

## **Choice of Law**

### **Introduction**

1. In an arbitration, especially with the element of international parties, 4 systems of law become relevant:
  - (a) the law governing the agreement to arbitrate (i.e. the law of arbitration) or *lex arbitri*;
  - (b) the law governing the substantive law of disputes or *lex causa/lex contractus*; and
  - (c) the law that determines the conflict of laws rules applicable when it becomes necessary or *lex loci*;
  - (d) the procedural law or rules of the arbitration (rules and procedures of arbitration) or *lex fori*.
  
2. This paper deals with the extent to which a party in Malaysia is given the liberty to choose the laws mentioned in (a), (b), (c) and (d) above based on the current legislation and the ensuing problems.

#### **A. The Law of Arbitration**

3. Parties, especially foreign parties, are often reluctant to settle their disputes by an arbitration governed under the laws of a country with which they are unfamiliar for the simple reason because they are unsure as to how effective the arbitration process would be. Further added to such uncertainty is the concern as to judicial interference, delays and cost implications. Not surprisingly, there are also concerns (be it false or true) that the integrity of judicial systems in certain particular States may be in question and thus it may likewise affect the integrity of the arbitral system.

4. It is in light of this general concern and its indirect impact on global commerce that led to the setting up of Working Committees under the auspices of the United Nations in order to discuss and agree on a globally acceptable *lex arbitri*.
5. In Malaysia, under the previous *lex arbitri*, there was no distinction between domestic and international arbitration and hence judicial attitude towards ensuring domestic arbitrations met domestic legal standards was extended to all forms of arbitrations. It was only in 1980 that parliament first implemented a legislated curtail on judicial interference vide **Section 34** but this was of a limited extent as it was only applicable to KLRCA arbitrations or those arbitrations that applied the UNCITRAL Rules as the *lex arbitri* or the *lex fori*.

#### **The new Malaysian Arbitration Act 2005**

6. Reform finally took place with the enactment of the new **Arbitration Act 2005** (Act 646) on 30 December 2005, which is based on the United Nations Commission on International Trade Law (UNCITRAL) Model Law on International Commercial Arbitration (“the Model Law”). The new Act repeals and replaces the previous **Arbitration Act 1952** and the New York Convention enacted by Act 320 which dealt with the recognition and enforcement of international awards.
7. It is applicable to all arbitrations proceedings which are commenced after 15 March 2006, while the old 1952 Act will continue to apply to arbitral proceedings commenced before the operative date of the new Act.
8. By the adoption of the Model Law, it is clear that there are some concentrated efforts in making the law of arbitration in Malaysia more appealing to international arbitration. This is because the Model Law has widely received recognition from international States and hence, international businesses are more likely to feel comfortable with the *lex arbitri* being Malaysian law.

9. To fulfill the need of ensuring domestic arbitration is to some extent in accordance with domestic standards, the Act provides for two distinct arbitral regimes, i.e. international arbitrations and domestic arbitrations. This is modeled on the New Zealand act. The main difference between the two regimes lies in the degree of interference from the Courts with arbitral awards but yet options are provided.
10. The general workings of the Act is that it provides a gap filling function by providing default positions for various matters relating to the arbitration process. It is divided into 4 parts. In so far as the provisions in Parts 1, II, and IV are concerned, they are made mandatory provisions which apply to all arbitrations where the seat is in Malaysia. The provisions in Part III (which contains enabling provisions for judicial control) becomes the crucial consideration. For international arbitrations, Part III is made non-mandatory by the Act. As for domestic arbitration, Part III becomes automatically applicable.
11. One important features of the Act is the “opting in” and “opting out” provisions. Essentially, the opt out/opt in feature provides the parties with an option to modify their arbitration regime. Parties to a domestic arbitration are given power to opt out of the provisions in Part III, in whole or in part. This in effect allows the parties to bring the domestic arbitration regime closer to the international arbitration regime. The international arbitration structure also gives the parties freedom to opt in to all or any part of the provisions in Part III.
12. In addition, the Act also gives parties the right to avoid the “default” positions as set out in the Act. It must be pointed out that the Act contains many default provisions which deal with specific powers of the arbitral tribunal and the Courts. As these default provisions apply in the absence of the parties’ agreement to the contrary, it is important for parties to direct their minds as to whether they wish

the default provision to apply. If not, they must specifically provide for an alternative. This can essentially be a draftsman's nightmare.

