the parties to address every possible issue that may arise from a contract.³ Thus, it is important to know which law applies to that contract because that law governs those issues not expressly dealt with by the parties.⁴ However, determining the proper law is probably the most challenging part of contract negotiations, and it is even more challenging in case of international commercial contracts. Parties negotiating international commercial contracts will often feel the need to submit their contract to neutral rules that do not favor either party.⁵ In other words, parties will often want to avoid the application of any domestic law and to subject their contract to a neutral regime. And a valid alternative for the parties are the UNIDROIT Principles of International Commercial Contracts (hereinafter: the UNIDROIT Principles).

The UNIDROIT Principles are “a non-legislative codification or ‘restatement’ of the law of international commercial contracts in general”⁶ adopted in 1994 under the auspices of the International Institute for the Unification of Private Law⁷. The UNIDROIT Principles cover almost all areas of general contract law starting from contract formation, validity, content,

¹ Christiana Fountoulakis, *The Parties' Choice of 'Neutral Law' in International Sales Contracts*, 7 EJLR 303 (2005). See <http://www.cisg.law.pace.edu/cisg/biblio/fountoulakis.html>.

² “Parties are free to enter into a contract and determine its content (principle of party autonomy)” See University of Cologne, Comment to *Principle of Freedom of Contract*, TRANS-LEX.ORG, <http://www.trans-lex.org/918000/-/freedom-of-contract/#comments> (last visited Dec.1, 2016).

³ Fountoulakis, *supra* note 1.

⁴ *Id.*

⁵ Fabio Bortolotti et al., International Chamber of Commerce, Developing Neutral Legal Standards for International Contracts 4.

⁶ Michael Joachim Bonell, *Symposium Paper: The UNIDROIT Principles of International Commercial Contracts: Achievements in Practice and Prospects for the Future*, 17 Austl. Int'l L.J. 177, 178 (2010).

⁷ UNIDROIT is an independent intergovernmental Organization. Its purpose is to study needs and methods for modernizing, harmonizing and co-ordinating private and in particular commercial law as between States and groups of States and to formulate uniform law instruments, principles and rules to achieve those objectives. See UNIDROIT, *History and Overview*, [unidroit.org, http://www.unidroit.org/about-unidroit/overview](http://www.unidroit.org/about-unidroit/overview).

interpretation, non-performance, performance, and remedies to third party rights, agency, conditions, assignment and limitation periods.⁸ In addition, few other issues were addressed in the recent third edition of the Principles such as restitution, illegality, plurality of obligors and obligees, and conditions. Since the UNIDROIT Principles have the status of soft law instrument, they become binding only if expressly or implicitly agreed upon by the parties. Furthermore, the Principles constitute one of the ‘branches’ or ‘components’ of transnational law.⁹

The preamble of the UNIDROIT Principles provides for the various uses that can be made of the Principles and the list is not even exhaustive.¹⁰ Nevertheless, the preamble suggests a hierarchy of such uses.¹¹ It is provided that at the top of this hierarchy is the use contained in paragraph 2 of the preamble that provides that the Principles “shall be applied when the parties have agreed that their contract be governed by them”.¹² Basically, when parties to an international business transaction want to avoid the application of any domestic law and want to subject it to a more neutral regime, they can agree on the application of the Principles. However, the effects of such an agreement may vary depending on whether it is invoked before

⁸ MICHEAL JOACHIM BONELL, THE UNIDROIT PRINCIPLES OF INTERNATIONAL COMMERCIAL CONTRACTS: PRESENT STATE AND PROSPECT FOR THE FUTURE 1 (Speech at CLE Seminar, Sydney Law School, 2008).

⁹ Markus Petsche, *The Application of Transnational Law (Lex Mercatoria) by Domestic Courts*, 10 J P Int'l L. 489, 500 (2014).

¹⁰ The text of the Preamble of the Principles:

(Purposes of the Principles)

These Principles set forth general rules for international commercial contracts.

They shall be applied when the parties have agreed that their contract be governed by them.

They may be applied when the parties have agreed that their contract be governed by general principles of law, the *lex mercatoria* or the like.

They may be applied when the parties have not chosen any law to govern their contract.

They may be used to interpret or supplement international uniform law instrument.

They may be used to interpret and supplement domestic law.

They may serve as a model for national and international legislators.

See UNIDROIT, PREAMBLE (PURPOSE OF THE PRINCIPLES), unidroit.org, <http://www.unidroit.org/instruments/commercial-contracts/unidroit-principles-2010/418-preamble/862-preamble-purpose-of-the-principles>.

¹¹ Ralf Michaels, *The UNIDROIT Principles as global background law*, 19 Unif. L. Rev. 643, 645 (2014).

¹² “...the only use marked as mandatory in the preamble (‘shall be applied,’ as opposed to ‘may be applied’).” See Michaels, *supra* note 11.

an arbitral tribunal or a domestic court.¹³ The first question that arise is why there is such a distinction when the parties and the dispute are still the same. This issue is extremely important because the Principles, like other transnational law norms and unlike domestic law, offer certain advantages. More precisely, the Principles avoid the undesirable consequences produced by a domestic law when applied in the context of international business transactions. It is provided that since transnational law norms - including the UNIDROIT Principles- are created by the international business community itself, they “respond to the specific needs and expectations of international business operators, i.e. they are particularly suitable for the purposes of international business transactions.”¹⁴ For this reason, this thesis will examine the issue of whether or not parties to an international business transaction should be given the right to choose the UNIDROIT Principles as the governing law of their contract.

The first chapter discusses current state of affairs, in other words, the effect given to the parties’ choice of the UNIDROIT Principles as a governing law by courts and arbitral tribunals. This chapter emphasizes parties’ limited freedom as to the choice of the applicable law provided for both in the EU and the US legislation. The second chapter addresses, on the one hand, the undesirable consequences created by domestic law once applied in the context of international business transactions, and on the other hand, the advantages that the UNIDROIT Principles offer to parties involved in such transactions. In addition, the second chapter will analyze the scholarly debate as to whether or not the UNIDROIT Principles should be made available as the applicable law in the sense of private international law. And lastly, this chapter will describe the developments suggesting possible changes in the status of the UNIDROIT Principles as the governing law.

¹³ Bonell, *supra* note 6.

¹⁴ Petsche, *supra* note 9, at 506.

CHAPTER 1 – Parties' Right to Choose the UNIDROIT Principles as a Governing Law: Current Approaches Followed by Courts and Arbitral Tribunals

Globalization and international trade between market participants coming from various nations and legal orders have caused international trade and investment to become highly complex.¹⁵ This complexity is particularly concerned with “the law as a service discipline to such trade and transactions”.¹⁶ At present, there is no single legal mind that can master all important aspects.¹⁷ Whenever parties to an international business transaction retain a lawyer, the later one needs to compare the various laws that might be applicable and choose the one that best fits the circumstances of the case.¹⁸ Parties to such transaction will often want to submit their contract to a neutral law that does not favor either of the parties.¹⁹ According to most conflict-of-law rules in the world parties can choose the law that courts or arbitrators have to apply to their contract.²⁰ And the traditional approaches include the law of one of the parties or the law of a third country. Taking in to account the parties' need to submit their contract to a neutral regime, the traditional solution that is being used consist of submitting the contract to the domestic law of a third country.²¹ When parties submit their contract to the law of a third country, they will find themselves in a similar position, i.e. both will have to deal with an unfamiliar law.²² Even though this solution is much balanced than the choice of the domestic law of one of the parties,²³ this is not the best option available to parties engaged in international trade.

¹⁵ Eckart Brodermann, *The Impact of the UNIDROIT Principles on International Contract and Arbitration Practice- the Experience of a German Lawyer*, 16 Unif. L. Rev. 589 (2011).

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ Andreas Schwartz, *New Trends in Parties' Options to Select the Applicable Law? The Hague Principles on Choice of Law in International Contracts in a Comparative Perspective*, 12 U. St. Thomas L.J. 87 (2015).

²¹ Bortolotti et al., *supra* note 5.

