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Eleven Months without Jurisdiction to Decide on the Invalidity of a Contract

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On July 18, 2014 the Cassation Court – the highest court in Armenia, in the case EKD/1910/02/13 delivered a decision ("Decision") which paralyzed the whole arbitration system in the country. In the mentioned case the Cassation Court ("Court") needed to answer a question *whether an arbitral tribunal was entitled to decide the matter of invalidity of the contract*. The Court eventually held that only state courts had jurisdiction over the invalidity issue.

The Court relied heavily on the proper mechanisms of the civil rights protection. It referred to section 1 of art. 13 of the Civil Code which stated that the protection of civil rights […] is conducted by court. The Court reasoned that according to the Constitution (art. 18) and European Convention for the Protection of Human Rights and Fundamental Freedoms (art. 13) every person whose rights and freedoms are violated shall have an effective remedy before a national authority, and thus it is the state's duty to create effective mechanisms to protect such rights. The Court made a very "interesting" statement that the protection of civil rights could be done through judicial, administrative and public (arbitration) means, from *which the most guaranteed option was the judicial option because in such case the protection was conducted in accordance with the judicial procedure strictly envisaged by the law, which included firm guarantees to find out the circumstances which were important for the case and to ensure the execution of the judicial rights of the parties*.

Only three years ago the Minister of Justice mentioned in an interview that the distrust toward the courts in the society was 80%, which in fact had not changed since then. Moreover, one should always ask a question, even if we presume that pre-determined public judicial procedure provides effective forum for civil rights protection, is this what parties want – not to have a say on the design of their dispute resolution procedure and rely on strictly regulated civil procedural norms? Indeed, some will prefer the pre-determined system since thereby they do not need to worry about the next step – designing the procedures themselves. However, more sophisticated parties would prefer to build their system themselves, especially for complex and large disputes. Moreover, the experience shows that in many cases arbitration is chosen exactly for the same reason mentioned by the Court – *to find out the circumstances which are important for the case and to ensure the execution of the rights of the parties*.

The Court relied on art. 91 of the Constitution which stated that only courts could provide justice in Armenia. The Court also referred to art. 14 and art. 303 of the Civil Code whereby a way to protect

civil rights is to reserve only for courts to have jurisdiction to recognize the contract as invalid, but not for arbitral tribunals. The Court gives two main reasons for its Decision to assign the exclusive jurisdiction to state courts to decide on the invalidity of contracts:

> 1. Exclusive grounds for invalidity of contracts provided in the Civil Code, the existence or absence of which, according to the Court, may be discovered only through the execution of certain judicial steps, and
> 2. Contracts are made to create, modify, or terminate civil rights and obligations, and therefore disputes connected with them shall require a more guaranteed and effective procedure, which is, according to the Court, the judicial protection.

Indeed, courts are well equipped with tools of discovery and arbitration tribunals often need court's help to make the procedure more effective. However, there is no effective tool that may help a state court to determine the validity of contract that an arbitration tribunal could not have access to. Moreover, the effectiveness of courts and ability to provide more guarantees are very doubtful.

The Court has probably overseen that section 2 of art. 12 of the Civil Code specifically mentions that "[…] court, economic court or arbitration tribunal **(hereinafter – court)** may reject a person to protect its rights" [emphasis added]. This means that wherever after section 2 of art. 12 we see a notion "court" it should equally refer to a state court, economic court (which were abolished) or an arbitration tribunal. However, when interpreting the very next article – art. 13 of the Civil Code, the Court interpreted the notion of "court" ignoring its definition in the prior article. Moreover, the Court also forgot about the decision of the Constitutional Court on the conformity of the New York Convention to the Constitution as of 26 September 1997. It would be interesting to see how the recognition and enforcement of a foreign arbitral award related to invalidity of contract would play out in the light of the Decision.

However, having criticized the Court's decision it would not be fair not to mention also one of the hidden reasons for the Court's decision. This very case involved three Armenian citizens who wanted to regain their right of protection in the state courts versus a large Armenian bank who insisted to go to arbitration for a dispute involving a claimed breach of a credit contract by these citizens.

In 2010, Union of Banks in Armenia established an institutional arbitration center ("Center") with the aim to resolve cases which involved banks and financial institutions that were suffering losses due to the lengthy judicial proceedings after the financial crisis. Gradually many banks, including the defendant bank, started to include arbitration clauses providing for the jurisdiction of the Center in their contracts, and in fact many of the arbitrators at the time were officials of the banks or financial institutions. Apparently many consumers were signing contracts with arbitration clauses not realizing that thereby they were waiving their right to resort to state courts. Eventually, the Court noticed this practice.

To some extent it was justified to change the direction in which the arbitral practice was going. However, it needs to be taken into account that that also impacted other (non-collection) arbitration cases. For almost eleven months arbitration tribunals were handling cases with caution, since in case any of the parties wanted to delay, especially in Banks Union arbitration cases, it could challenge the validity of the contract, and hence the case would go to state courts. Although

according to the law this could not stop the arbitration proceedings, and the tribunal could continue the case and make a decision, after the award was rendered the opposing party could suspend the execution on the ground that the validity of the contract was challenged. Therefore, by its decision the Court created a distressing atmosphere for arbitration in the country. The Head of the Civil and Administrative Chamber of the Court mentioned in a meeting that they were not against arbitration, but quite the opposite that they strive to the development of arbitration in the country, and for that reason the law should be reformed in a way to provide the arbitral tribunal with jurisdiction to hear the matter on the validity of contract.

On 19 June 2015, articles 12 and 13 of the Civil Code were modified to make it clear that civil rights protection can be provided both by a court and an arbitral tribunal. More specifically, section 2 of art. 12 now reads as follows:

"In case the requirements provided in section 1 of this article are not observed, *the court or arbitral tribunal may reject a person in protection of his/her rights*" [emphasis added].

And section 1 of art. 13 provides:

"In accordance with the jurisdiction stipulated in the Civil Procedural Code of the Republic of Armenia the protection of civil rights is provided *by a court or arbitral tribunal* (hereinafter – court)" [emphasis added].

This was a good chance to make other modifications to the Law on Commercial Arbitration of 2006 to make it compliant with UNCITRAL Model Law on International Commercial Arbitration (1985) as amended in 2006 ("Model Law"). However, in its attempt to provide the arbitral tribunal with jurisdiction, the legislator created another layer of limitation specifically related to international cases, in particular, related to conflict-of-law rules in art. 28 of the Model Law. In particular, art. 28 of the Law on Commercial Arbitration now stipulates mandatory requirement for the arbitral tribunal to apply the Armenian law upon the absence of choice of law by the parties if the seat of arbitration is Armenia and one of the parties is an Armenian citizen or a legal entity incorporated in Armenia.

The major question that one would ask is whether the above mentioned change of law made a shift in grounds on which the Court heavily relied on in delivering its Decision – *"uniqueness" of juridical steps to identify the existence or absence of contract invalidity ground, and the need to provide more guaranteed and effective procedure for civil rights protection*? If the Court was right in identifying those issues, then in order to resolve the problem certain additional juridical steps should have been provided to arbitration courts which did not exist at the time and were available only for state courts, as well as more guarantees should have been envisaged for civil rights protection. It turned out it was not about that, but only about *the extension* of jurisdiction, which probably needed to be identified as an issue stemming from the needs of the specific case.

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