13. In essence, the Act recognizes the right of contracting parties to define their chosen processes within the arbitration regime. In line with the underlying theme of the Model Law, the Act focuses on the doctrine of party autonomy.
14. One basis of maintaining party autonomy is the reduction of judicial intervention, especially for international arbitrations with an additional allowance for domestic arbitrations to expressly opt out of judicial intervention as well. **Section 8** of the new Act also curtails the judicial interference by stating that: "*unless otherwise provided, no court shall intervene in any of the matters governed by this Act*". This is a restatement of **Article 5** of the Model law. The power of the Malaysian High Court to intervene in arbitration proceedings are thus limited to those situations specifically provided for in the Model law.<sup>1</sup>

**Its limitation/problems**

15. Despite the above, there appears to be some ambiguity/limitation that may lead to undesired results contrary to the intention of the Act. They are as follows:-
  - (a) there may be an issue of whether the court can intervene if the seat of arbitration pursuant to the agreement to arbitrate is outside Malaysia; and
  - (b) the likelihood of further disputes that is cause by allowing the opting in/opting out.

*Issue (a): What happens if the Seat of Arbitration is outside Malaysia*

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<sup>1</sup> However, the Court's power to remedy abuses such as fraud, corruption and non-observance of the rules of natural justice and enforcement of arbitral awards is preserved by s. 37.

16. It is important to bear in mind that the Act fixes the territorial limits on the scope of the application of the Act. The Act applies only to arbitrations in which the “seat of arbitration” is in Malaysia. This can be seen in **Section 3 of the Act**:-

“3 *Application to arbitrations and awards in Malaysia*

- (1) *This Act shall apply throughout Malaysia.*
- (2) *In respect of a domestic arbitration, **where the seat of arbitration is in Malaysia-***
  - (a) *Parts I, II and IV of this Act shall apply; and*
  - (b) *Part III of this Act shall apply unless the parties agree otherwise in writing*
- (3) *In respect of an international arbitration, **where the seat of arbitration is in Malaysia-***
  - (a) *Parts I, II and IV of this Act shall apply; and*
  - (b) *Part III of this Act shall not apply unless the parties agree otherwise in writing.*
- (4) *... ”*

17. The seat of arbitration is determined by the provisions in **Section 22 of the Act**. It provides that:

“22 *Seat of Arbitration*

- (1) *The parties are free to agree on the seat of arbitration.*
- (2) *Where the parties fail to agree under subsection (1), the seat of arbitration shall be determined by the arbitral tribunal having regard to the circumstances of the case, including the convenience of the parties.*
- (3) *Notwithstanding subsections (1) and (2), the arbitral tribunal may, unless otherwise agreed by the parties, meet at any place it considers appropriate for consultation among its members, for hearing witnesses, experts or the parties, or for inspection of goods, other property or documents. “*

18. It is clear that **Section 22** provides for a two-tiered system which gives the parties freedom to choose the seat of arbitration (**Section 22(1)**). In cases where the parties fail to determine the seat of arbitration, the arbitral tribunal has a default power to determine the seat of arbitration by having regard to the circumstances of the case, including the convenience of the parties (**Section 22(2)**)<sup>2</sup>.
19. Reading **Section 22** in conjunction with **Section 3**, it is clear that the **Act** will only apply if either the parties have expressly chosen Malaysia as the seat of arbitration or if the arbitral tribunal determines and concludes that the seat of arbitration is Malaysia by looking at the forum convenience and other matters involved in the particular case.

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<sup>2</sup> In respect of **Section 22(2)**, the arbitral tribunal cannot simply fix the venue of its choice regardless of the convenience of the parties. It has to consider all the material circumstances, including the nationality, residence of the parties, their witnesses, freedom to transfer necessary funds, the subject matter of the reference, the balance of convenience and whether there is adequate infrastructure including the availability of skilled support to accommodate the parties (see *UP Ban Nigam Almora v. Bishan Bath Goswami* AIR 1985 ALL 351 at 353, per NN Sharma J; *Hiscox v. Outhwaite (No. 1)*[1992] 1 AC 562.). In the final analysis, the suitability of a particular place is dependent on its legal environment for the conduct of the arbitration and enforcement of the award. (see Redfern and Hunter, p 322, paragraph 6-13).

