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Awarding Compound Interest in International Arbitration

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AWARDING COMPOUND INTEREST IN INTERNATIONAL ARBITRATION

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I. INTRODUCTION

Few, if any, international arbitrators choose to tackle the equation $P_n = P_0(1+ i/m)^{mn}$ [1] in their arbitral awards. In fact, few international arbitral awards explicitly address the issue of whether an award of interest should attract compound, rather than simple, interest. While there is little consensus on approaches to awarding interest generally in international arbitration, the issue of compound interest is especially problematic. This is due to the fact that compound interest is often singled out for prohibition in domestic legal systems, yet it is the commercial norm in calculating interest in modern financial transactions.

The practices of financial institutions mean that a party with surplus funds can invest those funds to earn compound interest. Equally, those who are kept out of their money and are forced to borrow from banks pay compound interest. This article attempts to demystify compound interest, and to identify the sources of hostility to compound interest in international arbitral awards.

Restrictions on compound interest in domestic cases often advance a "public policy for the protection of the weak and ignorant debtor against extortion and oppression by the grasping creditor who, by an apparent indulgence is enabled to delude his victim into certain ruin."[2] In international arbitrations, however, the parties, their level of business sophistication, and the amounts of money at stake give rise to quite different concerns. The paradigm case of the necessitous consumer borrower is unlikely ever to present itself before an international arbitrator.

In many international arbitrations, considerable amounts of principal are at stake, and lengthy periods elapse between the origin of a dispute and the final award. Both the large sums at issue and the length of time over which interest is calculated add to the financial importance of the question of whether compound interest will be awarded. While interest is a significant issue in

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[1] Where P_n = end balance including interest earned
P_0 = beginning amount of principal
m=number of compounding periods per year
n=number of years
i=annual rate of interest.

[2] Young v. Hill, 67 N.Y. 162, 177-78 (1876).

many international arbitrations, uniform approaches to interest issues are lacking.[3] This lack of uniformity means that it may be entirely impossible to predict in advance whether an arbitral tribunal will award compound interest. Domestic laws on compound interest differ widely, and there is no consensus on whether the issue of compound interest is a question of substance or procedure. International rules and general principles of law also fail to provide unequivocal guidance on the issue of compound interest.

Uncertainty as to whether compound interest will be awarded is problematic. The fact that parties are unable to ascertain their liabilities (or the amount they may possibly gain) may reduce chances of settlement. Parties may further delay the arbitral process if they believe the cost of interest which they will eventually pay is below the market rate. This lack of uniformity means that parties in similar situations are treated differently so that considerable resources are spent in litigating interest issues.[4]

Compound interest is rarely discussed in international arbitral awards. This may be explained in part by the difficulties imposed by the confidential nature of arbitral awards. Only some of the many awards are published, those that are published are often in a condensed form where discussion of the interest issue may not appear, and the claims made by the parties are rarely included. But even where full reports of arbitrations are given, compound interest is rarely discussed in detail. Compound interest is awarded or rejected with rarely any discussion of its purpose and role. For example, in an arbitration between an Austrian franchiser and a South African franchisee the compounding of the interest owing was refused by the U.K. arbitrator with the words, "The claimant further asks for compound interest, but I am not disposed to award this."[5]

What does this mean? That the arbitrator was not willing to award compound interest? That he felt that the applicable law prevented him from awarding compound interest? That he felt that he lacked the authority to make

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[3] Commentators who have addressed the issue of awarding interest generally in international arbitration include Julian D.M. Lew, *Interest on Money Awards in International Arbitration*, *in* MAKING COMMERCIAL LAW: ESSAYS IN HONOUR OF ROY GOODE 543 (Ross Cranston ed. 1997); John Y. Gotanda, *Awarding Interest in International Arbitration*, 90 AM. J. INT'L L. 40 (1996); Paolo Cerina, *Interest as Damages in International Commercial Arbitration*, 4 AM. REV. INT'L ARB. 255 (1993); David J. Branson & Richard E. Wallace Jr., *Awarding Interest in International Commercial Arbitration: Establishing a Uniform Approach*, 28 VIRGINIA J. INT'L L. 919 (1988); Stewart C. Boyd, *Interest for the Late Payment of Money*, 1 ARB. INT'L 153 (1985); Martin Hunter & Volker Triebel, *Awarding Interest in International Arbitration – Some Observations Based on a Comparative Study of the Laws of England and Germany*, 6(1) J. INT'L ARB. 7 (1989).

[4] Branson & Wallace, *supra* note 3 at 921.

[5] Final Award in Case No. 5460 of 1987, 13 Y.B. COM. ARB. 104, 109 (1988).

such an award? That he lacked a "specified mental inclination"[6] to awarding compound interest? No further discussion of compound interest, or of the choice of law governing compound interest is made. The rejection of compound interest without discussion by a Chamber of the Iran-United States Claims Tribunal led one of the arbitrators, Richard Allison, to note his objection to the award of simple interest and to call for "a more careful and reasoned treatment" of the issue in the future.[7] This article echoes that call.

II. DEFINITIONS AND CONCEPTS

Considerable confusion exists about the nature and function of compound interest. The issue of compounding interest arises in three distinct situations – where parties provide for compound interest in their agreements, where compound interest is awarded by an arbitral tribunal as damages, and where compound interest is awarded as restitution. The role of compound interest in each of these situations is unique and part of the confusion surrounding compound interest arises from a failure to distinguish the different functions of compound interest as an item of damages, an item of restitution, and as a contractual term. The confusion that surrounds compound interest in many legal settings is also traceable to the complete dearth of literature examining the nature and function of compound interest.[8]

Compound interest is rarely defined in legislation, case law or legal commentaries.[9] Where compound interest is defined, it is often defined simply and imprecisely as "interest on interest" which may exacerbate existing confusion regarding its meaning and application. The precise definition of compound interest is essential to distinguish it from other forms of interest, and ultimately to the understanding of the rationale behind its application or prohibition.

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[6] The definition of "disposed" in the *Concise Oxford English Dictionary*.

[7] Shahin Shaine Ebrahimi v. Iran, Award in Case Nos. 44, 46 and 47 of 12 Oct 1994, 20 Y.B. COM. ARB. 404, 452-53 (1995).

[8] The fact that "the problem of compound interest has apparently never been fully analyzed" is acknowledged by Professor Mann in a rare article on the subject. *See* F.A. Mann *Compound Interest as an Item of Damage in International Law*, in FURTHER STUDIES IN INTERNATIONAL LAW 377 (F.A. Mann ed. 1990). One of the other rare commentaries on compound interest is in German, *see* Karsten Schmidt, *Das Zinseszinsverbot* [1982] JURISTENSEITUNG 829.

[9] On the failure of U.S. statutes and cases to define compound interest *see* C.L. Feinstock, *Annotation, What is "Compound Interest" Within Meaning of Statutes Prohibiting the Charging of Such Interest*, 10 A.L.R. 3d 421 (1967).

A. *Interest and Usury*

Interest is defined as "the return or compensation for the use or retention by one person of a sum of money belonging to or owed by any reason to another."[10] Essentially, interest is a charge for the use of money. Wide definitions of interest are often adopted in an attempt to enforce the policy rationales which underlie laws on usury. Courts in the United States have responded to this need by holding that a bank's practice of computing service charges on balances, including unpaid service charges,[11] or charging finance charges on unpaid finance charges[12] amounts to unlawful compounding of interest. A First Circuit decision in Massachusetts further states that the meaning of the term interest is not limited to a numerical percentage of a borrowed sum, and that accordingly, late payment fees charged on credit cards fit within the definition of interest.[13]

Central to most definitions of interest is the idea of compensation. Interest in the damages context refers to the compensation allowed by law for the loss of the use of money during the time between the accrual of the claim and the date of actual payment.[14] An award of interest may compensate a party for its foregone return on investment (where the money could have been invested had there not been the delay in payment), or may compensate for the borrowing cost of money, where money is withheld forcing the creditor to borrow money to carry on his or her business.

Academic treatment of interest often neglects the fact that interest claims arise not only in the damages context but also as restitutionary claims. Interest awarded in restitutionary contexts is not based on the concept of compensation but rather on the entirely different principle of enrichment. Judicial interest awarded as damages or restitution also must be distinguished from contractual interest which is based on a promise, rather than awarded for the withholding of money.

Any attempt to define interest in an international context must situate interest in the context of usury laws. The term usury is often used loosely and can have multiple meanings. The original sense of the term usury implied any payment for the "use" of money itself.[15] This is the meaning now widely attributed to the term interest. In a strict sense the term usury is used today to

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[10] 32 HALSBURY'S LAWS OF ENGLAND para. 106 (4th ed., 1980).

[11] Haas v. Pittsburgh Nat. Bank, 526 F.2d 1083 (3d Cir. 1975).

[12] Acker v. Provident Nat. Bank, 512 F.2d 729 (3d. Cir. 1975).

[13] Greenwood Trust Co. v. Massachusetts, 971 F.2d 818, 824-26 (1st Cir. 1992) *cert. denied* 506 U.S. 1052 (1993).

[14] CHARLES T. MCCORMICK, HANDBOOK ON THE LAW OF DAMAGES § 50 at 205 (1935).

[15] THOMAS F. DIVINE, INTEREST: AN HISTORICAL AND ANALYTICAL STUDY IN ECONOMICS AND MODERN ETHICS 3 (1959).

refer to excessive interest beyond the lawful rate allowable by statutes, or to an exorbitant rate of interest.[16]

B. *The Meaning of Compound Interest*

Compound interest exists where "the interest of a sum of money is added to the principal, and then bears interest, which thus becomes a sort of secondary principal."[17] From this definition several essential criteria can be distilled: (i) a principal sum which will bear interest, (ii) the non-payment of that interest in due time, (iii) the addition of that unpaid interest to the principal sum forming new principal, and (iv) the bearing of interest on that new principal.

What the above definition and criteria do not make explicitly clear is that compound interest involves a dynamic process not merely of charging interest on interest, but of charging interest on interest on interest on interest. The compound interest method of figuring interest "results in interest *ad infinitum*."[18] The difference between simple interest and compound interest is that simple interest does not merge with the principal, and thus does not become part of the base on which future interest is calculated.[19]

A survey of domestic legal systems unveils four main layers of restriction on contracts for compound interest:

1. In some Islamic countries all interest-bearing loans will be illegal as contrary to the *Shari'a*.
2. Agreements for compound interest may specifically violate laws or public policies against compound interest.
3. Agreements for compound interest may violate maximum interest laws such as those which exist in many states of the United States.
4. Agreements for compound interest may not be allowed where they are unconscionable or grossly extortionate.

While the differences between these methods of limiting agreements for compound interest are significant, each of these means of restricting compound interest is motivated to some extent by the same two concerns: the exploitation of debtors and the clarity of the burden of compound interest.

The potential for compound interest to exploit a vulnerable debtor is one of the earliest cited rationales for prohibitions on agreements for compound

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[16] "Usury" *in* BLACK'S LAW DICTIONARY 1545 (6th ed., 1990).
[17] "Compound Interest" *in* BLACK'S LAW DICTIONARY 286 (6th ed., 1990).
[18] In Re Wisconsin Ry Co., 63 F.Supp. 151 (D.C. Minn 1945).
[19] "Interest" *in* BLACK'S LAW DICTIONARY 812-13 (6th ed., 1990).

interest. The fear of such exploitation in early societies can be traced to the fact that loans were employed not as capital for profitable production but for consumption, and were consequently taken by those in need. Those who defaulted on payment, whether of principal or interest, were often made slaves to work off the debt.[20]

Compound interest is reviled in many legal systems for leading to much greater exploitation of a debtor than simple interest:

> Interest upon interest, promptly and incessantly accruing would, as a general rule, become harsh and oppressive. Debt would accumulate with a rapidity beyond all ordinary calculation and endurance. Common business cannot sustain such overwhelming accumulation. It would tend to inflame the avarice and harden the heart of the creditor.[21]

Compound interest is rejected by courts as "over avaricious,"[22] "oppressive,"[23] and even "draconian in nature."[24] In the words of Holzschuher, "the ancient hatred of interest must naturally be intensified against interest on interest."[25]

Essential to this idea of exploitation is the existence of a weaker party. This weaker party is rarely defined but is assumed to be the necessitous borrower. The idea that those who borrow are borrowing out of need has not been entirely erased by the developments of modern commerce. Assumptions still reign about the nature and identity of borrowers and lenders. Interest, and particularly compound interest, has been restricted throughout history so that "young men and those in want, might not too easily be exposed to extortion and oppression."[26]

The fear of exploiting the "unwary" debtor reflects a related concern about the "unfair" element of surprise compound interest can pose by its rapid accrual of interest. The fear here is that an "improvident debtor is not likely to realize the extent to which the interest will accumulate" when it is

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[20] For examples of this in Roman law *see Interest and Usury*, *in* 2 PALGRAVE'S DICTIONARY OF POLITICAL ECONOMY 429 (Henry Higgs ed., 1923).

[21] Connecticut v. Jackson, 1 Johns Ch. 13, 7 Am. Dec. 471 (N.Y. 1814).

[22] Lemnos Broad Silk Works, Inc. v. Spiegelberg, 127 Misc. 855, 861, 217 N.Y.S. 595, 601 (Sup. Ct. N.Y. Cty 1926).

[23] Stewart v. Petree, 55 N.Y. 621, 623 (1874).

[24] In the Matter of Chipboard Products Limited (In Liquidation) and in the Matter of the Companies Act, 1963 to 1983, [1994] 3 Irish Rep. 164 (High Court).

[25] *Quoted in* Karsten Schmidt, *Das Zinseszinsverbot* [1982] JURISTENSEITUNG 829 at 829.

[26] JOHN LOCKE, FURTHER CONSIDERATIONS CONCERNING RAISING THE VALUE OF MONEY (MDCXCV).

compounded.[27] This concern is reflected in requirements that the effective interest rate be clearly disclosed. Agreements for compound interest thus must generally be express and only in very limited situations will implied agreements for compound interest be upheld. Not only is a potential borrower warned of the rate of interest which may be imposed, but fully disclosed rates allow a borrower to shop around and compare the rates charged by different financing institutions.[28]

III. INTERNATIONAL ARBITRAL RULES AND THE AUTHORITY TO AWARD COMPOUND INTEREST

A. *Arbitrators' Authority to Award Compound Interest*

The power of arbitrators to grant interest in making arbitral awards, in the absence of any contrary provision by the parties, is generally recognized as part of the authority to award fair and just compensation.[29] In practice, it is rare for parties to expressly confer on arbitrators the power to award interest.

