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Impact of Foreign Bankruptcy Proceedings on Pending Arbitrations in Switzerland: Need for a Change in Swiss Legislation?

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This post suggests revisiting the issue of whether bankruptcy of a foreign company party to arbitration proceedings pending in Switzerland can prevent the arbitration from moving forward and questions whether a specific provision should be introduced in Swiss legislation to specifically address the issue.

The State of Play

As it stands, the issue is not governed by any specific Swiss law provision. It has however been addressed in two decisions rendered by the Swiss Supreme Court ("Supreme Court") in 2009[1)] and more recently in 2012.[2)]
The first is the very controversial *Vivendi v. Elektrim* decision rendered in 2009: the Supreme Court confirmed that the bankruptcy of the respondent Polish company had discontinued the pending arbitration in Geneva. In 2012, the Supreme Court, following a slightly different reasoning than in the *Vivendi v. Elektrim* decision, reached the opposite conclusion: it ruled that the bankruptcy of the respondent Portuguese company did not prevent the launch of an arbitration in Geneva. Although these two decisions have already abundantly been commented on (see for instance Nathalie Voser's recent blogpost), it is necessary to briefly come back on them for the sake of the present analysis.

Vivendi v. Elektrim

The Supreme Court upheld an arbitral tribunal's decision to discontinue the arbitration pending in Geneva after the respondent Polish company Elektrim had been declared bankrupt. The Supreme Court first reaffirmed that Chapter 12 of the Swiss Private International Law Act ("PILA") (which applies to arbitration matters) did not entail any conflict rule regarding the capacity to be a party to an arbitration. General principles had therefore to be applied, and more particularly Article 155(c) PILA which provides that legal capacity of an entity is determined according to the laws of the state where the entity is incorporated. Relying on Article 142 of the Polish Bankruptcy Law ("PBL") which provides as follows: "*any arbitration clause concluded by the bankrupt shall lose its legal effect as at the date bankruptcy is declared and any pending arbitration proceedings shall be discontinued*", the Supreme Court considered that Elektrim had lost capacity to be party to the arbitration and therefore ruled that the arbitral tribunal had rightly discontinued the arbitration.

The decision is particularly brief and was not published in the official collection of reported Swiss Supreme Court decisions, which is an indication that the Supreme Court did not intend to create a precedent. The decision was nevertheless hotly debated and severely criticized.

The summary of the *Vivendi v. Elektrim* would not be complete without in particular mentioning the LCIA arbitration also initiated against Elektrim at the same time. The LCIA tribunal had likewise to determine the impact of Elektrim's bankruptcy on the arbitration pending in London. It however reached the opposite conclusion, holding that the bankruptcy of the Polish company did not prevent the proceedings from moving forward. The LCIA tribunal relied on Article 15 of the Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings ("EC Regulation"), which provides that "*the effects of insolvency proceedings on a lawsuit pending concerning an asset or a right of which the debtor has been divested shall be governed solely by the law of the Member State in which that lawsuit is pending*". The award was confirmed by the High Court and by the Court of Appeal.

Decision 138 III 714 (2012)

This more recent decision calmed down the fears generated by the *Vivendi v. Elektrim* decision. The Supreme Court held that an arbitral tribunal had jurisdiction to resolve a dispute involving a bankrupt party (the Portuguese respondent company in the present instance). It considered that a company's capacity to hold rights and obligations, in other words its legal capacity, was solely decisive to determine a company's capacity to be party to Swiss arbitration proceedings. Other restrictions regarding arbitration proceedings imposed by the law of the state of incorporation of the company were irrelevant. The Supreme Court referred to Article 87 of the Portuguese Insolvency Law ("PLI") which provides that "*(1) Without prejudice to provisions contained in applicable international treaties, the efficacy of arbitral agreements relating to disputes that may potentially affect the value of the insolvency estate and to which the insolvent is party shall be suspended. (2) Procedures that are pending at the moment of the declaration of the insolvency shall continue, without prejudice to the provisions set forth in Article 85(3) and of Article 128(3) if applicable*". It noted that it was not disputed that the Portuguese company still had legal capacity and that Article 87 LPI in any event itself provided that pending proceedings could be pursued (thus implying a continued capacity to be party to proceedings). The Supreme Court therefore came to the conclusion that even if Article 87(1) PLI had to be interpreted as preventing a bankrupt party from being party in arbitrations in Portugal, the fact that the bankrupt company could still be subject of rights and obligations was sufficient to allow it to be party to an arbitration in Switzerland. It went on to indicate that the validity of an arbitral clause had to be analysed under Article 178(2) PILA which establishes the principle of *favor validitatis* ("*Furthermore an arbitration clause is valid if it conforms either to the law chosen by the parties, or the law governing the subject-matter of the dispute, in particular the main contract or to Swiss law*"). As under Swiss law bankruptcy does not have any impact on the validity of an arbitration clause, Article 87 LPI (which was considered as governing the material validity of the arbitration clause) was devoid of any effect on the pending arbitration. The Supreme Court did not have to decide whether arbitrators sitting in Switzerland should take into account foreign mandatory provisions (*lois d'application immédiate*) when ruling on the validity of an arbitration clause. It indeed considered that Article 87(1) PLI in any event lacked the required binding character: it clearly had not been the Portuguese legislator's intent to render the provision mandatorily applicable as Article 87(1) PLI itself reserved the application of international conventions.

The judges who rendered the decision were, except for one, the same who rendered the *Vivendi v.*

Elektrim decision in 2009. The 2012 decision is much more developed, and importantly, has been published in the official collection of reported Swiss Supreme Court decisions. The Supreme Court thus this time clearly intended to create a precedent. By making clear that the *Vivendi v. Elektrim* decision had to be understood in the specific context of Polish law and doctrine and that foreign bankruptcy did not necessarily cause pending arbitrations in Switzerland to be discontinued, it is likely that it wanted to reassure the arbitration community given the virulent reactions to its *Vivendi v. Elektrim* decision. The fear was indeed that a party could invoke its national law to shirk from arbitration when the entering into an arbitration clause precisely aims at shielding parties from such situations.

