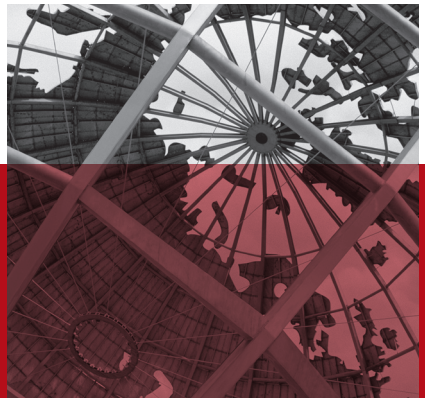

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International Arbitration

NEWS IN BRIEF

Avoiding Pitfalls in Drafting and Using Unilateral Option Clauses

By Philip Clifford and Oliver Browne

Why provide a unilateral option to arbitrate or to litigate?

There are number of reasons for a party to choose arbitration over litigation as the means of dispute resolution. For example, a key feature of arbitration is the potential for recognition and enforcement of arbitral awards around the globe. Arbitration is also a private process, thus giving the parties a chance to protect their business reputation and commercially sensitive information.

On the other hand, some courts allow default judgments where no defence is filed, and, in English or US courts, for example, issue summary judgments where a party has no real prospect of successfully advancing or defending a claim. Such procedural devices have no real equivalent in arbitral proceedings and may be useful as quick and relatively inexpensive means of resolving very straightforward disputes.

A unilateral option clause provides the flexibility to select the dispute resolution method most appropriate to the case at hand. As the suitability of a specific dispute resolution method depends on the particularities of an individual case (not least the location of the assets against which enforcement of an award might be required), a party to a contract with a stronger bargaining power may therefore seek the flexibility of a unilateral option clause.

Pursuing flexibility, however carries the risk of catastrophe. Unilateral rights might be considered invalid and unenforceable in certain jurisdictions because of lack of certainty, lack of mutuality or the doctrine of unconscionability. If a party successfully challenges a unilateral option to arbitrate, the beneficiary of the option will have to resolve any dispute through the appropriate courts, whether or not a judgment from those courts could ever be enforced in the jurisdiction where relevant assets are located. If a court determines a unilateral option to arbitrate is invalid and unenforceable, when an award reaches the enforcement stage, the award might also be deemed invalid and unenforceable, rendering the whole arbitral proceedings a waste of time and resources (and potentially giving rise to limitation issues if a new claim needs to be started).

Legal Pitfalls

With unilateral option clauses there are a number of common legal pitfalls.

In some jurisdictions, courts may refuse to relinquish jurisdiction in favour of arbitral proceedings, if the arbitration clause lacks clear wording requiring them to do so. Similarly, some jurisdictions may require a clear expression of the parties' intention to resort to arbitration. The existence of a unilateral option to arbitrate could, in some jurisdictions, be used to undermine the required certainty with respect to submitting to arbitration, and thus make the clause susceptible to being challenged or held unenforceable. Even in "arbitration friendly" jurisdictions, courts have imposed certainty-related conditions on the validity of unilateral option clauses.

For example, English courts have held that the beneficiary of a unilateral option clause must elect a particular dispute resolution mechanism at an early stage of the process. In *NB Three Shipping Ltd v. Harebell Shipping Ltd*, the court ruled that the unilateral option was "not open ended" and that it "would cease to be available if [the beneficiary of the option clause] took a step in the action or they otherwise led [the other party] to believe on reasonable grounds that the option […] would not be exercised."[1]

In another more recent English case, *Deutsche Bank AG v. Tongkah Harbour Public Co Ltd and another*, the court held that "whilst a jurisdiction clause […] that gives one party only the option to arbitrate is perfectly valid, once the option has been exercised in favour of arbitration, litigation of the same matter is subject to the statutory stay."[2] A similar approach has been adopted in some other jurisdictions.[3] Overall, if the beneficiary of a unilateral option clause takes substantive steps in arbitral or court proceedings before exercising their option, they may waive their right to arbitrate or litigate under the unilateral option clause.