Express authorization for arbitral awards of compound interest from either the parties or arbitral rules is equally rare. The UNCITRAL and ICC Arbitration Rules do not contain any explicit provisions on awarding interest.[30] These rules, like most other arbitral rules, presume that arbitrators will determine interest questions by first determining, then applying, the applicable law.[31]

The absence of any mention of a power to award compound interest in global arbitration rules such as the ICC Rules can be attributed to several

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[27] Household Finance Corp v. Goldring, 33 NYS2d 514, (1942) *affd* 289 NY 574, 43 NE2d 715.

[28] This assumes that people will shop around for the most favorable rates, an assumption which has been significantly challenged. *See* James J. White & Frank W. Munger, *Consumer Sensitivity to Interest Rates: An Empirical Study of New Car Buyers and Auto Loans*, 69 MICHIGAN L. REV. 1207 (1971); National Commission on Consumer Finance, *Consumer Awareness of Annual Percentage Rates of Charge in Consumer Installment Credit Before and After Truth in Lending Became Effective* 100-103 (1972) (This study concludes that credit cost and disclosure are not determinative factors on most credit transactions).

[29] JOHN A. WESTBERG, INTERNATIONAL TRANSACTIONS AND CLAIMS INVOLVING GOVERNMENT PARTIES CASE LAW OF THE IRAN-UNITED STATES CLAIMS TRIBUNAL 253 (1991).

[30] There is also no provision for awarding interest in the UNCITRAL Model Law (U.N. Doc A/40.17 Annex 1 as Adopted by the UN Commission on International Trade Law on June 21, 1985) but some jurisdictions in implementing this Model Law have added an express provision on awarding interest. *See e.g.* International Commercial Arbitration Act of British Columbia s 31(7) providing that the arbitral tribunal may award interest.

[31] UNCITRAL ARBITRATION RULES Art. 33; UNCITRAL Model Law, Art. 28; INTERNATIONAL CHAMBER OF COMMERCE (ICC) RULES Art. 13(5); AMERICAN ARBITRATION ASSOCIATION (AAA) RULES, Art. 29(2); HONG KONG INTERNATIONAL ARBITRATION CENTRE RULES Art. 33.

factors. The fact that a power to award compound interest is not expressly mentioned in the Rules reflects a recognition that these rules are procedural rules and that their function is not to determine the merits of the case, including the possibility of an award of compound interest. Interest is generally perceived as part of the substantive law so no additional empowerment to award interest through arbitral rules may be necessary. The lack of mention of compound interest is also likely a result of the global scope of the rules and the attempt not to isolate certain countries through potentially objectionable rules.

Even where there is no express mention of the power to award compound interest, the fact that there is no exclusion of its potential award suggests that compound interest can be awarded. In domestic law, courts are careful to provide expressly that interest cannot be awarded on interest if this power is to be curtailed.[32]

There are rare exceptions to this general silence on the power to award compound interest. The Arbitration Rules of the World Intellectual Property Organization (WIPO) provide at Article 60(b) that "[t]he Tribunal may award simple or compound interest to be paid by a party on any sum awarded against that party. It shall be free to determine the interest rates as it considers to be appropriate . . . ."[33] Article 28(4) of the American Arbitration Association's International Arbitration Rules also provides that a "tribunal may award such pre-award and post-award interest, simple or compound, as it considers appropriate, taking into consideration the contract and applicable law."[34]

The London Court of International Arbitration Rules expressly provide for an award of interest, including compound interest. Rule 26.6 provides:

> The Arbitral Tribunal may order that simple or compound interest shall be paid by any party on any sum awarded at such rates as the Arbitral Tribunal determines to be appropriate, without being bound by legal rates of interest imposed by any state court, in respect of any period which the Arbitral Tribunal determines to be appropriate ending not later than the date upon which the award is complied with.[35]

In England, before the Arbitration Act 1996 came into effect, arbitrators did not have the power to award compound interest.[36] Other countries have

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[32] *See e.g.* s 35A Supreme Court Act 1981 (UK), Section 289 German Civil Code (Germany), Schweizerisches Obligationenrecht [OR] Article 105 (Switzerland).

[33] 34 I.L.M 559 (1995).

[34] AAA INTERNATIONAL ARBITRATION RULES, Art. 28(4) (2001).

[35] LONDON COURT OF INTERNATIONAL ARBITRATION (LCIA) RULES, Art. 26.6 (1998).

[36] President of India v. La Pintada Compania, [1984] 2 Lloyd's Rep 9.

equally restricted the power to award compound interest to judges and not arbitrators.

B. *Domestic Debates on the Power of Arbitrators to Award Compound Interest*

The issue of whether arbitrators should have the power to award compound interest has attracted debate in several countries.[37] These domestic debates are relevant when the procedural law of that country is applied by the arbitral tribunal.[38] In England, until recently, arbitrators could award only simple interest under the Arbitration Act 1950.[39] This situation was changed by the Arbitration Act 1996 which came into effect on January 1, 1997. Section 49(3) and (4) of the Act expressly grants the arbitrator the discretion to award compound interest.

Similar debates about an arbitrator's power to award compound interest have taken place in Hong Kong. In a 1997 decision, the Hong Kong Court of Appeal reversed the Hong Kong Supreme Court's decision in *AG v. Shimizu Corporation* which upheld an arbitrator's award of compound interest.[40] In July 1996, Mr. Justice Conrad Seagrott, writing for the Hong Kong Supreme Court held that the Hong Kong Arbitration Ordinance (Cap 341) allows an arbitrator to decide "in his discretion" when an award of compound interest is appropriate.[41] This finding was rejected by the Appeal Court on the grounds that it relied on the absence of the word "simple" before the word "interest" in Section 22A of the Arbitration Ordinance to evidence a discretion to award compound interest.[42]

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[37] In South Africa, for example, the South African Law Commission has recently considered the issue and after receiving submissions in support of compound interest, has concluded that "the arbitral tribunal in an international arbitration should be able to award compound interest in appropriate circumstances." Law Commission of South Africa, *Arbitration: An International Arbitration Act for South Africa* para 2.246 (Report on Project No. 94, July 1998).

[38] *See* Lew, *supra* note 3 at 546-7.

[39] Aside from statute, the absence of any common-law power to award compound interest was asserted by Lord Brandon writing for the House of Lords in *President of India*, *supra* note 36 at 16. Lord Brandon rejected "as a matter of both principle and authority" the statements of Lord Denning in *Techno Impex v. Gebr. Van Weelde Scheepvaartkantoor BV*, [1981] 1 Lloyd's Rep 587 (CA) that arbitrators are not bound by common-law rules against interest nor by the statutory provisions.

[40] [1997] Hong Kong L Rep & Digest 297 (CA).

[41] In the Matter of the Arbitration Ordinance Cap 341 and In the Matter of an Arbitration between the Attorney General and Shimizu Corp. Nos. 185 and 186 of 1996, *reported in* 12(5) INT'L ARB. REP. 7 (1997).

[42] [1997] Hong Kong L. Rep. & Digest 297, 299.

The Court of Appeal held that there was no such power to confer on arbitrators the power to award compound interest under Section 22A of the Arbitration Ordinance by reference to the wording of the Ordinance as well as its legislative history.[43] Since this case was decided, the Arbitration Amendment Ordinance 1996 has been enacted in Hong Kong which expressly provides jurisdiction to award compound interest.

IV. COMPOUND INTEREST IN INTERNATIONAL ARBITRAL PRACTICE

A. *Contractual Compound Interest*

Many contracts expressly provide for interest to be payable if payment is not effected on a certain day.[44] Such a provision may state when interest will start accruing, the rate of interest to be charged and whether such interest will be simple or compound. International tribunals will ordinarily enforce contractual provisions that address the payment of interest.[45] This respect for the express terms chosen by the parties promotes party autonomy as well as certainty of obligations. Problems with enforcing contractual clauses imposing compound interest arise when a potentially applicable mandatory rule of law restricts the award of such interest. Such a mandatory rule of law may form part of the law governing the contract (the *lex causae*) or the law of the place governing the arbitration (the *lex arbitri*).

Despite the considerable importance of party autonomy in international arbitration, some limitations on the parties' freedom to choose the applicable law, or aspects of the applicable law, may be imposed by mandatory rules of law. Article 3(3) of the European Convention on the Law Applicable to Contractual Obligations (the Rome Convention), for example, provides:

> The fact that the parties have chosen a foreign law, whether or not accompanied by the choice of a foreign tribunal, shall not, where all other elements relevant to the situation at the time of the choice are connected with one country only, prejudice the application of rules of the law of that country

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[43] *Id.* at 299-301.

[44] *See generally* Lew, *supra* note3 at 553.

[45] *See e.g.* Southern Pacific Properties v. Egypt, ICSID Award of 20 May 92 in Case No. ARB/84/3, 32 I.L.M. 933 at para. 222 (1993) (awarding compound interest as stipulated in a loan agreement governed by English law); RJ Reynolds Tobacco Co v. Iran, 10 Y.B. COM. ARB. 258, 261 (1985) (awarding interest at the rate stipulated in the contract of LIBOR plus 2%).

> which cannot be derogated from by contract, hereinafter called "mandatory rules."[46]

It does not necessarily follow from this that an arbitrator is bound to disregard a chosen law in cases where a court would do so.[47] Nathalie Voser's study of the treatment of mandatory rules by international arbitrators reveals a distinct divergence of approaches.[48] Part of the problem of addressing mandatory rules in the international arbitration context arises from the terminology of private international law which addresses foreign mandatory rules and mandatory rules of the *lex fori*. International arbitral tribunals lack a *lex fori* as the term is used in the private international law sense. In the words of the U.S. Supreme Court in the *Mitsubishi* case, "the international arbitral tribunal owes no prior allegience to the legal norms of particular states."[49] It is thus difficult to transfer the guidance given on mandatory rules in the Rome Convention to the international arbitral sphere.[50]

It is difficult to ascertain whether restrictions on compound interest constitute either ordinary mandatory rules or supranational mandatory rules. Mandatory rules protect social and economic interests of a society,[51] and include laws designed to protect parties in an inferior bargaining position, which is arguably a goal of laws restricting compound interest. Supranational mandatory rules of law "must be applied in international relationships irrespective of the law which . . . would normally be applicable."[52] Interest restrictions, including prohibitions on compound interest, may in some countries constitute ordinary mandatory rules from which the parties cannot escape if the law of a certain country applies, but they are unlikely to constitute supranational mandatory rules from which the parties cannot escape by a choice of law.

Arbitrators need to consider not only the law of the place of the arbitration and the *lex causae*, but in giving effect to contractual provisions for compound

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[46] Such mandatory rules apply to contractual obligations irrespective of any contrary agreement and irrespective of the governing law. DICEY & MORRIS, THE CONFLICT OF LAWS 1240 (12th ed. 1993).

[47] *See* Michael Pryes, *Choice of Law Issues in International Arbitration in* CURRENT LEGAL ISSUES IN INTERNATIONAL COMMERCIAL LITIGATION 105, 118 (1997).

[48] Nathalie Voser, *Mandatory Rules of Law as a Limitation on the Law Applicable in International Commercial Arbitration*, 7 AM. REV. INT'L ARB. 319 (1997).

[49] Mitsubishi Motors Corp v. Soler Chrysler-Plymouth Inc., 473 U.S. 614, 636 (1985).

[50] Article 7(2) of the Rome Convention, for example, addresses the mandatory rules of the forum. ("Nothing in this Convention shall restrict the application of the rules of the law of the forum in a situation where they are mandatory irrespective of the law otherwise applicable to the contract").

[51] *See e.g.* Art. 5 of the Rome Convention on Consumer Protection.

[52] Nathalie Voser, *supra* note 48 at 321.

interest they must also keep in mind the law of the place where the award is likely to be enforced. This arises from an arbitrator's obligation to render an award that is legally enforceable.[53] At the level of enforcement, an award giving effect to a contractual provision for compound interest and valid under both the *lex arbitri* and the *lex causae* may be refused enforcement under the public policy exemption in the New York Convention.[54]

The obligation to render a legally enforceable award may at times conflict with an arbitrator's obligation to give effect to the expressed contractual intentions of the parties.[55] An arbitrator may consider making the interest ruling which includes compound interest part of a separate partial award where it could form the basis for the entire award being denied recognition and enforcement.[56] One approach to saving a provision for compound interest where such interest is prohibited under the *lex causae*, but permitted under a different law, would be to apply the concept of *dépeçage*. A specific reference to compound interest in the agreement between the parties can be seen as an overt choice to have the issue of compound interest governed not by the substantive law but by the law authorizing such interest. The provision on compound interest could be seen as modifying the choice-of-law clause.[57]

Arbitrators sometimes find reasons outside the issue of the applicable law to refuse to give effect to contractual provisions on compound interest. In *Anaconda-Iran v. Iran*, Chamber III of the Iran-United States Claims Tribunal

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[53] *See* Article 35 of the 1998 ICC Rules ("In all matters not expressly provided for in these Rules, the Court of Arbitration and the arbitrator shall act in the spirit of these Rules and shall make every effort to make sure that the award is enforceable at law"); LCIA Rules, Art. 32.2 ("In all matters not expressly provided for in these Rules, the LCIA Court, the Arbitral Tribunal and the parties shall act in the spirit of these Rules and shall make every reasonable effort to ensure that an award is legally enforceable").

[54] Article V(2)(b) of the 1958 United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention), June 10, 1958, 330 U.N.T.S. 38, 21 U.S.T. 2518. *See* Laminoir-Trefilieries-Cableries de Lens, SA v. Southwire Co., 484 F.Supp. 1063 (N.D. Ga. 1980) where the court refused to enforce part of an arbitral award under the ICC Arbitration Rules. This was because the arbitrators had applied a French law which increased the rate of interest by 5% after 2 months from the date of the award, which the American court found to be an impermissible penalty under American law.

[55] This obligation is set out in the ICC Arbitration Rules Art. 17.2; UNCITRAL Arbitration Rules Art. 33.3; UNCITRAL Model Law, Art. 28.4; Rules of the Hong Kong International Arbitration Centre, Art. 33.3.

[56] Lew, *supra* note 3 at 554.

