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# Legal Aspects of Procurement

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## USAID-Funded Economic Governance II Project

**Presented To: Ministry of Electricity Senior Personnel**

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# What this Course will Cover

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- Traditional approach; risks and allocation; new, structured finance approach; situation in Iraq – donor funding; disciplined approach

# What this Course will Cover

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- Turnkey design and build and EPC Contracts; fundamental legal issues to negotiate

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# Procurement in Context

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## What do we mean by Procurement; its Importance

- Refers to the purchase of plant, equipment, materials and services, and construction of works, ie. contracts – particularly today, infrastructure contracts:

*“Procurement” defined: a process of identifying a need, specifying the requirements to fulfil that need, identifying potential suppliers, soliciting bids and proposals, evaluating bids and proposals, awarding contracts or purchase orders, tracking progress and ensuring compliance, taking delivery, inspecting and inventorying the deliverable, and paying the supplier.*

- “Procurement” is most often used within governmental organizations. More specific terms are "purchasing" and "acquisition".

# Procurement in Context

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## The MoE and Procurement

- Iraq Ministries will enter into significant procurement contracts:
  - Especially the MoE, as purchaser
  - Construction and rehabilitation of works
  - Purchase of plant, materials, services
- International vendors familiar with international legal standard contracts
- Engineers, finance dept, environmental experts, consultant, senior personnel
- Legal Aspects: negotiating and writing contracts, identifying and allocating risks, advising on important clauses, project management, advising on and assisting in resolution of disputes – important team member working alongside

# Procurement in Context

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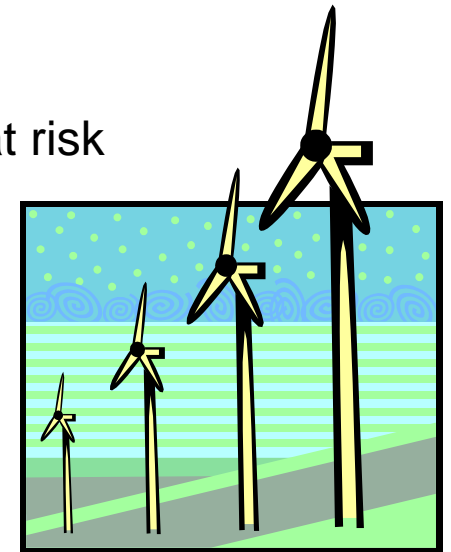
## Donor Funded and Privately Financed (or Partly-financed) Projects

- Will be a mix of these
- Initially, likely to be donor funding however:
  - MoE responsible for carrying out the project, including award of contracts
  - Loan agreements (whether development, credit, grant or financing) will govern rights and obligations of the MoE and the provider of the loan or credit
  - Procurement/tender contracts will govern rights of MoE and vendors
- But the Loan Agreement will stipulate the form of these contracts and method of contracting:
  - Iraqi lawyers, procurement advisors and project managers need to understand procurement method and legal issues/terms involved

# Procurement in Context

## Donor Funded and Privately Financed (or Partly-financed) Projects (cont.)

- Private participation in infrastructure contracts will mean greater complexity – because all parties share the risks of the project:
  - Many different parties with competing interests
  - Many contracts – complex matrix
  - Each party depends on performance of all parties
  - Each risk must be identified and its impact assessed, and that risk assigned to the party that can most effectively control it
  - Therefore, much negotiation and drafting





# Effective Negotiations

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***“Avoid ineffective conflicts”***

**Requires that you**

- Think strategically and act tactically; and
- Act professionally; and
- Be diplomatic and flexible

**Basic Rules**

**Group Discussion**

# Group Discussion

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## Experience of negotiations

- Non-lawyers/lawyers
- Experience working with lawyers – MoE/private?
- Main or common legal issues
- How improve?
- What can we do to help – training?