²² *Id.*

²³ *Id.*

When choosing the law of a third country, it is very rare that the parties have a good knowledge of that law.²⁴ Since parties will usually not have time during the contract negotiations to check whether their contract is fully in compliance with the chosen law, it may come out later that some of the contractual provisions do not comply with that law or that some of the gaps will be filled by provisions which give rise to unexpected outcomes.²⁵ Therefore, coming back to the point that parties negotiating an international contract will often want to submit their contract to a neutral law, submitting ones contract to any domestic law is not the best choice. The other alternative that parties have is to submit their contract to transnational rules. It is in this context that the UNIDROIT Principles can come into play and serve as neutral set of rules (not as a neutral law). However, as it was mentioned above, the effect of parties' recourse to such neutral set of rules varies depending on the dispute settlement body the parties choose.

1.1 Impossibility for the Parties to Choose the UNIDROIT Principles in Litigation

Domestic courts, unlike arbitral tribunals, do not allow the application of the UNIDROIT Principles or any other branch of transnational law as the governing law of a contract. In other words, domestic courts refrain from respecting parties' choice of the UNIDROIT Principles as the applicable law. The general rule is that domestic courts are bound to apply their own domestic law, as well the appropriate conflict-of-laws rules.²⁶ Professor Michael Bonell²⁷ asserts that "the traditional and still prevailing view [is that] the choice of law applicable to international contracts is limited to a particular domestic law, which is to the

²⁴ *Id.*

²⁵ *Id.*

²⁶ Michael Joachim Bonell, *UNIDROIT Symposium: Soft Law and Party Autonomy: The Case of the UNIDROIT Principles*, 51 Loy. L. Rev. 229, 243 (2005).

²⁷ Professor of Law, University of Rome "La Sapienza", Chairman of the Working Group for the preparation of the UNIDROIT Principles.

exclusion of any international normative system”²⁸. This view is confirmed by the legislation of several countries, including but not limited to the European Union and the United States.

1.1.1 Parties’ limited freedom as to the choice of the applicable law in the European Union

In case of the European Union, there is the Regulation on the Law Applicable to Contractual Obligations (hereinafter: the Rome I Regulation) that elaborates on the issue of choice of law.²⁹ Article 3 (1) of the Rome I Regulation provides that “a contract shall be governed by the law chosen by the parties”.³⁰ Nothing in paragraph 1 of the relevant article suggests that parties’ freedom to choose the applicable law is limited to a choice between domestic laws. However, in the Preamble of the Rome I Regulation it is provided that parties can only incorporate by reference into their contract a non-State body of law or an international convention (i.e. transnational law).³¹ Based on this formulation one can conclude that under the Rome I Regulation parties are not allowed to choose any transnational law such as the UNIDROIT Principles as the law governing their contract. Thus, in the EU, parties’ freedom to choose the applicable law is limited to a choice between domestic laws. This view is also confirmed by the legislative history of the Rome I Regulation.

Since the Rome I Regulation is the successor of the Rome Convention on the Law Applicable to Contractual Obligations (1980), during the period of transformation of the Convention into the Regulation, the European Commission³² proposed to amend Article 3 of the Convention by allowing the parties to choose, apart from law of a particular state, a non-

²⁸ Bonell, *supra* note 26, at 236.

²⁹ Regulation (EC) No 593/2009 of the European Parliament and of the Council of 17 June 2008 on the Law Applicable to Contractual Obligations; The Regulation is directly applicable, meaning that it automatically becomes part of the domestic laws of the member states.

³⁰ *Id.* Available at <http://eur-lex.europa.eu/legal-content/EN/TEXT/PDF/?uri=CELEX:32008R0593&from=EN>.

³¹ *Id.* Recital 13: “This Regulation does not preclude parties from incorporating by reference into their contract a non-State body of law or an international convention”.

³² EU body responsible for proposing laws and for their enforcement once the European Parliament and Council adopt them.

state body of law as the applicable law.³³ It was specifically indicated in the proposal that the UNIDROIT Principles can be an option.³⁴ However, the proposal was rejected by the governments of the Member States.³⁵ The situation as to the choice of the applicable law is quite the same on the other side of the Atlantic.

1.1.2 Parties' limited freedom as to the choice of the applicable law in the United States

In the US, the controlling body in the field of conflict-of-laws is the Restatement Second on Conflict of Laws (hereinafter: the Restatement). The Restatement gives the parties the freedom to choose the applicable law, but at the same time limits the freedom to a choice between laws of States. This follows from the language used in the Restatement. For example, section 187 of the Restatement stipulates that “the *law of the state* chosen by the parties to govern their contractual rights and duties will be applied...”(emphasis added).³⁶ Also, section 188 of the Restatement asserts that in case of an absence of effective choice by the parties of the law governing their contract, the governing law shall be “*local law of the state...*”³⁷ Since reference is made only to state law, one can conclude that the Restatement only permits the choice of a state law.³⁸

Basically, both in the EU and the US, when parties want to bring their dispute before a national court, their choice of the applicable law is limited to a choice between domestic laws. In case of a deviation from the general rule, no effect will be given to such a choice. However,

³³ Proposal for a Regulation of the European Parliament and the Council on the Law Applicable to Contractual Obligations (Rome I), COM (2005) 650 final (Dec.15, 2005).

³⁴ *Id.* at 24.

³⁵ Brodermann, *supra* note 15, at 595.

³⁶ Restatement (Second) of Conflict of Laws §187 (1969 Main Vol.), <http://www.kentlaw.edu/perritt/conflicts/rest187.html>.

³⁷ Restatement (Second) of Conflict of Laws §188 (1969 Main Vol.), <http://www.kentlaw.edu/perritt/conflicts/rest188.html>.

³⁸ Petsche, *supra* note 9, at 494.

even though parties are not allowed to choose any transnational law as the governing law of their contract, they are allowed to incorporate such non-state body of law into their contract.

1.1.3 Parties' Right to Incorporate the UNIDROIT Principles in to their Contract

Since the traditional and still prevailing view is that the choice of the applicable law in international contracts is limited to a particular domestic law,³⁹ in case if the parties refer to the UNIDROIT Principles as the governing law of their contract, “domestic courts are likely to consider such a reference as a mere agreement to incorporate the Principles into the contract”.⁴⁰ This means that the proper law of the contract must be determined by the court on the basis of private international law of the forum.⁴¹ In case of incorporation by reference, the Principles will only bind the parties to the extent they do not affect the rules of the applicable domestic law from which the parties may not derogate, i.e. mandatory rules.⁴² Parties' ability to incorporate the UNIDROIT Principles by reference into their contract is provided both in the Rome I Regulation and the US Restatement.

As it was mentioned earlier, the Rome I Regulation does not preclude parties from incorporating into their contract a non-State body of law (Recital 13 of the Rome I Regulation).⁴³ The notion of incorporation means that the non-state law that will be applied by the parties would have the value of contractual clause.⁴⁴ Basically, reference to the UNIDROIT Principles in a choice-of-law clause must be interpreted in light of the interpretation rules of the applicable domestic law that is determined by application of the Rome I Regulation with due regard to Recital 13 of the Regulation.⁴⁵ The “choice of the UNIDROIT Principles” clause

³⁹ See *supra* text accompanying note 28.

⁴⁰ Bonell, *supra* note 26, at 237.

⁴¹ *Id.*

⁴² *Id.*

⁴³ See *supra* note 31.

⁴⁴ Bortolotti et al., *supra* note 5, at 7.

⁴⁵ Brodermann, *supra* note 15, at 596.

is not a “choice-of-law” clause in the sense of Article 3 of the Rome I Regulation since it does not provide for the application of a national law.⁴⁶ Consequently, the proper law, i.e. the applicable national law, will have to be determined in accordance with Article 4 of the Rome I Regulation dealing with the applicable law in the absence of choice.⁴⁷ But, the “choice of UNIDROIT Principles” clause still reaches its goal due to the principle that exists in most if not all European laws.⁴⁸ According to the principle, the true intent of the parties must be taken into account when constructing or interpreting commercial contracts.⁴⁹ Therefore, “even the technically incorrect ‘choice-of-law’ clause referring to the UNIDROIT Principles must be read as an expression of the intent of the parties to apply [the Principles] to the extent that such application does not violate the otherwise applicable national law”.⁵⁰ The otherwise applicable national law will only intervene when the UNIDROIT Principles, whether incorporated fully or partially, violate mandatory national law.⁵¹ In a nutshell, regardless of the wording of the Article 3 of the Rome I Regulation, parties are permitted to incorporate the UNIDROIT Principles into their contract and deal with the peculiarities of such incorporation.