[57] Pierre Mayer, *Mandatory Rules of Law in International Arbitration* 2 ARB. INT'L 274, 281 (1986) (stating that parties may exclude the application of public policies of chosen law so long as those policies are not mandatory rules of law governing the contract); Yves Derains, *Public Policy and the Law Applicable to the Dispute in International Arbitration*, in COMPARATIVE ARBITRATION PRACTICE AND PUBLIC POLICY IN ARBITRATION 227, 240 (Pieter Sanders ed. 1986) (stating that parties may expressly exclude certain rules of the chosen law to be applied, and arbitrators may not then enforce the application of those rules).

indicated that it would refuse to give effect to a contractual provision for compound interest in the following words:

> The Tribunal notes that there are several reasons why judicial authorities, be it on a national or international level, generally do not award compound interest.
>
> First of all, the inherent effect of a contractual provision for compound interest is to dissuade the other party from defaulting in fulfilling its contractual obligations. Such an effect is particularly relevant in the context of a continuing relationship. If, however, a dispute emerges as to the scope and content of the contractual obligation and if, as in the present case, such a dispute leads to a termination of the contract in question, this purpose is mooted. Secondly, the mathematical result of a full application of contractual provisions such as Section 7.04, particularly in view of the delays that any adjudication of a dispute involves, is that the interest due could, by far, exceed the principal awards awarded. This is particularly relevant in the context of the proceedings before this Tribunal, as the great number of cases simultaneously under consideration causes the individual parties to incur additional delays. Consequently, to implement such a contractual clause would cause a benefit, and indeed a profit, to accrue to the successful party, which would be wholly out of proportion to the possible loss that the successful party might have incurred by not having the amounts due at its disposal.[58]

While the Tribunal acknowledged that the provision on compound interest was "not unclear," it suggested it was "ambiguous, due to the unreasonable results that such a technical interpretation may yield."[59] The Tribunal concluded that "the awarding of compound interest in the present Case must be deemed to be outside the scope of the possible common intent of the

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[58] Case No 167 Iran-U.S. Cl. Trib. Rep. 199, 234-5 (1986). Section 7.04 of the Technical Assistance Agreement is not entirely clear in its provision for compound interest, however. Such interest might be inferred from the provision based on the reference to the Chase Manhattan Bank Rate (which could include compounding) or by reference to the payment of interest "plus accrued interest on said amount." (Section 7.04 provides that the National Iranian Copper Industries Company "shall pay to AI interest at the rate per annum equal to the prime rate then being charged by the Chase Manhattan Bank (Nat'l Assn) or its successor, plus 2%, on any amounts due AI under this Agreement, whether on account of fees or costs, from the date due until said amount, plus accrued interest on said amount, shall have been paid in full.") *Id.* at 233.

[59] *Id.* at 235.

Parties, and that, therefore, compound interest pursuant to Section 7.04 must be disallowed."[60]

This decision is problematic in a number of respects. The argument that the essential purpose of providing for compound interest is to dissuade a party from defaulting may be an accurate one. But it does not provide any real basis for failing to give effect to an arms-length agreement between contracting parties. The economic argument that compound interest presents a windfall to the successful party "wholly out of proportion to the possible loss" suffered has been repeatedly and convincingly disputed.[61] The decision fails to adequately respect party autonomy. Even tribunals that have generally been hostile to an award of compound interest have recognized that an express stipulation for such interest should be respected.[62]

B. *Awarding Compound Interest as Damages*

The first step an arbitrator may take in determining whether to award compound interest as damages is to examine the agreement between the parties to see if it provides for such interest or designates a specific law to govern the issue. An arbitrator may also examine other contractual provisions for evidence of whether the parties intended to include or exclude awards of compound interest. Many agreements, however, fail to deal expressly with interest issues.

Agreements may also fail to include a choice-of-law clause, or the applicable law may be unclear due to the uncertainty surrounding the question of whether issues relating to the award of interest are substantive or procedural. Even where a choice of law is made by the parties, an arbitrator "should keep a wary eye on the national public policy of the place of arbitration" and must give effect to certain provisions of the law of the place of arbitration notwithstanding express agreement by the parties to the contrary.[63] The law of the place of arbitration may provide for arbitral awards

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[60] *Id.*

[61] *See e.g.* Mann, *supra* note 8 at 384. ("It is a fact of universal experience that those who have a surplus of funds normally invest them to earn compound interest. This applies, in particular, to bank deposits or savings accounts. On the other hand, many are compelled to borrow from banks and therefore must pay compound interest. This applies, in particular, to business people whose own funds are frequently invested in brick and mortar, machinery and equipment, and whose working capital is obtained by way of loans or overdrafts from banks.").

[62] See the award in French Claims Against Peru (11 Oct 1920), 1 UNRIAA 216, 220 (Permanent Court of Arbitration) ("...the capitalization of the interest can result only from a stipulation or from circumstances of fact making clear the consent of the debtor to assume such an onerous obligation") (translation author's).

[63] JULIAN D. M. LEW, APPLICABLE LAW IN INTERNATIONAL COMMERCIAL ARBITRATION 540 (1978).

which violate the public policy of that place to be vacated. The UNCITRAL Model Law provides that a court may set aside arbitral awards resulting from arbitrations taking place in a state if "the award is in conflict with the public policy of this State."[64] Faced with such a confusing array of potentially applicable laws and public policy considerations, a tribunal generally proceeds in one of three ways.[65]

The first approach is to determine whether compound interest can be awarded by reference to a specific national law. This involves a process of traditional conflict of laws analysis. The second approach is to search for an answer in general principles of transnational commercial law, by reference to international conventions, general principles of law and international law, or trade usages. A third approach determines whether compound interest can be awarded based on what is fair and reasonable in the circumstances.

1. *The Conflict of Laws Approach*

The use of conflict of laws rules may lead to the rules (both substantive and conflict of laws rules) of many different legal systems being considered to answer the question of whether compound interest can be awarded. When contracts are silent on the question of compound interest, an arbitrator will have to determine which law is applicable to the issue. If there is an express choice of law then this should be referred to by an arbitrator to decide any question on interest.[66]

a. *Selecting an appropriate choice-of-law rule*

In the absence of a choice of law by the parties, an arbitral tribunal generally determines the applicable law by reference to the appropriate conflict of laws rules, and then applies the law to which the conflict of laws rules refer it.[67] Some arbitral rules, such as the Rules of the ICC International Court of Arbitration, free the arbitrators from applying the choice-of-law rule of a particular national system such as those of the place of arbitration, and

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[64] Art. 34(2)(b)(ii).

[65] For an examination of these three approaches to the award of interest generally, *see* John Y. Gotanda, *Awarding Interest in International Arbitration*, 90 AM. J. INT'L L. 40 (1996).

[66] When parties make an express choice of law, this is generally applied to the issue of interest. *See e.g.* Final Award No 6531 of 1991, 17 Y.B. COM. ARB. 221, 223 (1992) (ICC) (interest was awarded at the French statutory rate because the contract stated that French law was to be applied to the merits of the dispute); Consultant (French) v. Egyptian Local Authority, Final Award No 6162 of 1990, 17 Y.B. COM. ARB. 153, 162 (1992) (ICC) (applying a 5% statutory Egyptian rate of interest as the contract specified that "Egyptian laws will be applicable").

[67] Section 46(3) of the English Arbitration Act 1996 (c 23) ("If, or to the extent that there is no such choice or agreement, the tribunal shall apply the law determined by the conflict of laws rules which it considers applicable").

instead authorize them to apply such choice-of-law rules as they deem appropriate.[68]

A tribunal faces many choices in deciding which choice-of-law rule will be applied to select the relevant national law. The lack of certainty as to which approach to choice of law will be adopted, coupled with the fact that arbitrators may not explicitly describe the choice-of-law process they have adopted, but merely name the applicable national law,[69] means that it may be virtually impossible to know in advance which national law will govern the question of compound interest.

Generally, one or more of three relevant systems of law will be considered in determining issues of compound interest. They are the law governing the arbitration, the law applicable to the substance of the dispute, and the law of the place of enforcement. The determination of which law will govern the question of compound interest largely depends on whether the question is determined to be one of procedure or substance.

b. *A matter of procedural or substantive law?*

A problem with the conflict of laws approach is that different national systems classify interest questions differently – some as matters of procedure, others as questions of the substantive law. If a domestic court were to look at these questions of classification, it would resolve the questions by the application of the *lex fori*. In arbitration, however, the situation is less clear as the proceedings may be governed by the law of the place where the arbitration takes place, or the parties may choose to have the proceedings themselves governed by a different law. Indeed, there is a wider debate as to whether an arbitration is itself governed by law, and if so, whether this is necessarily the law of a state.[70]

The classification of the question of compound interest as one of substance or procedure is essential for the determination of the applicable law as different laws may govern substance and procedure. There is no international consensus on whether interest is a matter of substance or

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[68] ICC RULES, Art. 17(1) (1998). *See generally* Hans Smit, *Substance and Procedure in International Arbitration: The Development of a New Legal Order*, 65 TULANE L. REV. 1309, 1310-11 (1991).

[69] For example, a tribunal may simply state that the issue of interest is to be governed by the law where a debt will be paid without discussing the choice-of-law process which led it to such a conclusion. *See e.g.*, Two Yugoslav Enterprises v. Swiss Company, ICC Case No 2930, 9 Y.B. COM. ARB. 105, 107-8 (1984) (applying Swiss law where the debt will be paid rather than Yugoslav law which governs the exchange contract).

[70] See the discussion on the "seat" theory and the delocalization theory in arbitral law in ALAN REDFERN & MARTIN HUNTER, LAW AND PRACTICE OF INTERNATIONAL COMMERCIAL ARBITRATION 81-91 (2nd ed., 1991); *see also* Beda Wortmann, *Choice of Law by Arbitrators: The Applicable Conflict of Laws System*, 14 ARB. INT'L 97, 106 (1998).

procedure. Interest is regarded as a substantive question in many countries, including both the United States and Germany.[71] It appears that the majority of arbitrators also prefer this view.[72] Paolo Cerina in a review of international arbitral cases found that "apparently no reported case, however, indicates that arbitrators have referred to procedural norms to decide questions of interest."[73] After examining a number of published arbitral awards, Cerina concludes that the great majority of arbitrators have treated interest as a substantive matter governed by the proper law of the contract.[74]

The view that interest is a matter of substantive law is not unanimous. John Westberg in a study of the jurisprudence of the Iran-United States Claims Tribunal writes that "in international tribunals generally, the issues pertaining to interest are usually viewed as being procedural in nature and therefore governed by the law of the forum state or the rules of a particular arbitral regime."[75] In England, there tends to be a distinction made between the right to interest which is regarded as a substantive matter, and the question of the rate of interest which is considered a matter of procedure.[76]

In the context of international arbitration, the absence of established procedural norms on questions of compound interest suggests that such an issue may be one of substance. The long history of hostility towards compound interest on the part of some international tribunals and the existence of specific laws which prohibit compound interest further suggest that compound interest represents something more than procedure. The fact that the application of the law of the forum does not likely reflect the parties' legitimate expectations, as parties choose arbitration to settle international disputes with the idea of avoiding the peculiarities of local law also supports

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[71] Paolo Cerina, *Interest as Damages in International Commercial Arbitration*, 4 AM. REV. INT'L ARB. 255, 265 (1993), quoting as American authority, RESTATEMENT (SECOND) CONFLICT OF LAWS § 207, cmt. e which states that the substantive law governing the contract, "[d]etermines whether plaintiff can recover interest, and, if so, the rate upon damages awarded him for the period between the breach of contract and the rendition of judgment." For Germany, *see* Hunter & Triebel, *supra* note 3 at 19.

[72] *See e.g.* French Seller v. Spanish Buyer, ICC Case No 2637, 2 Y.B. COM. ARB. 153, 155 (1977) (arbitrators are "bound to apply the rate fixed by the French commercial law since it has been recognized that the contract is governed by French law"); Consultant (French) v. Egyptian Local Authority, ICC Case No 6162, 17 Y.B. COM. ARB. 153, 163 (1992) (applying interest as indicated by applicable substantive Egyptian law).

[73] Cerina, *supra* note 71 at 266.

[74] *Id.* at 265-66.

[75] JOHN WESTBERG, INTERNATIONAL TRANSACTIONS AND CLAIMS INVOLVING GOVERNMENT PARTIES: CASE LAW OF THE IRAN-UNITED STATES CLAIMS TRIBUNAL 253 (1991).

[76] Miliangos v. George Frank (Textiles) Ltd. (No 2), [1977] QB 489, 496 (Bristow J). In Helmsing Schiffahrts GmbH v. Malta Drydocks Corporation, [1977] 2 Lloyd's Rep 444, 449, Kerr J. prefers the view that the rate of interest is governed by the law of the contract. The Law Commission seems to prefer the approach of Bristow J. *See* English Law Reform Commission, REPORT ON FOREIGN MONEY LIABILITIES (Report No 124, 1983) paras 2.32, 3.55.

the characterization of compound interest as a substantive issue.[77] A final argument in support of treating compound interest as a matter of substance lies in the idea that all questions relating to the performance of a contract, or consequences of non-performance such as damages, should be addressed by the same law, the substantive law of the contract.[78]

c. *Applying the* lex causae *to the issue of compound interest*

In most cases, the *lex causae* or law governing the contract is thought to govern the question of interest.[79] This means that in cases where the *lex causae* is a law, such as French law, which allows compound interest, such interest may be awarded.[80] Alternatively, when the applicable substantive law is a law under which interest is not recoverable, claims for interest have been rejected.[81]

The significance of which law governs the question of compound interest is evident in the ICSID arbitration of *Southern Pacific Properties*.[82] On the question of the liability for compound interest on the main expropriation claim, the tribunal applied Egyptian law and thus denied compound interest as such interest was prohibited under Egyptian law.[83] In awarding interest based on the loan agreement, the tribunal took a different approach and awarded compound interest pursuant to the agreement. The loan agreement specifically

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[77] Cerina, *supra* note 71 at 268.

[78] *Id.* at 268. This is the approach taken in Article 10 of the Rome Convention which provides that the law applicable to the contract shall govern, amongst other issues ... "the consequences of the breach, including the assessment of damages in so far as it is governed by rules of law." 1980 OJEC (L 266). *See also* the Giuliano-Lagarde Report on the Convention, Art. 10 cmt.

[79] Lew, *supra* note3 at 555.

[80] In the 1987 award in *ICC Case No 5121* compound interest was allowe d by application of French law, following the stipulation in the French Civil Code that compound interest was only allowed on interest already due at the date of the demand for arbitration, *reported in pertinent part in* Yves Derains, *Intérêts Moratoires, Dommages- Intérêts Compensatoires et Dommages Punitifs Devant L'Arbitre International, in* ÉTUDES OFFERTS À PIERRE BELLET 101, 113- 114 (1991).

[81] *See* French Contractor v. Ministry of Irrigation of African Country X, ICC Case No 5277, 13 Y.B. COM. ARB. 80, 89 (1988); Final Award of 20 November 1987, 14 Y.B. COM. ARB. 47, 68 (1989) (the applicable law of the contract was Saudi Arabian Shari'a Islamic law under which any award of interest was forbidden).

[82] Southern Pacific Properties v. Egypt: ICSID Award of 20 May 1992 in Case No ARB/84/3, 32 I.L.M. 933 at para 222 (1993).

