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The Consequences of the Non-Disclosure of Conflict of Interest on the Enforceability of Awards: The German Stance

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Arbitrators and tribunal-appointed experts are at all times obliged to disclose any and all circumstances that might give rise to doubts as to their impartiality and independence. This is one of the most fundamental duties to safeguard the legitimacy of arbitration. Yet, what are the consequences if they fail to do so?

This question has kept two German courts, the Higher Regional Court Karlsruhe ('OLG Karlsruhe') and the German Federal Court of Justice ('BGH'), busy for six years, but now the question appears to be appropriately solved – better late than never!

Background

The DIS arbitration, which triggered the above-mentioned court proceedings, started as early as 2010 and it involved two parties that were in dispute as to the root cause of the defects of their jointly manufactured products.

In 2011, the DIS tribunal, with the consent of the parties, appointed a publicly certified expert to examine this issue. In 2013, based on the expert's report, the DIS tribunal issued its award in which it held that the defects were 100% caused by one of the parties.

Still, in 2013, the defeated party requested the annulment of the award before the OLG Karlsruhe. Among others, it argued that the expert on whose report the arbitral tribunal had based its decision had failed to disclose that his direct superior at the expert company had previously been working for more than 20 years for the other party and only recently started to work for the expert company. Moreover, it claimed that it had discovered this former working relationship only after the award had been rendered. The winning party, in turn, opposed the request for annulment by applying for a declaration of enforceability instead.

What followed were joint annulment/enforcement proceedings that ultimately produced not one, but four German court decisions, two by the OLG Karlsruhe and two by the BGH, on the key legal question: *What are the consequences for the enforceability of the award if an arbitrator or tribunal-appointed expert fails to disclose circumstances which may call into question their independence or impartiality?*

OLG Karlsruhe: Annulment Only in Exceptional Circumstances[1)]

In December 2015, after two years of proceedings, the OLG Karlsruhe decided the issue for the first time – it declared the award enforceable and rejected the request for annulment.

In line with a judgement of the BGH from 1999[2)], the OLG Karlsruhe argued that, in light of the *res judicata* nature of an award, any failure to disclose that becomes known only after the award is issued, warrants its annulment only in very exceptional circumstances, *i.e.* in a case of obvious and severe bias. The OLG Karlsruhe held that this was not the case here, as only the superior and not the expert himself had worked for a party and the superior's involvement in the expert report was unclear.

BGH: Overturning Former Jurisprudence[3)]

In May 2017, after reviewing the OLG Karlruhe's decision, the BGH set it aside and remitted the case to the OLG Karlsruhe.

The BGH expressly relinquished its case law from 1999 on which the OLG Karlsruhe had relied. It held that any failure to disclose, regardless when it becomes known, means that the arbitration has not been conducted in accordance with the German *lex arbitri* and, thus, warrants annulment if it affected the award. According to the BGH, such effect is deemed to exist if the non-disclosed circumstances would have been sufficient to successfully challenge the arbitrator or expert during the arbitration, which is the case if those circumstances give rise to justifiable doubts as to their impartiality and independence. The *res judicata* principle does not justify retaining the previous threshold of 'obvious and severe' bias because an award will only become *res judicata* once declared enforceable.

However, based on the (undisputed) facts available to the BGH, it could not decide whether there had even been a failure to disclose, let alone one with the required effect on the award. Thus, it remitted the case to the OLG Karlsruhe requesting it to reopen the case in order to establish these, in the BGH's view, material facts and render a new decision.

