International Arbitration Alert

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The 'Third Act' in the Kabab-Ji Saga—What Law governs the Arbitration Agreement (Law of the Seat or Law of the Underlying Contract)?

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In a Judgement handed down on 27 October 2021[1], the UK Supreme Court upheld the English Court of Appeal finding in *Kabab-Ji SAL v. Kout Food Group* of 20 January 2020 that English law as the law governing the relevant contract, also governed questions of the validity of the arbitration agreement despite the fact that the arbitration agreement provided for a seat of arbitration in France, rather than in the United Kingdom.[2] On that basis, the Supreme Court confirmed that the International Chamber of Commerce (ICC) Award rendered in September 2017 was unenforceable in the United Kingdom. The Supreme Court's position differed from the approach taken by the arbitral tribunal who found that French law applied to the arbitration agreement since the arbitration was seated in France. The Supreme Court Judgement is also in tension with the position of the *Cour d'appel* de Paris that found in its 23 June 2020 Judgement that French law governed the arbitration agreement and that the Award is enforceable in France. The French *Cour de cassation* is seized of an appeal but has yet to rule on the issue.

The Supreme Court Judgement is noteworthy to contract drafters as well as users of international arbitration for three reasons:

- The Supreme Court analysis from *Enka v Chubb*[3], on which we previously reported, was instructive in that under English law a choice of law clause governing the whole of the contract will presumptively apply to questions as to the validity of the arbitration agreement absent express agreement by the parties. The selection of an arbitral seat is not an express agreement which would displace the general choice of law clause.
- Although many contract drafters and international arbitration practitioners (particularly those from civil law backgrounds) may find the position taken by the Supreme Court to be out of step with international practice (including under the New York Convention), the Supreme Court found that there was not a clear consensus among national laws / courts on whether a choice of an arbitral seat rather than a choice of law clause is a clear indication of the law to which the parties subjected the arbitration agreement. The Supreme Court was also unpersuaded that the

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"validation principle" should be extended to apply to questions of third-party non-signatories.

- The Supreme Court underlined the importance of the *Rock Advertising*[4] Judgement of 16 May 2018 upholding the enforceable (and restrictive) nature of "No Oral Modification clauses" under English law including in the context of construing third-party (non-signatory) consent to arbitration.

These reasons are discussed in further detail below.

Background

The claimant (and appellant) Kabab-Ji is a Lebanese company which licenced rights under a franchise development agreement dated 16 July 2001 (FDA), to a Kuwaiti company, Al Homaizi Foodstuff Company (Al Homaizi), to operate a franchise using its restaurant concept in Kuwait for a period of ten years. Under the FDA, the claimant and Al Homaizi subsequently entered into a total of ten franchise outlet agreements (FOAs) in respect of individual outlets opened in Kuwait (collectively the FDA and FOAs are referred to as the "Franchise Agreements"). The Franchise Agreements are all expressly governed by English law. As a result of a corporate restructuring in 2005, a new holding company called Kout Food Group (KFG) was established and Al Homaizi became a subsidiary of KFG. However, the terms of the Franchise Agreements remained unchanged. Kabab-Ji prevailed in ICC arbitral proceedings against KFG (as sole defendant) and sought to enforce the ICC Award in London. KFG sought to resist enforcement.

The Relevant Statutory Regime

Recalling that the case before the Court was in the context of an appeal from an application for enforcement, the relevant statutory regime applicable was Article V(1)(a) of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards as enacted in Section 103(2)(b) of the 1996 Arbitration Act. Section 103(2)(b) states:

> *(2) Recognition or enforcement of the award may be refused if the person against whom it is invoked proves -*
>
> *[…]*
>
> *(b) that the arbitration agreement was not valid under the law to which the parties subjected it or, failing any indication thereon, under the law of the country where the award was made;*

The Supreme Court distilled the article into two rules: (i) a "primary rule" according to which the validity of the arbitration agreement is governed by the law chosen by the parties and (ii) a "default rule" where no choice has been indicated, according to which the validity of the arbitration agreement is governed by the law of the country where the award was made (deemed to be the place of the seat).

The applicability of the Enka Tests / Analysis

Under the "primary rule", the Supreme Court reiterated its conclusion in *Enka* that a "general choice of law to govern a contract containing an arbitration clause should normally be sufficient to satisfy the first rule in article V(1)(a)" as the word "indication" signifies that something less than an express and specific agreement will suffice. While the Court made clear that the layered presumption tests in Enka[5] are not

“directly applicable in the present case”, it considered that, as a matter of consistency and coherence, the principles for identifying the applicable law governing an arbitration clause should be the same whether the question is raised before or after an award has been made. Moreover, Kabab-Ji had in fact accepted that the general principles set out in *Enka* would be equally relevant to a determination of governing law in relation to Section 103(2)(b) of the Arbitration Act 1996.

Construing the underlying contract, the Court found that the parties had included “a typical governing law clause” which provided that the agreement would be governed by the laws of England and should be read as to denote all the clauses incorporated in the contract, including the arbitration agreement. Further, the Court held there was no good reason to infer that the parties intended to exclude the arbitration clause from their general choice of law clause. While the Supreme Court recognized that the aim of the New York Convention was to establish a single set of rules in relation to enforcement of arbitral awards and should be construed accordingly by the courts of the contracting states, the Court found that there was “no clear consensus among national courts about where or when a choice of law for the contract as a whole constitutes a sufficient indication of the law to which the parties subjected the arbitration agreement in particular where it differs from the law of the seat”[6] and concluded the English courts should form their own view based on first principles.