20. The problem arises as to the extent of judicial interference or judicial assistance that will be offered by our Malaysian courts when the seat of arbitration is outside Malaysia.
21. Examples of the problems that may arise are:-
- An arbitration in Singapore but a Malaysian Court grants an injunction preventing the Malaysian parties from proceeding with an arbitration or refuses to grant a stay of proceedings in the Malaysian Courts, because no Act applies and the courts are free to interfere based on their inherent jurisdiction;
  - An arbitration in Singapore but a Malaysian Court refuses interim preservation applications (i.e. Mareva injunction) because no Act applies and the Court believes that as such, there is no other jurisdiction.
22. Under **article 1(2)** of the Model Law, this problem is in fact prevented. Under the Model Law, there are four other provisions that survive despite the seat being outside the territory in question. The equivalent provisions in the new Act are:
- a. Article 8, Arbitration agreement and substantive claim before court (stay powers)
  - b. Article 9, Arbitration agreement and interim measures by High Court
  - c. Article 35, Recognition and enforcement of awards
  - d. Article 36, Grounds for refusing recognition or enforcement of awards.
23. The particular Model Law approach has been adopted in various other jurisdictions such as England namely through **Section 2(2) English Arbitration Act 1996**. It is uncertain as to why the **Arbitration Act 2005** did not incorporate the approach taken by **Article 1(2)** of the Model Law.

*Issue (b): the likelihood of further disputes- the Opt in/Opt out rights and the default provisions*

24. It must be remembered that the power to “opt in/opt out” is only exercisable vis-à-vis provisions in Part III of the Act. There are also many default provisions that apply unless parties agree.
25. There are 2 serious problems that can arise from this freedom to contract:-
- Does a party know whether it would fall within the international or domestic regimes in order to decide whether it has to opt in or opt out?
  - When drafting the opt in or opt out provisions in addition to any other term that may otherwise attract a default provision, ambiguity is created and disputes arise as to the true intention of the parties on the *lex arbitri*
26. On the first problem as to whether a party falls within the international or domestic regimes, at first blush, it would seem pretty straightforward based on the definitions provided in the Act.
27. **Section 2(1) of the Arbitration Act 2005** states:
- "international arbitration" means an arbitration where—*
- (a) one of the parties to an arbitration agreement, at the time of the conclusion of that agreement, has its place of business in any State other than Malaysia;*
- (b) one of the following is situated in any State other than Malaysia in which the parties have their places of business:*
- (i) the seat of arbitration if determined in, or pursuant to, the arbitration agreement;*

*(ii) any place where a substantial part of the obligations of any commercial or other relationship is to be performed or the place with which the subject-matter of the dispute is most closely connected; or*

*(c) the parties have expressly agreed that the subject-matter of the arbitration agreement relates to more than one State;”*

28. **Section 2(2) of the Arbitration Act 2005** states

*“(a) in the definition of "international arbitration"—*

*(i) where a party has more than one place of business, reference to the place of business is that which has the closest relationship to the arbitration agreement; or*

*(ii) where a party does not have a place of business, reference to the place of business is that party’s habitual residence;”*

29. The difficulty however arises when the parties have more than one place of business and at least one of its places of business is also in Malaysia. The Act then refers to a second test that is to apply namely *“the place of business in that which has the closest relationship to the arbitration agreement”*.

30. An ambiguity is created by this term *“closest relationship to the arbitration agreement”* which is an identical wording to that used in **Article 1 (4) (a)** of the Model Law. The ambiguity becomes clear when the disputes that have already arisen in other jurisdiction are considered.

31. Parties have argued that it must mean where the arbitration agreement itself was negotiated, offered, accepted, executed etc.

32. Nevertheless, an interpretation which cannot be construed from any literal reading of the words has now been applied and accepted by the Working Committees of the Model Law and the foreign Courts.

33. In **Aron Broches's Commentary on the UNCITRAL Model Law on International Commercial Arbitration** (1990) published by Kluwer, the commentary states:-

*“The Law deals in subparagraph (4)(a) with the case in which a party has more than one place of business, and in (4)(b) with the rare case in which a party has no place of business. Divergent views were expressed in the Working Group with respect of what become (4)(a). Some felt that where a party had more than one place of business, its principal place of business should be regarded as its place of business for the application of subparagraph (3), since this would provide a clear criterion. The prevailing view in the Working Group was, however, in favour of the place of business which has the **closest relationship to the arbitration agreement**, a criterion which was similar to **Article 10(a) of the 1980 Vienna Sales Convention**. The relationship between a place of business and an arbitration agreement is not a very clear concept. It should probably be understood as meaning, or at least including, the implementation of the agreement and the subject matter of the dispute. [emphasis added].”*

34. In the UNICITRAL Model Law on International Commerce Conciliation with Guide to Enactment and Use 2003, where a similar provision exist, the commentary states:-

*“Factors that may indicate that one place of business bears a close relationship with the agreement to conciliate may include that a substantial part of the obligations of the commercial relationship that is the subject of the*

*dispute is to be performed at that place of business, or that the subject matter of the dispute is most closely connected to that place of business.”*