[83] Egyptian law was applied by the tribunal under Article 42(1) of the Washington Convention which governs ICSID arbitration and provides: "The Tribunal shall decide a dispute in accordance with such rules of law as may be agreed by the parties. In the absence of such agreement, the Tribunal shall apply the law of the Contracting State party to the dispute (including its rules on the conflict of laws) and such rules of international law as may be applicable." Washington Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, Mar. 18, 1965, 575 UNTS 159.

provided for compound interest if interest payments were not made on time and was governed by English law which the tribunal noted allowed such a compounding of interest.[84]

This is a rare case in that the arbitrators expressly set out why they were allowing compound interest on one aspect of the claim and not on another – by reference to the applicable law. More often in arbitrations, compound interest is rejected without any reference to the applicable law at issue. In such cases, arbitrators may be silent on the issue of the law governing the award of compound interest or they may expressly reject national law approaches in favor of applying general principles of transnational commercial law.

2. *Applying General Principles of Transnational Commercial Law*

Some arbitrators feel unnecessarily restricted by domestic laws on interest, including compound interest, and suggest that "statutes fixing statutory rates of interest, because they impose unreasonable rigidity, should be construed narrowly."[85] One means of attempting to escape narrow statutory provisions which do not achieve the goals of international business is to apply general principles of transnational commercial law.

The greatest impediment to awarding compound interest on this basis lies in determining if any "general principles" can be said to exist on such a narrow topic as compound interest. It is much easier to establish a right to interest for late payment as a general rule,[86] than to enunciate a principle about anything as specific as compound interest. Although some arbitrators have attempted it, it seems hardly possible to deduce a general principle of contract law sufficiently specific and widely supported on a subject as precise and as controversial as compound interest.

a. *Terminology*

National law may sometimes be rejected by arbitrators in favor of "general principles." These "general principles" are alternatively referred to as "general principles of law," "general principles of international law," "general principles of contract law" or "general principles of transnational commercial

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[84] Southern Pacific Properties v. Egypt: ICSID Award of 20 May 1992 in Case No ARB/84/3, *supra* note 82 at paras 228-9.

[85] Hans Smit. Case Comment, *Carte Blanche (Singapore) Pte, Ltd. v. Carte Blanche International Ltd.*, 1 AM. REV. INT'L ARB. 172, 176 (1990).

[86] The award of interest for late payment is well-established in most legal systems and relevant international conventions and is said to have an "international general principle or *Lex Mercatoria* character." Lew, *supra* note 3 at 558; Klaus Peter Berger, *The Lex Mercatoria Doctrine and the Unidroit Principles of International Commercial Contracts*, 28 LAW & POLICY OF INT'L BUSINESS 943, 973 n. 144 (1997).

law." While these terms can be distinguished, the way they are used in this context often overlaps.[87] A general principle of law is defined as "some proposition of law so fundamental that it will be found in virtually every legal system."[88] General principles of law focus on municipal analogies while general principles of international law include international law principles and practice.

Both the term "general principles of law" and the term "general principles of international law" are public international law terms which may be inadequate in describing the many sources referred to by international commercial arbitrators in ruling on interest issues. I use the term "general principles of transnational commercial law" to describe the principles taken from international trade conventions, trade usages, general principles of law and of international law, and from arbitral practice. General principles of transnational commercial law have been described as "the totality of principles and rules, whether customary, conventional, contractual or derived from any other source, which are common to a number of legal systems."[89] When commercial arbitrators choose not to resolve interest issues by reference to national law, but instead look to international rules and principles for guidance, it is to principles of transnational commercial law that they turn.

b. *The role of international trade conventions*

When parties do not provide in their contracts for specific issues, such as interest rates or the compounding of interest, courts may look for default rules to apply. Such rules have an important role in contract law as they can reduce transaction costs as parties need not explicitly negotiate every aspect of their contracts.[90] Even when conventions such as the U.N. Convention on Contracts for the International Sale of Goods (Vienna Convention)[91] do not apply to a specific transaction, the general uniform rules such conventions set out might be used by arbitrators in a gap-filling function. Thus, in the absence of the requisite connection to a contracting state, the Vienna Convention may

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[87] For example, the reliance on general principles by the tribunal in *Sapphire Int'l Petroleum Ltd v. National Iranian Oil Co.*, 35 I.L.R. 136 (1963), is labelled an illustration of the role of "general principles of law" by John Gotanda and as an example of reliance on "general principles of international law" by Julian Lew. *See* JOHN GOTANDA, SUPPLEMENTAL DAMAGES IN PRIVATE INTERNATIONAL LAW 50 (1998); Lew, *supra* note 3 at 558.

[88] MARK W. JANIS, AN INTRODUCTION TO INTERNATIONAL LAW 55 (2nd ed. 1993).

[89] Roy Goode, *Usage and Its Reception in Transnational Commercial Law*, 46 ICLQ 1, 3 (1997).

[90] *See* Karin L. Kizer, *Minding the Gap: Determining Interest Rates Under the UN Convention for the International Sale of Goods*, 65 U. CHICAGO L. REV. 1279, 1279 (1998).

[91] United Nations Convention on Contracts for the International Sale of Goods, Apr. 10, 1980, S. Treaty Doc. No. 9, 98th Cong., 1st Sess., 19 I.L.M. 668 (1983) [hereinafter Vienna Convention].

still be applied where the parties have contractually incorporated provisions of the Convention in their contract, or where the provisions of the Convention represent trade usages, or aspects of the *lex mercatoria*.[92]

Article 78 of the Vienna Convention provides that "if either party fails to pay the price or any other sum that is in arrears, the other party is entitled to interest on it, without prejudice to any claim for damages recoverable under Article 74."[93] Unlike its predecessor, the Uniform Law on International Sales,[94] the Vienna Convention does not set out a rate of interest. Nor does it specify whether compound interest may be awarded. These silences have resulted in much litigation. A definite split in the jurisprudence has emerged between cases where interest issues not dealt with in Article 78 are determined by reference to the applicable domestic law[95] and those cases which attempt to forge a uniform approach and award interest based on the general principles of the Convention.[96]

This second approach gives effect to the gap-filling provisions of Article 7(2) of the Convention.[97] The problem with this uniform approach lies in identifying what general principles can be deduced from the rest of the

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[92] The Vienna Convention Rules have been applied by the Iran-United States Claims Tribunal as part of the *lex mercatoria*. Watkins-Johnson Co. and Watkins-Johnson Ltd. v. Islamic Republic of Iran, 15 Y.B. COM. ARB. 220 (1990). For a discussion of these bases of application of the Convention *see* ROY GOODE, COMMERCIAL LAW, 929 (2nd ed. 1995)

[93] Article 74 of the Vienna Convention provides: "Damages for breach of contract by one party consist of a sum equal to the loss, including the loss of profit, suffered by the other party as a consequence of the breach. Such damages may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract, in light of the facts and matters of which he then knew or ought to have known, as a possible consequence of the breach of contract."

[94] Article 83 of the Uniform Law on the International Sale of Goods 1964, (1972) U.N.T.S. 108 at 159 provides: "Where the breach of contract consists of delay in the payment of the price, the seller shall in any event be entitled to interest on such sum as in arrear at a rate equal to the official discount rate in the country where he has his place of business, or if he has no place of business, his habitual residence, plus 1%.

[95] Partial Award of Mar. 21, 1996 and Final Award of June 21, 1996 (Hamburg Chamber of Com.), *reprinted in* 22 Y.B. COM. ARB. 35 at 42 (1997) (stating that the rate of interest is to be determined by reference to national law as Article 78 of the CISG does not address the issue). For a list of cases and arbitral awards supporting reference to national laws to determine interest issues under Article 78 *see* INTERNATIONAL CASE LAW AND BIBLIOGRAPHY ON THE UN CONVENTION ON CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS ("UNILEX") (1997) C.3 at Article 78 (M. J. Bonell ed. 1997).

[96] This approach is favored by John Honnold who insists that "[d]eference to domestic law . . . seems inconsistent with the policy underlying Article 78." JOHN HONNOLD, UNIFORM LAW FOR INTERNATIONAL SALES UNDER THE 1980 UNITED NATIONS CONVENTION, 525-6 (2nd ed. 1991).

[97] Article 7(2) of the Vienna Convention provides: "Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable by virtue of the rules of private international law."

Convention. A strong case can be made for applying the principle of full compensation.[98] Interest has therefore been awarded at the prime rate based on this principle of full compensation.[99]

Can the principle of full compensation be used to justify an award of compound interest? Full compensation has no fixed meaning. One may argue that full compensation requires the amount of interest to be based on the credit costs faced by the aggrieved party.[100] If the borrowing charges the aggrieved party has faced have included compound interest, then a case can be made for awarding compound interest to achieve full compensation.

Providing for compound interest in this way, by relying on general principles under the gap-filling section of the Convention, assumes that the Convention applies to the issue but does not expressly resolve it, not that the issue falls outside the scope of the Convention.[101] The fact that compound interest does not seem to have been discussed for possible inclusion in the Convention makes one question the accuracy of this assumption.

As compound interest is not dealt with by the Convention, it can be argued that this question falls outside the scope of the Convention and therefore should be determined by the applicable domestic law.[102] An argument can be made that the question of compound interest, like the rate of interest, falls outside the scope of the Convention because disagreements of opinion on these controversial issues made it impossible to agree upon a rate of interest. The rejection of compound interest in many domestic systems makes it unlikely that a provision permitting such an award would have been included in the Convention when wide support for the Convention was sought.

Franco Ferrari examines how differing political, economic and religious views made it impossible in drafting the Convention to agree upon a formula

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[98] Support for the principle of full compensation can be found in the other articles on damages in the Convention – Articles 74, 75 and 76.

[99] Awards No. SCH-4318 and SCH-5366, June 15, 1994, Internationales Schiedsgericht der Bundeskammer der gewerblichen Wirtschaft-Wein, *summarized in pertinent part in* JOSEPH LOOKOFSKY, UNDERSTANDING THE CISG IN THE USA 96 (1995).

[100] JOHN O. HONNOLD, *supra* note 96 at 523-24.

[101] On this distinction and its application to the issue of interest rates, *see* Franco Ferrari, *Uniform Application and Interest Rates Under the 1980 Vienna Sales Convention*, 24 GEORGIA J. INT'L & COMPARATIVE L. 467, 471 (1995).

[102] Commentators who support the resolution of interest issues not directly specified in the Convention by reference to applicable domestic law include FRITZ ENDERLEIN & DIETRICH MASKOW, INTERNATIONAL SALES LAW: UNITED NATIONS CONVENTION FOR THE INTERNATIONAL SALE OF GOODS CONVENTION ON THE LIMITATION PERIOD IN THE INTERNATIONAL SALE OF GOODS 312 (1992) ("where the parties agreed nothing, the amount of interest will have to be calculated on the basis of the applicable domestic law"); Peter Schlechtriem, *Recent Developments in International Sales Law*, 18 ISRAEL L. REV. 309, 324 (1983) ("there is an obligation to pay interest, but the details of this obligation are left up to the domestic law called upon by the rules of private international law").

for the rate of interest.[103] Proposals to set an interest rate were rejected by many countries including Islamic countries which banned interest in their domestic law.[104] These same countries, which ban compound interest domestically, would equally oppose a provision permitting an award of compound interest. Although undocumented, and perhaps not discussed, compound interest issues would give rise to a similar diversity of views.[105] Lack of determination of the issue of compound interest can be seen as intentional as the Convention was designed to apply to a great variety of transactions among diverse private parties from many different nations.[106]

While there is no discussion of compound interest in the drafting history of the Convention itself, a general prohibition on compound interest can be found in drafts of the Uniform Law on International Sales (ULIS) up until 1963 when this prohibition was removed. In the complete absence of any guidance on compound interest in the Convention, it could be argued that this silence itself is significant as the clause prohibiting compound interest in the early drafts of the ULIS was removed so that no impediment stands in the way of awarding compound interest.

c. *References to general principles of law*

Arbitral tribunals have based their awards of interest (including compound interest) on general principles of law in the absence of any choice of law by the parties, but also by disregarding the parties' choice of law. Tribunals have been especially willing to determine interest issues based on general principles of law rather than by reference to a particular national law in cases between private parties and states where there may be some reluctance to subject the private party to the law of that state.[107]

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[103] Ferrari, *supra* note 101 at 473-74. For a discussion of the irreconciliable differences in approach between Western industrialized countries and the countries "at that time called socialist countries" to interest questions in negotiating the Convention, *see* ENDERLEIN & MASKOW, *supra* note 102 at 310.

[104] First Committee Deliberations, 34th Meeting, Statement of Mr. Shafik (Egypt), DOC C(4) (A/CONF.97/C.1/SR.34), OR 415, 416 (1980), *reprinted in* JOHN O HONNOLD, DOCUMENTARY HISTORY OF THE UNIFORM LAW FOR INTERNATIONAL SALES THE STUDIES, DELIBERATIONS AND DECISIONS THAT LED TO THE 1980 UNITED NATIONS CONVENTION WITH INTRODUCTIONS AND EXPLANATIONS 637 (1987).

[105] Compound interest does not appear to have been considered for inclusion in the Convention. *See* United Nations Conference on Contracts for the International Sale of Goods, Vienna, 10 March-11 April 1980, Official Records 388-93 (1981).

[106] *See* HONNOLD, *supra* note 96 § 103.1 at 160 (who argues that the lack of specificity in Articles 14-88 of the Vienna Convention was intentional).

[107] This is often the case in the jurisprudence of the Iran-United States Claims Tribunal. *See e.g.* CMI Int'l Inc. v. Islamic Republic of Iran (Ministry of Roads and Transp), 10 Y.B. COM. ARB. 316, 318 (1985).

In *DST v. Rackoil*, there was no choice-of-laws clause governing the agreement on oil and gas exploration.[108] The arbitrators thought it inappropriate to apply either the laws of R'as Al Khaimah or to submit it to the laws of another state. The entire contract was therefore determined to be governed by "internationally accepted principles of law governing contractual relations." On the compound interest issue, it was determined that simple interest would be awarded in the absence of any explicit provision for compound interest. The arbitrators did not specify that this would be in keeping with "internationally accepted principles of law governing contractual relations" but arguably such a point could be made.