The same ‘incorporation by reference’ is provided in the US Restatement.⁵² But what is unique about the US is that in two states, Oregon and Louisiana, parties are allowed to choose non-state norms, such as the UNIDROIT Principles, by means of private international law.⁵³ For instance, in case of Oregon, the 2001 Oregon Choice of law Codification intentionally uses

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² Petsche, *supra* note 9, at 497.

⁵³ Schwartze, *supra* note 20, at 94. In case of Louisiana, Article 3540 (called Party Autonomy) of the Louisiana Civil Code stipulates the following: “*All other issues of conventional obligations are governed by the law expressly chosen or clearly relied upon by the parties, except to the extent that law contravenes the public policy of the state whose law would otherwise be applicable under Article 3537*” (emphasis added). In simple terms, the word *law* is used instead of *state law*, thus, giving some discretion to the courts to decide what law is.

word *law* instead of *state law*,⁵⁴ and in the official comments it is provided that parties may select model rules or principles such as the UNIDROIT Principles.⁵⁵

The incorporation of the UNIDROIT Principles or any other transnational law norms, however, complicates the parties' legal relationship.⁵⁶ Because the "transnational law norms and domestic contract law are similar in nature and scope, those two set of norms will generally overlap and number of questions will arise as to whether a particular transnational law norm is valid under the applicable domestic law".⁵⁷ If parties decide to incorporate the UNIDROIT Principles into their contract, a lot of problematic issues may arise. For example, an issue could arise in relation to the question of whether judicial contract adaptation provided for in the Principles is compatible with the applicable domestic law.⁵⁸ It is provided that since certain difficulties may arise as a result of the incorporation of transnational law norms, these norms are "ill-suited for incorporation as contract terms".⁵⁹ The 'basic function' of transnational law is to "provide parties with an independent, comprehensive set of norms that govern all issues arising out of their transaction".⁶⁰ And the combined application of the UNIDROIT Principles, or any other transnational law norms, and domestic law defeats this basic purpose.⁶¹

The UNIDROIT Principles were drafted by international business community to meet the specific needs of business actors, and every provision contained within them has its own purpose. However, through incorporation these provisions are not given full effect, because their application depends upon the mandatory rules of the applicable domestic law.

⁵⁴ Johanna Hoekstra, *The UNIDROIT Principles as the Law of the Contract in France and the US*, <http://blogs.sps.ed.ac.uk/sls/files/2013/08/Johanna-Hoekstra.pdf>.

⁵⁵ Symeon Symeonides, *Oregon' Choice-Of-Law Codification for Contract Conflicts: An Exegesis*, 44 *Williamette L. R.* 205, 288 (2007).

⁵⁶ Petsche, *supra* note 9, at 498.

⁵⁷ Petsche, *supra* note 9, at 498.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*

1.2 Right of the Parties to Choose the UNIDROIT Principles in Arbitration

As for today, only in the context of international commercial arbitration parties are often allowed to choose a soft law instrument such as the UNIDROIT Principles as the governing law of their contract instead of a domestic law.⁶² Parties' right to choose transnational law, comprised of the UNIDROIT Principles and several other branches⁶³, as the governing law of their contract is provided in most national arbitration laws and institutional arbitration rules. For instance, UNCITRAL Model Law on International Commercial Arbitration, which has served as a model for other states when adopting their national arbitration laws,⁶⁴ provides in Article 28 that the arbitral tribunal shall decide the dispute in accordance with such *rules of law* as are chosen by the parties.⁶⁵ In the Explanatory Note by UNCITRAL Secretariat on the Model Law, it is provided that the Model Law by referring to *rules of law* instead of *law* broadened the "range of options available to the parties as regard the designation of the law applicable to the substance of the dispute".⁶⁶ According to the Explanatory Note "parties may agree on *rules of law* that have been elaborated by an international forum but have not yet been incorporated into any national legal system" (emphasis added).⁶⁷ Thus, since the UNIDROIT Principles are set of rules adopted by an intergovernmental body, parties can choose them as the rules of law governing their contract. Similar provision is contained in the arbitration laws of the states that do not follow the Model law.

⁶² Bonell, *supra* note 6, at 183.

⁶³ "Some of the better known and more frequently applied, branches of transnational law include the so-called *trunc commun*, UNIDROIT Principles, General Principles, and trade usages." See Petsche, *supra* note 9, at 500.

⁶⁴ There are about 73 states that have adopted their legislation on the basis of the Model Law. See UNCITRAL, *Status UNCITRAL Model Law on International Commercial Arbitration (1985), with amendments as adopted in 2006*, [uncitral.org](http://www.uncitral.org),

http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/1985Model_arbitration_status.html.

⁶⁵ UNCITRAL Model Law on International Commercial Arbitration, Art. 28(1).

⁶⁶ UNCITRAL Secretariat, *Explanatory note by UNICTRAL Secretariat on the 1985 Model Law on International Commercial Arbitration as amended in 2006*, Sec. 39, available at

<http://www.uncitral.org/pdf/english/texts/arbitration/ml-arb/MLARB-explanatoryNote20-9-07.pdf>.

⁶⁷ *Id.*

States that do not follow the Model Law also give parties the possibility to apply transnational law to their contracts. The arbitration laws of France, Switzerland and Netherlands can serve as an example. Their arbitrations laws were the first ones that intentionally used the term *rules of law* instead of law, in order to make it clear that the parties' freedom as to the choice of the applicable law was no longer restricted to particular domestic law, but also included the rules of law of a supranational or transnational character.⁶⁸

Furthermore, parties to an international transaction are granted the right to choose the UNIDROIT Principles as the law governing their contract under the rules of several arbitration institutions⁶⁹. For instance, Article 21 of the International Chamber of Commerce Arbitration Rules provides that "parties shall be free to agree upon the rules of law to be applied by the arbitral tribunal to the merits of the dispute". An identical provision is contained in Article 22.3 of the London Court of International Arbitration Rules. A similar situation exists in case of *ad hoc* arbitration. Parties choosing an ad hoc arbitration over institutional one frequently use UNCITRAL Arbitration Rules,⁷⁰ which provide for the application of rules of law chosen by parties to the merits of the dispute.⁷¹

In sum, the arbitration law and rules that use the term *rules of law* instead of law, allow the parties to apply the UNIDROIT Principles to their contract, and consequently, such a choice will be given effect by the tribunals when deciding dispute arising out of the parties' contract. The disputes include not only disputes concerning interpretation and performance/non-performance of the contract, but also contract formation.⁷² The present distinction in the parties' freedom to choose the UNIDROIT Principles as the applicable law depending on

⁶⁸ Bonell, *supra* note 26, at 242.

⁶⁹ E.g. International Chamber of Commerce (ICC), London Court of International Arbitration (LCIA), American Arbitration Association (AAA), Vienna International Arbitration Centre (VIAC).

⁷⁰ UNCITRAL, *UNCITRAL Arbitration Rules*, [uncitral.org, http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/2010Arbitration_rules.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/2010Arbitration_rules.html).

⁷¹ UNCITRAL Arbitration Rules (as revised in 2010), Art. 35.1.

⁷² Bonell, *supra* note 26, at 243.

whether they decide to submit their dispute to court or arbitral tribunal, becomes of a particular concern due to the advantages the Principles offer to parties engaged in international commerce. Therefore, it is important to determine the reasons for such a distinction and make a final determination as to whether or not the UNIDROIT Principles should be made available in the sense of private international law (*see infra* Chapter 2).

CHAPTER 2 - Parties' Right to Choose the UNIDROIT Principles as a Governing Law: Future Perspective

The UNIDROIT Principles have been adopted by an intergovernmental organization such as the UNIDROIT in order to address the specific needs of parties engaged in cross-border transactions. This chapter will examine to what extent the needs of the parties to an international contract are satisfied when domestic law is applied and when the UNIDROIT Principles are applied, in order to make a final determination as to whether or not it is necessary to abolish the current distinction in the parties' freedom to choose the UNIDROIT Principles as the applicable law depending on whether they decide to submit their dispute to arbitration or litigation.

