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When Does an Arbitration Agreement Have a Binding Effect on Non-Signatories? The Group of Companies Doctrine vs. Conflict of Laws Rules and Public Policy

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A recent decision of the German Federal Supreme Court dated 8 May 2014 (case reference no. III ZR 371/12) again calls for a debate on the binding effect of an arbitration agreement for a non-signatory – a well-known and highly-debated phenomenon since the Dow Chemical arbitration.

The Dow Chemical case

According to the award rendered in the Dow Chemical arbitration (ICC Case No. 4131, Y.C.A. Vol. IX (1984), 131), a third party non-signatory to the contract containing the arbitration clause can be obliged to submit to arbitration proceedings if the common intentions of the signing parties demand for such interpretation. This may be the case in particular if the non-signatory company has effectively and individually participated in the conclusion, performance and termination of the respective contract, appeared as the actual party both to the contract and to the arbitration clause and has taken or will probably take advantage of such appearance. In addition, the arbitral tribunal rendered its decision on jurisdiction by taking into account ‘usages conforming to the needs of international commerce, in particular, in the presence of a group of companies’ (the so-called ‘group of companies doctrine’). It is important to note that the arbitral tribunal in Dow Chemical reached its conclusion on the basis of alleged general international principles instead of a careful interpretation of the parties’ intentions under the applicable law. The award was upheld by the Cour d’Appel de Paris (Rev. Arb. 1984, 98) and has caused numerous arbitral tribunals in subsequent cases to accept jurisdiction over non-signatories of the arbitration clause.

Differing approaches in international case law

The ‘group of companies doctrine’ is well established in particular in France, where scholars supported this doctrine early on. In other countries, it is highly disputed among international scholars, and both arbitral tribunals and national courts have taken differing views.

The debate is spurred by the fact that national courts usually have the final say, either in ordinary court proceedings if the respondent objects that the matter is subject to an arbitration agreement, or when deciding on an application for annulment (particularly in jurisdictions that adopted the UNCITRAL Model Law, cf. Article 34(2)(a)(i) 2nd alternative) or on the recognition and enforcement under the New York Convention (cf. Article V(1)(a) 2nd alternative). Consequently, national court decisions must be taken seriously to avoid a success in the arbitration becoming a

Pyrrhic victory.

Case law of national courts other than France clearly shows that the courts tend towards a prudent approach and to thorough analysis of the specific circumstances of a case. Yet, the efforts made by the courts differ significantly. On the one hand, there are court decisions that treat the issue without mentioning the group of companies doctrine, without determining the applicable law and without properly considering related principles such as agency or implied consent. A recent example is a judgment handed down by the Dutch Supreme Court (judgment of 20 January 2006, LJN:AU4523). On the other hand, there are other courts that take the issue more seriously. A good example is the well-known English High Court decision in *Peterson Farms Inc. vs. C&M Farming Ltd.* (judgment of 4 February 2004, [2004] EWHC 121 (Comm)) which partly set aside an ICC award while carefully analysing the law applicable. Whilst the arbitral tribunal had accepted jurisdiction over non-signatories of the arbitration clause based on the ‘group of companies doctrine’, the High Court considered “*the issue as one subject to the chosen proper law of the Agreement and that excludes the doctrine which forms no part of English law*” (no. 62). According to the High Court, “*the ‘law’ the tribunal derived from its approach was not the proper law of the Agreement nor even the law of the chosen place of the arbitration but, in effect, the group of companies doctrine itself*” (no. 47), an approach it considered as “*seriously flawed in law*” (no. 44).

The case before the German Federal Supreme Court

In line with this thorough approach, the German Federal Supreme Court carefully examined several questions connected with the binding effect of an arbitration agreement for a non-signatory under German law in its recent ruling. The questions arose in ordinary court proceedings in which the respondent raised the objection that an arbitration agreement was in place regarding the matter in dispute.

The claimant was a company based in Denmark which produces casings for electrical equipment. The managing director and sole shareholder of the claimant, L, owns a patent to a three-dimensional frame design. The respondent to the proceedings is a company based in India that is active in the same market as the claimant. The claimant initiated proceedings against the respondent following the Hannover trade fair in 2010. It accused him of having presented casings covered by the patent without being entitled to do so. The claimant, simply presented, derived its right to bring an action against the respondent from L who had assigned his claims to the claimant.

