'Commerciality' in International Commercial Arbitration

Anurag K. Agarwal
D. Harsh Jain

W.P. No. 2006-04-10

April 2006

INDIAN INSTITUTE OF MANAGEMENT
AHMEDABAD-380 015
INDIA

'Commerciality' in International Commercial Arbitration

Anurag K. Agarwal*
D. Harsh Jain!

Abstract

Enterprises, the world over, now conduct business on a dramatically more international scale. The growth of world economies is directly connected with millions of commercial contracts, which are becoming more international in character owing to global integration. Commercial arbitration has been hailed as the most efficient form of dispute settlement available to participants in international trade. As the purpose of the commercial arbitration is to resolve commercial disputes, often issues have been raised whether a particular dispute is commercial or not. With globalisation and seamless trade the aspirations of global business community, it would be of immense importance to understand the meaning of 'commercial' as construed in 'international commercial arbitration' in some of the major jurisdictions of the world.

Key Words:

Arbitration, Commercial, Liberal Construction, Model Law, New York Convention

* LL.M. (Harvard), LL.D. (Lucknow); Faculty – Business Policy Area, Indian Institute of Management Ahmedabad; akagarwal@iimahd.ernet.in
! Student B.A., LL.B. (Hons.); National Law School of India University, Bangalore; harshjain@gmail.com

'Commerciality' in International Commercial Arbitration

Anurag K. Agarwal
D. Harsh Jain

The Concept of Commerciality

In 1958, forty-five countries, including India and the United States, participated in the U. N. conference that culminated in the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, 1958 (the New York Convention). The Convention encourages the recognition and enforcement of international arbitration agreements and awards. Article I (3) of the Convention provides that a State may declare that it will apply the Convention 'only' to differences arising out of legal relationships, whether contractual or not, which are considered as 'commercial under the national law' of the State.

On September 30, 1970, the U.S. signed the New York Convention, with the following 'declarations and reservations':

- The United States of America will apply the Convention, on the basis of reciprocity, to the recognition and enforcement of only those awards made in the territory of another Contracting State.
- The United States of America will apply the Convention only to differences arising out of legal relationships, whether contractual or not, which are considered as **commercial** under the national law of the United States.

The rationale behind this "reservation" (i.e. states can restrict the applicability of the Convention) probably derives from the recognition of the legal regimes in civil law countries, where a distinction exists between "commercial" and "non-commercial" contracts. A commercial contract can broadly be understood to be a contract made by merchants and traders in the ordinary course of their business. These "commercial" contracts are governed by a special code of commercial law. In many civil law countries, only disputes arising out of commercial contracts can be submitted to arbitration.

The first aspect that should be noted in this context is that of the 137 states that are signatories to the Convention, only 46 adopted the "commercial reservation" with respect to the Convention.[1] Interestingly, many common law countries like India, the USA, Canada, etc. have also adopted this reservation, despite the fact that there is no general distinction between "commercial" and "non-commercial" contracts as understood in civil law countries. One possible reason why these countries kept the "commercial reservation" could be because they were concerned about issues relating to sovereign immunity.

Thus, the effect of the reservation was that each country could restrict the application of the Convention to only those matters which were considered to be commercial under the law of that particular country. Since, different countries defined and interpreted the word "commercial" differently, it gave rise to many problems. Hence, during the drafting of the UNCITRAL Model Law, when there was a renewed exercise to bring about unification and harmonization of ICA law across the world, there was an attempt to provide a definition of the word "commercial." However, this did not prove to be an easy task. Countries like Mexico specifically wanted foreign direct investments and financial transactions entered by the government to be excluded (as they are considered to be part of public debt). On the other hand, countries like Germany and the

[1] http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html (April 28, 2006).