2.1 Potential Deficiencies of Domestic Law as the Governing Law in the Context of International Business Transactions

By the end of the 20th century there was a rapid increase in international trade due to globalization.⁷³ Even though the increase in international trade brought a huge potential for economic growth, along with it came greater risks to the parties involved in cross-border trade.⁷⁴ The parties had to face new challenges that were specific to cross-border transactions.⁷⁵ As for today, since parties involved in international commercial transactions are limited in their choice of the applicable law when standing before courts, there are number of risks that they have to bear.

⁷³ Christine M. Whited, *The UNIDROIT Principles of International Commercial Contracts: An Overview of their Utility and the Role they have Played in Reforming Domestic Contract Law Around the World*, 18 ILSA J Int'l & Comp L 167 (2011).

⁷⁴ *Id.*

⁷⁵ *Id.* at 168.

According to Professor Fabio Bortolotti, there are number of challenges that lawyers face when representing client engaged in cross-border transaction.⁷⁶ One of the risks that lawyers face relates to their ability to understand a foreign country's rules on contracts.⁷⁷ It is provided that "in most countries, domestic rules on contracts, and particularly those concerning the general aspects of contract law, are the outcome of a long evolution".⁷⁸ The domestic rules on contracts are complicated, on the one hand, because of the complexity of the matters covered, and on the other hand, because they reflect several years, if not centuries, of legal thinking, which sometimes complicates even simple things.⁷⁹ Thus, it is difficult for a lawyer negotiating an international contract to "really understand a foreign country's rules on contracts".⁸⁰ A lawyer negotiating an international contract with a foreign law involved might be able to spot the text of the relevant rules provided that they are codified (which is not always the case), and the rules may be available in an accessible language, but in most cases he won't be able to assess their actual content with any certainty.⁸¹ These problems, according to Professor Bortolotti, can be dealt with by hiring a lawyer familiar with the applicable law, but there are certain barriers that render this option less effective.⁸² First, in most cases there is no time during the contract negotiations to hire a lawyer, and second, there are communication problems between the lawyers coming from different countries ("probably because most of them are used to reasoning within the confines of their domestic law").⁸³ As to the communication issue, Professor Bortolotti points out that "often the local lawyer will fail to

⁷⁶ Fabio Bortolotti, *The UNIDROIT Principles and the Arbitral Tribunals*, Unif. L. Rev. 141 (2000), in: Whited, *supra* note 71, at 172.

⁷⁷ *Id.*

⁷⁸ Fabio Bortolotti, *The UNIDROIT Principles as basis for alternative choice-of-law clauses, with particular reference to the ICC model contracts*, 19 Unif. L. Rev. 542, 544 (2014).

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² Bortolotti, *supra* note 76, at 141-142, in: Whited, *supra* note 71, at 172.

⁸³ *Id.*

grasp the substance of the problem he is required to answer, while the requesting lawyer will have trouble understanding...advice base on legal reasoning unfamiliar to him”.⁸⁴

The other risk that parties to international contracts have to bear, when applying law of one of the parties or that of a third country, is the “uncertainty of the outcome in the face of a legal dispute”⁸⁵. It is provided that ideally contract should eliminate surprises by predetermining all aspects of a contractual relation between parties.⁸⁶ This predictability is even more important for international traders because they are usually “not dealing at arm’s length and have higher frequency of misunderstanding due to communication barriers”.⁸⁷ In case of international transaction, it can be very difficult for a lawyer to predict the outcome of a dispute for his/her client.⁸⁸ For instance, parties to an international contract agreed on the application of one of the parties’ domestic contract law, which might be very difficult since the other party will most probably not feel comfortable agreeing to be bound by an unfamiliar foreign law to resolve future disputes.⁸⁹ It will be difficult for the lawyer of the other party to predict the outcome of the dispute for his client, because he will not have “intimate understanding of the other nation’s law”.⁹⁰ And even if the lawyer will have time during contract negotiations to hire a lawyer familiar with the applicable law, there could be communication barriers between the two either because of language or differences in legal reasoning.⁹¹ All of the above will make it difficult for the lawyer to understand how a contract will be interpreted by a foreign court or arbitral tribunal applying the foreign law and “will

⁸⁴ *Id.*

⁸⁵ Whited, *supra* note 73, at 172.

⁸⁶ *Id.*

⁸⁷ *Id.* at 173.

⁸⁸ *Id.*

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *Id.*

make it difficult for the lawyer to draft a contract giving the client maximum legal protection and sound legal advice”.⁹²

In order to have a better understanding of the risks that arise in the context of international transactions as a result of the application of a particular domestic law, it has been suggested to consider a potential scenario. For example, two companies with a place of business in different countries enter into a sale contract and choose Florida law as the governing law of their contract and Miami as the forum.⁹³ One of the first things that the parties should have been aware of before choosing Florida law as the governing law is that there is no common contract law in the US and that parties have to choose contract law of a particular state. Moreover, if both parties had their place of business in countries that were members to CISG and the contract provided for the application of Florida law, the governing law would be CISG and only procedural law of Florida would apply.⁹⁴ But, if the contract provided for the application of Florida contract law and expressly excluded CISG, then only the former would apply. Also, there is another issue that parties should have been aware of before choosing Florida law as the governing law. According to section 187 (2) (a) of the Restatement Second on Conflict of Laws when parties choose a law of state that has no “substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties’ choice”, this law will not be applied.⁹⁵ Thus, if the contract between the parties in the hypothetical case had no connection with State of Florida, the court of Florida may decide that “jurisdiction is not

⁹² *Id.*

⁹³ *Id.*

⁹⁴ *Id.* US has adopted CISG, but has made reservation under Article 95 of the Convention by excluding the application of the subparagraph 1(b) of Article 1. According to the reservation made, under the US legal system, CISG will be applicable between the parties only if both of them have their place of business in different Contracting States.

⁹⁵ Restatement (Second) of Conflict of Laws § 187; In the EU, unlike in the US, the Rome I Regulation does not require a connection between the law chosen and the parties or the transaction. Even though it is not explicitly stated in Article 3 of the Regulation that such connection is not required, this conclusion is based on the fact that in the Regulation there is no limitation on the choice of certain legal system. See Schwartz, *supra* note 20, at 92.

appropriate in the state based on *forum non conveniens*”⁹⁶, and as a result the contract would be subject to some other law in the US or somewhere else.⁹⁷ Consequently, the “result of this would be anyone’s guess”.⁹⁸

For the sake of illustrating the risk associated with international business transactions as was initially intended, it has been suggested to assume that parties in the hypothetical case agreed on the application of Florida law excluding CISG and that there was a sufficient connection between the contract and the State of Florida in order for the court to accept jurisdiction (e.g. contract was signed in Florida).⁹⁹ Consequently, the foreign lawyer would then have to deal with number of issues. First, the foreign lawyer will have to determine “what Florida state contract law is and how those laws affect rights and obligations of the parties to the contract”, which is not a simple task even for a local lawyer.¹⁰⁰ Second, he/she will have to determine whether the state has adopted the Restatement of Contracts in its entirety or partially, and if partially then which provisions of which edition of the Restatement it has adopted.¹⁰¹ In addition, the lawyer will have to go through case law and for that he/she has to pay to get access to the databases containing the cases.¹⁰² When going through the relevant cases, the lawyer will have to determine whether the holdings in those cases still constitute a good law or not. This particular course of action, i.e. *Shepardizing*,¹⁰³ is not generally understood by civil law lawyers.¹⁰⁴ Overall, the time spent by the lawyer to research the unfamiliar law is not only

⁹⁶ “*Forum non conveniens* is a discretionary power that allows courts to dismiss a case where another court, or forum, is much better suited to hear the case. Such a dismissal does not prevent plaintiff from submitting the case to a more appropriate forum. This doctrine may be invoked either by court or defendant”. See Legal Information Institute, *Forum Non Conveniens*, law.cornell.edu, https://www.law.cornell.edu/wex/forum_non_conveniens.

⁹⁷ Whited, *supra* note 73, at 174.

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ *Shepardizing*: A term used to describe the process of using a citator to discover the history of a case or statute to determine whether it is still good law. See *West's Encyclopedia of American Law*, edition 2. S.v. “Shepardizing.” Retrieved December 5, 2016 from <http://legal-dictionary.thefreedictionary.com/Shepardizing>.

