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Brazilian Court of Appeals Finds 'Manifestly Illegal' Arbitration Agreement As An Exception To Kompetenz-Kompetenz

Emily Westphalen (Herbert Smith Frehills) · Wednesday, January 29th, 2020 · Herbert Smith Freehills

On September 10, 2019, in considering an interlocutory appeal to stay arbitration proceedings, the Espírito Santo Court of Appeals decided to grant an exception to the competence-competence principle on grounds that the arbitration agreement was prima facie "manifestly illegal". (Interlocutory Appeal No. 0013950-80.2019.8.08.0012, injunctive relief issued on September 10, 2019).

Background

In 2001, the appellants Amphilophio de Oliveira Júnior and others (the "Appellants") formed a privately-held corporation, called Hospital Meridional (the "Hospital"). The Appellants and other partners concluded a Shareholders Agreement (the "Shareholders Agreement"), which guaranteed the shareholders the exclusive right to provide the services of their respective specialties within the Hospital.

The Shareholders Agreement had a term of 20 (twenty) years from its renewal in July 2006 and, in addition to binding the shareholders and their successors, also established that the shareholders of the same medical specialty should have preference in the acquisition of the shares held by other partners.

The shareholders consolidated the control of the Hospital into a single legal entity, Vitória Participações S.A. (the "Holding"), which held more than 90% (ninety percent) of the Hospital's shares. However, the Appellants, as the minority shareholders, had the exercise of their corporate rights constrained, as the Holding tried compelling them to dispose of their shares, without observing the preference provisions in the Shareholders Agreement.

In addition, the Holding refused to renew the lease of spaces inside the Hospital, where the Appellants carried out their activities, and tried to dilute their corporate participation through abusive increase of share capital.

Consequently, the Appellants filed a series of lawsuits against the Hospital and the Holding (the "Appellees"), all of which were successful. Seeing these results, the Holding, using its power of control of the Hospital, unilaterally amended its bylaws to include a clause providing for arbitration in the event of any disputes. The Appellees then requested an arbitral institution to

commence arbitration against the Appellants, in order to determine whether the filing of the aforementioned actions constituted an abusive act.

The Appellants sought to stay the arbitration proceedings, on the grounds that they had never consented to arbitration. Based on the competence-competence principle, the Court of First Instance refused to stay the arbitration proceedings. The Appellants submitted an interlocutory appeal to the Espírito Santo Court of Appeals seeking a provisional suspension of the arbitration proceedings.

The Espírito Santo Court of Appeal's Decision

In accordance with the Brazilian Code of Civil Procedure, in order to grant the provisional request to suspend the arbitration proceedings, the Espírito Santo Court of Appeals considered whether the following requirements were present: (i) the relevance of the Appellant's reasoning (*fumus boni juris*) and (ii) the possibility of serious harm to the Appellants (*periculum in mora*) if the arbitration proceedings continued.

First, the Espírito Santo Court of Appeals examined Article 4 of the Brazilian Arbitration Act (Law No. 9,307/1996), which requires prior acquiescence by the parties to an arbitration agreement. As the Court of Appeals explains:

> "Indeed, consent is an inseparable element of the arbitration jurisdiction, even more because it concerns a limitation to the guarantee of the right to access to justice, enshrined in art. 5, XXXV of our Constitution, which has the status of mandatory clause and, as such, is not subject to implicit waiver".

Second, the Court of Appeals analysed Brazilian Corporate Law (Law No. 6,404/1976.), and briefly discussed whether the Appellees could unilaterally amend the Hospital's bylaws and subject the Appellants to arbitration proceedings.

Pursuant to article 136-A of the Brazilian Corporate law, the approval of the insertion of an arbitration agreement in the bylaws shall observe the quorum of article 136 of the same law, which requires the approval of shareholders representing at least half of the voting shares. Article 136-A also provides that any dissenting shareholder shall have the right to withdraw from the company through the reimbursement of the value of their shares, pursuant to art. 45 of the Brazilian Corporate Law.

In this case, the Court of Appeals found that the facts demonstrate how the arbitration clause was (i) inserted in the bylaws *ex post facto* of the events in dispute, (ii) not in accordance with the procedure provided under the Brazilian Corporate Law, and (iii) consequently, the Appellants never consented to arbitration.

The Court of Appeals clarified that it was "not unaware of the *kompetenz-kompetenz* principle contained in article 8 of the Brazilian Arbitration Act…", however, the Court also found that the competence-competence principle "does not have an absolute character, remaining to the Judiciary the prerogative of declaring the nullity of an arbitration commitment whose content is manifestly

illegal…."

The Court reasoned that "the adoption of *kompetenz-kompetenz* in this case would only serve to materialize the aggravating damages" to the Appellants, as they would have to pay the initial fees of the arbitration estimated at R$ 242,770.00 (two hundred and forty-two thousand, seven hundred and seventy reais), only to later question the validity of the pathological arbitration clause, which, in the Court of Appeal's opinion is "a behaviour completely disconnected from the principle of objective good faith."

As a result of the arbitration clause included in the bylaws not having the proper consent of the Appellants, the Court of Appeals agreed that the Appellants had a plausible right and suffered the risk of serious harm should the arbitration continue. The Espírito Santo Court of Appeals thus, repudiated the lower court's decision and determined the provisional stay of the arbitration proceedings.

Comment

In Brazil, once the arbitration commitment is established, as a rule, it is the arbitrator's responsibility to decide their own competence, due to the so-called competence-competence principle, enshrined in the sole paragraph, of article 8 of the Brazilian Arbitration Act:

> "It will be up to the arbitrator to decide of ex officio, or at the provocation of the parties, the questions about the existence, validity and effectiveness of the arbitration agreement and the contract that contains the arbitration clause".

Nevertheless, the Brazilian Superior Court determined in 2016 that:

> "The Judiciary may, in cases where a "pathological", i.e., manifestly illegal, arbitration agreement is prima facie identified, declare the nullity of this agreement, regardless of the state of the arbitration proceedings." (REsp 1602076/SP, Rel. Ministra NANCY ANDRIGHI, TERCEIRA TURMA, julgado em 15?09?2016, DJe 30/09/2016)

At a first glance, exceptions to *kompetenz-kompetenz* might seem dangerous to arbitration in Brazil and to the country's status as pro-arbitration. However, this case demonstrates the way in which the Espírito Santo Court of Appeals applied the exception as the Superior Court intended it to be: a narrow limit to the effects of *kompetenz-kompetenz*. Accordingly, despite the decision of the interlocutory appeal being without prejudice to a new examination after the parties exchange full pleadings, the application of the manifestly illegal exception in this case promotes confidence that arbitration proceedings cannot be used to circumvent due process.

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