United States specifically wanted a clause to expressly state that the nature of the transaction i.e. whether it was commercial or not would not depend on the nature and character of the parties to the transaction. Thus, for example the fact that a person who is not a merchant had entered into an otherwise commercial transaction would have no effect on the commerciality of the transaction.[2]

These differing viewpoints among various countries were almost irreconcilable and hence as a compromise, it was decided to annex a footnote to Article 1 of the Model Law to aid in the interpretation of the term. As a result Footnote 2 to Article 1(1) of the Model Law reads:

> The term "commercial" should be given a wide interpretation so as to cover matters arising from all relationships of a commercial nature, whether contractual or not. Relationships of a commercial nature include, but are not limited to, the following transactions: any trade transaction for the supply or exchange of goods or services; distribution agreement; commercial representation or agency; factoring; leasing; construction of works; consulting; engineering; licensing; investment; financing; banking; insurance; exploitation agreement or concession; joint venture and other forms of industrial or business co-operation; carriage of goods or passengers by air, sea, rail or road.

However, uncertainty remains about the legal effect of such a footnote. Many countries do not adopt this kind of legislative technique. While Footnote 1 of the Model Law states that Article Headings are to be used for reference purposes only and are not to be used for purposes of interpretation, there is no mention of the use of Footnotes themselves. A problem also might arise where a national legislation although based on the Model Law specifically makes a requirement of the transaction being "commercial" under the law of that nation. In such a situation it is unclear what effect the footnote might have. This is because the Footnote might include certain transactions to be commercial which are not considered as commercial under the nation's legal system.

An example of such a national legislation is the Indian Act. It makes a specific reference to the Model Law and is almost an identical replica of the Model Law. It however contains a requirement that the dispute need to be commercial under the law in force in India. The relevant portion of the Indian law[3] is as follows:

> Section 2(1)(f): "international commercial arbitration" means an arbitration relating to disputes arising out of legal relationship, whether contractual or not, considered as *commercial under the law in force in India* and ……

Some other aspects of the Footnote in the Model Law are:[4]

1. The list is illustrative and not exhaustive.
2. The legislative intent behind the Footnote is to construe the term "commercial" in a broad manner.
3. Although the Footnote has not referred to it, transactions for supply of electrical energy, transport of liquefied gas via pipeline and "non-transactions" such as claims of damages arising out of a commercial context are meant to be covered.
4. Labour or employment disputes and ordinary consumer claims are not meant to be covered despite their relation to business.

---

[2] Analytical compilation of comments by Governments and international organizations on the draft text of a model law on international commercial arbitration: report of the Secretary-General, 18th session of UNCITRAL, June 3-21, 1985, UN Doc. A/CN.9/263 at para. 12.
[3] The Arbitration and Conciliation Act, 1996 [Act No. 26 of 1996], India
[4] Analytical commentary on draft text of a model law on international commercial arbitration: report of the Secretary-General, 18th session of UNCITRAL, June 3-21, 1985, UN Doc. A/CN.9/264 at para. 18.

It is important to keep these aspects in mind, since some legislation like the International Commercial Arbitration Act, 1990 of Ontario, Canada makes an express provision to the effect that the analytical commentaries accompanying the drafting of the Model Law can be used to interpret the relevant legislation which deal with ICA. Even where no express provisions have been made, while interpreting national legislations which are largely based on the Model Law, courts might find it useful to consider these commentaries.

It can reasonably be inferred that the Model Law progresses from the Convention, as the Convention had no guidance on this issue whatsoever and left it completely at each nation's discretion. However, it should be noted that the interpretation of the word "commercial" still remains important. This is because countries like India have retained the "commercial reservation" even after enacting a new law on the lines of the Model Law. The Convention might still govern a number of cases despite the fact that the countries have enacted the Model Law. Moreover, as compared to the Convention, only 48 states have enacted legislations based on the Model Law.[5]

Interpretation across jurisdictions

Different jurisdictions across the globe interpret 'commerciality' differently. Some of the more important jurisdictions are:

(a) The USA

Overall, the judiciary in the US has construed the term "commercial" broadly with regard to ICA.[6] In the case of *Societe Generale de Surveillance, S.A.* v. *Raytheon European Management and Systems Co.*[7], an American company was involved in a dispute with a French company in a contract for the field testing, inspection, and evaluation of missiles. Even though the contract was strictly one about services, and not about an exchange of commodities, the court held that it was commercial. The court also observed that there is a strong judicial policy favouring the submission of contractual disputes to arbitration particularly under the provisions of the Federal Arbitration Act (FAA), and the term "commerce" should be broadly construed.