¹⁰⁴ Whited, *supra* note 73, at 174.

highly costly, but also “result in ethical violations for lack of competency”.¹⁰⁵ The main issue is that it is very likely that crucial mistakes will occur that will disadvantage the client.¹⁰⁶ Even though there is an option to retain a lawyer familiar with the law applicable, such an alternative will also be costly.¹⁰⁷

In a nutshell, when domestic law is applied in the context of international business transactions it leads to number of undesirable consequences. First, the application of domestic law undermines the neutrality between the parties.¹⁰⁸ For example, when party A and B agree on the application of the domestic law of the later, that party will have “strategic advantages in terms of familiarity with the governing law and predictability of likely litigation outcomes”.¹⁰⁹ Second, applying domestic law to an international business transaction may be inappropriate because domestic laws are usually designed for a domestic context.¹¹⁰ They may contain some “domestic technicalities that are not widely recognized and are not suitable in an international context”.¹¹¹ These technicalities refer to various difficulties created by domestic laws which are unknown in other countries (e.g. peculiar formalities, brief cut-off periods, etc.).¹¹² Thus, the only way to avoid facing all these problems or minimize their impacts is to submit a contract to a more neutral legal framework, such as the UNIDROIT Principles.

2.2 The UNIDROIT Principles: A Viable Alternative for the Governing law in the Context of International Business Transactions

While domestic laws do not meet the “specific needs” of international business transactions such as the “the necessity to escape legal restrictions intended to apply in a purely domestic

¹⁰⁵ Whited, *supra* note 73, at 174.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ Petsche, *supra* note 9, at 492.

¹⁰⁹ *Id.* at 507.

¹¹⁰ *Id.* at 492.

¹¹¹ *Id.*

¹¹² O Lando, *The Lex Mercatoria in International Commercial Arbitration*, 34 International & Comparative Law Quarterly 747 (1985), in: Petsche, *supra* note 9, at 507.

context and neutrality”, the UNIDROIT Principles do meet these needs (emphasis added).¹¹³ It is provided that transnational law norms that are created by international business community itself respond to the specific needs and expectations of international business actors.¹¹⁴ This implies that transnational law norms such as the UNIDROIT Principles are more suitable for the purpose of cross-border transactions. Moreover, the UNIDROIT Principles are free from domestic technicalities (emphasis added).¹¹⁵

The UNIDROIT Principles or any other transnational law norms in general provide for the ‘neutrality’ that is desired in the context of international business transactions. The neutrality of transnational law “refers to the idea that the application of transnational law [norms] ensure equality between the parties”.¹¹⁶ The neutrality of transnational law does not mean that the norms are substantively fairer or more balanced than domestic rules, but it means that “its applicability ensures that parties are equally familiar with the applicable rules”.¹¹⁷ Thus, only with the application of transnational law norms parties to an international contract will be in a similar position as to the applicable law. Therefore, the UNIDROIT Principles serve as an alternative legal framework for parties to an international commercial contract who want to submit their dispute to a neutral legal regime which does not put any party at an unfair advantage.

The UNIDROIT Principles offer number of other significant advantages that are found to be attractive by trade actors. First of all, the Principles are available in many different languages and also, written simply in order to be easily understood by trade actors.¹¹⁸ Second, there is comprehensive commentary attached to all of the provisions of the Principles, including

¹¹³ Petsche, *supra* note 9, at 505.

¹¹⁴ LY Fortier, *The New Lex Mercatoria, or, Back To The Future*, 17 *Arbitration International* 121,127 (2001), in: Petsche, *supra* note 9, at 506.

¹¹⁵ Petsche, *supra* note 9, at 506-507.

¹¹⁶ *Id.* 507.

¹¹⁷ *Id.*

¹¹⁸ Whited, *supra* note 3, at 175.

illustrations that show how those provisions were intended to operate.¹¹⁹ Third, all international case law and decision of arbitral tribunals that one way or another make reference to the Principles are available free of charge on the UNILEX' website¹²⁰, which in turn reduces the cost of research.¹²¹ Moreover, since the UNIDROIT Principles do not address specific type of contract but apply to contracts in general, they are considered to be “flexible in nature and adaptable to the special circumstances of the contractual relationship and the various interests of the parties”.¹²² Due to this flexibility, the UNIDROIT Principles can be easily adapted to the technical and economic changes that take place in the field of international commerce.¹²³ Lastly, drafters of the UNIDROIT Principles while drafting the Principles did not choose the solutions that prevail in most legal system, but the solutions which they thought to be most suitable for cross-border contracts (*better rule* approach).¹²⁴

As was demonstrated above, parties' ability to choose the UNIDROIT Principles as the governing law of their contract depends on whether they decide to submit their dispute to arbitration or litigation. If parties agree to submit their dispute to litigation they are prevented from agreeing on the application of the UNIDROIT Principles as the governing law of their contract, and can only incorporate the Principles into their contract together with the applicable domestic law. But, such a combined application defeats the purpose of the Principles. Thus, taking into account the advantages that the UNIDROIT Principles offer to parties engaged in

¹¹⁹ *Id.*

¹²⁰ Ctr. For Int'l Comparative and Foreign Law Studies, *UNILEX on CISG and UNIDROIT Principles*, unilex.info, <http://www.unilex.info/>.

¹²¹ Whited, *supra* note 73, at 175.

¹²² Ceyda Sural, *Respecting the Rules of Law: The UNIDROIT Principles in National Courts and International Arbitration*, 14 VJ, 249, 251 (2014).

¹²³ *Id.*

¹²⁴ Bortolotti et al., *supra* note 5, at 13; “...while as a rules preference was given to solutions generally accepted at international level (common core approach), whenever...it was necessary to choose between conflicting rules what was decisive was not just which rules were adopted by the majority countries, but rather which of the rules under consideration had the most persuasive value and/or appeared to be particularly well suited for cross-border transactions (*better rule* approach)”. See *Symposium on the 2010 UNIDROIT Principles of International Commercial Contracts: Towards a “Global” Contract Law*, 1 (2011), available at <http://www.law.georgetown.edu/cle/materials/UNIDROIT/2011.pdf>.

cross-border transactions, depriving parties of the benefits offered by the Principles only when they submit their dispute to litigation seems to be unjustified. Parties choose litigation over arbitration and vice versa because of certain features of each dispute resolution process. Some contracting parties tend to choose arbitration due to certain characteristics pertinent to it, such as confidentiality, absence of an appeal, and impartiality (i.e. parties do not trust domestic courts thinking that they are biased or corrupted). Others may prefer to submit ones' dispute to domestic courts because they want to have an appeal opportunity. Since parties and the dispute are still the same in case of both dispute resolution processes, and parties choose one process over another only because it has some feature that they find attractive, it seems logical to give parties the right to choose the UNIDROIT Principles as the governing law of their contract. However, scholars are split on the issue of whether the UNIDROIT Principles should be made available as the applicable law in the sense of private international law.

2.2.1 Objections to the Application of the UNIDROIT Principles as a Governing Law

Some arguments have been raised against the application of the UNIDROIT Principles as the governing law of a contract. One of these arguments relates to 'incompleteness' of the Principles. Professor Ralf Michaels¹²⁵ has pointed out that the UNIDROIT Principles are incomplete in two regards: first, they do not contain rules on specific contracts; and second, they contain a provision providing for the application of the mandatory rules of a domestic law.¹²⁶ Also, the Principles make it clear that matters not expressly settled within them must be resolved by a domestic law.¹²⁷ What all this means is that the parties will not be able to "select [in the Principles] rules catered specifically to their specific contracts", and the parties will still

¹²⁵ Ralf Michaels is an expert in comparative law and conflict of laws, and a professor at Duke University School of Law.

¹²⁶ Michaels, *supra* note 14, at 663.

¹²⁷ *Id.* at 678; See also Article 1.6 of the Principles (comment 4).

have to comply with the rules that they most wanted to avoid when choosing the Principles.¹²⁸ The argument of incompleteness has some merits, but it can be rebutted. As was mentioned earlier, the UNIDROIT Principles are now available in their third edition, and with each edition the lacunae that existed were addressed.¹²⁹ Since the 2010 edition provides for the main general parts of contract law and the needs of the parties, few, if any problems should be anticipated.¹³⁰ Moreover, the UNIDROIT Principles are becoming more relevant and concrete due to their increasing use in arbitration and litigation.