If this recent decision is to be clearly welcomed, it can be questioned whether foreign law should at all have any bearing on the capacity of the bankrupt party to be a party in an arbitration in Switzerland (absent a *loi d'application immédiate*). The reasoning followed in the Supreme Court's 2012 decision still carries significant unpredictability. It appears that the characterization of the applicable foreign provision (referred to by Article 155(c) PILA) can be relatively problematic as it is never easy to distinguish capacity from for instance material validity or arbitrability issues.[3] Moreover the Swiss approach does not fully protect the parties' expectations when entering into the arbitration agreement as such expectations may be upset if the applicable law at the place of incorporation of the other party is considered as providing for the loss of capacity to be party to an arbitration following bankruptcy. It will therefore in some instances still be open to the bankrupt party to rely on its national law to escape arbitration.

Need for a Change in Swiss Legislation?

In the light of the still not yet fully satisfying situation, it is hoped that the ongoing revision of Chapter 12 PILA will lead to the passing of a new provision in the PILA to specifically address the issue. It however seems that it has not been contemplated that the issue should be covered by the revision. Be it as it may, an idea could be to introduce a provision similar to Article 15 of the EC Regulation or to modify Article 177(2) PILA (according to which a State party cannot rely on its own law to deny its capacity to be a party) adding that a private party cannot either rely on its own law to contest its capacity to arbitrate.[4] It has also been suggested to modify Article 178(3) PILA (which provides that the arbitration agreement cannot be contested on the grounds that the main contract is not valid or that the arbitration agreement concerns a dispute which has not yet arisen) so as to add that the arbitration agreement cannot be contested on the ground that the arbitration agreement would no longer be valid because of the loss of capacity of a bankrupt party to participate in an arbitration.[5] The two latter suggestions however go further than Article 15 of the EC Regulation as their scope is not limited to pending arbitrations (Article 4(e) and (f) of the EC Regulation indeed provides that the law of the State of the opening of the insolvency proceedings determines the effects of insolvency proceedings on current contracts to which the debtor is party and on proceedings brought by individual creditors (with the exception of lawsuits pending in that latter case)). It should be noted that the above described principles established by Swiss case law also exceed the scope of the EC Regulation as in the 2012 Supreme Court's decision the Portuguese party had been declared bankrupt prior to the launch of the arbitration.

The EU Regulation is currently under revision. The revision mainly concerns pre-insolvency and hybrid proceedings, jurisdiction, coordination between main and secondary proceedings, publication of proceedings and group insolvency. The European Commission's proposal for an amendment of the EU Regulation however contains a modified version of Article 15. The revised

text provides as follows: "*Article 15 (Effects of insolvency proceedings on lawsuit or arbitral proceedings pending) The effects of insolvency proceedings on a pending lawsuit or arbitral proceeding concerning an asset or a right of which the debtor has been divested shall be governed by the law of the Member State in which the law is pending or in which the arbitral proceedings have their seat*". The provision thus simply dissipates doubts which had been casted as to whether Article 15 also applied to arbitration. There is no amendment suggestion with regard to Article 4(e) and (f) of the EU Regulation. It is unknown whether the text of the Commission's proposal will undergo modifications. The European Parliament voted in favour of the Commission's proposal on 5 February 2014. The proposal however still needs to be adopted jointly by the European Parliament and by the EU Member States in the Council. The Council has welcomed the Commission's proposal, but is in the process of discussing the draft law.

Conclusion

There seems to be general consensus that bankruptcy should in principle not prevent pending arbitrations from moving forward. The clarification brought by the Supreme Court's decision rendered in 2012 is therefore to be welcomed. That being said, as the Supreme Court has decided to consider the issue as a matter of legal capacity governed by the law of the state of incorporation of the bankrupt company, unpredictability remains.

It is therefore submitted that the adoption in the PILA of a provision similar to Article 15 of the EU Regulation or to the same effect appears to be the most efficient way to protect the parties' expectations.

In an ideal word, the impact of bankruptcy on pending arbitration proceedings should be harmonized at an international level. Given that national legislation and practice with regard to bankruptcy matters can significantly diverge, this is however unlikely to materialize. In the light of Switzerland's reluctance to modify its legislation and bearing in mind the principle guiding the revision of the PILA ("as much as necessary – as little as possible"), it might well be that the introduction of a new provision in the PILA is as unlikely to materialize and that creditors will have to, for the time being, put up with some degree of unpredictability.

Irrespective of whether Swiss legislation is modified or not, creditors should not lose sight of the possible risk that the award be refused recognition and enforcement in the state where the insolvency proceedings were opened.

References

?1 Decision 4A_428/2008 dated 31 Mach 2009, published in ASA Bull. 1/2010, pp. 104ff.

?2 Decision 4A_50/2008 dated 16 October 2012 (138 III 714), published in ASA Bull. 2/2013, p. 354

?3 See for instance Gabrielle KAUFMANN-KOHLER/Laurent LÉVY/Sabina SACCO, The Survival of the Arbitration Agreement and Arbitration Proceedings in Cases of Cross-Border Insolvency: An Analysis from the Swiss Perspective in The Paris Journal of International Arbitration, 2010/2, pp. 371ff.

?4 Real issues of legal capacity governed by the law of the place of incorporation of the bankrupt party being reserved.

?5 Pierre A. KARRER, Views on the decision by the Swiss Supreme Court, ASA Bulletin 28/1, pp. 111-112.

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