Some tribunals have taken a step further and applied general principles of law in awarding interest in disregard of a choice of law made by the parties. In *Grove-Skanska v. Lockheed Aircraft Int'l AG*, the tribunal disregarded a contractual provision providing that the laws of New York should govern both the substantive and procedural aspects of the agreement.[109] The tribunal rejected the application of the New York Civil Practice Laws and Rules which then prescribed an interest rate in such breach of contract actions of 6% per annum, stating that such a rate may apply to court actions but not to arbitration proceedings. The tribunal held that the claimant was instead "entitled to a realistic rate of interest" based on general principles of law.[110]

Chamber Two of the Iran-United States Claims Tribunal made a similar decision to disregard a contractual provision determining the applicable law to be the law of Idaho, in determining damages claims including compensatory interest in *CMI Int'l, Inc v. Ministry of Roads and Transp.* Although the contract was expressly governed by the laws of Idaho, the Tribunal preferred to determine the claim with reference to "general principles of law" and its "search ... for justice and equity."[111]

The Tribunal argued that it had the discretion to award interest based on general principles of law and in disregard of the chosen national law, as a result of the wording of Article Five of the Tribunal's Claims Settlement Declaration.[112] Article Five provides that:

> [t]he Tribunal shall decide all cases on the basis of respect for law, applying such choice of law rules and principles of commercial and international law

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[108] 14 Y.B. COM. ARB. 111, 117 (1989).

[109] ICC Award No 3903 of 1981, *summarized in pertinent part in* David J Branson & Richard E Wallace Jr, *Awarding Interest in International Commercial Arbitration: Establishing a Uniform Approach*, 28 VIRGINIA J. INT'L L. 919 at 933-37 (1988).

[110] *Id.* at 934-36.

[111] 8 Iran-US Claims Trib. Rep. 316, 318-19 (1983).

[112] *Id.* at 318.

> as the Tribunal determines to be applicable, taking into account relevant usage of the trade, contract provisions and changed circumstances.[113]

The Tribunal indicated that it preferred to follow general principles of law in examining questions of damages. The legitimacy of this decision can be questioned as the Tribunal has no authority, from Article Five of the Claims Settlement Declaration or any other source, to disregard the parties' express choice of law.

While tribunals have thus been willing to state that they are applying general principles of law rather than domestic law, they have been less forthcoming in the actual content of these general principles of law. Where general principles are disclosed, there is a tendency to "make sweeping claims that a principle is common to all or most of the States in the world, but to support that claim by either citing no authority or by citing the law of only a few states."[114]

The prevalence of provisions in national legal systems prohibiting or at least restricting compound interest has led to the suggestion that a general principle of law prohibiting compound interest exists. Julian Lew heartily disputes such a suggestion, noting that even in those countries which explicitly prohibit compound interest, "the rules have been so far eroded to accommodate commercial reality that they can by no means be seen as expression of a general principle."[115] Professor Mann states more generally that "the general principles of law recognized by civilized nations do not yield an unequivocal guidance" on the question of compound interest.[116]

It is unlikely that any general principles can be said to exist on compound interest. Compound interest is far too specific and controversial an issue to be resolved by resorting to general principles derived from municipal systems of law. In *Simet v. Commission*, the European Court of Justice dismissed a plaintiff's argument that an ECSC general decision providing for the charging of compound interest was invalid because it violated a general principle of law prohibiting compound interest. The Court, in dismissing the plaintiff's claim, stated that "it does not appear that the legal systems of the member States include in general a fundamental principle opposed to the charging of compound interest."[117]

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[113] *Id.*

[114] Michael Akehurst, *The Application of General Principles of Law by the Court of Justice of the European Communities*, BRITISH Y.B. INT'L L. 29, 31 (1981).

[115] Lew, *supra* note 3 at 567.

[116] Mann, *supra* note 8 at 381.

[117] [1971] Eur. Ct. Rep. 197, 202, 207-8, 219.

At best, one may be able to establish the existence of general principles of compensation which may lend support to an award of compound interest. In an attempt to forge some uniformity in interest awards by the Iran-United States Claims Tribunal, Judge Virally in the *McCollough* case suggested:

> The absence of a uniform rule [on awarding interest] does not, however, imply the absence of general principles. On the contrary, two principles or guidelines, of general import, albeit of delicate implementation, can be deduced from international practice briefly described above.
>
> The first principle is that under normal circumstances, and especially in commercial cases, interest is allocated on the amounts awarded as damages in order to compensate for the delay with which the payment to the successful party is made....
>
> The second principle is that the rate of interest must be reasonable, taking due account of all pertinent circumstances....
>
> These two principles, drawn from international practice, are principles of commercial and international law, within the meaning of Article V of the Claims Settlement Declaration. By virtue of the nature of the arbitral tribunals which apply them and of the cases involved, they qualify as general usages of trade.[118]

d. *General principles of international law*

The decisions of international tribunals which refer to a general principle of international law against the awarding of compound interest reveal one of the main problems with reliance on general principles – the identification of such a general principle. Chambers of the Iran-United States Claims Tribunal have been especially keen to deny claims for compound interest on the basis of a "settled" rule of international law that compound interest is not allowable.[119] The source of this often-quoted "general principle of international law" is a statement by Marjorie Whiteman in her 1943 work *Damages in International Law* that "[t]here are few rules within the scope of

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[118] McCollough & Company, Inc v. Ministry of Post, Case No. 89, 11 Iran-US Claims Trib. Rep. 3, 29-30 (1986).

[119] RJ Reynolds Tobacco Co. v. Iran, Award of Aug. 6 1984, 10 Y.B. COM. ARB. 258, 261(1985); Anaconda-Iran Inc v. Iran, Case No 167 of 1986, 13 Iran-US Claims Trib. Rep. 199, 234 (1986).

the subject of damages in international law that are better settled than the one that compound interest is not allowable."[120]

Those arbitrators or commentators who have rejected Ms. Whiteman's conclusions have done so primarily based on the date of her work. Judge Holtzmann in the *Starrett* case, commented that: "[t]he Tribunal relied on a 1943 treatise for the proposition that the rule against compound interest was 'settled.' Whether or not such a rule existed before 1943, it is no longer appropriate or justifiable."[121] Paolo Cerina suggests that this statement on the prohibition of compound interest was "perhaps appropriate in the early twentieth century (the period of time to which the citation supporting this "established" principle refers), in a different society having fewer technological capabilities with which to calculate the value of money."[122] The fact that logarithm tables and compound interest calculations have been around for centuries, however, suggests that the problem with Ms. Whiteman's statement is not simply that it is outdated.

Close examination of the authorities Ms. Whiteman relies on reveals that it is questionable whether there was any such consensus on compound interest in 1943 as to constitute a general principle of international law. What is surprising is that in none of the many cases which rely on Ms. Whiteman's "general principle of international law" is there any examination of the evidence on which she relies.

In support of her argument, Ms. Whiteman cites the case of the *USS Monocacy* between the Government of China and the United States. As the claim for "interest on interest" in this case was dropped before the case was resolved, there was no opportunity for compound interest to be rejected.[123] In the case of *Lord Dundonald (Great Britain v. Brazil)*, settled by arbitration on October 6, 1873, the claimant was awarded a total amount of £38, "apparently disallowing simple and compound interest."[124] This again is hardly evidence of a general principle against compound interest as all interest was refused by the tribunal. Finally, in the decision by the tribunal constituted to consider the claims of Norway against the United States under the provisions of the special agreement of June 30, 1921, compound interest was not awarded in the course of a decision made on October 13, 1922 as the tribunal indicated "that the claimants have not advanced sufficient reasons why an award of compound

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[120] MARJORIE MILLACE WHITEMAN, 3 DAMAGES IN INTERNATIONAL LAW 1997 (1943).

[121] Starrett Housing Corp v. Iran, Case No 24, 16 Iran-US Claims Trib. Rep. 112, 253 (1987).

[122] Cerina, *supra* note 71 at 260.

[123] *Discussed in* WHITEMAN, *supra* note 120 at 1997, noting the case is on file with the US Department of State, File No. 493.11 Ob 6/51.

[124] *Id.* at 1999, noting the case is reported at 1874 For. Rel. 70-73.

interest, in this case, should be made."[125] Again, this case offers no universal rejection of compound interest, but rather the suggestion that if a claim for compound interest were properly advanced, it would be entertained by the tribunal.

There is a clear difference between compound interest being refused on principle and it being rejected as inappropriate in particular cases. The authorities cited by Ms. Whiteman generally fall into this latter category and thus fail to support the existence of a general principle of international law against the awarding of compound interest. At most, it can be said that the question of whether compound interest can be awarded is an unsettled question before international tribunals.[126] Compound interest may not often be awarded by international tribunals, but, "one cannot go further than to state that such recovery [of compound interest] generally is not granted by international tribunals."[127]

Most international tribunals that award simple interest do not discuss the possibility of awarding compound interest. Those that actually refuse compound interest do so on the basis that other tribunals have refused compound interest, and while precedent is not binding on tribunals it does seem to exert significant weight on this subject.[128] A claim for compound interest was thus rejected by the Iran-United States Claims Tribunal in *International Systems & Controls Corp. v. Iran*, as compound interest had never before been awarded by the Tribunal.[129] As it is precedent rather than principle that prevents tribunals from awarding compound interest,[130] there is a real possibility that future tribunals will be less hostile towards compound interest.

The fact that tribunals reject compound interest based on precedent rather than on principle is made clear in the ruling by Max Huber in *Great Britain v. Spain (Spanish Zone of Morocco)*. The *Rapporteur* explains that in the face of

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[125] Norwegian Shipowners' Claims (Norway v. United States), 1 UNRIAA 307, 341 (1922).

[126] This view is supported by CHRISTINE GRAY, JUDICIAL REMEDIES IN INTERNATIONAL LAW 32 (1990) ("the law on this question [of compound interest] is unsettled in the jurisprudence of arbitral tribunals").

[127] JEAN-LUC SUBILIA, L'ALLOCATION D'INTÉRÊTS DANS LA JURISPRUDENCE INTERNATIONALE 24 (1972).

[128] The Tribunal in *Anaconda-Iran Inc.* was significantly influenced by the fact that compound interest had never previously been awarded by any chamber of the Tribunal. Case No 167 of 1986, 13 Iran-US Claims Trib. Rep. 199, 234. The fact that the Tribunal in *Norway v. United States* was led to believe that "compound interest has not been granted in previous arbitration cases" also influenced its decision. *See* Norwegian Shipowner's Claims, 1 UNRIAA 307, 341 (1922).

[129] Case No 494, 24 Iran-US Claims Trib. Rep. 47, 83-84 (1922).

[130] In none of the cases cited by Ms. Whiteman is any principle or rationale for prohibiting compound interest advanced.

case law which is "unanimous, as far as the *Rapporteur* knows, in disallowing compound interest . . . very strong, and quite specific arguments would be called for to grant such interest in this case."[131]

In the 1987 case of *Starrett Housing Corporation v. Iran*, one of the arbitrators, Judge Holtzmann, takes a dramatic step away from the usual rejections of compound interest by the Iran-United States Claims Tribunal and suggests that compound interest should be awarded because such an approach "would be consistent with international law."[132] In support of this statement, Judge Holtzmann cites the award of compound interest in the *Aminoil* arbitration, and the evidence provided to the Tribunal by Professor Mann that "municipal and international law evidence a trend toward compound interest in circumstances, such as exist in this Case, where the injured party has incurred compound interest charges as the direct result of the wrongful acts of the other party."[133]

Judge Holtzmann acknowledges that "international tribunals and respected commentators have come to recognize this principle [that injured parties who have themselves suffered actual compound interest charges be compensated on a compound basis in order to be made whole]" and states that compound interest is demanded by both modern commercial reality and equity.[134] Admittedly the evidence Judge Holtzmann cites in support of this international trend towards awarding compound interest is a bit weak.[135] But if the half-century of influence of Ms. Whiteman's general rule against compound interest proves anything, it is that one statement, one case, or the words of one commentator may snowball into evidence of a general principle of international law which may influence the practice of numerous international tribunals.

e. *Trade usages*

Trade usages have been cited by international tribunals in support of awards of compound interest, but just as with general principles of international law, questions have been raised as to how well-established these usages are and their potential scope. In the ICC Arbitration Award in *Case No. 5514 of 1990*, the question of compound interest was examined in detail. The tribunal determined that the law of the civil-law country in question

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[131] Affaire des Biens Britanniques au Maroc Espagnol (Great Britain v. Spain (Spanish Zone of Morocco)), 2 UNRIAA 615, 650 (translation taken from Mann, *supra* note 8 at 378-79).

[132] Starrett Housing Corp et al. v. Iran, Award of 14 Aug 1987, 16 Iran-US Claims Trib. Rep. 112, 253 (1987) (concurring opinion of Judge Holtzmann).

[133] *Id.* at 253-4.

[134] *Id.* at 254.

[135] He cites one case (*Aminoil*) and one commentator (Profesor Mann).

which governed the contract for financing did not prohibit compound interest in those circumstances in response to a default in payment. Any prohibitions on compound interest in the Civil Code would amount to prohibitions of *droit interne* which do not constitute matters of *ordre public international* and thus do not intervene in such an international contract.[136]

The tribunal went on to state that "commercial usages, which following Article 13 of the ICC Rules of Arbitration, the tribunal must take into consideration, demand the allowance in the present case of compound interest in favor of the two parties."[137] In affirming the existence of a usage of compound interest in international commercial dealings, the tribunal refers to an article by Dr. Wetter,[138] the opinion of Judge Holtzmann in the *Starrett case*,[139] the *Aminoil* decision of 1982,[140] and an article by Professor Mann.[141] The tribunal affirms that this is the only equitable solution given that the Enterprise had to pay compound interest when it borrowed to make up for the state's failure to pay on time. The tribunal also provides that the state is to receive compound interest on the sums wrongly retained by the Enterprise.[142]

In a commentary on the case, Yves Derains raises the question of whether a usage of international commerce in favor of compound interest is really as well-established as the tribunal suggests. He suggests that even the tribunal had doubts on this, as is reflected in the tribunal's emphasis that commercial usages demand the award of compound interest "in the present case." While he questions the existence of this usage, he applauds the decision of the tribunal to award compound interest as compensating the prejudice actually suffered.[143]

Mr. Derains' comments underline many of the difficulties with applying trade usages. Despite the strong support for applying trade usages in international arbitrations,[144] there is little guidance on obtaining evidence of

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[136] Award in Case No 5514 of 1990, *reported in* COLLECTION OF ICC ARBITRAL AWARDS 1991-1995, 459, 463 (Jean-Jacques Arnaldez et al. eds. 1997).

[137] *Id.* at 463 (translation by author).

[138] J. Gillis Wetter, *Interest as an Element of Damages in the Arbitral Process*, INT'L FINANCIAL L. REV. 20 (December 1986).

[139] Starrett Housing Corp et al. v. Iran, *supra* note 121 at 237 (concurring opinion of Judge Holtzmann).

[140] Government of the State of Kuwait v. The American Independent Oil Company (Aminoil), 21 I.L.M. 976 (1982).