# Effective Negotiations

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## Basic Rules – 1. Make the Subject Matter Clear

- Prepare your materials in advance – be, and appear to be, professional
- Define the purpose and key terms of negotiation – structure the subject matter
- Know what you want and what they want – communication is important:
  - Ask questions, understand the other side and ensure they understand you
  - Summarise and agree what’s been discussed at points during the meeting
- Distinguish between people and substantive issues:
  - Understand perspective of other side’s personnel. Finance? Engineering? Legal? Management?
  - Be flexible – adapt style/approach if it helps the situation
  - Don’t be afraid to ask/seek explanation if you need to
  - Become the teacher if other side inexperienced

# Effective Negotiations

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## Basic Rules – 2. Understand Different Phases Negotiations go Through - Generally 4 Phases:

- Opening/non task-sounding
- Exploration/task-related exchange of information
- Bidding/negotiating/concessions
- Settlement/non-settlement

## Basic Rules – 3. Control the Development of Negotiations

- Use agenda and timetables – focuses attention
- Take breaks; don't be bullied into all night negotiations – not effective
- If aware of a strategy being used (“good guy/bad guy” routine) – tell them

# Effective Negotiations

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## Basic Rules – 3. Control the Development of Negotiations (cont.)

- Widen the areas of negotiation – avoid getting stuck on single issues:
  - Add areas where you can give something; or
  - You sense you can gain something from them
- Choose the right time to say “No” – if 5 issues and one is critical to you, agree on the 4 first
- Be consistent:
  - In disclosing information
  - In arguments
  - Otherwise you will not gain trust and respect of other side

# Effective Negotiations

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## Basic Rules – 4. Positive Tactics

- Breaks or recesses – chance for internal discussions
- Delegation of subject matter upwards – negotiation on a higher level
  - But caution: limit the times you do this
- Third party's assistance as negotiator or arbitrator/mediator:
  - Provides neutral, fresh approach to tough situation
  - Can provide new momentum
  - Can perform a face-saving function

# Effective Negotiations

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## Basic Rules – 5. Negative Tactics

- Tricks and fairness
- What is my BATNA (Best Alternative To a Negotiated Agreement)?
  - Would my interests be better served by dealing with other parties or focusing on other possible outcomes?
- How should I react if the other party with whom I have to negotiate threatens me or my company? What kinds of threats might they raise?
  - If you think about these issues before negotiation starts, you will be far better prepared for whatever they might throw at you

# Effective Negotiations

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## Basic Rules – 5. Negative Tactics (cont.)

- What if their offer or proposal is seriously off the mark or inappropriate?
  - Don't explode; play it with a poker face, stay silent
- Keep asking yourself, "What is the point of this interchange?" Why is the party with whom you're negotiating saying or doing something particular?
- Never – ever – say something contrary to your interest
- Bullies are afraid of failure – tell them, "I'm afraid we may fail to reach agreement"



# International Negotiations

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## National Characteristics Play Important Part in International Arena

- Give consideration to this fact and adapt style accordingly
- But do not become subservient to counterpart's foreign culture
- But understand and respect their culture
- While keeping your own courtesies

## Negotiating with People from the USA

- Do not consider an impersonal – “time is money” – approach as impolite
- Or an informal approach to be sheer friendliness – rather, their usual way
- Will be:
  - Technically well-prepared; and
  - Will look for pragmatic solutions

# International Negotiations

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## Negotiating with People from the USA (cont.)

- Professionalism very important to Americans:
  - Thorough preparation
  - Well-structured agenda
  - Leading negotiations in pragmatic, serious way
- Achieving results more important than building a good or long lasting relationships
- Once contract concluded, US partner will regard it as binding and lasting
- Avoid making US partner lose face

# International Negotiations

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## Negotiating with People from the UK and Western Europe

- Climate and personal relationship less important than achieving the result
- Serious attitude and professionalism and preparation very similar to the US
- Also avoid making partner lose face

## For both US and UK, Western Europe Negotiations, Consider

- The organization you are dealing with
- The specific industry or service-sector of your partner
- Their competence
- Their personality (their needs and constraints)

# International Negotiations

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## Negotiating with People from Japan

- Japanese believe negotiations require much time and planning – reserve extra time
- Climate is important – relationships and long-term considerations as important as the results
- Preparation is meticulous – will want details of every area
- Japanese refrain from saying “No”. Will either:
  - Circumscribe; or
  - Answer in both the affirmative and negative
- If circumstances change, will feel free to renegotiate and change the agreement (or part of it)
- Avoid making your partner lose face

