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Paraguayan Court of Appeal Recognizes Arbitrators' Powers to Decide Issues of Illegality and Corruption

Raul Pereira de Souza Fleury (FERRERE Abogados) · Saturday, December 29th, 2018

In a [decision](#) from June 6, 2018, the Third Chamber of the Paraguayan Court of Appeal (the “**Court**”) decided an annulment application, recognizing that issues of illegality and corruption are arbitrable, as long as such decision does not imply the imposition of sanctions, something that is left to the local criminal courts¹⁾

Although the issue is relatively settled in the international arbitration community²⁾, in the sense that arbitrators can rule on these matters, it is an important development for arbitration in Paraguay, considering the scarce jurisprudence related to recognition, enforcement and set aside of arbitration awards.

The case involved a contract between Taller RC (hereinafter “**Claimant**”) and the Paraguayan Environmental Secretariat (hereinafter “**SEAM**” for its Spanish acronym), for the provision of maintenance and repair services of SEAM’s vehicles. Claimant initiated arbitration after SEAM failed to pay several invoices for works performed under the contract. The sole arbitrator ruled in favor of Claimant, prompting SEAM to apply for the set aside of the award.

SEAM based its annulment application on article 40(b) of the [Paraguayan Arbitration Act](#) (the “**PAA**”), which has its origin in article 34(b) of the UNCITRAL Model Law, and article V(2) of the New York Convention, SEAM argued that the controversy was not capable of being settled by arbitration under Paraguayan law and therefore, the award was contrary to public policy. SEAM’s main argument was that the Prosecutor’s Office needed to participate in the arbitration because a corruption and illegality complaint had been filed in relation to the contract which could result in criminal sanctions against the implicated officers.

Claimant, on its part, argued that the claim before the arbitrator concerned a breach of contract, a subject matter that is arbitrable under the PAA. Claimant also added that the claim did not seek a criminal penalty for SEAM, but only the payment of the unpaid invoices.

As such, the Court delimited its analysis on both of SEAM’s arguments, namely whether: (a) the dispute was arbitrable given an alleged necessary participation of the Prosecutor’s Office; and (b) the award was contrary to public policy.

- **Arbitrability of the dispute**

Regarding the first issue, the Court reasoned that, while there was an open criminal cause for irregularities in the execution of the contract between Claimant and SEAM, such allegation of illegality did not “*in itself deprive the arbitral tribunal of jurisdiction. On the contrary, it is generally held that the arbitral tribunal is entitled to hear the arguments and receive evidence, and to determine for itself the question of illegality.*” The Court continued adding that “*if in the course of an arbitration an allegation of corruption is made in clear terms, the arbitral tribunal has a clear duty to take it into consideration and decide whether it has been sufficiently proven or not.*”

In this sense, the Court recognized a clear power of arbitrators to pursue the analysis of corruption allegations brought before them, irrespective of whether there is an ongoing criminal investigation pending resolution.

The Court concluded that the SEAM did not prove its allegation that the claim was not arbitrable because its only evidence on this matter was a memo from its Anticorruption Office recommending SEAM’s Minister to order an administrative investigation against the officers involved in the corruption allegations.

The Court then took the opportunity to clarify certain issues. First, it indicated that the fact that a criminal investigation was on course did not mean that the Prosecutor’s Office needs to participate in the arbitration, because in the criminal case, the Prosecutor has an active role, as plaintiff, whose main interest is the investigation and punishment of the crime. On the contrary, the claim submitted to arbitration was for the breach of a contract. Second, the Court addressed the administrative nature of the contract, explaining that nothing specific or ex-post laws prevented or limited the arbitrability of disputes arising from its performance.

- **Public policy violation**

On the second issue, the Court clarified that while each State may have its definition of “public policy”, the story is different with arbitration, which is an “*institution that develops from the autonomy of the parties with a transnational framework*” and as such, adopted the definition of international or transnational public policy from the [interim report](#) of the Committee on International Commercial Arbitration of the International Law Association on the topic of public policy as a ground for refusing the recognition and enforcement of international arbitral awards, which comprises fundamental rules of natural law, principles of universal justice, jus cogens in public international law, and the general principles of morality accepted by what are referred to as “civilized nations”.