Professor Ralf Michaels is of the opinion that there is no need to even deal with the question of should the UNIDROIT Principles be made available as the applicable law because parties rarely use them for the choice-of-law purposes (i.e. there is lack of interest shown by parties).¹³¹ According to Professor Michaels, the rare use of the Principles for the choice-of-law purposes is justified in case of litigation since courts are unwilling to give effect to such a choice, but it is not justified in case of arbitration where parties' choice is given effect. By going through cases available in the UNILEX, Michaels claims that out of 186 arbitral decisions that mention the UNIDROIT Principles only 19 address the applicability of the Principles as rules of law governing the contract in dispute.¹³² Even though Michaels stresses that this is relatively low figure and there is no need as a result to give parties the right to choose the UNIDROIT Principles as the governing law of their contract, there are number of legal

¹²⁸ *Id.*

¹²⁹ "Nonetheless, tort may still be an issue since, although it appears to be addressed by rules on illegality, in reality it is still absent". See Sarah Lake, *An Empirical Study of the UNIDROIT Principles – International and British Responses*, Unif. L. Rev. 669, 678 (2011).

¹³⁰ *Id.* The UNIDROIT Principles are often compared to the US Restatement in order to illustrate their shortcomings. But, if the Principles would have the same degree of complexity as the US Restatement, they would end up being too detailed. Complexity of the UNIDROIT Principles might lead to denial of their application by less developed countries, because, unlike the developed countries, the former one would not be able to understand them. Thus, the UNIDROIT Principles "offer general contract law without impairing their universality: they are equally applicable to any international commercial contract". The generality of the Principles is advantageous because they can be used for different types of transaction. See Lake, *supra* note 129, at 679.

¹³¹ Michael, *supra* note 14, at 646, 663.

¹³² *Id.* at 646. As for today, according to the UNILEX database, the total number of decision that refer to the UNIDROIT Principles one way or another is 189.

writers that hold an opposite view. For instance, Professor Bonell argues that parties should be able to choose the UNIDROIT Principles both before courts and tribunals and that the present distinction is unjustified. Bonell is of the view that there are plethora of arbitral and judicial decisions that one way or another refer to the UNIDROIT Principles and in a number of those arbitral decisions the Principles were applied as the rules of law governing the substance of the dispute.¹³³ Bonell did not attach any importance to the number of cases when making the argument that parties should be given the right to choose the UNIDROIT Principles even before courts. And this seems to be the right approach because the lowness of the figure does not change the fact that the UNIDROIT Principles offers significant advantages over domestic laws. Moreover, there are reasons for why the figure is low and it has nothing to do with lack of interest. On the one hand, the figure provided by Professor Michaels is not accurate, because due to the confidentiality feature of arbitration many cases remain undisclosed, and on the other hand, some parties are unaware of, or unfamiliar with, the UNIDROIT Principles.

In order to determine the UNIDROIT Principles' use in the commercial world, a survey was conducted among 500 UK practitioners and 500 practitioners internationally at random¹³⁴. As to the use of the UNIDROIT Principles for choice-of-law purposes, the British responses were quite different from the international responses. In case of British practitioners, over half of them were unfamiliar with the UNIDROIT Principles, while the remaining 45% were familiar but chose not to apply them.¹³⁵ However, it was clarified that such an attitude on the part of British practitioners was not limited to the UNIDROIT Principles. There was a similar attitude towards the use of other international instruments.¹³⁶ In case of international

¹³³ Michael Joachim Bonell, *Towards a Legislative Codification of the UNIDROIT Principles*, Unif. L. Rev. 233, 235 (2007).

¹³⁴ Practitioners were at international law firms and practiced commercial contract law or international arbitration. See Lake, *supra* note 129, at 671.

¹³⁵ *Id.* at 672; 3% out of 45% of those who were familiar with the Principles applied them.

¹³⁶ *Id.* at 675; A similar attitude existed toward the use of other international instruments: CISG, PECL, Incoterms, and others.

practitioners, 30% have used the UNIDROIT Principles and 60 % were familiar with them and interested in using them but have done so mainly because of their client's wishes.¹³⁷ Moreover, one third of international respondents that have used the UNIDROIT Principles once, used them again. What this shows that "evidential benefits were proven upon application warranting further use".¹³⁸ Lastly, in the survey a theoretical question was posed concerning the appropriateness of the UNIDROIT Principles as a choice of law, and the international responses indicated positive view of the Principles.¹³⁹

2.2.2 Structural Similarities between the UNIDROIT Principles and National Laws

It is provided that there are structural similarities between the UNIDROIT Principles and most national laws.¹⁴⁰ There are two reasons for these similarities, first the Principles are the result of intensive comparative legal research and debate, and second, they have influenced a lot of legislators over the years.¹⁴¹ The structural similarity becomes evident once a lawyer gets to examine the UNIDROIT Principles. Lawyers that start studying the Principles will find a lot of familiar concepts.¹⁴² Professor Dr. Eckart Brodermann demonstrates the structural similarities between the UNIDROIT Principles and the applicable national laws on the example of a real case in which he took an active part.¹⁴³

In the case at hand, the dispute concerned the interpretation of an unworkable choice-of-law clause in a satellite lease contract.¹⁴⁴ The proponents argued that either English or Swiss law should apply.¹⁴⁵ But from the circumstances of the case it was obvious that parties had

¹³⁷ *Id.* at 673.

¹³⁸ *Id.*

¹³⁹ *Id.* International responses as to the appropriateness of the Principles as choice of law: 42 % appropriate, 16% undecided, 42 % not appropriate.

¹⁴⁰ Brodermann, *supra* note 15, at 590.

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ *Id.* at 591.

¹⁴⁵ *Id.*

intended to agree on neutral legal order.¹⁴⁶ The tribunal, during the pre-hearing conference, suggested the parties to apply the UNIDROIT Principles, since they had the intention to rely on neutral law.¹⁴⁷ But later on, Brodermann being assisted by team of lawyers from three nations came to the conclusion that it would make no difference whether the UNIDROIT Principles or English law will be applied to the issues raised in this arbitration, because both lead to the same result. The author states that when going through the examples provided in the official commentary to the Principles, he found out that some of these examples are similar to English precedents.¹⁴⁸ According to the author this similarity is normal, because during the process of drafting the Principles numerous cases are discussed in order to choose examples “which document the functioning of the Principles”.¹⁴⁹ Thus, “these examples often correspond to similar examples from various jurisdictions”.¹⁵⁰ The author clarifies that the case was based on a contractual damages claim and all the applicable laws contained restrictions with regard to such claim. For instance, French law required that the damage must be foreseeable, German law required an adequate link of causality between the breach and the damage, and lastly, English law required that the damage should not be too remote from the event.¹⁵¹ Ultimately, the parties agreed on the application of the UNIDROIT Principles, because the Principles contained similar limitation to damages claim.¹⁵² Since, all the possibly applicable laws and the UNIDROIT Principles contained restrictions on damages claim, and from the circumstances of the case it was evident that the parties had an intention to agree on neutral law, not applying the Principles would have been absurd. Even though this was an arbitration case, there is no

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

¹⁵² *Id.* at 592.

any legitimate justification for why the domestic courts should not treat the Principles in same way as tribunals.

In the commentary to the preamble of the UNIDROIT Principles it is provided that the UNIDROIT Principles “...represent a system of principles and rules of contract law which are **common to existing national systems** or best adapted to the special requirements of international commercial transactions” (emphasis added).¹⁵³ Since there are structural similarities between most national laws and the UNIDROIT Principles, and the later ones are much helpful in overcoming barriers in contract negotiations, it would be logical if national courts will give effect to parties’ choice of the UNIDROIT Principles as the governing law of their contract. Going back to the advantages of the UNIDROIT Principles the following can be concluded. First, the UNIDROIT Principles ensure that parties are equally familiar with the applicable law. Second, they enable parties to avoid the costly research of an unfamiliar State law. Third, choosing the Principles over some neutral State law is much reasoned choice, because choice of a random domestic law always carries the risk of unexpected consequences.¹⁵⁴ And lastly, in most of the cases parties will find rules of conduct and terms in the Principles with which they are familiar from their domestic laws. Thus, it seems that there are no valid reasons available that would justify the present distinction in the parties’ freedom to choose the UNIDROIT Principles as the applicable law depending on whether they decide to submit their dispute to court or arbitral tribunal, but there are many reasons for eliminating the present distinction.