OLG Karlsruhe: Annulment Only in Case of Justifiable Doubts[4)]

As requested by the BGH, the OLG Karlsruhe reopened the case. By examining the expert and his superior as witnesses, it established that there actually had been a failure to disclose. When rendering his report, the expert had been aware of his supervisor's previous work position. However, during the 20 years in which the superior had worked for one of the parties, he had not been involved with the product in dispute. Further, in line with the expert company's internal rules, the superior had not influenced the expert's substantive findings in any way, but had for organizational reasons merely signed the letter by which the report was transmitted to the arbitral tribunal and the parties. On this basis, the OLG Karlsruhe held that neither the mere failure to disclose nor the non-disclosed facts give rise to justifiable doubts as to the expert's impartiality and

independence or otherwise justify annulment. Thus, it again declared the award enforceable.

BGH: A Differentiated Approach[5)]

After yet another legal review, the BGH upheld the OLG Karlsruhe's decision and, thus, declared the award enforceable for good.

In its decision, the BGH clarified under which circumstances the failure to disclose warrants the annulment of an award.

First, a mere failure to disclose, *i.e.* irrespective of the non-disclosed facts, only justifies an annulment if already such failure in itself shows the arbitrator's or tribunal-appointed expert's bias. In the BGH's view, this is only conceivable in case of intentional concealment.

Second, in the absence of such intention, enforceability or annulment depends on an *ex post* analysis by the competent state court as to whether the arbitral tribunal would have decided that the non-disclosed facts give rise to justifiable doubts, if they had been duly disclosed already during the arbitration proceedings. In other words, in the BGH's view, the standard to assess the enforceability or annulment of an award is, when dealing with a failure of disclosure, the same as the standard to challenge an arbitrator or expert during the arbitral proceedings.

This assessment is to be conducted from a 'subjective-objective perspective'. Though the court must adopt the **subjective** perspective of the challenging party, it must thereby assume that, when confronted with the non-disclosed fact, this party would **objectively** appreciate all relevant facts in order to decide whether justifiable doubts exist. All relevant facts are not only the unduly concealed facts, *i.e.* the facts which the arbitrator or expert should, but did not disclose. Rather due regard has to be paid to all connected circumstances, *i.e.*, circumstances that the parties and/or the challenged arbitrator/expert would have reasonably disclosed during the 'challenge procedure'.

Thus, the BGH approved that the OLG Karlsruhe had examined the expert and his superior as witnesses.

Concluding Remarks

The fact that it took the claimant six years to enforce an award that had been issued after three years of arbitration, shows that the German 'two-instance' enforceability/annulment regime is not ideal and potentially in need for reform (although the present case is certainly an extreme scenario). Yet, more importantly, the two BGH decisions provide important guidance on the handling of non-disclosure cases.

On the one hand, annulment may well be a consequence of a failure of disclosure. Hence, any arbitrator and expert are well-advised to disclose rather too much than too little.

On the other hand, annulment is not an inevitability. Only in the extreme case of intentional non-disclosure, the non-disclosure in itself warrants annulment. In all other cases, the competent state courts are requested to do precisely what, in the BGH's view, any arbitral tribunal or arbitral

institution is required to do when deciding on challenges. Faced with the disclosure of a fact potentially impairing an arbitrator's/experts' independence and impartiality, they must establish, if required by taking evidence, all circumstances connected to the non-disclosed fact and submit them to careful appreciation from the perspective of a reasonably thinking challenging party.

Both BGH decisions are well in line with the IBA Guidelines on Conflict of Interest (2014), which also require a reasonable balance between the parties' right to comprehensive disclosure and the defence of formalistic challenges. Hence, any party choosing Germany as the place of arbitration can be assured that – although it sometimes may take a while – it is still in the BGH's truly 'safe hands'.

References

?1 *OLG Karlsruhe*, Decision of 18 December 2015, 10 Sch 12/13.

?2 *Bundesgerichtshof*, Judgement of 04 March 1999, III ZR 72/98.

?3 *Bundesgerichtshof*, Decision of 02 May 2017, I ZB 1/16.

?4 *OLG Karlsruhe*, Decision of 01 June 2018, 10 Sch 12/13.

?5 *Bundesgerichtshof*, Decision of 31 January 2019, I ZB 46/18.

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