Damages for damages: If a state court imposes damages on a party in violation of an arbitration agreement, can an arbitral tribunal award damages negating those court-imposed damages?

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An arbitral tribunal's relationship to state courts remains a complex and often contested topic. A particularly interesting question in this regard is whether a party to arbitral proceedings should be able to seek recovery of damages it was ordered to pay in state court proceedings initiated in breach of the arbitration agreement. Many arbitrators would initially be wary of such a request. But on closer examination, awarding "damages for damages" can be fully appropriate in a number of cases.

Take a situation in which a party (Party A) initiates state court proceedings against another party (Party B) in regard to a dispute between the two. This dispute is governed by a contract that contains an arbitration agreement with typical wording. Overlooking the arbitration agreement, the state court asserts jurisdiction and issues a judgment ordering Party B to pay damages to Party A. To recover these funds, Party B files a request for arbitration, alleging that Party A's initiation of state court proceedings breached the arbitration agreement. Party B not only seeks damages for the costs it incurred in defending its interests, but also for the damages it was ordered to pay.

In a decision released on 30 September 2013, the Supreme Court of Switzerland confirmed the validity of an award that provided for damages of the kind described above.[fn]Decision 4A_232/2013 (30 September 2013).[/fn] Mathias Scherer has already commented on the decision in his post of 21 February 2014.[fn]See http://kluwerarbitrationblog.com/blog/2014/02/21/damages-as-a-sanction-for-commencing-court-proceedings-in-breach-of-an-arbitration-agreement/.[/fn] Briefly, a UK company initiated arbitral proceedings and, among other things, successfully requested damages equal in value to any potential amount it would be ordered to pay to a Greek company in the context of Greek court proceedings that the latter had initiated. The fact that the harm had yet to be incurred and that the court proceedings were still pending is a complicating factor that goes beyond the hypothetical provided above (and appears to be quite problematic). We wish to focus here on the award of damages for (anticipated)

damages. Unfortunately, the Supreme Court's decision provides little insight into when damages for damages may or may not be appropriate. Nor is the issue often discussed in the literature on arbitration.

At first glance, there is little to stop an arbitral tribunal from awarding damages for damages. It is widely accepted that a claim for damages arising from the breach of an arbitration agreement falls within the scope of that very arbitration agreement. Usually, the claim made on the basis of such a breach is limited to legal and other costs incurred by the defending party in state court proceedings. The *lex arbitri* in most countries appears to allow for such damages. In Switzerland, the issue was most recently addressed in a 2009 decision of the Supreme Court.[fn]Decision of the Swiss Supreme Court 4A_444/2009 (11 February 2010).[/fn] The English High Court recently did the same in the latest *West Tankers* decision.[fn]{2012} EWHC 854 (Comm). See also Kluwer Blog Post by Manuela Caccialanza (http://kluwerarbitrationblog.com/blog/2014/05/27/damages-for-breach-of-the-obligation-to-arbitrate-a-step-forward-of-national-courts-in-favour-of-arbitration/). [/fn]

In our view, damages for damages should be treated identically. In our hypothetical, the unjustified imposition of damages is a harm directly caused by Party A's breach of the arbitration agreement. In that regard, Party B's request is a typical claim for such breach. Some may counter by alleging that causation can only be established where Party B is able to demonstrate that it would not have been required to pay such damages had Party A initiated arbitral (and not court) proceedings. But in our view, assumptions about the outcome of proceedings that might otherwise have been initiated by Party A are too far removed from the chain of causation to justify consideration. The approach we advocate is also more practical and arbitration-friendly. Ultimately, Party A should be required to make its case before the correct forum (and it may do so by way of counterclaims in the arbitration initiated by Party B).

There exists, however, a more fundamental unease amongst many arbitration practitioners about awarding damages for damages. It lies in the fact that such damages would in effect overturn, or negate, the judgment of a state court. This raises sensitive issues of *res judicata* and corresponding fears about intruding on jurisdictional realms asserted by state courts. We will address these concerns from a Swiss law perspective, though we note that many other jurisdictions would arrive at similar conclusions.