35. This definition which suggests that the place of performance or the place of dispute is the place with the most closest relationship to the arbitration agreement has now been adopted in jurisdictions such as Hong Kong<sup>3</sup> and Singapore<sup>4</sup>.
36. Will the Malaysian Courts interpret it the same way? Can such an interpretation be taken when it clearly does stretch the imagination that “*closest relationship to arbitration agreement*” can be construed as being “*closest relationship to the substantive agreement*” especially when the Model Law and **S.18 (2)** of the **Malaysian Arbitration Act 2005** has taken great efforts in ensuring that the arbitration agreement is to be construed as independent from the substantive agreement.
37. Further, reading **Section 2 (1)** of the **Malaysian Arbitration Act 2005** (*pari material* with the Model Law), the place of business definition connotes an identification at the time of the conclusion of the arbitration agreement (ie. execution) [emphasis added] and not at the time when a disputes arise or contract is performed. Surely this was done intentionally to identify the place of execution of an agreement. As such, could the place of business be ever construed as that closest to the place of performance from whereat the dispute arises? Surely not in any common sense approach.
38. Where does this leave companies that are not Malaysian but yet are carrying out business in Malaysia but are executing the agreement in their own countries? Do they opt in or do they opt out?

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<sup>3</sup> Fong Sang Trading Ltd v Kai Sun Sea Products & Food Co Ltd [1991] 2 HKLR 526

<sup>4</sup> Mitsui Engineering & Shipbuilding Co Ltd v PSA Corp Ltd and Another [2003] ISCR 446

39. The resolution to this problem may lie in **Section 2 (1) (c)** of the definition of international arbitration where parties may have to then expressly agree that the subject matter of the arbitration agreement relates to a foreign state as well. However, how can this be done if the subject matter of the dispute can only be in Malaysia and the seat of arbitration is Malaysia?
40. Further, the freedom to draft more provisions dealing with the *lex arbitri* and the fact that language is after all an ambiguous creature, may and will likely lead to more disputes on the implementation of the arbitration processes based on the *lex arbitri* even before proceeding with the substantive disputes can commence. This will lead to serious delays.
41. Hence, the freedom to contract on various matters relating to the *lex arbitri* will likely than not cause more litigation.

**B. The Substantive Law**

42. **Section 30** of the **Arbitration Act 2005** deals with the issue of the applicable law to the substantive dispute, i.e. the law that will govern the relationship between the party in relation to the entire contract and not the arbitration agreement or arbitration clause itself.
43. **Section 30** reads as follows:-

“30 *Law applicable to substance of dispute*

(1) *In respect of a domestic arbitration where the seat of arbitration is in Malaysia, the arbitral tribunal shall*

*decide the dispute in accordance with the substantive law of Malaysia.*

(2) *In respect of an international arbitration, the arbitral tribunal shall decide the dispute in accordance with the law as agreed upon by the parties as applicable to the substance of the dispute.*

(3) *Any designation by the parties of the law of a given State shall be construed, unless otherwise expressed, as directly referring to the substantive law of that State and not to its conflict of laws rules.*

(4) *Failing any agreement under subsection (2), the arbitral tribunal shall apply the law determined by the conflict of laws rules.*

(5) *The arbitral tribunal shall, in all cases, decide take into account the usages of the trade applicable to the transaction.”*

44. **Section 30(1)** seeks to restrict party autonomy in domestic arbitrations where the seat of arbitration is in Malaysia. It mandates that the domestic parties are not free to choose their own choice of law to determine the substantive disputes. Under **Section 30(2)** and for international arbitration, the parties are allowed the freedom to choose the applicable substantive law.

45. Whilst at first blush, there should not be any concern as to compulsory choice of Malaysia law for domestic arbitration, it becomes a matter of concern when viewed with the problems that arise from the definition of international and domestic arbitration, whereby a foreign company with a place of business in

Malaysia will have no choice but to accept Malaysian law for disputes arising out of its business in Malaysia or otherwise it would either have to ensure it has no place of business in Malaysia or ensure the seat of arbitration is not in Malaysia. The Act therefore becomes arguably self-defeatist.

46. Furthermore, even if it is a domestic arbitration, the freedom to choose the applicable law was never intended to be curtailed by the Model Law and it contradicts the basic jurisprudence and theories that have evolved contract law to the total *lazzie-faire* concepts that are applicable in today's world. Furthermore, this freedom existed in Malaysia under the previous legislation and clearly a compelling argument must be given as to why freedoms that previously existed are now restricted.
47. It must be noted that parties determine the choice of law because they intend to dictate their vested rights by such laws. The vested rights will change if the parties are deemed to be bound to another law not of their choice and this will surely result in interpreting contracts not based upon the intentions of the parties.
48. Furthermore, Malaysia must be aware of the theory of comity which arises from mutual interest and utility in that justice and morals dictate that parties are given the freedom of choice in Malaysia, so that Malaysian companies are likewise given freedoms in other States.