# International Negotiations

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## How Negotiations in Arab World are Perceived

- Very hospitable and favourably disposed towards their partners
- Climate of and communications during negotiations very important – decisions often based on personal impressions supplemented by facts
- Sometimes not available because of observance of religious and cultural customs
  - Very important to respect them
- Reserve extra time
- Dealings are sociable and enjoyable
- Difficulties in saying “No” – anxious to avoid loss of face on either side
- Oral agreement signals commitment, but if circumstances change, will believe renegotiation or modification is necessary

# International Negotiations

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## My Personal Perceptions of Iraq

- Very hospitable and favourably disposed – welcoming of their partners
  - Dealings are pleasant and sociable
- Personal relationships very important – signs of bad faith, impatience or disrespect reflect badly on the foreigner, are not easily dismissed or forgiven
- But there can be many interruptions or delays – other business conducted at same time
- Extremely modest about their own present difficulties and personal dangers faced
  - Very brave people who do not complain
- Observance of holidays can be difficult for foreigner:
  - We may not be aware of them
  - Sometimes on short notice

# International Negotiations

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## My Personal Perceptions of Iraq (cont.)

- Strict hierarchy of authority that is sometimes not made clear – leads to difficulties in
  - Decisions being made: restrictions on authority and/or delays in what we may believe are administrative decisions
  - Objectives or circumstances being changed by senior figures not involved in meetings
  - Difficulties in saying “No”; while we are able to with ease, perhaps too easily
  - Information being shared
- Extra time usually needed
- Training is often needed, but Iraqis are very quick to learn

# International Negotiations

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## Major Mistakes in International Negotiations

- Not enough understanding/knowledge of differences in:
  - Ways of thinking
  - Origins, history, culture
  - Government and political processes
  - Status of individuals and customs of business
- Insufficient attention to the need to save face – the need to:
  - Keep cool under pressure; and
  - Refrain from showing anger, losing composure or even showing disrespect



# International Negotiations

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## Major Mistakes in International Negotiations (cont.)

- Insufficient recognition of decision-making process
  - Includes lack of attention to internal communications and procedures
- Insufficient understanding of the role of personal relations and personalities
- Not allocating sufficient time for negotiations
  - Allow time for getting to know other side, sharing experiences and accepting hospitality;
  - Plan for delays you may expect to happen
- Lack of experience with, or thought given to, using interpreter

# International Negotiations

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## Suggestions in Using Interpreter

- Brief the interpreter ahead of time
- Speak loudly, clearly and – above all – slowly
- Avoid slang or little known phrases
- Explain major concepts in several different ways
- Exercise patience and allow note taking – allow time to clarify
- Think about possible areas of misunderstanding
- Be pleasant and have frequent breaks

# Project Management



## Why Projects Succeed

- Organization structure suited to the project and team
- Team participates in forward planning and acts as team
- Project manager committed to established schedules and budgets
- Project manager committed to performance goals
- Absence of bureaucracy
- Clearly established success criteria
- Effective status and progress reporting



# Project Management

## Why Projects Fail

- Project manager has inadequate or insufficient authority
- Lack of project planning – generally or as a team
- Insufficient involvement of project team in problem solving
- Improper structuring and use of status and progress reports
  - Or ineffective reports generated
- Lack of:
  - Management skills
  - Technical skills
  - Administrative skills
- Unrealistic project goals and/or schedules



# Project Management

## Teamwork – Some Suggestions

- Limit the number of participants
- Appoint one member to control time and procedures
- Define precisely each individual member's role
  - Engineering and/or technical
  - Finance
  - Legal
  - Administrative
- Support your team and present united picture
  - Body language, gestures during negotiations



# Power Projects – Introduction to Structured Finance



## Power plant, transmission, distribution asset construction and rehabilitation

Or water, oil and gas facilities

*Traditional Approach* Government (MoE) would assume all risks of the plant itself, ie. contract with construction company to build, but



Would itself maintain and operate the facility

Purchase or supply fuel without a facility-specific contract

Receive output and deliver or sell energy/capacity without specific off-take (power purchase) contracts

# Power Projects – Introduction to Structured Finance



## *Traditional Approach*

With traditional approach

MoE finances the plant and therefore ...