Another important case is that of *Faberge Intern. Inc.* v. *Di Pino*.[8], where the court held that an employment agreement was "commercial" and hence disputes arising out of it, could be submitted to arbitration. The court observed:

> "the fact that the employer-employee relationship may include a degree of fiduciary obligation does not deprive it of its commercial character."

This decision is notable because the Commentary to the drafting of the Model Law indicates the legislative intent to exclude employment agreements from the scope of the word "commercial." In this case however the court went ahead and construed the term broadly.

The decision in *Bautista* v. *Star Cruises*[9] is important in the context of the scope of the word "commercial" with regard to American arbitration law. The court approved of the use of

---

5 http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/1985Model_arbitration_status.html (April 28, 2006).

6 I. Eliasoph, "A Missing Link: International Arbitration and the Ability of Private Actors to Enforce Human Rights Norms", 10 *New England Journal of International and Comparative Law* (2004) 83, at 110.

7 643 F.2d 863 (1st Cir. 1981).

8 109 A.D.2d 235 (N.Y.App. Div. 1985).

9 396 F.3d 1289. However, this decision has been criticized for adopting such an interpretation and going against legislative intent. See: S. Karamanian, "The Road to the Tribunal and Beyond: International Commercial Arbitration and United States Courts", 34 *George Washington International Law Review* (2002) 17.

arbitration provisions with regard to contracts signed by some Filipino seamen. Chapter 1 of Title 9 the US Code codifies the FAA. Under Chapter 1 seamen agreements are exempt from arbitration. Under Chapter 2, which codified the Convention, "commercial disputes" include the definition under Chapter 1. The court, however, held that the definition under Chapter 2 was not limited by the definition under Chapter 1 and the reference in Chapter 2 to Chapter 1 was illustrative. Thus, Chapter 2 was considered to be broader in its application and included crewmember agreements, despite the fact that the agreements would not have been "commercial" under the FAA.

A number of cases have arisen in the U.S. with respect to the concept of commerciality in the context of the Foreign Sovereign Immunities Act, 1976 (FSIA). The main aim of FSIA is to make foreign states immune from suits arising from its "sovereign" or "governmental" acts, but not from its "commercial" acts. It is in this context that courts in the US have needed to interpret what the word "commercial" meant. While most of these cases arose as a direct lawsuit against a foreign state, some of them also arose in the context of arbitration law.

FSIA defines a "commercial activity" as "either a regular course of commercial conduct or a particular commercial transaction or act."[10] It is obvious that such a definition is tautological and is not really helpful. FSIA however directs a court to determine the "commercial character" of an activity by reference to its "nature" and not its "purpose." It is in the interpretation of these provisions that a number of cases have been decided.

Private Person Test

Courts have evolved the "Private Person test" to determine commerciality in such cases. The steps involved in this test are:

1. Identification of relevant activity

While, this step seems relatively easy and it may appear that all the court would have to do is identify cases like a "contract for purchase of X good." However, this is not always the case. In some cases, courts have mixed the definition of the relevant activity with the purpose of the activity or with the some other activities which the state has performed. The famous case in this regard is *MOL, Inc.* v. *People's Republic of Bangladesh*[11]. The Bangladesh Ministry of Agriculture had granted MOL a license to capture and export a specified quantity of monkeys at designated prices. MOL undertook to build a breeding farm and agreed that the animals would be used only "for the general benefit of all peoples of the world." After the market price of monkeys rose, Bangladesh terminated the agreement, claiming that MOL failed to construct the farm and sold monkeys to the U.S. military in violation of the agreement. MOL sought arbitration under the agreement, and Bangladesh refused. MOL then sued Bangladesh in the United States, seeking damages for Bangladesh's termination of the license agreement.

