Kluwer Arbitration Blog

Milan Court Torpedoes International Arbitration and Substitutes Own Decision on Merits

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Despite the prominence of Italian industry in international trade – Italy is one of the G7 countries – the country has long struggled to build a reputation in international arbitration as a reliable and arbitration-friendly seat. Italy's court system is notoriously among the slowest in Europe, and the slowest to reach a conclusion through its Supreme Court. But just as damaging to Italy as the speed of justice is an open question of whether the judiciary is capable of adopting a modern approach to arbitration.

A recent decision by the Milan Court of Appeals, the court in Italy's leading industrial city, demonstrates the risk parties face that judges will simply substitute their view of the merits over those of the arbitrators chosen by the parties. Judgment no. 1790/2021 of 8 June 2021 is a virtual roadmap of the pitfalls a party may encounter when choosing Italy as a seat of arbitration:

(a) merits-based annulment;

(b) re-determination of the merits by the court, ordering a foreign respondent to pay the damages sought by an Italian claimant without any re-hearing of the evidence;

(c) "de-internationalization" of an arbitration despite the presence of a foreign party where the court, in its discretion, deems Italy to be the "centre of interests" for the performance of obligations;

(d) deference to a partial award issued by a tribunal whose chair was successfully recused and replaced before the final award;

(e) lengthy delay (i.e., over three years for a decision on an award rendered on 30 March 2018).

The background reported in the judgment was a relatively straightforward contract to deliver turbines for a wind farm that was to include project financing, which the buyer ultimately failed to obtain after the seller had begun deliveries. After initial work was delivered and advance payments of circa Euro 10 million made, the buyer failed to obtain the required project financing and initiated arbitration under the rules of arbitration of the Milan Chamber of Arbitration (CAM) for restitution of sums paid. The seller counterclaimed for damages, or in alternative for costs and expenses incurred prior to termination.

The final award rejected the claimant's request. The Milan Court of Appeals came out with a very

different result that will leave non-Italian parties questioning whether to opt for Italy as a seat of arbitration.

Background

In 2009, Wind Energy Racalmuto Srl (WER) entered into a contract for the supply and the installation of wind turbines for the realisation of an electric production plant with GE Wind Energy Gmbh and GE International inc. Italian Branch (GE). The contract provided for two advance payments amounting in aggregate to 50% of the contract price. The remaining consideration was to be guaranteed through a payment security (PS) granting an irrevocable mandate to a project financing entity that would pay directly GE.

WER paid the first instalment, and GE provided an advance payment bank guarantee (AP bond) for the same amount. The contract was then amended twice in 2010 due to WER's inability to obtain project financing, and the deadline for the provision of the PS was eventually postponed indefinitely.

By June 2010, GE had delivered some of the work, including parts of the foundations of the wind turbines, issued a parent company guarantee and provided the AP bond, and WER had paid 20% of the total price. Throughout 2011 and 2012 WER attempted in vain to secure the financing to finalise the project.

In August 2013, WER claimed that GE had breached the contract by not renewing the expired AP bond, and demanded restitution of the entire amount paid up to that moment. GE responded that renewal of the AP bond was not required until WER delivered the PS.

In February 2015, WER initiated arbitral proceedings claiming termination of the contract due to GE's contractual breach.

With a partial award issued in June 2016, the Tribunal held that:

- the parties had put the contract on hold, subjecting its future performance to a "condition precedent" of a project financing;
- neither party's breach was preponderant and of such gravity to justify termination of the contract; hence, no party was entitled to contractual damages;
- the contract was nonetheless terminated due to the non-occurrence of the condition precedent, which had become impossible;
- GE was still to be compensated for the delivery of contractual goods initially accepted and later challenged by WER; lacking a precise determination in the contract, a further evidentiary phase was needed.

The partial award, albeit challenged by GE, became final.

The court's judgment reports, however, that GE subsequently sought the recusal of the President of the Tribunal, who was duly substituted. The judgment does not state the grounds for the recusal, but the 2010 CAM rules contain a code of ethics that imposes upon arbitrators strict obligations of competence, availability, independence, and impartiality.

The re-constituted arbitral tribunal issued a final award in March 2018. The award held that GE was entitled to retain the amounts paid by WER.

Annulment and "Reformulation" of the Annulled award

WER challenged the award on four grounds, the contrariety of the final award to the partial award being the only one actually analysed by the Court.

Relying heavily on the dissenting opinion by the only Italian arbitrator of an international tribunal, the court held that the case met the remarkably high-standard test set by the Supreme Court for successfully challenging an award for incoherent or lacking reasoning of the decision.[1)] This requires the reasoning to be entirely absent or so scant that the rationale of the decision is impossible to understand. In particular, the Court held that the Tribunal went too far with the analysis of the nature (retroactive or not) of the termination as the partial award had simply remitted to later determination the costs incurred by GE in delivering the initial phase of the contract. In the court's interpretation, this entailed an irremediable incoherence between the awards, sufficient to vacate the final award.

In evaluating the nature of the termination, however, the Court observed that the arbitration had included the report of a quantum expert who had assessed GE's costs of delivering equipment but took no note of it. Further, the Court's decision simply mentioned in passing the recusal of the president of the arbitral tribunal that had issued the partial award.