**TAKES ALL THE RISKS**



# Power Projects – Introduction to Structured Finance



## All Projects Face Risks. What if:

Demand for power suddenly drops, because a major industry fails or economic conditions worsen?

Fuel source suddenly ceases to be available in sufficient quantities, or supply quantity or delivery failure?

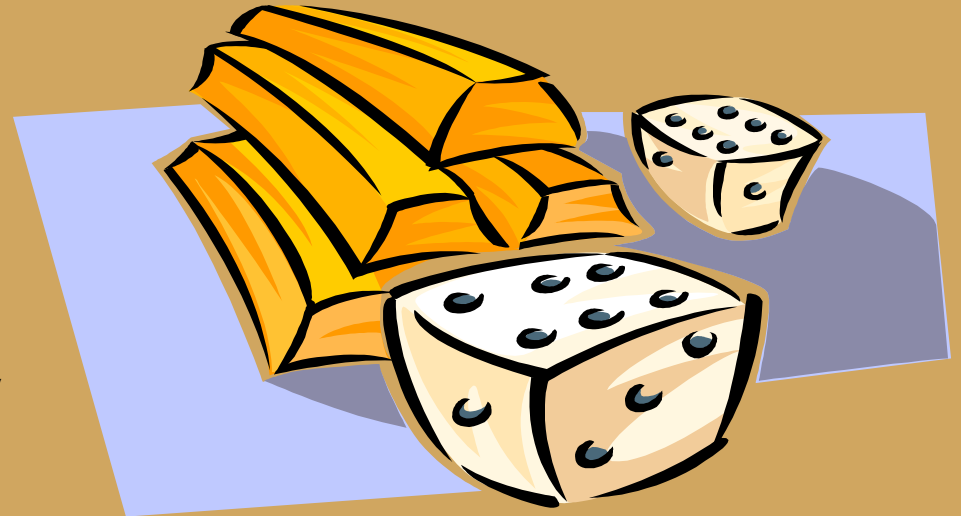
The price of fuel is increased?

Transmission lines fail? Local distribution company has a network failure?

Turbines do not perform to specification, because of inherent design fault or operator does not perform routine or major maintenance?

Major catastrophe occurs, either natural disaster or insurgent activity?

Regulatory environment changes, eg. new law regarding emissions, repatriation of taxes





# Power Projects – Introduction to Structured Finance



## With the *Traditional Approach* to Infrastructure Projects

All or most of these risks affecting the project's performance lie with the government

With a design and build contract, government contracts to place risk of plant and turbine failure with the construction contractor

Governments and utilities around the world decided not to accept these risks – prefer to have major investments “off balance sheet”

**Governments and utilities now employ a very different approach from that traditionally adopted – grant of “concession” to private company to build public sector project**

# Power Projects – Introduction to Structured Finance



## Government “Concession”:

- Private company will use a project company to obtain finance
- Project company will
  - Contract for – procure – the design and construction of the works
  - Purchase fuel
  - Contract for sale and delivery of the output
  - Operate the facility during the concession period

## Forms of Project or Structured Finance now Common

Situation in Iraq? These Forms not yet Possible. Will be

# Power Projects – Introduction to Structured Finance



## Where Donor Funding is Available – as in Iraq – more Likely that

- Government will own the project company
- And contract with construction company to design and build
- And enter other contracts (or project company will)
- Loan agreement with donor will stipulate the forms of these contracts and method of contracting, such as FIDIC (or UNCITRAL or ICE)

## Look at Three Areas

- Government as owner
- Performance and security bonds
- Construction contracts



# Power Projects – Introduction to Structured Finance



## Structured Finance Approach - BOO, BOT and BOOT transactions

### Some brief comments:

- Financiers provide the funding but look to the project earnings for loan repayments, not the sponsors (or the utility)
- Credit assessment based on the project, not creditworthiness of borrower
- Security is taken by financiers over project assets – limited or no “recourse” against borrower

### Mean the Banks take on the Project Risks



# Power Projects – Introduction to Structured Finance



## **Banks must be Completely Satisfied with all Aspects of the Project**

- Secure, firm obligations to provide long term fuel supply
- Construction standards, turbine performance covered by warranties
- Capabilities and standards of performance of O&M contractor
- Secure, long term, firm off-take agreement – ie. purchaser of output accepts market risk itself (ability to sell power at sufficient price)
- Secure, long term delivery contracts (transmission, distribution)