A helpful starting point here is the principle of Kompetenz-Kompetenz, which looms large within the *lex arbitri* of practically every member state of the New York Convention. In Switzerland, Chapter 12 of the Private International Law Act (PILA) was even amended in 2006 to make it absolutely clear that an arbitral tribunal may decide on its jurisdiction "*notwithstanding an action on the same matter between the same parties already pending before a state court or another arbitral tribunal, unless there are serious reasons to stay the proceedings*". [fn]Article 186(1bis) PILA.[/fn] The provision, however, is not intended to shield arbitral tribunals from the *res judicata* effect of a state court judgment. And there is case law from 2004 clearly establishing that a decision by a Swiss court to accept jurisdiction has *res judicata* effect on any arbitral tribunal seated within Switzerland. The Supreme Court argued that this rule was simply a manifestation of the power held by Swiss courts (more specifically, the Supreme Court) to decide on the jurisdiction of an arbitral tribunal seated in Switzerland in the context of proceedings to set aside an award.

But what about judgments by courts other than those of the jurisdiction in which the arbitral seat is situated? Several important aspects of private international law come into play. If an arbitral tribunal must accept the *res judicata* effect of a judgment issued by a court in the jurisdiction of the seat of arbitration, then it must also do the same for foreign judgments that would be formally *recognized* by a court at the seat of the arbitration. In Switzerland, it is helpful to distinguish here between two

categories of foreign judgments. The first arises from jurisdictions to which standard principles of private international law apply. [fn]Specifically, those contained in Articles 25-27 PILA.[/fn] An accepted ground for a Swiss court to refuse recognition of a foreign judgment is the existence of a valid arbitration agreement between the relevant parties that would cover the dispute. [fn]See Decision of the Swiss Supreme Court 124 II 83 E. 5b.[/fn] And while there remains some uncertainty about which criteria should be applied, several commentators argue that the validity of the arbitration agreement should be considered pursuant to Swiss law alone.[fn]Berger & Kellerhals, International and Domestic Arbitration in Switzerland, 2nd ed., 2010, at para. 1512c; Manuel Liatowitsch, Schweizer Schiedsgerichte und Parallelverfahren vor Staatsgerichten im In- und Ausland , 2002). This approach would make sense, as it would be fully in line with that taken by Swiss courts to determine whether any foreign judgment should be recognized in Switzerland. This would be done in accordance with a Swiss understanding of court jurisdiction. [/fn] This would effectively shield an arbitral tribunal's award from the effects of a foreign judgment, and nothing would then stand in the way of awarding "damages for damages".

A more problematic category consists of judgments from a jurisdiction within the realm of the Lugano Convention. As a member state, Switzerland is required to recognize foreign judgments from other member states and generally cannot deny recognition simply on account of a valid arbitration agreement between the parties. [fn]See Articles 33-37 of the Lugano Convention. [/fn] Accordingly, arbitral tribunals would also be required to respect the *res judicata* effect of these decisions or risk violating Swiss public policy. Interestingly, though, the most recent *West Tankers* decision appears to suggest that the approach taken in England in these circumstances might well be different.

It should also be kept in mind that a state court judgment, even if not recognized at the seat of the arbitration, can nonetheless affect an arbitral award, as it would inevitably lead to the award's unenforceability within the jurisdiction of the relevant state court. But as already explored in a previous post, [fn]See http://kluwerarbitrationblog.com/blog/2013/01/28/the-lazy-myth-of-the-arbitral-tribunals-duty-to-render-an-enforceable-award/. [/fn] and as the Swiss Supreme Court confirmed recently, [fn]Decision of the Swiss Supreme Court 4A_654/2011 (23 May 2012); Decision of the Swiss Supreme Court 4A_388/2012 (18 March 2013). [/fn] the potential unenforceability of any resulting award should not generally detract an arbitral tribunal from its mission of issuing that award and resolving the dispute that has been brought before it.

In the event an arbitral tribunal finds itself in a situation that does allow for damages for damages, it should be mindful of certain issues in considering Party B's plea. The first relates to whether Party B would be required to contest the jurisdiction of the state court during the state court proceedings. The arbitral tribunal is very likely to perceive any failure to do so as an implicit waiver of the arbitration agreement and acceptance of the state court's jurisdiction. Individuals and entities that find themselves in Party B's situation should, therefore, formally record their objections as early as possible during the state court proceedings. Another potential issue is one of causation: what efforts should Party B make to mitigate those damages it has been ordered to pay? Would it be appropriate for an arbitral tribunal to require, for example, that Party B exhaust all state court appeals before being entitled to seek the value of those damages in arbitral proceedings?

While several issues still require further exploration, damages for damages can in a number of circumstances be a wholly appropriate form of redress at arbitrators' disposal. It may even have a helpful deterring effect on parties willing to initiate state court proceedings in violation of an arbitration agreement. International arbitration, then, has something to gain from a broader acknowledgment amongst arbitrators, counsel and parties of the legitimacy of damages for damages.