In some jurisdictions, courts may also hold unilateral option clauses invalid and unenforceable for lack of mutuality, particularly lack of mutual consent. Arguably, a clause that provides one party to a contract with discretion to choose a dispute resolution mechanism contradicts the principle of mutuality of consent. Accordingly, local law might require that the clause give bilateral rights of reference to arbitration or litigation and/or require that all parties to a contract consent to a specific dispute resolution method; the mere agreement to the option to arbitrate/litigate in the future may be insufficient.

Several federal and state courts in the US have rejected the mutuality argument and upheld unilateral option clauses.[4] Under English law, the lack of specific mutual consent to arbitrate or litigate likewise does not invalidate unilateral option clauses. As the Court of Appeal held in *Pittalis v. Sherefettin*, "The fact that the option is exercisable by one of the parties only seems to me to be irrelevant. The arrangement suits both parties."[5]

However, even where a clause is more specific, it may still be held void for want of mutuality. In a recent French case, which involved both a clause providing for the exclusive jurisdiction of the Luxembourg courts and a unilateral option to litigate in another jurisdiction,[6] the *Cour de Cassation* invalidated the jurisdiction clause, including the unilateral option clause, as "potestative" in favour of the lender and thus breaching Article 23 of the Brussels Regulation.[7] Under French law, a potestative condition, which is defined as "one which makes the fulfilment of the agreement depend upon an event which one or the other of the contracting parties has the power to make happen or to prevent,"[8] is void.[9] Consequently, the jurisdiction clause, which was subject to a potestative condition, was invalid.

Whilst the decision of the *Cour de Cassation* has invited wide criticism,[10] it illustrates the risk associated with providing for unilateral options to arbitrate or to litigate.

In a similar vein, in *CJSC Russian Telephone Company v Sony Ericsson Mobile Telecommu-nications Rus LLC*, the Presidium of the Supreme Arbitration Court of the Russian Federation decided in June 2012 that a unilateral option to litigate was invalid as it put the beneficiary of the clause in a privileged position, thus disrupting the balance of the parties' interests and violating the principle of equality between the parties.[11]

In certain jurisdictions, unilateral option clauses may also be considered invalid and unenforceable in light of the doctrine of unconscionability. Several courts in the US have taken this approach, particularly with respect to cases involving employees and consumers. In *Armendariz v. Foundation Health Psychcare Services, Inc.*, for example, the California Supreme Court ruled that a mandatory arbitration clause in a standardized employment contract was unenforceable as it was unconscionable both procedurally, because of the unequal bargaining power between the parties, and substantively, because it was "overly harsh" or "one-sided."[12] In *Iwen v. U.S. West Direct*, a Montana state court reached the same conclusion.[13] However, other courts have held that unilateral option clauses are not per se unconscionable.[14]

Currently, unilateral option clauses have been held void in certain jurisdictions and the legal position in a number of other jurisdictions is unclear.[15]

Drafting Pitfalls and Practical Steps

Given the potential legal pitfalls of unilateral option clauses, careful consideration should be given to their inclusion and drafting. To avoid any confusion and consequent unnecessary delay and expense, unilateral option clauses should clearly and precisely spell out when and how the option may be exercised and the consequences of exercising the option. The following practical steps may be taken in order to minimise the risks associated with unilateral options:

- Seek specialist legal advice about unilateral dispute resolution options, which might include advice on the law of various jurisdictions (such as the law governing the arbitration agreement, the law of the seat of the arbitration and the law of the jurisdiction in which enforcement of the arbitral award might be sought).
- Assess whether the benefits of the unilateral option clause outweigh the costs and risks associated with the option.
- Draft the unilateral option clause clearly and precisely.
- Draft the arbitration and litigation aspect of the unilateral option clause as separate clauses, ensuring that each of them is capable of operating independently in case they need to be severed.
- In case the unilateral option clause fails, ensure that the default position is adequate and acceptable.
- The beneficiary of an option to arbitrate should avoid taking any substantive step in court proceedings before exercising the option in order to limit the risk of the clause becoming unenforceable. Similarly the beneficiary of an option to litigate should avoid taking any substantive step in an arbitration before exercising its option.

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[1] [2004] EWHC 2001 (Comm), para 11.

[2] [2011] EWHC 2251 (QB), para 25.