In adopting a preference of the partial award over the final in its reasoning, the Milan appeals court also failed to mention the discretionary power granted under the 2010 CAM Rules to a newly-constituted Tribunal to repeat all or some of the acts of the proceedings prior to a successful recusal, nor even the potential ineffectiveness of the activities of a recused arbitrator under the applicable Italian law (Art. 815 of the Civil Procedure Code). Considering that in some circumstances such a recusal might even render the partial award invalid,[2)] it is odd that the Court failed to address this while deferring to the partial award in its decision. In sum, not only did the Court completely overlook the CAM's finding that an arbitrator was unfit for chairing the Tribunal, but also went so far as giving preference to the recused arbitrator's decision over that of the re-constituted Tribunal.

Incredibly, after having declared the final award void, the court asserted its own power to decide the actual merits of the case.

In doing so, the court held that the arbitration was not to be treated as international under Italian law, which requires either party to be domiciled abroad at the time of entering into the arbitration agreement (Art. 830 of the Civil Procedure Code). Although one of the parties was, in fact, domiciled in Germany, the Court found there to be a "centre of interests" with its Italian branch, such that it should be treated as domiciled in Italy. This is in open contrast with the nature of the dispute, the domicile of the parties, and the CAM's (correct) interpretation of the dispute resulting in its choice of an international Chair (pursuant to Art. 14.5 CAM Rules). The court's interpretation is further at odds with the intentions of international parties contracting to do work in Italy, who adopt arbitration in order to avoid the vagaries of the Italian legal system. And it does not compare at all well with the clear rules of a nearby civil law jurisdiction, France, where

arbitration is deemed international when international commercial interests are at stake (Art. 1504 Code de Procédure Civile), regardless of the domicile of the parties. The uncertainty of the Italian approach – apparently granting the courts discretion to determine that an arbitration is not international despite the existence of a foreign party – appears strikingly not arbitration friendly.

Finally, the court held that, despite the findings of the final award on the work performed by GE, WER was entitled to full restitution of the entire amount it had paid because reimbursement of expenses was incoherent with the determination of the partial award that the parties were entitled to no damages.

The decision is, candidly, so at odds with modern practice of arbitration – domestic and international – that comment on its conclusions hardly seems necessary. It may be worth noting, however, that the court's decision appears to fall outside of the set-aside grounds under Art. IX of the European Convention on International Commercial Arbitration 1961 (ECICA), with the consequence that the award should be still enforceable in any of the contracting States of the ECICA.

All considerations above should be further put into context giving the right weight to the judgement having been rendered by a Court of second instance, with a three-senior-judge deciding panel, in the most industrialised and business-oriented city in Italy.

A look at the future

Even in the best of circumstances, the development of a reputation as an arbitration-friendly jurisdiction requires the active support of the courts. Nearby France, for example, took steps in March 2018 to further burnish its pro-arbitration reputation by introducing a specialised section of the Court of Appeals to hear all annulment proceedings of Paris-seated international arbitral awards.

By contrast, a national judiciary already lacking a reputation of expertise in international arbitration, combined with an inclination to impose its own view of the merits over those of the adjudicators agreed by the parties, would normally be enough to send international parties to more favourable seats.

The WER judgment, however, goes a step even further towards disincentivizing arbitration over the courts in Italy. Had the dispute been decided in the first instance courts, the respondent would have been presented an opportunity for its costs to be considered in the calculation of losses, instead of undergoing an entire arbitration, reaching an award on the merits, only to be followed by an annulment decision that granted to the claimant the entirety of its demand without the opportunity for the defendant to present its case.

In an effort to overcome the severe impact of the inefficiencies of its courts on the overall economy (some studies here and here), Italy has embraced the use of both arbitration and mediation as a means to lighten the burdens on the justice system. The latest commissions created with this purpose, namely the Alpa Commission and the more recent Luiso Commission which submitted its conclusions at the end of May 2021, have proposed some amendments which would certainly improve the overall system. Whether Parliament will follow the suggestions of the Luiso

Commission, and whether this will be enough for a significant improvement,[3)] is yet to be seen.

At the same time, CAM has adopted forward-looking Rules over the course of 2019 to support this.

However, as the WER judgment of the Milan Court of Appeals makes clear, all such noble efforts will be in vain if the courts remain hostile to the decisions of arbitrators chosen by the parties.

References

?1 When dealing with an alleged inconsistency between the partial and the final award, Italian Courts seem to be relying on Art. 829(1) no. 8, and – to a lesser extent, possibly not relevant when the partial award has already become res judicata – on Art. 829(1) no. 4 or no. 11. The Milan Court of Appeals seem to have also applied Art. 829(1) no. 5. On the distinction between Art. 829(1) no. 5 and no. 11, and the possible reasons behind their joint application, see M. V. Benedettelli, International Arbitration in Italy, Kluwer Law International, 2020, § 10.72, jointly written with Z. Crespi Reghizzi.

?2 U. Draetta – R. Luzzatto (Editors), The Chamber of Arbitration of Milan Rules: A Commentary, JurisNet, Huntington, 2012, 292.

?3 For a critical analysis see R. Oliva, Il (nuovo?) progetto di riforma, available in Italian here.

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