The respondent raised the objection that the matter brought before the court is subject to an arbitration agreement contained in a licence contract concluded in 1999 between IPH, a Mauritius-based company represented by L, and BIP, an Indian-based company and the respondent’s legal predecessor. With the licence contract, BIP had acquired the right of use of the design subject to L’s patent. The contract’s arbitration clause provided that any disputes between the parties were to be solved by ICC arbitration in New Delhi. According to the respondent, the claimant was bound by the arbitration clause due to its close connections with IPH and L.

The regional court considered the respondent’s arbitration objection as unfounded. The Higher Regional Court of Braunschweig dismissed the subsequent appeal as the claimant was not bound by the arbitration agreement. The ‘group of companies doctrine’ was not recognised under the applicable Danish law and violated German public policy.

The German Federal Supreme Court's ruling

The German Federal Supreme Court disagreed with the lower court's ruling. It set aside the judgment and referred the case back to the appeal court as the latter had not determined all facts necessary to render a final judgment on the respondent's arbitration objection. When doing so, it *inter alia* instructed the lower court how to decide on (i) the law applicable to the question whether a third party is bound by an arbitration agreement, (ii) the form requirements in such cases and (iii) the question whether such an interpretation of an arbitration agreement violates German public policy.

The law applicable to determine the binding effect of an arbitration agreement on a third party

Regarding the applicable law, the German Federal Supreme Court did not follow the Dow Chemical approach. It did not answer the question on the basis of principles of international law but rather chose to determine the applicable national law and looked for the appropriate conflict of laws rule. In this regard, the court first of all noted that there are no precedents it could rely on and that the question has also been rarely addressed by scholars. It then stated that there are mainly two approaches: First, one could apply the law applicable to the arbitration agreement which is, absent an express choice of law or an implied choice of the law applicable to the main contract, the law of the place of arbitration. Secondly, the question could be answered based on the law supposedly applicable to the legal relationship between the third party and one of the parties to the arbitration agreement. The court agreed that, otherwise, the parties to the arbitration agreement would have the power to determine the applicable law to the third party's detriment. Yet, the court held that there was no necessity in the present case to protect L as he had been involved in the conclusion of the arbitration agreement between IPH and BIP. The court thus regarded it as appropriate to also apply the law applicable to the arbitration agreement to the question whether L is bound by it. In the case at hand, this was Indian law.

Does such an interpretation meet the writing requirement of Article II(1) of the New York Convention?

With view to the form requirements for arbitration clauses, the German Federal Supreme Court found that Article II(1) of the New York Convention does not necessarily prevent the application of the arbitration clause in question to the claimant due to the most-favoured nation principle of Article VII(1) of the New York Convention. Under this principle, German conflict of laws rules can be applied according to which a contract is formally valid if it either satisfies the formal requirements of the applicable substantive law or the law of the country in which it was concluded. The appeal court thus will have to determine the arbitration agreement's formal validity under Indian law.

Does the 'group of companies doctrine' violate German public policy?

It then went on to address whether public policy considerations applicable by virtue of German conflict of laws rules prevent the arbitration agreement from being extended to the claimant. According to the appeal court, this is the case. It provided this additional reasoning without even analysing whether the group of companies doctrine formed part of the applicable law. The German Federal Supreme Court decided that this reasoning falls short of the special circumstances of the case: L is not only the assignor of the claim but was also involved in the conclusion of the

arbitration agreement. In addition, the court clarified that the public policy exception does not discharge the courts from actually applying foreign law and determining the result in the particular circumstances of the case. Only if this particular result, as opposed to the potential result of a rule of foreign law as such, contradicts the fundamental principles of German law and notions of justice shall its application be refused for violation of German public policy.