[3] See, for example, the German case BGH, 24.09.1998 – III ZR 133-97 (Jena).

[4] In *Sablosky v. Edward S. Gordon Co.*, the court ruled that "Since […] the validity of an arbitration agreement is to be determined by the law applicable to contracts generally […], there is no reason for a different mutuality rule in arbitration cases"; 535 N.E.2d 643 (N.Y. 1989), p. 646. See also *Harris v. Green Tree Fin Corp*, 183 F. 3d 173 (3d Cir 1999); *U.S. v. Consigli Constr. Co.*, 873 F. Supp. 2d 409 (D. Me. 2012); *Forbes v. A.G. Edwards & Sons, Inc.*, No. 08 Civ. 552 (TPG), 2009 U.S. Dist. LEXIS 12894 (S.D.N.Y. Feb. 18, 2009); *Barker v. Golf U.S.A., Inc.*, 154 F.3d 788 (8th Cir. 1998).

[5] [1986] 1EGLR 130, p. 132.

[6] Case No. 11-26.022, 26 September 2012.

[7] Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters.

[8] Article 1170 of the French Civil Code.

[9] Article 1174 of the French Civil Code.

[10] In the recent case of *Mauritius Commercial Bank Ltd v. Hestia Holdings Ltd and another* [2013] EWHC 1328 (Comm), the English Commercial Court considered and rejected an argument based on the apparent reasoning in the *Cour de Cassation* decision and held that a one-way jurisdiction clause was effective to confer jurisdiction on the English courts.

[11] Case No. 1831/12, dated 19 June 2012, pp. 5-7.

[12] 24 Cal. 4th 83 (2000), pp. 114-115, 119-121.

[13] 977 P.2d 989 (Mont. 1999).

[14] See, for example, *Hannon v. Original Gunite Aquatech Pools, Inc.*, 434 N.E.2d 611 (Mass. 1982); *Forbes v. A.G. Edwards & Sons, Inc.*, No. 08 Civ. 552 (TPG), 2009 U.S. Dist. LEXIS 12894 (S.D.N.Y. Feb. 18, 2009); *Harris v. Green Tree Fin Corp*, 183 F. 3d 173 (3d Cir 1999); *Tranchant v. Ritz Carlton Hotel Co.*, No. 2:10-cv-233-FtM-29DNF, 2011 U.S. Dist. LEXIS 35099 (M.D. Fla. March 31, 2012); *Barker v. Golf U.S.A., Inc.*, 154 F.3d 788 (8th Cir. 1998). One US federal circuit court of appeals rejected the contention that a unilateral arbitration clause was unconscionable, but noted in passing that *"one-sided agreements to arbitrate are not favored"; DiMercurio v. Sphere Drake Ins. PLC*, 202 F.3d 71, 81 (1st Cir. 2000).

[15] It is unclear, for example, how unilateral option clauses would be treated under Chinese law (which requires that an arbitration agreement, among other things, contains an expression of intention to apply for arbitration). There is very little case law on this point, although in 1999 the Beijing Higher People's Court opined that a unilateral option clause was invalid, deeming such clauses "unconscionable" or "unfair". In Germany, according to the Federal Court of Justice, unilateral option clauses are valid in principle (BGH, 24.09.1998 – III ZR 133-97 (Jena)). However, such clauses may, depending on their content or the circumstances in which they were agreed, violate the principle of good faith and thus become invalid (BGH, 10.10.1991 – III ZR 141/90 (Bremen)). If the option operates for the benefit of a defendant, the unilateral option clause must provide that the defendant has to exercise its option before the claimant officially launches proceedings and specify certain consequences of exercising the option (BGH, 24.09.1998 – III ZR 133-97 (Jena)). In Hong Kong, unilateral option clauses have been held to be valid and enforceable in Hong Kong as a sufficiently clear submission to arbitration. See the Hong Kong Court of Appeal decision in *China Merchants Heavy Industry Co Ltd v. JGC Group* [2001] HKLRD (Yrbk) 21, referring to and applying the English Court of Appeal case of *Pittalis v. Sherefetin* [1986] 1 QB 868. In Singapore there is currently no reported authority on the enforceability of unilateral option clauses and the legal position remains uncertain.