[141] Mann, *supra* note 8 at 377.

[142] Award in Case No 5514 of 1990, *reported in* COLLECTION OF ICC ARBITRAL AWARDS 1991-1995, *supra* note 136 at 464.

[143] Yves Derains "Observations," Case No 5514 of 1990, *in* COLLECTION OF ICC ARBITRAL AWARDS 1991-1995, *supra* note 136 at 467.

[144] International arbitral rules require an arbitrator to consider trade usages when resolving a dispute. *See* ICC RULES, Art. 17(2) ("In all cases the arbitrator shall take account of the provisions of the contract and the relevant trade usages"); UNCITRAL ARBITRATION RULES

these usages. The fact that usages may be of local or international scope and may affect a certain trade or many commercial sectors makes them all the more elusive. An unwritten trade usage is defined as "a practice or pattern of behaviour among merchants established by repetition which has in some degree acquired normative force."[145]

In trying to identify usual practice in international commercial transactions, guidance may be sought in instruments formulated by international bodies. The UNIDROIT Principles of International Commercial Contracts[146] make no mention of compound interest and the Principles of European Contract Law have also been traditionally silent on the issue of compound interest.[147] Part III of the Principles of European Contract Law is in the course of preparation, however, and includes a new section devoted to compound interest.

The recognition that the cost of the loss of the use of money is best represented by compound interest and that compound interest may not be awarded in certain jurisdictions without an express agreement of the parties, has led to the inclusion of compound interest in standard term contracts in the construction industry. The Institution of Civil Engineers (ICE) *Conditions of Contract* (6th ed. 1991) provides at Article 60(7) for compound interest on overdue payments. In the event of such an overdue payment:

> the Employer shall pay to the Contractor interest compounded monthly for each day on which any payment is overdue or which should have been

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Art. 33(3) ("In all cases, the arbitral tribunal shall decide in accordance with the terms of the contract and shall take into account the usages of the trade applicable to the transaction"); AAA INTERNATIONAL RULES, Art. 28(2) ("The tribunal shall decide in accordance with the terms of the contract and shall take into account usages of trade applicable to the contract"); European Convention on International Commercial Arbitration of 1961, 484 UNTS 349 (1961) at Art. VII (an arbitrator "shall take account of the terms of the contract and trade usages" in determining the law applicable to the contract).

[145] Roy Goode, *Usage and Its Reception in Transnational Commercial Law*, 46 ICLQ 1, 7 (1997).

[146] See Article 7.4.9 of the UNIDROIT Principles (1994) which provides for interest generally. ("Article 7.4.9 (1) If a party does not pay a sum of money when it falls due, the aggrieved party is entitled to interest upon that sum from the time of payment whether or not the non-payment is excused. (2) The rate of interest shall be the average bank short-term lending rate to prime borrowers prevailing for the currency of payment at the place of payment, or where no such rate exists at that place, then the same rate in the State of the currency of payment. In absence of such a rate at either place, the rate of interest shall be the appropriate rate fixed by the law of the State of the currency of payment. (3) The aggrieved party is entitled to additional damages if the non-payment caused it a greater harm.").

[147] See Article 9:508 on interest (Article 9:508 (1) If a payment of a sum of money is delayed, the aggrieved party is entitled to interest on that sum from the time when payment is due to the time of payment at the average commercial bank short-term lending rate to prime borrowers prevailing for the contractual currency of payment at the place where payment in due").

> certified and paid at a rate of equivalent to 2% per annum above the base lending rate of the bank specified in the Appendix to the Form of T ender.[148]

The International Federation of Consulting Engineers (FIDIC) Fourth Guide equally provides that a contractor would be well advised to seek the inclusion of a provision for compound interest based on the inclusion of such a provision in the ICE *Conditions of Contract*.[149]

In the sphere of international banking, charging compound interest may be universal in certain transactions (such as current accounts). As early as 1900, the arbitrator Lachenal declared in the *Fabiani* case that "the capitalization of interest is authorized in the subject of current accounts and analogous operations."[150] Compounding interest in current accounts seems to be a usual practice which has been recognized in domestic systems as a "trade usage" and has thus escaped domestic law restrictions which otherwise limit or prohibit compound interest.[151]

In applying trade usages, it is likely that arbitrators will apply their ideas of the usual practice of a particular trade. They may not even advertise the fact that they are applying such trade usages. Professor Andreas Lowenfeld provides an example from his own experience of trade usages being applied in awarding interest, where the contract in question contained no provision as to interest for late payments. The respondent requested that no interest at all should be payable on the sums the tribunal found owing. The arbitrators quickly agreed that interest on sums owing should be awarded and that to award no interest on sums due years before was "commercially unreasonable and, therefore, contrary to law."[152] In response to the question, "what law?," the only answer could be "contrary to the law reflecting the normal expectations and usages of enterprises engaged in international construction

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[148] ICE CONDITIONS OF CONTRACT (6th ed. 1991). This marks a change from the fifth edition of the ICE CONDITIONS OF CONTRACT (1973, revised 1979) where there was no express provision for compound interest.

[149] E.C. CORBETT, FIDIC 4TH: A PRACTICAL GUIDE 386-7 (1991).

[150] France v. Venezuela (24 février 1891) *reported in* H. LA FONTAINE, PASICRISIE INTERNATIONALE 1794-1900, HISTOIRE DOCUMENTAIRE DES ARBITRAGES INTERNATIONAUX 368 (1902) (translation by author).

[151] *See e.g.* Reddie v. Williamson, (1863) 1 Machp (Ct of Sess 228) (Scotland) (recognizing the practice of compounding interest on current accounts as a usage of bankers); Article 233 of the Egyptian Civil Code which provides that ". . . commercial usage shall be applicable for calculation of compound interest in respect of current accounts." 3 BUSINESS LAWS OF EGYPT 3. 1-46 (Nicola H. Karam, trans) (Michael Davies ed. looseleaf).

[152] Andreas F. Lowenfeld, *Lex Mercatoria: An Arbitrator's View*, *in* LEX MERCATORIA AND ARBITRATION 71, 82 (Thomas E. Carbonneau, Rev. ed. 1998).

projects."[153] Perhaps a similar argument could be advanced for compound interest.

3. *Fairness Considerations*

Some arbitral tribunals have chosen to rely on principles of "fairness" and "reasonableness" in making interest awards rather than relying on any rules of national or international law.[154] Some concern has been voiced that fairness considerations lie on the frontiers of amiable composition.[155] Most arbitral rules provide that tribunals may only decide *ex aequo et bono* when authorized by the parties to do so.[156] A line can probably be drawn, however, between applying principles of fairness such as full compensation and forseeability which are arguably aspects of the *lex mercatoria* and relying purely on equity:

> The arbitrator who, without being an *amiable compositeur*, refers to the *Lex Mercatoria* to fix a rate of interest independent of national law does not leave himself to be guided by equity. From this point of view, the notions of a "reasonable" rate of interest and a "just" or "equitable" rate of interest must be carefully distinguished. In searching for a reasonable rate of interest which will repair the prejudice suffered from the deprivation of capital, the arbitrator who invokes the *Lex Mercatoria* follows an approach identical to that of a legislator who legislates a legal rate of interest. The difference is that the arbitrator determines this reasonable rate in the circumstances of the specific case while the legislator creates a rule of general application. Neither one nor the other is concerned with equity.[157]

What factors determine if an award of interest, and its inclusion or exclusion of compound interest, is fair or reasonable? Chamber Three of the

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[153] *Id.*

[154] The law applicable to the interest issue is often not even mentioned and instead a fair rate of interest is set. *See e.g. Ad Hoc UNCITRAL Award of 17 November 1994*, between a French bank and the Kuwaiti Inter-Arab Investment Guarantee Corporation. The applicable national law to the question of interest was not discussed. Instead the tribunal awarded interest at "the LIBOR rate for US dollar interbank deposits with prime banks" as "a reasonable measure of the loss of earnings or cost of money arising from non-receipt of US dollars by a bank." 21 Y.B. COM. ARB. 13, 37 (1996).

[155] Yves Derains, *Intérêts Moratoires, Dommages- Intérêts Compensatoires et Dommages Punitifs Devant L'Arbitre International, in* ÉTUDES OFFERTS À PIERRE BELLET 101, 108 (1991).

[156] *See* ICC RULES OF ARBITRATION, Art. 17(3) (1998); AMERICAN ARBITRATION ASSOCIATION INTERNATIONAL ARBITRATION RULES, Art. 28(3) (1997); Statute of the International Court of Justice, Art 38(2), as annexed to the Charter of the United Nations, 59 Stat. 1055, USTS 993 (entered into force Oct. 24, 1945).

[157] Derains, *supra* note 155 at 109. (translation by author). *See also* B. Goldman *La Lex Mercatoria Dans les Contrats et L'Arbitrage Internationaux: R•alit• et Perspectives*, J. DROIT INT'L (CLUNET) 475 (1979).

Iran-United States Tribunal in *McCollough & Co. Inc. v. Ministry of Post* determined that awards of interest should be based on the principles of fairness and reasonableness, considering:

(i) any pertinent contractual stipulations;
(ii) the rules and principles of the law applicable to the contract;
(iii) the nature of the facts generating the damage;
(iv) the nature or level of the compensation awarded, particularly if it extends to the lost profit or includes a profit in the costs to be reimbursed;
(v) the knowledge that the defaulting party could have had of the financial consequences of its default for the other party;
(vi) the rates in effect on the markets concerned: and
(vii) the rate of inflation.[158]

The problem with fairness determinations is that different arbitrators have different opinions of what is fair. Judge Brower's dissenting opinion in this award questions the fairness of the interest award in this case. The Chamber awarded interest at a rate of 11% which Judge Brower argued was inconsistent with the commercial approach to interest awards adopted by other Chambers.[159]

The inherent subjectivity of fairness considerations is evident from other decisions of the Iran-United States Claims Tribunal. Following the approach in *McCollough*, the Tribunal in *American Bell International Inc. v. Iran*, held that "in a commercial case like the present one Claimant is clearly entitled to interest at a "reasonable" or "fair" rate."[160] In the opinion of the Tribunal, such a "fair" or "reasonable" rate would involve simple interest. However, if the arbitrator in the case were Judge Holtzmann,[161] compound interest might have been seen as an integral aspect of a fair award. This might also be the case if the arbitrator were Richard Allison.[162]

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[158] McCollough & Company, Inc. v. Ministry of Post. Case No 89 of 1986, 11 Iran-US Claims Trib. Rep. 3, 29-30 (1986).

[159] *Id.* at 42-43 (Brower J., concurring and dissenting). Chamber 1 of the Tribunal prefers an approach which fixes the rate of interest based on the amount that the claimant would have been able to earn if the sum had been paid on time. Sylvania Technical Systems Inc v. Iran. Case No 64, 11 Y.B. COM. ARB. 290, 296 (1986).

[160] Case No 48 of 19 September 1986, 12 Iran-US Claims Trib. Rep. 170, 229 (1986).

[161] Starrett Housing Corp et al v. Iran, *supra* note 121 at 253 (concurring opinion of Judge Holtzmann).

[162] *See* Shahin Shaine Ebrahimi v. Iran, *supra* note 7 at 452-3 (Separate Opinion of Judge Allison advocating an award of compound interest).

In deciding whether it is "fair" and "reasonable" to award compound interest two considerations seem to dominate. The first is whether the award of compound interest is needed to fully compensate the party who has been deprived of the use of funds. This looks at fairness from the perspective of the deprived party. The deprivation of capital creates a prejudice that will not always be compensated through simple interest.[163] This is particularly a consideration in international arbitrations because of the nature of the parties and their businesses. Those who resort to international arbitration generally have their capital tied up in industrial or commercial operations, far past any ability to self-finance. Late payments thus translate generally into an obligation to go to the financial markets and borrow in conditions that are not favorable, or even to reduce the volume of business undertaken.[164]

A second consideration in determining the fairness of an award of compound interest is the foreseeability of the deprived party suffering losses which include compound interest. In the *Starrett Housing* Case, for example, Judge Holtzmann notes that the:

> [r]espondents were fully aware that Starrett was borrowing money from its U.S. banks on a compound basis in order to finance the Project and provide loans to Shah Goli... Starrett offered uncontested evidence that these banks charged it interest on a compound basis ... the Respondents' wrongful acts have led to the direct and foreseeable consequence of forcing Starrett to borrow money on a compound basis.[165]

This focus on the debtor side is relevant not only in determining the forseeability of damages, but also when compound interest is awarded from a completely different perspective – that of restitution.

C. *Compound Interest as a Restitutionary Remedy*

When money is wrongly withheld, the debtor has the use of funds to which he or she is not entitled. This represents an unjust enrichment. In interest awards, the debtor side is not usually relevant.[166] Focus is usually on

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[163] Yves Derains, *Intérêts Moratoires*, *supra* note 155 at 114.

[164] *Id.* at 120.

[165] Starrett Housing Corp et al. v. Iran *supra* note 121 at 252 (concurring opinion of Judge Holtzmann).

[166] Phanesh Koneru looks at the issue of awarding interest under Article 78 of the Vienna Convention and identifies the primacy of the goal of compensating loss rather than disgorging enrichment. *The International Interpretation of the UN Convention on Contracts for the International Sale of Goods: An Approach Based on General Principles*, 6 MINNESOTA J. GLOBAL TRADE 105, 128 (1997). ("An analysis of the interplay between the general principle of

loss rather than unjust enrichment: "the definition of interest, however, focuses on the damages side only. Interest is 'conceptually ... an item of damage. Its award is intended as compensation for the temporary withholding of money, and its measure is the cost of such deprivation.'"[167]

A debtor can thus benefit in an interest award situation without repaying this benefit. This occurs when a debtor who has a bad credit rating owes money to a creditor with a better credit rating. The debtor profits from the good credit rating of the creditor as the interest he or she will have to pay back is usually only that which the creditor would pay for such borrowing.[168] In international arbitrations, only in rare cases "where the primary obligation is not to pay money but to give back unjustly acquired property" is the debtor side relevant.[169] Two examples of this are the award of the Russian Foreign Trade Arbitration Commission in *Sojuznefteexport v. Joc Oil Limited* [170] and *ICC Case 4629*.[171]

In *Joc Oil*, Joc Oil (a Bermuda-based oil company) received oil from a Russian company although the underlying contract between them was void. In a claim for restitution in arbitration proceedings, Joc Oil was forced to reimburse all profits from its unjustly acquired property. The tribunal held that pursuant to Article 473 of the Russian Civil Code "a person who has unjustly acquired property is obligated also to return or reimburse all profits which he received or should have received from the property from the time when he knew or should have known about the unjustified receipt of the property." This meant that "apart from payment of the basic sum of the debt, [Joc Oil] is obligated also to pay interest for the use of the monetary sum."[172]

Joc Oil attempted to argue that this interest should be limited to the statutory three per cent per annum applicable under Article 226 of the Civil Code as late-payment interest on monetary sums. The tribunal disagreed as the restitutionary claim in question

> arises not from Art. 226 of the CC, which deals with the consequences of delay by a debtor in relation to a monetary obligation, but as already noted, from paragraph 5 of Art. 473 of the CC obliging a person who has unjustly

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preventing unjust enrichment and the earlier-stated general principle of full compensation suggests that the principle of preventing unjust enrichment has a limited role in the Convention").