¹⁵³ Bortolotti et al., *supra* note 5, at 11.

¹⁵⁴ *Id.*

2.3 Developments Suggesting Possible Change in the Status of the UNIDROIT Principles as a Governing law

Bonell, in his speech at a seminar on “The UNIDROIT Principles of International Commercial Contracts: What Do They Mean for Australia?” held in Sydney Law School in 2008, stated that there are number of developments suggesting possible changes in the parties’ freedom as to the choice of the applicable law in the near future. Among those developments were the Proposal of the European Commission to amend Article 3 of the Rome Convention, the Inter-American Convention on the Law Applicable to International Contract, and Official Comment to the United States Uniform Commercial Code.¹⁵⁵ Since Bonell emphasized that the developments suggested possible changes in the near future, it would be appropriate to determine whether or not his prediction materialized up to this day.

i. The Proposal of the European Commission

As it was mentioned earlier, in 2005 the European Commission during the transformation of the Rome Convention into Rome I Regulation made a proposal to amend Art.3 and soften the restriction imposed upon parties’ choice of the applicable law, i.e. permit the application of transnational law as the governing law of a contract. However, this proposal was vetoed by Member States who were “apparently concerned about the risk of excessive legal uncertainty deriving from the choice of a-national principles and rules as the law governing the contract as compared to the alleged certainty and predictability of the choice of a particular domestic law”.¹⁵⁶ Later on, the Member States regretted their decision.¹⁵⁷ There is a reason for Member States to regret their decision, because what they feared the most, uncertainty and

¹⁵⁵ Bonell, *supra* note 8, at 6.

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

unpredictability, by the end of the day seem to arise from the choice of a foreign national law rather than transnational law.

ii. Inter-American Convention on the Law Applicable to International Contracts

The other development suggesting possible changes as to the parties' freedom to choose the applicable law concerns the 1994 Inter-American Convention on the Law Applicable to International Contract.¹⁵⁸ The Convention addresses principles of international commercial law in number of instances. For example, in Article 10 of the Convention it is provided:

*"In addition to the provisions in the foregoing article, guidelines, customs, and principles of international commercial law as well as commercial usage and practices generally accepted shall apply in order to discharge the requirements of justice and equity in the particular case".*¹⁵⁹

Bonell suggests that this provision "open[s] the door to the application of the UNIDROIT Principles...as the law chosen by the parties".¹⁶⁰ According to Professor Markus Petsche,¹⁶¹ since this view of Bonell is not confirmed by any case law, no conclusion can yet be made.¹⁶² However, Professor Petsche stresses out that there are few certainties with regard to the Convention based on which one can draw a conclusion as to the Convention' reference to transnational law. First, the Convention does not use the term *rules of law*, which as it was mentioned above implies that parties are allowed to choose transnational law as the governing law, and second, under the Convention parties and courts can only apply domestic law(s).¹⁶³

¹⁵⁸ *Id.*

¹⁵⁹ Inter-American Convention on the Law Applicable to International Contracts art.10, Mar. 17, 1994, O.A.S. 78.

¹⁶⁰ Petsche, *supra* note 7, at 495.

¹⁶¹ Associate Professor, Legal Studies Department, Central European University.

¹⁶² *See supra* note 160.

¹⁶³ *Id.* The Convention' articles on the applicable law:

Article 7 "The contract shall be governed by the law chosen by the parties."

Article 9 "(1) If the parties have not selected the applicable law, or if their selection proves ineffective, the contract shall be governed by the law of the State with which it has the closest ties. (2) The Court will take into account all objective and subjective elements of the contract to determine the law of the State with which it has

Therefore, it has been suggested that “a choice of law providing for the exclusive application of some transnational law codification [e.g. the UNIDROIT Principles] seems to be incompatible with a literal reading of the Convention”.¹⁶⁴ But in order to make some use of the reference made (i.e. not to deprive it of its usefulness), it has been suggested that it would be reasonable to assume that these transnational law rules were intended to apply together with the governing domestic law, notably as gap-filler or interpretive tool.¹⁶⁵

iii. Uniform Commercial Code of the United States

Another reference to the possibility for the parties to agree on the application of the UNIDROIT Principles can be found in the Official Comments to the Uniform Commercial Code. In the Official Comment to § 1-302 of the UCC it is provided that “parties may vary the effect of [the Code’s] provisions by stating that their relationship will be governed by recognized bodies of rules or principles applicable to commercial transactions... [such as for example] the UNIDROIT Principles of International Commercial Contracts...”¹⁶⁶ However, this reference to the UNIDROIT Principles is made in the context of section 1-302 providing for the principle of freedom of contract and not in the context of section 1-301 dealing with the parties’ right to choose the applicable law. This leads to the following that whenever parties agree that their contract be governed by the UNIDROIT Principles, such an agreement will be respected only to the extent that the UCC grants parties the right to derogate from its provisions.¹⁶⁷ Moreover, in case if the parties actually opt for the UNIDROIT Principles as rules of law governing their contract, the probability that some of the Principles’ provisions

the closest ties. It shall also take into account the general principles of international commercial law recognized by international organizations.”

¹⁶⁴ *Id.* at 495-496.

¹⁶⁵ *Id.* at 496.

¹⁶⁶ Uniform Commercial Code (Official Text and Comments, 2001 edition).

¹⁶⁷ Michael Joachim Bonell, *The UNIDROIT Principles 2010: An International Restatement of Contract Law*, 17 (2011), available at <http://www.law.georgetown.edu/cle/materials/UNIDROIT/2011.pdf>.

will be struck out due to their incompatibility with the UCC is rather remote, especially since most of the mandatory provisions of the UCC are dealing with consumer transactions.¹⁶⁸

iv. The Draft Hague Principles

When discussing the development suggesting possible changes in the status of the UNIDROIT Principles as a governing law, Bonell stated that it would be a good idea to have a formal recognition at universal level of parties' right to choose a soft law instrument such as the UNIDROIT Principles as the governing law in an international commercial contract. It was suggested that the Hague Conference on Private International Law would be the most appropriate body to launch such a project.¹⁶⁹ After a couple of years, specifically in 2012, the Hague Conference submitted a proposal for the Hague Principles on Choice of Law in International Contracts (PCLIC). The Principles were slightly revised in 2014 and then finally approved on March 19, 2015.¹⁷⁰ Thus, what is left is to examine the content of the Hague Principles and determine their contribution toward transnational law becoming eligible for the governing law of international commercial contracts.

As it was mentioned earlier, parties to an international contract have the ability to choose the law that courts or arbitrators will have to apply to their contract under almost all conflict of law rules in the world.¹⁷¹ However, most private international law norms provide different ways to exercise choice of law and introduce different restrictions to party autonomy (choice of law being part of the principle).¹⁷² It has been provided that "to remove the differences between conflict of laws regimes regarding choice of law and the connected legal

¹⁶⁸ *Id.* at 17-18.

¹⁶⁹ Also, Bonell mentions that the Hague Conference on PIL "would have the merit of rendering the principle of party autonomy consonant with the needs of businesses engaged in international trade, while at the same time eliminating the totally unjustified differentiation in the parties' freedom to choose the applicable law depending on whether they decide to have their disputes settled by arbitration or in court". See Bonell, *supra* note 8, at 6.

¹⁷⁰ Schwartze, *supra* note 20, at 90.

¹⁷¹ *Id.* at 87.

¹⁷² *Id.* at 88.

uncertainties leading to high expenses for information and significant transaction cost, an international unification for choice of law rules [similar to the CISG or to the UNIDROIT Principles] in the area of substantive law, would be suitable”.¹⁷³ Therefore, the Hague Conference on Private International Law has made an attempt to unify choice of law worldwide by proposing the Hague Principles on Choice of Law in International Contracts.¹⁷⁴

The Hague Principles have number of features and one of these features is of a particular relevance for the issue discussed in this paper. According to the Hague Principles, a contract is governed by the law chosen by the parties,¹⁷⁵ and the law chosen by the parties may be “*rules of law* that are generally accepted on an international, supranational or regional level as a neutral and balanced set of rules, unless the law of the forum provides otherwise” (Article 3) (emphasis added)¹⁷⁶. As was mentioned above, the term *rules of law* used in most arbitration laws and rules refers to rules that do not emanate from State source.¹⁷⁷ Thus, Article 3 of the Hague Principles broadens the scope of party autonomy by stipulating that parties may choose not only state law but also *rules of law* to govern their contract, “regardless of the mode of dispute resolution”.¹⁷⁸ But before making such a choice, parties have to make sure that the *rules of law* they want to apply meet the requirements set forth in the Article 3 of the Hague Principles. For instance, parties can only choose *rules of law* that are generally accepted on an international, supranational or regional level. This means that the *rules of law* must be recognized beyond a national level.¹⁷⁹ More specifically, they “cannot refer to a set of rules

¹⁷³ *Id.* at 90.