**C. The Law that applies to Conflict of Laws**

49. It is to be noted that for international arbitrations, the freedom to choose the substantive law is maintained
50. If parties have however failed to choose the substantive law applicable, **Section 30(4)** dictates that the arbitral tribunal shall apply the law determined by the conflict of laws rules.

51. Each state under its laws, have differing conflict of laws rules and the Act has not prescribed the laws of any particular state that is to apply so that the arbitral tribunal can conclude which conflict of laws rules are to be used by them in determining the substantive law applicable to the arbitration dispute.
52. Without any clear direction, the arbitral tribunal is left to guess as to whether the conflict of laws rules that are to apply are to be the *lex arbitri* or otherwise.
53. If otherwise, then which conflict of laws rules are to be utilized? Is it the *lex domicilie* of the parties? Is it the *lex loci actus* or the law of the place where the performance and dispute arises? Is it *lex reis sitae* or the law where the subject matter property is situated?
54. If the *lex arbitri* is to be the basis of the conflict of laws rules and it is Malaysia, then the conflict of laws rules applicable in Malaysia prescribes that the applicable substantive law (i.e. the proper law) is to be the one with which “*has the closest and most real connection with the [contractual] transaction.*” (see **YK Fung Securities Sdn Bhd v. James Cape (Far East) Ltd (CA)** [1997] 4 CLJ 300). It was held that the territory where the contract was made is only one of the relevant factors in the determination of the proper law of these contracts. The court must look at the whole circumstances of the case.

*“This issue must therefore be determined by common law principles set out in r. 180 of Dicey and Morris’ Conflict of Laws (11<sup>th</sup> Edn) Vol 1, p. 1161 et seq, which the learned judge correctly applied.*

*Even so, the territory where the contract was made is only one of the relevant factors in the determination of the proper law of these contracts. In addition to those listed by the trial judge, we consider the following factors equally relevant, namely: (i) the defendant could only legally make them in Ipoh; (ii) the documents*

exchanged indicate an implied choice of Malaysian law; and (iii) the circumstances show that delivery and payment were required to be made and were in fact made in Ipoh where the breach occurred.”

55. There are suggestions that the arbitral tribunal ought to determine which conflict of laws rules to apply by using the system of law with which the transaction has its closest and most real connection (Dicey and Moriss, pp. 1196-1197).
56. Again, there is no reason why this should be the case and what is certain, is that there could be further delays and potential judicial interference if the substantive laws that determine the dispute itself is challenged on the basis that the arbitral tribunal decided to use a particular system of law based on an unfair or inapplicable conflict of laws rules.

#### **D. The Procedural Law**

57. **Section 21** of the Act deals with the issue of procedures applicable in conducting arbitration proceeding. The previous Act was silent on the question of who was to determine the procedures to be adopted in the arbitration. Such omission is now remedied in the Act.
58. The parties are free to determine the procedure, subject to overriding rules requiring fairness. The parties can agree on any procedural rules for an ad hoc arbitration process or they can agree on an institutional arbitration where generally the institution’s rules will apply. Where the parties do not make the determination for themselves, the decision on the procedural rules reverts to the arbitral tribunal. The default mechanism in **Section 21** empowers the arbitral tribunal with a wide discretion on how to conduct the proceedings, subject to the principle of equal treatment. Implicitly, **Section 21** recognises the need for supplementary rules that would fill in the gap where parties fail to stipulate an arbitral procedure.

59. **Section 21** reads as follows:-

*“21 Determination of rules of procedure*

*(1) Subject to the provisions of this Act, the parties are free to agree on the procedure to be followed by the arbitral tribunal in conducting the proceedings.*

*(2) Where the parties fail to agree under subsection (1), the arbitral tribunal may, subject to the provisions of this Act, conduct the arbitration in such manner as it considers appropriate*

*(3) The power conferred upon the arbitral tribunal under subsection (2) shall include the power to –*

*(a) Determine the admissibility, relevance, materiality and weight of any evidence;*

*(b) ...*

*(c)*

*(i) make such other orders as the arbitral tribunal considers appropriate“*

60. From the above, it is apparent that **section 21** recognises the need to allow parties freedom to choose and tailor the procedural rules that are applicable to the arbitral tribunal. It is not too far fetched to say that such freedom accorded to the parties constitutes one of the major attractions of arbitrations.

61. We attach herewith a comparison of various institutional rules that can also be used as an ad hoc basis.