[167] Lew, *supra* note 3 at 563, *quoting* Brower J. in McCollough & Co. Inc., *supra* note 159 at 42.

[168] *See* Lew, *id.* at 563 n. 70.

[169] *Id.* at 563.

[170] 18 Y. B. COM. ARB. 92 (1993).

[171] 18 Y. B. COM ARB. 11, 30 (1993).

[172] 18 Y. B. COM ARB. at 107.

> received property to return or to reimburse the said profits referred to above.[173]

A more relevant interest rate according to the tribunal would be that "level of interest which is used in the oil trade."[174] The interest rate was of significance as the amounts claimed as restitution exceed $US 96 million. While compound interest was not claimed in this case, the case suggests that by framing a claim as a reversal of unjust enrichment, rather than fitting it under a statutory claim for late-payment interest, one may open a window for allowing compound interest which may otherwise be prohibited by statute.

In *ICC Case No 4629* the claimants, contractors on a Middle Eastern hotel project, had advanced money to purchase goods that were needed for the project before the effective date of the contract occurred. In arbitration, they claimed the interest which they stated they had paid to borrow the money for these purchases which was at a rate of between 18 and 20%. The tribunal rejected the interest claim based on the claimants' losses, and instead applied the interest rate applicable to the respondent, which would be 7.5%, as the claimants "never told the respondent that they would charge him with an interest rate of 20%."[175] The respondent thus was forced to pay the rate of interest which he saved by not advancing the sums, which was the amount by which he was effectively unjustly enriched.

Many, if not all, domestic legal systems have found it necessary to provide for remedies for situations of unjust enrichment, distinct from traditional categories and techniques, where relief is considered appropriate.[176] The existence of this concept in a broad range of domestic legal systems has caused many authors to conclude that "unjustified enrichment" is a "general principle of law."[177] This general concept of unjustified enrichment often underlies claims for compensation for expropriated foreign property. Professor Brownlie writes that in setting out the compensation rule for expropriation, reference is made to "general principles of law, including those of unjust enrichment and abuse of rights."[178]

In certain cases, in questions of computing the amount of compensation due in cases of nationalization, arbitrators and judges have preferred to focus on profit and unjust enrichment rather than on traditional notions of damages.

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[173] *Id.* at 107-108.

[174] *Id.* at 108.

[175] 18 Y. B. COM. ARB. at 30.

[176] For a comparative discussion of the principle of unjust enrichment *see* Christopher H. Schreuer, *Unjustified Enrichment in International Law*, 22 AM. J. COMP. L. 281, 281-84 (1974).

[177] *Id.* at 282; JIMÉNEZ DE ARÉCHAGA, YEARBOOK OF THE INTERNATIONAL LAW COMMISSION 237, 243 (1963 II).

[178] IAN BROWNLIE, PRINCIPLES OF PUBLIC INTERNATIONAL LAW 533 (4th ed. 1995).

In some circumstances, remedies are awarded to reverse accretions of wealth in situations where contractual or delictual remedies would be unable to reach the same result.[179]

In other cases, although tort or contract remedies were available, tribunals have preferred to focus on profit rather than loss, and thus to frame a remedy in terms of reversing unjust profit. One such case was the *Lena Goldfields Arbitration* where actions of the Soviet government made it impossible for the concessionaire, Lena Goldfields Ltd, to carry on with its business.[180] The tribunal in ruling on the breach of the concession agreement determined that:

> ... the conduct of the [Soviet] Government was a breach of the contract going to the root of it. In consequence Lena is entitled to be relieved from the burden of further obligations thereunder and to be compensated in money for the value of the benefits of which it had been wrongfully deprived. On ordinary legal principles this constitutes a right of action for damages, but the Court prefers to base its award on the principle of "unjust enrichment", although in its opinion the money result is the same.[181]

The very point, however, of framing claims in restitution rather than breach of contract generally may be that the money result may not be the same. The actual benefit may exceed the actual loss in question so that restitution of the amount by which a debtor was unjustly enriched may exceed the creditor's loss. Calculation of compensation due is awarded based on the actual benefit received rather than on the damage suffered by the aggrieved party.[182]

In the *ELSI Investment Dispute* case before the ICJ, the United States framed its claim for compound interest from Raytheon in terms of reversing an unjust enrichment, as Raytheon would have generated interest earnings or savings by the money which would be measured in compound interest terms.

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[179] For a discussion of the use of restitutionary remedies in both crisis and non-crisis situations in international practice *see* Schreuer, *supra* note 176 at 289-97.

[180] The text of the award is reprinted in THE LONDON TIMES, 3 September 1930 at 7 and discussed in detail in V.V. Veeder, *The* Lena Goldfields *Arbitration: The Historical Roots of Three Ideas*, 47 I.C.L.Q. 747 (1998).

[181] THE LONDON TIMES *supra* note 180 at 7.

[182] The American owners were thus awarded the amount by which England actually benefitted by requestioning and using a U.S. ship (rather than being awarded compensation based on their own losses) by the arbitrator in The Edna, *reported in pertinent part in* 34 AM. J. INT'L. L. 737 (1940). Under certain legal systems however, such as English law, courts may not choose to make an award to disgorge profits while a contract remains "open." Rather, the action would have to be brought on the contract, for damages. *See* J.H. Baker, *The History of Quasi-Contract in English Law in* RESTITUTION PAST, PRESENT AND FUTURE ESSAYS IN HONOUR OF GARETH JONES 37, 49-52 (W.R. Cornish ed. 1998).

Unfortunately, the Court did not rule on this question as it never reached the issue of reparations.[183] Even in the absence of judicial determination of this issue, it is clear that compound interest may represent the actual profit gained by a party, and that giving effect to the general principle against unjust enrichment may call for this compound interest gained to be disgorged.

V. ENFORCEMENT CONSIDERATIONS

A. *The Meaning of Public Policy*

Under Article V of the New York Convention, a court may refuse to enforce a foreign arbitral award if certain grounds are met. One of the grounds for non-enforcement is a violation of public policy.[184] In the United States, this public policy exception has generally been defined narrowly to apply only where "enforcement would violate our 'most basic notions of morality and justice.'"[185] The French Code of Civil Procedure similarly provides that only awards which violate aspects of international public policy, rather than national public policy will be refused enforcement.[186]

An award for compound interest has not been found to violate international public policy in any of the jurisdictions where this question has been expressly examined. In proceedings on the enforcement of an arbitral award in Switzerland under the New York Convention, the appellant challenged the enforcement of the award on the basis of the violation of substantive public policy in the award of compound interest. The Swiss Tribunal Fédéral (Supreme Court) rejected the defendant's argument, stating that "contrary to the opinion of the appellant, Swiss law does not prohibit that the interest for delay be compounded."[187]

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[183] Elettronica Sicula SpA (ELSI) (U.S. v. Italy), 1989 ICJ Rep 15 (July 20). *See* Sean D. Murphy, *The ELSI Case: an Investment Dispute at the International Court of Justice*, 16 YALE J. INT'L L. 391, 438-39 (1991).

[184] Convention on the Recognition and Enforcement of Foreign Arbitral Awards [hereinafter New York Convention], opened for signature June 10, 1958, 330 U.N.T.S. 38, 21 U.S.T. 2517, Article V 2(b) ("Recognition and enforcement of an arbitral award may also be refused if the competent authority in the country where recognition and enforcement is sought finds that ... [t]he recognition or enforcement of the award would be contrary to the public policy of that country").

[185] Waterside Ocean Navigation Co. v. International Navigation Ltd., 737 F.2d 150, 152 (2d Cir. 1984).

[186] Code de Procédure Civile, Art. 1502, *reprinted in* 7 Y. B. COM. ARB. 281-82 (1982). ("An appeal against a decision granting recognition or enforcement of an award may be brought ... [i]f the recognition or enforcement is contrary to international public policy").

[187] InterMaritime Management SA (Switzerland) v. Russin & Vecchi (U.S.), 10(9) INT'L ARB. REP. D-1 (1995), *reprinted in* 22 Y. B. COM. ARB. 789, 798 (1997).

The Court stated that the provision of Swiss law in question, Article 105(3) of the Code of Obligations, which provides that "no penalty interest for delay shall be calculated over penalty interest for delay" was further not a mandatory provision of Swiss law. Even if it was, "substantive public policy is not necessarily violated where the foreign provision is contrary to a mandatory provision of Swiss law."[188] The Court stated that public policy "understood in the narrow sense, and even more so in enforcement proceedings – opposes the enforcement of foreign arbitral awards which hurt the Swiss legal feeling in an intolerable manner and violate the fundamental principles of the Swiss legal system."[189] The award of compound interest was thus enforced.

In Germany, the situation is less clear. Two cases, dating from 1880 and 1881, stand as authority for the proposition that the rule against compound interest forms part of German public policy and could be a basis for denying enforcement of an arbitral award based on foreign law allowing compound interest.[190] Recent commentators suggest that while these cases have not been expressly overruled, "it would be going too far to say that a foreign law which provided for the award of compound interest would contravene fundamental principles of German law."[191] A better view today is that a German court or arbitral tribunal is empowered to order payment of compound interest if this is what the relevant foreign proper law provides. In the absence of decided cases on this question, this opinion is based on the acknowledged exceptions to the rule against awarding compound interest in German law,[192] and the strength of support from academic commentators.[193]

In France, Article 1154 of the Civil Code on compound interest is determined to consist of *ordre public interne* rather than *ordre public international*.[194] One commentator on international commercial contracts suggests that municipal law prohibitions on compound interest are an example

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[188] 22 Y. B. COM. ARB. at 797.

[189] *Id.*

[190] 1 *Reichsgericht Zivilsachen* 51 and Vol. 5 at 254, *discussed in* Hunter & Triebel, *supra* note 3 at 19.

[191] Hunter & Triebel, *id.* at 19.

[192] Section 248 of the German Civil Code provides that "(1) An agreement made in advance to the effect that arrears of interest shall again bear interest is void. (2) Savings banks, credit institutions and bankers may agree in advance that uncollected interest on deposits shall be considered as a new interest bearing deposit. Credit institutions, which have been authorized to issue interest bearing bearer bonds in the amount of loans made by them, may demand in advance on such loans payment of interest on arrears of interest." *Translation from* FORRESTER, GOREN & ILGEN, THE GERMAN CIVIL CODE (1975).

[193] *See e.g.* STAUDINGER-RAAPE, COMMENTARY TO THE CIVIL CODE, (12th ed.) Note Q II (i) to Article 30, *quoted in* Hunter & Triebel, *supra* note 3 at 19.

[194] Cass Com 20 Oct 1953: REV. CRIT. DR INT. PR 1954, 386, note Y. Loussouarn: S 1954, 1.121, note P. Lescot.

of normal mandatory rules and not specific public policy provisions.[195] In England, it appears that an arbitral award for excessive interest or compound interest would be enforced without difficulty as there is no public policy rule in England that a foreign award of interest should be unenforceable in such situations.[196]

In India, the Supreme Court upheld a $12.3 million International Chamber of Commerce (ICC) Arbitration Award to the General Electric Co. (GE), determining that the award which included compound interest is not contrary to the public policy of India.[197] The interest portion of the award was computed by applying the U.S. average prime rate to the amounts withheld, compounded annually over 16 years. In the words of the arbitrators, "[c]ompounding is essential in computing compensatory damages, because the Claimant would have had to pay compound interest if it had replaced the improperly withheld funds by borrowing." The High Court of Bombay had enforced the award on October 21, 1988 under the New York Convention. The Supreme Court affirmed the lower court's decision.

In its judgment, the Supreme Court endorsed the arbitrators' decision to determine compensatory damages by applying the U.S. prime rate compounded annually. The Court expressly rejected Renusagar's claim that the award of compound interest was not permissible under New York law or the law of India, and that it was contrary to the public policy of New York State and India.[198] The Court upheld the award of compound interest, stating that Section 3(3) of India's Interest Act, 1978 allows for "the payment of compound interest in contracts for loans advanced by banks and financial institutions and the said contracts are enforced by courts. Hence, it cannot be said that [the] award of interest on interest, i.e., compound interest, is against the public policy of India."[199] The Supreme Court also noted that the Australian High Court and Canada's Federal Court of Appeal have upheld awards of compound interest.

The contract in question was governed by New York law,[200] but, citing the Foreign Awards Recognition and Enforcement Act of 1961, the Court rejected Renusagar's claim based on New York law. The Supreme Court stated that under Section 7(1)(b)(ii) of the Act the enforcement of a foreign award can

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[195] Otto Sandrock, *"Handcuffs" Clauses in International Commercial Contracts: Basic Reflections on the Autonomy of the Parties to Choose the Proper Law for their Contracts*, 31 INT'L LAW. 1105, 1111-1112 (Winter 1997).

[196] Hunter & Triebel, *supra* note 3 at 14.

[197] Renusagar Power Co. v. General Electric Co., Supreme Court of India, *reported in* 8 (11) INT'L ARB. REP. 3 (1993).

[198] *Id.* at 4

[199] *Id.*

[200] 8(12) INT'L ARB. REP. 3, 5 (1993).

only be challenged if such enforcement is contrary to the public policy of India.[201]

The Court determined that the expression "public policy" in these enforcement proceedings must be construed as meaning the doctrine of public policy as applied in the field of private international law. This means that "the enforcement of a foreign award would be refused on the ground that it is contrary to public policy if such enforcement would be contrary to (i) fundamental policy of Indian law; or (ii) the interests of India; or (iii) justice or morality."[202] The award of compound interest violated none of these.