¹⁷⁴ Hague Principles on Choice of Law in International Commercial Contracts (approved Mar.19, 2015), <https://www.hcch.net/en/instruments/conventions/full-text/?cid=135> (hereinafter: PCLIC).

¹⁷⁵ *Id.* at Art. 2.

¹⁷⁶ *Id.* at Art. 3.

¹⁷⁷ Commentary on Art.3 PCLIC, no.3.1.

¹⁷⁸ *Id.* “By endorsing the designation of “rules of law” with effect before judicial and arbitral tribunals, the Hague Principles seek to bridge the gap that currently exists between these two dispute resolution fora”. See Geneviève Saumier, *Designating the UNIDROIT Principles in International Dispute Resolution*, Unif. L.Rev. 533, 547 (2012).

¹⁷⁹ Commentary on Art.3 PCLIC, no.3.4.

contained in the contract itself, or to one party's standard terms and conditions, or to a set of local industry-specific terms".¹⁸⁰ Also, the *rules of law* must be neutral and balanced set of rules. In order to meet the neutrality standard, the *rules of law* must emanate from source that is recognized as a neutral, impartial body with diverse legal, political and economic perspectives.¹⁸¹ Even though Article 3 broadens the scope of party autonomy, it "recognizes that the forum State retains the prerogative to disallow the choice of *rules of law*"¹⁸². Since it was demonstrated above that most states do not allow their courts, as opposed to arbitration panels, to base their decisions on transnational law, one can conclude that Article 3, providing parties with an option to choose *rules of law* as the governing law of their contract but at the same time leaving the final determination on the availability of this option to states, does not have any effect.

According to Professor Schwartze, the main problem that may arise in applying [transnational law] is lack of authoritative sources for interpretation that leads to uncertainty.¹⁸³ However, if more parties apply this transnational law, the more court decisions will be available, which will in turn lead to more predictability.¹⁸⁴ Schwartze has suggested that the last part of the clause in Article 3 "...unless the law of the forum provides otherwise" should be omitted, because it hinders the Hague Principles' goal to harmonize choice of law and also establishes new uncertainty by empowering national legal order to ban non-state law.¹⁸⁵

Lastly, the Hague Principles is not a binding instrument but a non-binding set of principles, which the Hague Conference encourages States to incorporate into their "domestic

¹⁸⁰ *Id.*

¹⁸¹ Commentary on Art.3 PCLIC, no.3.11.

¹⁸² Commentary on Art.3 PCLIC, no 3.1.

¹⁸³ Schwartze, *supra* note 20, at 95-96.

¹⁸⁴ *Id.* at 96.

¹⁸⁵ *Id.*

choice of law regimes in a manner appropriate for the circumstances of each State”.¹⁸⁶ Thus, the Hague Principles “can guide the reform of domestic law on choice of law and operate alongside existing instruments on the subject”.¹⁸⁷ Even though the Principles leave for states to make a final determination regarding the parties’ freedom as to choice of the applicable law, the Principles still provide huge support in favor of giving parties the option to choose transnational law such as the UNIDROIT Principles as the governing law of their contract. Therefore, the Hague Principles might have huge influence on the law-makers across the globe,¹⁸⁸ which will in turn lead to harmonization of choice-of law regimes and create certainty that businesspeople desire to have while engaged in cross-border transactions.

¹⁸⁶ PCLIC, *supra* note 174, at Introduction § 8, <https://www.hcch.net/en/instruments/conventions/full-text/?cid=135>.

¹⁸⁷ *Id.*

¹⁸⁸ Petsche, *supra* note 9, at 497.

Conclusion

At present, both in the EU and the US, parties can only choose the UNIDROIT Principles as the governing law of their contract when they decide to submit their dispute to arbitration. In case if parties decide to go to courts, their choice of the UNIDROIT Principles as the governing law of their contract will not be given any effect, and such a reference to the Principles will only be considered as mere agreement to incorporate them in to the contract. The notion of incorporation implies that the Principles will only bind the parties to the extent they do not affect the rules of the applicable domestic law from which the parties may not derogate (the applicable domestic law will be determined by the court on the basis of private international law of the forum). In other words, the application of the UNIDROIT Principles will depend upon the applicable domestic law. Such a combined application of the UNIDROIT Principles and any domestic law defeats the basic purpose of the former. Therefore, incorporation is different from allowing parties to choose the UNIDROIT Principles as the law applicable to their contract. It deprives parties to an international contract of the actual effect created by the Principles once applied as *lex contractus*.

The UNIDROIT Principles, in contrast to domestic laws, offer significant advantages for parties to an international commercial contract. First, the UNIDROIT Principles are neutral, in the sense that they ensure that parties are equally familiar with the applicable law. More specifically, with the application of the UNIDROIT Principles neither party will have advantages in terms of familiarity with the applicable law or predictability of litigation outcomes. Second, the UNIDROIT Principles are available in many different languages, written simply and accompanied with a comprehensive commentary. Third, all judicial and arbitral decisions that one way or another make reference to the Principles are available free of charge on the UNILEX database that in turn significantly reduces the cost of research. More

importantly, the UNIDROIT Principles are drafted by the international business community by taking into account the specific needs of business people, but the domestic laws are designed for a domestic context and they contain technicalities that are not widely recognized and are not suitable in an international context. Thus, since the Principles are set of rules reflecting the needs of international traders, preventing international traders to benefit from the Principles only when they decide to submit their dispute to courts must be based on some well-founded reasons. Otherwise, the present differentiation in the parties' freedom to choose the UNIDROIT Principles as a governing law depending on whether they submit their dispute to arbitration or litigation seems to be unjustified since the parties and the dispute are still the same in case of both dispute resolution fora.

As was demonstrated in Chapter 2, there are no valid reasons available that would justify the current distinction in the parties' freedom to choose the UNIDROIT Principles as a governing law. However, few arguments have been brought forward as to why the status quo should not be changed. For example, one argument against allowing the parties to choose the UNIDROIT Principles as the governing law is that the Principles are incomplete. This argument is not long lasting because the Principles are available in their third edition and more gaps have been filled. Moreover, due to the increasing number of arbitral and judicial decisions, the Principles are becoming more relevant and concrete. Also, it has been argued that parties have not shown an interest in choosing the UNIDROIT Principle for choice-of-law purposes. But as it was shown above, there are various explanation to it. One explanation is that parties might not be aware of the Principles and of their effect in practice, and the other is that the list of cases that one way or another refer to the Principles is not a full one, since a lot of decision, specifically arbitral decision, remain confidential. Therefore, it seems that there are no valid reasons justifying the present distinction in the parties' ability to choose the UNIDROIT Principles as the governing law.

Taking into account that the UNIDROIT Principles are more suitable in the context of international business transactions as compared to domestic laws, and that parties are willing to subject their contract to a neutral legal regime, the UNIDROIT Principles should be made available to the parties even when they submit their dispute to courts. More solid objections need to be raised in order to argue against making the UNIDROIT Principles available in the sense of private international law. Moreover, the Hague Principles, providing parties an opportunity to choose *rules of law* such as the UNIDROIT Principles as the governing law of their contract but leaving the availability of this option at the discretion of states, still provide significant support in favor of giving parties such an option. The fact that the Hague Principles endorse the designation of *rules of law* also confirms the assertion that the current distinction is unjustified and parties should be allowed to enjoy full party autonomy as to the choice of the applicable. If parties will have an access to such a neutral legal framework, there will be an increase in international trade all over the world, because the parties will feel much safe if a neutral legal regime is applicable to them, rather than some unfamiliar domestic law. Since the UNIDROIT Principles create more predictability and reduce transaction costs, trade actors will be willing to enter into foreign markets, and thus contribute to the economy of the countries concerned.

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