**So, Extra Discipline must be Exercised in Concluding Contracts – much more Complex**

**Lead Time can be Lengthy; Significant Up-front Costs**



# Power Projects – Introduction to Structured Finance



## All Parties Share Risks of Project, not just the MoE or Project Company, Sponsor or JV.

- Requires that complex issues be resolved:
  - Many parties involved
  - Correspondingly significant number of interlocking contracts
  - Each party depends on performance of all parties, not just its counterpart
- Each risk must be identified – what are the risks?
- Likelihood of each risk occurring must be assessed – how likely?
- The impact on the project of the risk occurring determined – what impact?
- For each risk to be assumed (or layed off, eg. through insurance) by the party that can most effectively control it – which party takes the risk?

# Power Projects – Introduction to Structured Finance



## Each Party must then be Satisfied with:

- The risk allocation
- The creditworthiness of the risk assumer; and
- The reward flowing to the risk assumer

# Government as Owner – Legal Issues

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## Government Corporation, Agency or Company

- Ministry of Electricity, through a project company, or government corporation will:
  - Initiate the project
  - Conduct the tendering process and evaluation of tenderers; or where PSP
  - Grant to the sponsor the "concession" – right to build, own and operate the facility
- Government agency or company therefore must have powers to:
  - Enter contracts with other parties for the performance of the MoE's functions – construction and operation of the project
  - Make payments under the contracts – purchase output or "service" that will be provided by the facility
  - Grant long term lease of, or sell, the site to sponsor
  - Provide necessary approvals, authorizations and consents for construction



# Government as Owner – Legal Issues

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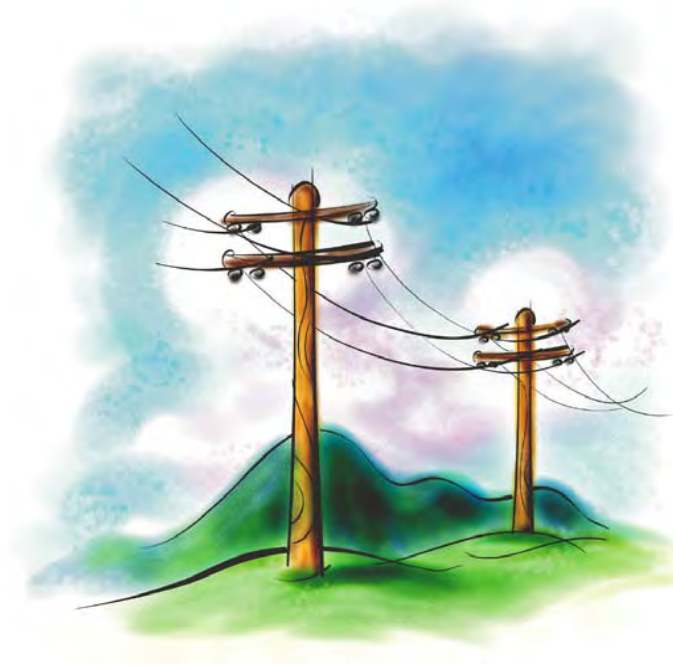
## Legislation and Regulations must be Scrutinised

- Does the corporation or agency have the necessary powers under its constituting laws to enter contracts and perform other obligations?
- If not, actions will be ultra vires (beyond authority)
- Guarantees and Comfort
  - Where a corporation or agency enters into project contracts, government's assistance to the project may also be required in form of undertakings or guarantees
  - Assurance that project company will be in a position to honour its financial and other obligations