In New York, the consequences of a foreign law provision on compound interest have been uncertain in enforcement proceedings. New York courts have traditionally held in domestic cases that a provision for compound interest will not be enforced on the ground that it contravenes New York public policy.[203] The standard applied by New York's conflict of laws rule would be that such a public policy is "an important public policy" so unless such a public policy is deemed important, an arbitral award in favor of compound interest would not be denied enforcement. The arbitrators in *Renusagar Power Co. v. General Electric Co* "examined at length" whether awarding compound interest would be contrary to New York public policy. They came to the conclusion that awarding compound interest is not against the public policy of the State of New York.[204] Recent legislation making agreements to pay compound interest enforceable in New York lends further support to this argument.[205]

Particular public policy concerns arise in attempting to enforce awards including interest in Middle Eastern states. A variety of approaches to interest are taken in Islamic countries and in some countries interest will be domestically prohibited but permitted in transactions with foreigners. Further, different approaches to public policy are taken depending on whether public policy is defined in a way similar to that of Western countries (as in Syria, Lebanon, Egypt and Kuwait), or whether an Islamic concept of public policy is adopted (as in Saudi Arabia, Qatar, Oman and North Yemen). In this first group of states, the concept of public policy:

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[201] *Id.*

[202] *Id.*

[203] For a discussion of the historic resistance of New York courts to compound interest, *see* Martin E. Gold, *New York Approves Law Legalizing Compound Interest*, N.Y. STATE BAR J. 26 (Oct. 1990).

[204] *See* Renusagar Power Co. v General Electric Co. (12 October 1989), enforcement proceedings in High Court of Bombay, 16 Y.B. COM. ARB. 553, 562 (1991).

[205] Section 5-527 of the General Obligations Law Ch. 202, L 1989 Reg Serv.

> is to be found in the laws relating to exchange control, the protection of tenants, illegal activities such as arms traffic and counterfeit currency, and in the statutory provisions which reserve to the exclusive jurisdiction of their national courts matters concerning labour law, commercial agencies and cases relating to immovable property including oil wealth.[206]

In this second group of states public policy is taken to mean policy which conforms to Islamic law tenets. Islamic law does not make a distinction between domestic public policy and international public policy.[207] In this way, an arbitral award based on a contract which contains a provision for interest may come against the prohibition of *riba* as violating public policy, and this could result in the refusal to enforce such an award.[208]

One commentator hypothesizes as to what would happen if a Kuwaiti court were to be faced with a judgment providing for interest upon interest.[209] Professor Ballantyne suggests that this question would likely be a matter of *ordre public* in Kuwait. As interest on loans is prohibited in the Civil Code and due to the mandatory prohibitions on compound interest in the Commercial Code, the Kuwaiti court would likely go beyond the foreign judgment and invalidate either the provision for interest on interest or the whole transaction.[210]

Enforcement considerations arise not only in countries with explicit public policies against compound interest but also in those countries with public policies against "excessive" or "unreasonable" interest which may target the practice of capitalization of interest. Julian Lew notes that in "most legal systems, the statutory interest rates are very low and often do not reflect the commercial realities. Therefore, even a considerable uplift on the statutory interest rates will in most cases not be considered as unreasonable."[211] Many municipal statutory rates provide a minimum rate that can be awarded without

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[206] Samir Saleh, *The Recognition and Enforcement of Foreign Arbitral Awards in the States of the Arab Middle East*, CONTEMPORARY PROBLEMS IN INTERNATIONAL ARBITRATION 340, 347 (Julian D. M. Lew, ed. 1986).

[207] *Id.* at 347.

[208] *Id.* at 348-49.

[209] W. M. BALLANTYNE, COMMERCIAL LAW IN THE ARAB MIDDLE EAST: THE GULF STATES 131 (1986). Compound interest is prohibited (with some exceptions) under Article 115 of the Kuwaiti Commercial Code ("Interest shall not be awarded on 'frozen interest,' and in no case shall the total interest due to the creditor exceed the capital, all the foregoing saving cases provided for in this Law and without prejudice to commercial principles and customs and principles applied to long-term loans").

[210] *Id.* at 131.

[211] Lew, *supra* note 3 at 554, referring to Société Iro Holding c. Société Sétiler, Paris 1er Supp, 9 Juin 1983, 1983 REV. ARB. 496 where the *Cour d'Appel de Paris* allowed an award of 19.2% interest to stand (when the maximum allowed by French law was 18.06%).

the need to show any loss. A higher rate of interest is permitted once actual loss at that rate can be shown. Interest awarded in arbitral awards for actual losses at rates which greatly exceed municipal statutory rates (or which exceed municipal rates through the allowance of compounding) may thus escape public policy scrutiny.

B. *Post-Award Interest*

Post-award interest has, in addition to the compensatory purpose shared by pre-award interest, the purpose of discouraging parties from pursing frivolous appeals, and creating an incentive for losing parties to promptly pay their damages, thus removing the need for further proceedings to enforce the award.[212] Like pre-award interest, post-award interest is often governed by national statutes and the rates to be applied on judgments and awards vary significantly between countries.

The distinction between pre- and post-award interest applicable in certain countries[213] has been argued to be of dubious value in international arbitrations. The reason for this distinction of periods from which interest will run appears to be so that the statutory fixed rate prescribed for local judgments will begin to run from the date of the award.[214] Whether international awards should be treated in an analogous manner to local judgments can be questioned. International arbitrators are to take into account the conditions of the international marketplace in awarding appropriate relief.[215] To apply the local statutory interest rates of the country where enforcement is sought neglects the distinct international nature of these awards. The rate of interest chosen by the arbitrator to compensate for the loss of money should apply from the interest commencement date until the actual payment is made. The decision of the Second Circuit in the United States that interest accruing from the date of an international arbitral award would accrue not at the rate set by the arbitral tribunal but rather at the rate prescribed by local statute has thus attracted much criticism.[216]

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[212] *See* the discussion on post-judgment interest in JOHN GOTANDA, SUPPLEMENTAL DAMAGES IN PRIVATE INTERNATIONAL LAW 56-93 (1998).

[213] The distinction between pre- and post-award interest is made in many common-law countries, including the UK: *see e.g.* Arbitration Act 1996, Sect. 49(3) and (4) (UK).

[214] Cerina, *supra* note 71 at 278.

[215] *See* Smit, *supra* note 85 at 176.

[216] Carte Blanche (Singapore) Pte Ltd. v. Carte Blanche International Ltd., 888 F.2d 260 (2nd Cir. 1989). For criticism, *see* Smit, *id.* at 172.

Most arbitrators, if awarding post-award interest specifically, limit their awards to simple interest.[217] Both the American Arbitration Association's International Arbitration Rules and the London Court of International Arbitration Rules expressly provide that post-award interest (as well as pre-award interest) may be compounded.[218]

What happens when an arbitral award specifies for compound interest to run on the award, yet the law applicable to civil judgments in the country where the award is to be enforced allows only simple interest? It is suggested that once an arbitral award is enforced in a country as a civil judgment, interest will accrue at the rate provided for civil judgments in that country, rather than the rate set by the arbitrators.[219] This may prevent interest from capitalizing although this is the express intention of the arbitrators in making their award.

VI. THE CASE FOR AWARDING COMPOUND INTEREST IN INTERNATIONAL ARBITRATION

The discussion of compound interest in the context of international arbitration thus far has focused on the practice of international arbitrators, and their tendency through various choices of applicable law and legal rules, to either reject or accept claims for compound interest. This section takes a step away from arbitral practice to consider the issue of whether compound interest should be awarded by international arbitrators.

A. *The Unique Context of International Arbitration*

The particular context of international arbitration raises several issues, including the flexibility of arbitrators to choose relevant rules of law to apply, the role of arbitrators in contributing to the operation of international business, and the question of the applicability of domestic concerns in international

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[217] GARY BORN, INTERNATIONAL COMMERCIAL ARBITRATION IN THE UNITED STATES 622 (1994).

[218] *See* Article 28(4) of the AAA International Arbitration Rules, 1997 (providing that the "tribunal may award such pre-award and post-award interest, simple or compound, as it considers appropriate, taking into consideration the contract and applicable law"); The London Court of International Arbitration Rules, Article 26.6 (1998) (stating that the "Arbitral Tribunal may order that simple or compound interest shall be paid by any party on any sum awarded at such rates as the Arbitral Tribunal determines to be appropriate, without being bound by legal rates of interest imposed by any state court, in respect of any period which the Arbitral Tribunal determines to be appropriate ending not later than the date upon which the award is complied with").

[219] JOHN GOTANDA, SUPPLEMENTAL DAMAGES IN PRIVATE INTERNATIONAL LAW, 85-86 (1998); REDFERN & HUNTER, *supra* note 70 at 406.

transactions. Many of the public policy concerns underlying domestic limitations on compound interest do not have a place in international arbitration.

Arbitrators often refer to national prohibitions on compound interest to justify their decisions to refuse to award compound interest as damages in international arbitrations. Such decisions are not always convincing because they confuse the functions of allowing contractual compound interest on the late payment of a debt, and the function of compensatory interest in the form of damages. Prohibitions on agreements for compound interest in domestic law are often designed to "protect the debtor against an exponential augmentation of his [or her] debt."[220] In awarding damages, the concern is quite different – to compensate for the loss suffered. If compound interest is an accurate measure of the loss actually suffered, then strong arguments can be made for its award. In the words of Judge Holtzmann in the *Starrett* case, "to make Starrett whole and to erase the consequences of the Respondent's wrongful acts, I would award Starrett interest on a compound basis."[221] Domestic public policies designed to protect the unwary debtor need not interfere with this.

Domestic public policies which limit compound interest may have at their root consumer protection issues which are of limited relevance in international commercial arbitrations which tend to involve corporations, or in some cases, states. In some jurisdictions, exceptions to prohibitive rules on compound interest have been allowed in cases where the borrower is large and sophisticated.[222] These are exactly the type of borrowers (and parties in general) involved in international arbitrations.

B. *Compound Interest as a Reflection of Economic Reality*

The identities of the parties are relevant when calculating the cost of the loss of money (or equally in calculating enrichment). Commercial parties who have claims against each other that are not duly paid will not simply lose the return on their investments during the relevant period but will have to borrow substitute funds for the period of delayed payment at the rate which is usually

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[220] Herbert Schönle, *Intérêts Moratoires, Intérêts Compensatoires et Dommages-Intérêts de Retard en Arbitrage International, in* ETUDES DE DROIT INTERNATIONAL EN L'HONNEUR DE PIERRE LALIVE 660 (C. Dominice et al. eds., 1993).

[221] Starrett Housing Corp et al. v. Iran, Award of 14, Aug. 1987, 16 Iran-U.S. Claims Trib. Rep. 112 at 252 (1987) (concurring opinion of Holtzmann, J.).

[222] This explanation shows why otherwise prohibited compound interest was allowed in *Corbin v. Federal Reserve Bank of New York*, 475 F.Supp. 1060 (1979). *See* Martin E Gold, *New York Approves Law Legalizing Compound Interest*, NEW YORK STATE BAR J. 26, 27 (October 1990).

charged for unsecured short-term credit in the country where the creditor has its place of business.[223]

It is usual commercial practice that banks, in some way or another, charge compound interest to finance these credit facilities or at least apply a method of computing interest which has the same effect as charging compound interest.[224] Consequently, compound interest costs are a direct result of non-payment and therefore should be awarded in the same way as ordinary interest claims. As bank methods of compounding differ, claimants cannot rely on set amounts of compound interest but must provide tribunals with evidence establishing the compound interest charges they have faced in borrowing.[225]

In attempting to reflect modern commercial reality in their interest awards, arbitrators may choose to apply rates of interest which represent commercial borrowing rates. A major problem (which arguably is repeated by the limited scope of this article) is the artificial separation of considerations of interest rates and the issue of compounding interest. In *International Systems & Control Corp. v. Nat'l Iranian Gas Co., Nat'l Iranian Oil Co. and Iran*,[226] the tribunal awarded interest at the rates applicable to six-month certificates of deposit, but failed to compound this interest as would be the normal practice with these certificates of deposit. The net effect of this decision is thus one of under-compensation.

Determining rates of interest, and whether to award compound interest, may depend on how interest is viewed conceptually. Where interest is viewed as an item of damage and its award is to compensate for the temporary withholding of money, then its measure should be the cost of such deprivation.[227]

The differences in capital markets between countries, and the resulting differences in the productivity of money in different states, make a uniform approach to the issue of awarding interest in international arbitration unlikely. It is within the context of each case that the arbitrator must determine whether the compounding of interest is demanded for full compensation of the prejudice suffered (or to fully address the unjust enrichment). This would give effect to modern economic conditions where surplus funds are invested in bank deposits or savings accounts which earn compound interest, and where those who are forced to borrow from banks pay compound interest.

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[223] KLAUS PETER BERGER, INTERNATIONAL ECONOMIC ARBITRATION 626 (1993).
[224] *Id.* at 630.
[225] *Id.* at 631.
[226] Case No. 494, 24 Iran-US Claims Trib. Rep. 47, 83-84 (1990).
[227] BERGER, *supra* note 223 at 625.

VII. CONCLUSIONS

While arguments for allowing compound interest in both domestic legal systems and international arbitrations focus on "contemporary commercial reality," compound interest has been around for thousands of years. Compound interest is not a modern financial technique. Rather, it is a long-recognized economic principle that acknowledges that not only principal attracts interest, but interest does as well. Those who present the battle to allow compound interest as one of overcoming "ancient and medieval prejudices"[228] ignore compound interest's long history.

At the beginning of this article, I set out the task of identifying why compound interest is so often rejected in international arbitral awards. The unsatisfactory, yet ultimately most accurate, response to this question is that often there is no rational policy basis underlying the rejection of compound interest. It is often precedent rather than principle which prevents international arbitral tribunals from awarding compound interest.

Central to much of the resistance to compound interest in domestic legal systems is a paradigm of a needy and potentially vulnerable consumer borrower. Laws restricting compound interest have almost universally developed with the consumer borrower rather than the commercial investor in mind. This paradigm goes a long way in explaining judicial and legislative resistance to compound interest. But it is of questionable applicability in the sphere of international arbitration.

Many international arbitrations involve sophisticated business entities, considerable amounts of principal, and long periods of time between the origin of the dispute and the final award. For the sort of parties involved in such arbitrations, compound interest is more likely than simple interest to reflect the cost of being kept out of money, or the profit gained from the possession of money. This is simply because commercial investors can and do earn compound interest and commercial borrowers pay such interest.

Resistance to compound interest can never be totally severed from the prejudices surrounding moneylending. In Christian societies, John Kenneth Galbraith suggests that "doubts as to the righteousness of moneylending have never been wholly expunged."[229] The potential for abuse and exploitation associated with compound interest has resulted in centuries of censure of the charging of such interest, at least by "avaricious" moneylenders.

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[228] John C. Keir & Robin C. Keir, *Opportunity Cost: A Measure of Prejudgment Interest*, 39 BUS. LAW. 129, 131 (1983).

[229] JOHN KENNETH GALBRAITH, A HISTORY OF ECONOMICS: THE PAST AS THE PRESENT, 23 (1991).

Notwithstanding commercial realities, for some, demanding compound interest will always be akin to demanding a pound of flesh.