The court held that the nature of Bangladesh's acts was the "regulation of its natural resources" which was a sovereign activity and not a commercial one and hence Bangladesh was entitled to immunity. The decision is a flawed one. There was a breach of contract. However, the court looked at the policy that the activity advanced rather than the activity itself. Thus, it was clearly against the direction mandated by the FSIA.

2. Identifying whether a private person can engage in the activity

The second step has also created a lot of confusion leading to differing results. Does the step focus on juridical form, by asking whether the legal nature of the activity makes it one in which a private person can or cannot engage (e.g., a contract versus a unilateral administrative act by a

[10] § 1603 (d)
[11] 736 F.2d 1326 (9th Cir.1984).

state)? Or does this test focus on subject matter, by asking whether the content of the activity, whatever its form, is such that a private person can engage in it (e.g., a contract for sale of cement versus a contract in which a state waives taxation)?[12] Earlier decisions concentrated on the juridical nature. A notable observation was made by the U.S. Supreme Court in *Republic of Argentina* v. *Weltover, Inc*.[13] The Supreme Court defined the "nature" of an activity as the "outward form of conduct that the foreign state performs or agrees to perform. It also stated:

> "the issue is whether the particular actions that the foreign state performs (whatever the motive behind them) are the type of actions by which a private party engages in commerce…Thus, a foreign government's issuance of regulations limiting foreign currency exchange is a sovereign activity, because such authoritative control of commerce cannot be exercised by a private party; whereas a contract to buy army boots or even bullets is a 'commercial' activity, because private companies can similarly use sales contracts to acquire goods".[14]

This approach helped in avoiding examination into the purpose of the activity; it still had a number of flaws. Since a private person's legal capacity to engage in a particular activity varies among legal systems, and it is unclear whether a court is to look to the forum legal system or to that of the foreign state defendant to determine immunity. Also, a strict approach along this line led to a situation in which states never enjoyed immunity.

Some cases on the other hand focus on the subject matter of the activity.

Thus, FSIA has not been very helpful. The distinction between nature and purpose of a particular activity has often resulted in confusion wherein courts have not been able to distinguish between the two. The determination of the relevant activity in question is largely discretionary. The observations in two decisions seem relevant in this context. In *De Sanchez* v. *Banco Central de Nicaragua*[15] the court held that an absolute separation between nature and purpose is not possible and many times the purpose (for example whether it is for profit) determines the nature. In *Segni* v. *Commercial Office*[16], the court significantly observed that taken to its logical conclusion, any governmental action, including the "commercial" purchase of goods can be defined as the execution of some governmental policy or otherwise. Similarly, to determine whether a private person can engage in that activity is a troublesome test. Thus, for example, it is not clear whether the raising of a private security force would be considered a sovereign function or not. The difficulty is compounded by the fact that in different countries the level of privatization is different. Hence, the extent and scope of sovereign functions would necessarily be different. A question may also arise with regard to an activity which is considered as sovereign in the foreign country but not in the host country where the suit lies and vice versa. In such cases, what is the standard to be adopted remains an open question.