# Government as Owner – Legal Issues

## Government Risk Guarantees

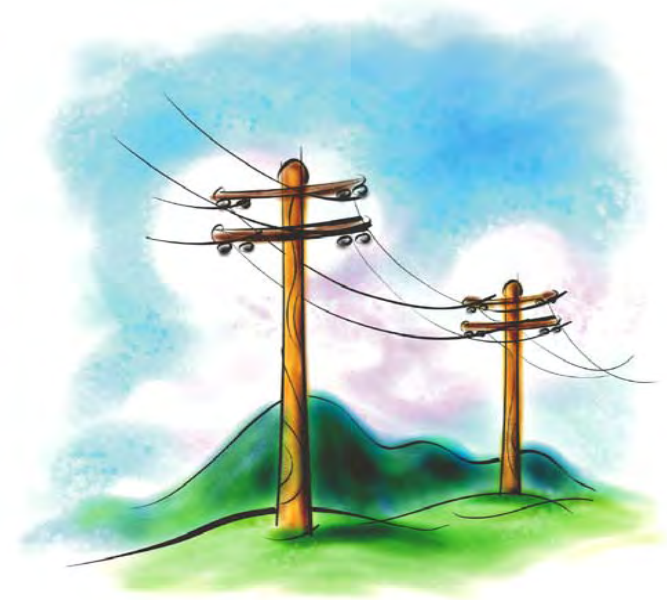
- Donors such as World Bank Group may require guarantee from Iraqi Government
- Mainly apply where utilities are privatised – regulatory certainty, especially regarding tariffs where independent regulator established
  - Provide comfort – certainty – regarding the legislative/regulatory framework where loans are made
  - Helps promote private investment
- Tariff changes that result in loss
- Independence v. attraction of private capital



# Government as Owner – Legal Issues

## Government Risk Guarantees

- Risk insurers such as Ex-Im Bank and OPIC may seek guarantees from the Government where private investment in generation occurs; similar to insurance
- Eg. private financier loses money as result of changes in government or regulatory environment:
  - Political risk insurance: loss of assets
  - Changes in law: tax; environmental compliance; subsidy changes; employment laws
  - Promised changes do not occur
- OPIC's mission: to mobilize and facilitate the participation of United States private capital and skills in the economic and social development of less developed countries and areas, and countries in transition from non-market to market economies



# Bonds and Security

## Purpose of System of Bonds and Guarantees

- Construction contractor required by the owner (ie. the MoE) to obtain from a bank or insurance company (called the “issuer”)
- Will be requirement of financing MoE has with donor agencies
- System devised to protect owner where contractor breaches contract and refuses to or cannot (because of insolvency) pay
- Even if the breach is dealt with in the construction contract

## Types of Bonds

- Bid bond, advance payment bond and various types of performance bond (default bond and on demand bonds)



# Bonds and Security

## Bid Bonds

- Learnt about this in previous days – purpose is to protect the MoE from risk that successful tenderer withdraws or refuses to enter into the contract
- Because MoE would need to re-tender the project, the costs would be large, especially with a power station project (new pre-qualification process, evaluation of tenders from different bidders and new negotiations)
- Bond provides payment direct from the bank or insurance company to meet these costs
- Bond is obtained by tenderer as part of bidding process and remains in force until contract is signed



# Bonds and Security

## Advance Payment Bonds

- Secures any advance payment required to be made by MoE to contractor before work has begun (ie. “upfront”)
- Contractor incurs large costs mobilising for the project, yet is not entitled to progress payments
- Can be significant – up to 10% or 15% of total price – and so represents great risk for MoE: large payment, yet no work received in return
- If contractor becomes insolvent, advance payment would be lost
- Solution? Obligation in contract on MoE to make advance payment conditional on contractor getting advance bond from bank
- Bond amount gradually reduces as work proceeds on site and MoE receives value



# Bonds and Security

## Performance Bonds

- Most important bond – protects MoE from losses suffered through breaches of contract by the contractor
- Will cover losses up to a stated amount – negotiable, but often up to 10% of contract price
- May be reduced at the end of construction, during warranty period or replaced by Warranty Bond
- Three main types of performance bond:
  - Default Bonds
  - “Pure” On Demand Bonds
  - On Demand with Certificate Bonds





# Bonds and Security

## Default Bonds (or Surety Bonds)

- Protection provided by these is not as secure for MoE – because in claiming, it must show sufficient proof of contractor’s breach and loss suffered by the MoE
- Also, bank (or insurance company) can use any defenses available to the contractor:
  - Right of set-off against amounts owed by MoE
  - Right to carry out work itself instead of payment
- Exact arrangement depends on negotiations and bargaining power of each party
- “Pure” On Demand Bond and On Demand with Certificate Bond offer better security
- Standby Letter of Credit, in US