Conclusion

A number of conclusions can be drawn from this decision:

- First and foremost, the Federal Supreme Court confirmed its commitment to adopt an arbitration-friendly stance, in particular when it comes to interpreting arbitration clauses. At the same time, the court takes seriously that party autonomy is one of the foundation stones of arbitration, which means that a party must have consented to it. Otherwise, there is no legal basis for depriving it of its right of access to the national courts.
- It is within this area of tension that the Federal Supreme Court clarified that German courts will base their decision whether a third party must submit to, or can be included in, arbitration proceedings on the applicable national law instead of general principles of international law. To determine the applicable law, the courts will make a thorough conflict of laws analysis and either opt for the law applicable to the arbitration agreement or, if the third party requires protection, the law that is supposedly applicable to the legal relationship between the third party and one of the parties to the arbitration agreement. Subsequently, the courts will assess the agreement under the applicable law, both regarding its content and formal validity.
- Finally, German courts will carefully examine whether the result is in line with German public policy. There is no set answer to this question. The decision rather shows that the courts will decide on a case-by-case basis whether the outcome is contrary to fundamental principles of German law. In the context of annulment or enforcement proceedings, it seems highly likely that German courts would look at the result and examine on the basis of the specific circumstances of the case whether the result is in line with the applicable national law and German public policy.
- Arbitration practitioners are thereby reminded that succeeding in the arbitration based on the ‘group of companies doctrine’ is only half the battle. The arbitration will almost always be followed by annulment proceedings; in addition, the award will most likely be challenged when it comes to enforcing the award abroad. The decision to go for arbitration against non-signatories of the arbitration agreement must thus be taken with eyes wide open.

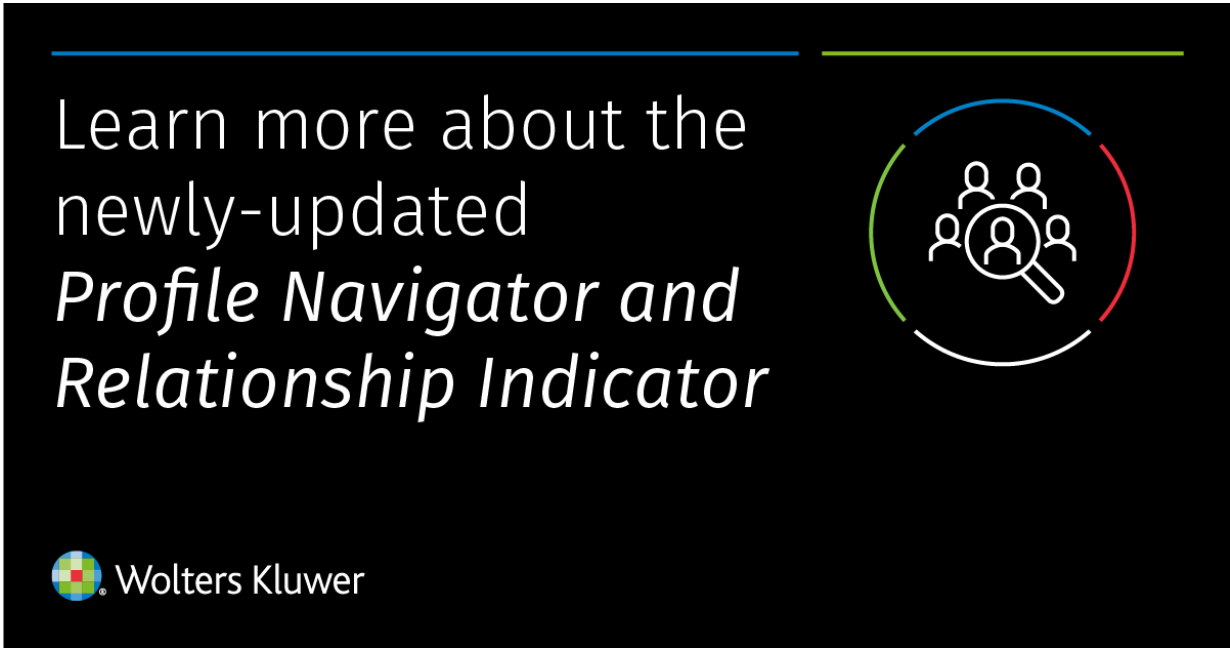
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