(b) Canada

The important case in this regard in Canada has been that of *Carter* v. *McLaughlin*.[17] In this case an arbitral award had been made after a dispute involving the condition of a house, which had been the subject matter of the sale between the two parties. Seeking to prevent the enforcement of the award, McLaughlin argued that the sale was for personal use and neither of the parties was involved in trade and hence the transaction was not "commercial." The court however rejected this contention. It observed that the mere fact that the sale was unconnected to the regular

---

[12] J. Donoghue, "Taking the "Sovereign" Out of the Foreign Sovereign Immunities Act: A Functional Approach to the Commercial Activity Exception", 17 *Yale Journal of International Law* (1992) 489, at 505.
[13] 504 U.S. 607.
[14] *Ibid.* at 614.
[15] 770 F.2d 1385.
[16] 835 F.2d 160.
[17] (1996) 27 O.R. (3d) 792, O.J. No. 328, Rutherford J.

business activity of the parties was not sufficient enough to term the transaction as non-commercial. Since, in this case the sale was done in a business-like way, with the assistance of professional realtors and within a legal framework appropriate for a transaction involving a large sum of money, it bore all the characteristics of a commercial transaction. Infact, the court observed that the only relationship between the parties was a commercial one.

Another significant case has been *Borowski* v. *Heinrich Fiedler GmbH* [18] (*Borowski*). In this case there was an employer-employee relationship between the parties and an arbitral clause in the contract. The court however held that the relationship was not a "commercial one." The court cited a number of dictionaries like the Shorter Oxford Dictionary, Webster's Third New International Dictionary, etc. All these defined commerce as something which involves trading of goods, especially on a large scale for profit.

Although, the case of *Pinebrook Golf & Country Club* v. *Alberta (Assessment Appeal Board*) [19] (*Pinebrook*) did not involve arbitration law, the court cited Black's Law Dictionary which has defined commerce as: The exchange of goods, productions, or property of any kind; the buying, selling, and exchanging of articles. In the case of *R*. v. *Wah Kee* [20] (*Wah Kee*) it was held that every business of profit could not be automatically classified as a commercial one. It would necessarily involve trading in some article of commerce. Both, *Pinebrook* and *Wah Kee* have been cited in *Borowski* to support its stand.

It is in this regard that some aspects need to be noted:

1. To imply that commerce necessarily connotes trade in some article, that too on a large scale, would mean giving an interpretation which is not consistent with the times. Over the years the idea of commerce has evolved to include many other activities like investment, banking, etc. The Footnote to the Model Law is illustrative of that change.
2. The U.S. Courts have held that employer-employee relationships are commercial ones while, as *Borowski* illustrates, in Canada they are not.

(c) France

As has been mentioned above, the idea of a "commercial reservation" becomes significant in civil law countries. It is also possible that the "domestic commerce" and "international commerce" may be interpreted in different ways.[21] European continental law shows that arbitration should not be used in consumer contracts unless under some specific rules.[22] However, such a restriction mainly applies only in case of domestic arbitrations and not with regard to international arbitrations involving consumers and there is no evidence of any country refusing enforcement of consumer arbitration awards in relation to the Convention.[23]

Such a stance is only in line with the decision of the Paris Court of Appeal in the case of *Kuwait Foreign Trading Contracting and Investment Co*. v. *Icori Estero Spa*.[24] The court held that the notion of "commercial" in ICA is distinct from the narrow, technical one employed in domestic

[18] (1994) 158 Alberta Reports, 213, Murray J.
[19] 1984 CarswellAlta 463.
[20] 1920 CarswellAlta 169.
[21] R. David, *Arbitration in International Trade* (Netherlands: Kluwer Publications, 1985) at 149.
[22] L. Biukovic, "International Commercial Arbitration in Cyberspace: Recent Developments", 22 *Northwestern Journal of International Law and Business* (2002) 319, at 330.
[23] L. Gibbons, "Creating a Market for Justice; A Market Incentive Solution to Regulating the Playing Field: Judicial Deference, Judicial Review, Due Process, and Fair Play in Online Consumer Arbitration", 23 *Northwestern Journal of International Law and Business* (2002) 1, at 56.
[24] Unreported Decision. Case discussed in E. Gaillard, "France: The "Commercial" Requirement in International Commercial Arbitration", 1(1) *International Arbitration Law Review* (1997) at N11-12.

contexts. The court observed that the "commercial" character of an international arbitration would not be dependent on the nature of the parties, the purpose of the contract or the applicable law. Rather it would be commercial when it related to an economic transaction involving the movement of goods or services. It is clear that by this case, the judiciary in France has aligned French law along the lines of common law systems as well as the approach adopted by modern international legal instruments which do not recognize the civil-commercial dichotomy.