# Bonds and Security

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## “Pure” On Demand Bonds

- Requires the bank to pay simply on receiving a demand from the MoE
  - No proof of loss or breach of contract required (but a demand made without justification would likely be a breach of the construction contract)
- Contractors will resist very strongly – rarely used

## On Demand with Certificate Bond

- On Demand Bond with a signed certificate from the MoE that confirms the contractor’s default
- In between “Pure” On Demand and Default Bonds, and so much more common – but contractors will resist very strongly
- Difficulty means contractor perceives increased risk, and so prices tender higher



# Bonds and Security

## Conclusions

- Well drafted construction contract will deal with all rights and obligations and correctly allocate responsibilities between MoE and contractor
- But consider:
  - What if contractor becomes insolvent?
  - Cost and effort (and difficulties) of conducting litigation, or arbitration?
- Bonds are only means of providing security for owner



# Construction Contracts

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## Turnkey Design and Build and EPC Contracts

- Favoured forms of contract –
  - Turnkey design and construct fixed price contract: contractor designs and builds and provides all work, materials and services necessary to operate; facility is free from defects for certain period
  - Engineering procurement and construction contract: contractor responsible for overall design, engineering, supply, installation (including owner’s requirements) and testing; completion time is fixed; price fixed (effect on tariff)
- FIDIC Silver Book, new 1999 – allocation of risks dealt with more specifically; developed for BOT and BOOT projects involving private finance; two party approach does away with independent engineer
- For power projects involving international companies “bespoke” agreement may still be necessary rather than FIDIC or other standard forms

# Construction Contracts

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## Fundamental Legal Issues to Negotiate

- Performance standards: guarantees must be provided (output; heat rate), requiring extensive testing regime, together with liquidated damages
- Payment and bonds/security; adjustments to price
- Completion on time, adjustments
- Allocation of risks, eg. force majeure
- Control of sub-contracting
- Warranties – extent and period
- Limitations of liability

# Construction Contracts

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## Underperformance

- Failure to deliver, in accordance with the construction contract, a power generating plant that:
  - Produces the specified (contracted) output; or
  - Is available to the contracted extent
- Position is different depending on type of transaction:
  - Traditional construction contract – contractor simply pays damages to owner/sponsor to compensate for level of underperformance
  - BOT structure – many different and significant consequences:
    - Government relying on plant to meet country’s electricity demand (structured its capital expenditure program on successful completion); any relief under off-take contract will not compensate;
    - Financiers’ security is diminished;
    - O&M contractor has to operate and maintain under-performing plant for long period; return is diminished

# Construction Contracts

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## Underperformance (cont.)

- Loss may be too large for contractor to bear – so may end up with the government or financiers (assuming sponsor has limited resources)
- What if underperformance is the fault of sponsor? Eg. fuel supplied to plant is below specification – contractor not responsible
  - Fuel supplier is liable (it will have accepted that risk)
  - Owner (sponsor) must back-to-back its obligations under construction contract with its remedies under fuel supply contract and off-take agreement

# Dispute Resolution

## International Arbitration

- Likely that international investors and donors will demand international arbitration of contract disputes
- Private international business dispute resolution through arbitration a very important practical development since WWII
- Advantages:
  - Confidential
  - Qualified arbitrators
  - Quicker, less adversarial and less expensive than court proceedings
  - More likely to be recognised and enforced in Iraq than foreign judgment
- Legal issue for Iraq: enforcement of arbitration decisions



# Dispute Resolution

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## International Arbitration (cont.)

- Arbitration much further developed than conciliation – much more significant body of rules
- Main arbitration proceedings and venues:
  - ICC (International Chamber of Commerce) headquartered in Paris – ICC International Court of Arbitration founded in 1923
  - London Court of International Arbitration, founded in the City in 1891
  - American Arbitration Association, operating since 1930
  - Arbitration Centre of the Official Franco-German Chamber of Commerce and Industry
  - Court of Arbitration of the Zurich Chamber of Commerce
  - UNCITRAL Arbitration Rules (United Nations Commission on International Trade Law), established in 1966 – in respect of international trade disputes