Under this premise, the Court explained that issues of corruption certainly raise questions of public policy, but such questions relate to the criminal and disciplinary consequences of corrupt actions, and not to the performance of the contract. Thus, since SEAM neither proved that there was a flagrant violation of the judicial and economic system, nor that the arbitration process violated the most basic and fundamental principles of justice, morality and customs, and that the dispute had the arbitrability requirements, the petition to set aside was denied.

As indicated above, the issue of the arbitrators’ powers to decide on issues of illegality and corruption in the execution and performance of a contract is relatively settled in the field of international arbitration, however, for a country in which arbitration is still in an “embryonic” stage, this decision is certainly welcomed. The Court made a clear distinction as to which matters pertaining to illegality and corruption are for national courts, and which ones can be decided by the

arbitrators, that is, are arbitrable. This is in line with the modern approach based on the separability principle, according to which an arbitration clause, even though included in, and related to an underlying contract, is a separate and autonomous agreement. As such, a claim that the contract is invalid because it was procured by corrupt means, does not invalidate the arbitration clause contained in it, it only means that arbitrators can hear arguments and admit evidence to determine such questions of illegality and corruption underlying the contract.

The reasoning on the issue of public policy violation is also welcomed, since it provides for a standard that can be applied in future cases of annulment and enforcement before Paraguayan courts. As it is well known by arbitration practitioners, the issue of set aside and denial of enforcement on the grounds of public policy violation is always a tricky one. Each State may have its own definition and clarifying the standard of proof gives more security to practitioners that choose Paraguay as their seat.

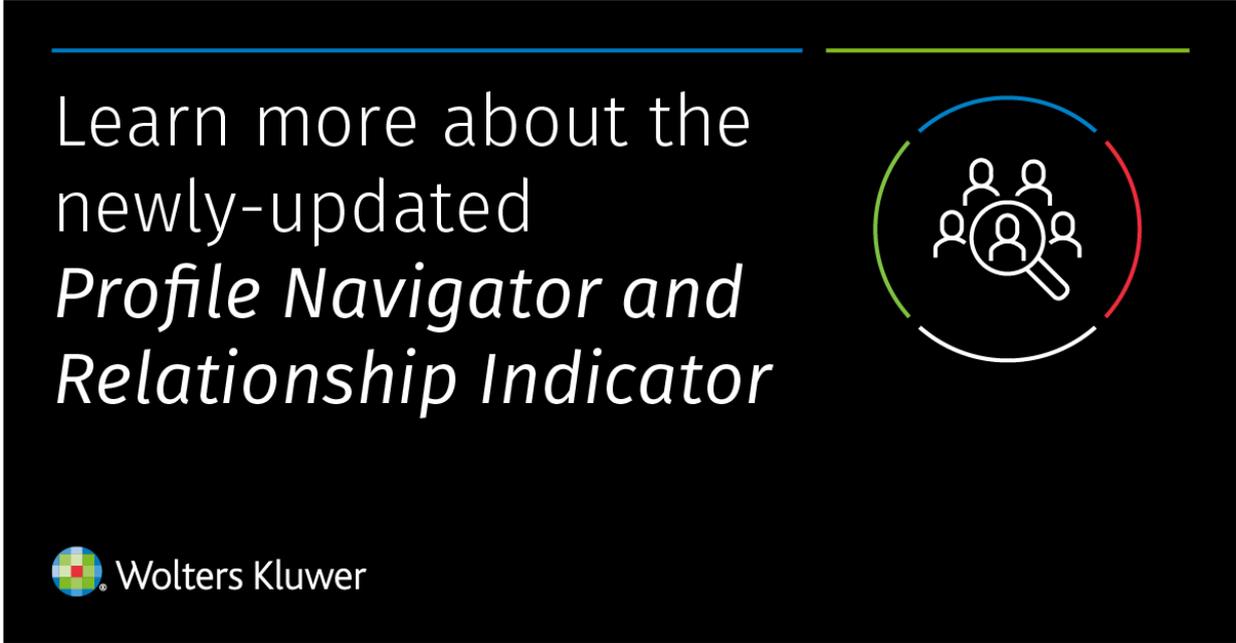
There is still much to be done in Paraguay for the development of arbitration, in order to shorten the gap with the important players of the region, such as Brazil, Chile, and Argentina, however, each small step forward is welcomed and celebrated.

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- ?2 See Blackaby, Partasides et al., *Redfern and Hunter on International Arbitration*, p. 120; Lew, Mistelis and Kroll, *Comparative International Commercial Arbitration*, pp. 210, 215

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