(d) India

The Indian judiciary has mostly interpreted the term "commercial" quite broadly. In *Renusagar Power Co. Ltd*. v. *General Electric Co*. [25], the Supreme Court held that the Foreign Awards (Recognition and Enforcement) Act, 1961, (which contained a similar provision with respect to commerciality) was meant to facilitate international trade and hence the expression should receive a liberal construction.[26] In the case of *RM Investments and Trading Co (P) Ltd*. v. *Boeing Co*.[27], the SC held that the term commercial should be considered broadly and the Model Law can be referred to. In this case, the court held that consulting was a commercial activity and commercial need not always imply trade. Many judgments involving arbitration law have cited the famous case of *Atiabari Tea Co. Ltd*. v. *State of Assam* [28] despite the fact that the case did not deal with arbitration. The Court held:

> Trade and commerce do not mean merely traffic in goods, i.e., exchange of commodities for money or other commodities. In the complexities of modern conditions, in their wide sweep are included carriage of persons and goods by road, rail, air and waterways, building contracts, banking, insurance transactions in the stock exchanges and forward markets, communication of information, supply of energy, postal and telegraphic services and many more activities- too numerous to be exhaustively enumerated- which may be called commercial intercourse.

However, there have been some other decisions which gave narrow interpretation despite such mandates. In *Josef Meisaner GMBR & Co*. v. *Kanoria Chemicals & Industries Ltd*.[29] and *Kamani Engg Corp Ltd.* v. *Societe De Traction Et D' Electricity Sociate Anonyme*[30], the courts held that the transactions were non-commercial merely because of the fact that they involved agreements for the supply of technical know-how. In the present time, this narrow interpretation is not desirable at all and if Courts insist on such an interpretation, this would cause a lot of avoidable trouble and anxiety to the business community.

In *Indian Organic Chemicals Ltd.* v. *Chemtex Fibres Inc.*[31] (*Chemtex*), a technology transfer agreement was held to be non-commercial. The court held that it would not be enough to prove that an agreement was commercial. Rather, it would be necessary to prove that it was commercial by virtue of a provision of law or operative legal principle in force in India. Better sense prevailed and this case was overruled in *European Grain & Shipping Ltd.* v. *Extractions (P) Ltd.*[32] where the court held that the mere use of the word "under" would not necessarily mean that a statutory provision or provision of law which specifically deals with the subject matter of a particular legal relationship being commercial in nature needs to be proved. Clearly, the decision in *Chemtex* was a flawed one.

---

[25] (1984) 4 SCC 679
[26] Also see: *Union of India* v. *Owner & Parties Interested in Motor Vehicle M/V Hoegh Orchid,* AIR 1983 Guj 34 at 40.
[27] AIR 1994 SC 1136.
[28] AIR 1961 SC 232.
[29] AIR 1985 Cal 45 at 54.
[30] AIR 1965 Bom 114 at 118.
[31] AIR 1978 Bom 106.
[32] AIR 1983 Bom 36.

Conclusion

With respect to commerciality, given the aims of international commercial arbitration law and the current era of globalization, a broad construction should be adopted. While it is impossible to exhaustively list each and every commercial relationship, an express amendment to the Indian Act in the main body of the statute, similar to Footnote 2 of the Model Law, would help in bringing about clarity and certainty. It would be advantageous for the global business if courts globally give liberal construction to 'commercial'. Only then, international commercial arbitration would be able to subserve the cause of facilitating international trade and promotion thereof by providing for speedy settlement of disputes arising in such trade through arbitration. Otherwise, the world business community would be busy interpreting the word 'commercial' and in the process defeating the very purpose of commercial arbitration.