Kluwer Arbitration Blog

Failing to pay the advance on costs and the risk of inoperability of the arbitration clause – Remedy?

Cederic Veryser (Lexlitis) and Dirk De Meulemeester (DMDB Law) · Thursday, July 31st, 2014

The advance on costs at the outset of the arbitration ensures that arbitrators are covered for the fees and expenses made upon rendering their final award. It is common practice both in institutional and *ad hoc* arbitration that the procedure will only continue – or even start – upon payment in full of the advance on costs. It is also common practice that upon indentifying the advance on costs, both sides are invited to pay half of the advance. And finally, it is becoming more and more common that a party – predominantly respondents – fail to meet this requirement as part of – in most cases – a dilatory tactic.

When a party fails to make payment of the advance, the other party is requested to fulfil this obligation. If that party refuses to do so, the arbitration will not proceed or will be suspended or – under certain arbitration rules – the claim will be considered withdrawn.

There have been several cases whereby a claimant, upon being confronted with a respondent unwilling to pay its share of the advance, considers the arbitration agreement inoperable, abandons the arbitration and reverts to the state court to rule on the merits. In some of those cases the respondent then raises the *exceptio arbitri*, stating that the state court has no jurisdiction because there is a valid arbitration agreement. The result is then that the claimant has no other choice than to further pursue the arbitration – or relaunch it – by *i.a.* paying the advance on costs in full. In other instances, a state court has held that the arbitration agreement did become inoperable. The latter is rather worrying and would mean that arbitration practice would not have a sufficient answer to these sort of dilatory tactics.

In a 26 February 2014 judgement of the English Queen's Bench Division, Commercial Court, the Hon. Mr. Justice Hamblen decided that – based on the facts before him – an arbitration agreement had not become inoperable, giving an interesting overview of the existing doctrine and case law. The case is known as BDMS LIMITED *v* RAFAEL ADVANCED DEFENCE SYSTEMS [2014] EWHC 451 (Comm).

The dispute in BDMS *v* RAFAEL concerned sums allegedly due to BDMS by RAFAEL under a consultancy agreement. The agreement contained an arbitration clause which specified that the arbitration would take place under the 1998 ICC-Rules and would have its seat in London. After filing the request for arbitration on 28 April 2011, the ICC fixed the advance on costs at $27,000 and invited both parties to pay half of the advance on costs (Article 30(3) 1998 ICC-Rules). A similar provision can be found in many – if not all – arbitration rules of established arbitration

institutions.

BDMS paid its part of the advance, RAFAEL however was only willing to pay its part of the advance if BDMS would provide an adequate security for costs, a demand BDMS was not willing to meet. Equally, BDMS was not willing to pay the other half of the advance on costs. Subsequently, the ICC had no other choice than to invite the arbitrator to suspend his work and to inform the parties that the claim would be considered withdrawn. On 13 March 2012 – almost one year after the request for arbitration – the ICC informed the parties that the claim was withdrawn by operation of Article 30(4) 1998 ICC-Rules.

In the meanwhile, on 7 February 2012, BDMS had already issued its Claim Form and Particulars of Claim before the High Court. Following that, RAFAEL filed an Application stating that the court had no jurisdiction. Article 9(4), juncto 9(1) of the 1996 Arbitration Act states that the state court shall grant a stay of proceedings when a claim – governed by an arbitration agreement – is brought in front of it, unless the arbitration agreement is null and void, inoperative, or incapable of being performed.

Subsequently, BDMS submitted that the failure of RAFAEL to pay its part of the advance was a repudiatory breach of the arbitration agreement, *i.e.* a breach that the law regards as sufficiently serious to justify termination as it goes to the root of the contract, thus allowing BDMS to pursue its claim before the state court and disregard the arbitration clause altogether.

The Hon. Mr. Justice Hamblen rightly stated that there are different views on whether the requirement to pay an advance on costs is a contractual obligation or a procedural obligation, relying on *Derains and Schwartz* (A Guide to the ICC Rules of Arbitration) and *Buhler and Webster* (Handbook of ICC Arbitration).

The contractual approach holds that since the arbitration agreement refers to *in casu* the ICC-Rules, these rules become part of the agreement and thus the payment of the advance on costs is a contractual obligation. Any dispute with regard to that obligation falls within the scope of the arbitration agreement and can be resolved by way of an award.

The procedural approach holds that the arbitration institution is responsible for *i.a.* the advance on costs and that the arbitral tribunal is only competent to decide which party shall bear the costs of the arbitration. Thus an order to pay the advance could only be made by way of an interim measure.

The court took a so-called contractual approach to the question on whether or not the failure to pay the advance on costs involves a breach of the arbitration agreement, as this contractual approach is supported by most arbitral and court decisions, as well as most commentators. It was expressly agreed upon that the arbitration agreement shall take place under the ICC-Rules. Article 30(3) 1998 ICC-Rules prescribes the obligation to pay the advance on costs by each party, which RAFAEL failed to do so. Consequently, the court decided that this failure did indeed involve a breach of the arbitration agreement.

However, in its judgment, the court was not of the opinion that this breach was to be considered repudiatory because the refusal of RAFAEL to pay its share of the advance was not absolute (it was a refusal unless security for costs was provided). Furthermore, the breach did not deprive BDMS's right to arbitrate since it could have paid the advance on costs itself in order to avoid the claim being withdrawn and could subsequently have sought an interim award or interim measure in

order to oblige RAFAEL to (re)pay its part of the advance. Finally, BDMS could bring the same claim to arbitration again.

It is hard to so see how the non-payment of the advance on costs would render an arbitration agreement inoperative. It would lead to a stay of the proceedings or a withdrawal of claim allowing a party to relaunch its claim in a later stage, but the arbitration agreement itself would not become inoperative.

However, in the RESIN case it was held that the refusal to pay did indeed render the arbitration agreement unworkable and thus inoperative because a claimant should not be compelled to post a defaulting party's share of an advance deposit, unless the applicable rules or arbitration agreement clearly require it to do so (see: *Eamon and Holub*).

The approach taken by the Hon. Mr. Justice Hamblen has – to a certain extend – been part of the SCC Arbitration Rules since 2007 and has proven to be successful. Apart from the classic rule that if a party fails to make a required payment, the other party will have the opportunity to do so, Article 45(4) SSC Arbitration Rules adds that; "*If the other party makes the required payment, the Arbitral Tribunal may, at the request of such party, make a separate award for reimbursement of the payment*". In its 2013 Arbitration rules, the Danish Institute of Arbitration adopted a similar rule (Article (6(2)).

Of course, the adding of this sentence is of a rather 'educational nature' since (1) a party can always request the tribunal for a separate award or interim measure (unless excluded *expressis verbis*) and (2) it remains at the discretion of the tribunal to grant such a request or not.

In a very interesting contribution by Gretta Walters on this SCC Practice, it was reported that in the period 2007-2011 in 23 SCC-cases a party requested a separate award for advance on costs, resulting in a staggering 22 awards in favour of the request. In most awards, the reasoning was not very extensive and makes reference to the possibility provided for by Article 45(4) SCC-Rules.

One could state that the SCC approach could avoid a party from abandoning the arbitration and filing with the state court, but the SCC solution is not 100% waterproof. A party could still try to make the case that the arbitration agreement became inoperable, because some jurisdictions will hold that a partial award on advance on costs is not a final resolution of a dispute and therefore not enforceable under the New York Convention. As was the case in a decision of the Supreme Commercial Court of the Russian Federation in 2010 (Resolution No 6547/10 – see the contribution of *Ekaterina Butler*).

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