Interestingly, the arbitration agreement provided that the arbitrators would also apply “principles of law generally recognised in international transactions” (which were agreed by the parties to be a reference to the International Institute for the Unification of Private Law (UNIDROIT) Principles). The Supreme Court found that the reference to the UNIDROIT Principles only concerned what rules of law were to be applied by the arbitrators in deciding the substantive issues[7] and therefore had no relevance in determining which law is to be applied to the question of the validity of the arbitration agreement. In any event, the Court, assuming (but not deciding) that a “law” should be restricted to the law of a country, considered that the law to be applied would consist of the system of national law selected by the parties without regard to the UNIDROIT Principles.

Restrictive Nature of the Validation Principle

The Supreme Court was also asked to consider whether the “validation principle” which in the context of international arbitration usually provides that an arbitration agreement will not be subject to a particular national law which would hold it to be invalid if it could be interpreted to be subject to another national law which would uphold the clause. This interpretative mechanism proceeds on the basis that commercial parties would be presumed to have intended their arbitration agreement to be valid and would not otherwise have intended to invalidate the agreement by the insertion of a general choice of law clause which would invalidate the agreement. The Supreme Court found at invoking the validation principle in the context of the FDA dispute, however, would extend its scope beyond its intended means. This is because the validation principle does not apply to questions under Section 103(2)(b) of the 1996 Arbitration Act as to whether any contract was ever made between the parties to the dispute. Rather it applies only when parties to a dispute have agreed to resolve their dispute in arbitration and seeks to uphold their presumed intention that their agreement to arbitrate should be legally effective.

The Importance and Enforceability of No Oral Modification Clauses

Another issue in the underlying case related to a claim that KFG became a party to the FDA although none of the contractual formalities of the FDA for amendment or waiver were complied with. The Supreme Court explained:

> *As Lord Sumption observed, the English law of contract "does not normally obstruct the legitimate intentions of businessmen, except for overriding reasons of public policy" and there is no policy reason why effect should not be given to the mutual bargain made in No Oral Modification clauses.*

The Supreme Court categorically rejected an argument that KFG could have been said to become a party to the FDA based upon the "No Oral Modification clauses" contained in the FDA which required, among other things, signatures by both parties to the FDA to amend or waive any of the written terms of the FDA and a lack of evidence for estoppel. The Supreme Court therefore upheld the Court of Appeal's finding that there was no prospect of success for the claim that KFG had become a party to the FDA because of "the terms of the 'No Oral Modification clauses' and the failure of the appellant to show any evidence of estoppel other than evidence of 'the informal promise itself'".

CLARITY IN ENGLISH LAW VS UNCERTAINTY IN INTERNATIONAL ARBITRATION PROCEEDINGS

Taking a step back—while the Kabab-Ji saga is not yet complete pending the appeal before the *Cour de cassation* in France—the clash between the French and the English Courts creates uncertainty for contract drafters and users of international arbitration alike. As the Supreme Court underlined, there is perceived uncertainty at the international level as to the law governing the arbitration agreement and so domestic courts will inevitably apply their own national principles. In practice, this result jeopardizes the enforceability of awards as parties have now new arguments in order to seek non-enforcement of awards and stays of on-going proceedings. The decision could also lead to forum and arbitrator-shopping.

A logical path to greater certainty is for drafters to ensure that the law governing the arbitration agreement is expressly specified in addition to providing an express choice of the substantive law governing the remainder of the contract. Designating a seat of arbitration different from the law governing the contract will not ensure that the law of the seat of the arbitration will govern the arbitration agreement.[8] More precision is required.

[1] *Kabab-Ji SAL (Lebanon) v Kout Food Group (Kuwait)* [2021] UKSC 48.

[2] This Alert follows two previous Alerts earlier this year discussing the English Court of Appeal Decision and the Paris Court of Appeal Decision.

[3] *Enka Insaat Ve Sanayi AS v OOO Insurance Company Chubb* [2020] UKSC 38; [2020] 1 WLR 4117 9 (Enka).

[4] *MWB Business Exchange Centres Ltd v Rock Advertising Ltd* [2018] UKSC 24; [2019] AC 119.

[5] *Enka*, at paragraph 170.

[6] *Kabab-Ji SAL (Lebanon) v Kout Food Group (Kuwait)* [2021] UKSC 48, at para. 32.

[7] The freedom of the parties to stipulate what rules of law the arbitrators are to apply in deciding the substantive issues in dispute are expressly recognized by Rule 21(1) of the 2017 and 2021 ICC Rules as well as Article 27(1) of the 2017 SCC Rules or Rule 31.1 of the 2016 SIAC Rules.

[8] It is worth noting that the Hong Kong International Arbitration Centre (HKIAC) is the only centre to date that suggests including such express provision in its Model Clauses explaining that "This provision should be included particularly where the law of the substantive contract and the law of the seat are different. The law of the arbitration clause potentially governs matters including the formation, existence, scope, validity, legality, interpretation, termination, effects and enforceability of the arbitration clause and identities of the parties to the arbitration clause. It does not replace the law governing the substantive contract". The ICC, Arbitration Institute of the Stockholm Chamber of Commerce (SCC), Singapore International Arbitration Centre (SIAC) and the London Court of International Arbitration (LCIA) Model Clauses only recommend specifying the applicable governing law for "the contract".