Kluwer Arbitration Blog

A Controversial Turkish Precedent on Arbitrators' Jurisdiction on Claims Initiated Through Bankruptcy Proceedings?

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The General Assembly of the Civil Chambers of Turkish Court of Cassation ("Court") rendered a controversial decision on 21 December 2021 with No. K.2021/1710 ("Decision").

The Decision provides that, notwithstanding a valid arbitration agreement, Turkish courts, not arbitrators, shall have jurisdiction to determine whether an alleged debtor, against whom a bankruptcy proceeding has been initiated, is indebted or not. This practically means that, when creditors initiate bankruptcy proceedings, they can circumvent the arbitral tribunal's jurisdiction and facilitate Turkish courts to hear the merits of the dispute although the parties agreed to arbitrate and thus not to litigate.

This post first summarizes the Turkish enforcement and bankruptcy proceedings, and their interplay with arbitral tribunals' jurisdiction. It then elaborates on the reasoning of the Decision and its potential practical impacts on the arbitration practice in Turkey.

Turkish enforcement and bankruptcy proceedings

The Decision revolves around the particularities of Turkish enforcement and bankruptcy proceedings. As these are unfamiliar to most jurisdictions, this section summarizes these proceedings first.

Turkish law provides creditors with mainly two legal routes to directly initiate enforcement through enforcement offices without resorting to litigation or arbitration:

- They can directly initiate debt collection proceedings before enforcement offices; or
- The creditors can also pursue enforcement by way of requesting (again from the enforcement offices) the bankruptcy of the debtor. The debtors can be subject to this bankruptcy proceedings for their due and payable debts, even for insignificant amounts. It is, therefore, irrelevant whether the assets of the debtors cover their liabilities.

The defining difference between the two proceedings relates to the role and rights of the creditors. Namely, if the creditor prevails in bankruptcy proceedings and the debtor is eventually declared bankrupt, not only the creditor who initiated the bankruptcy proceedings, but all creditors of the debtor shall be entitled to satisfy their receivables from the bankrupt debtor's estate. In contrast, in

debt collection proceedings, the procedure only concerns the debtor and the creditor, and other creditors are not involved unless they similarly initiate such proceedings.

In both proceedings, the enforcement office issues a payment order to the debtor where it states that the debtor must either pay, or object to the order within seven days.

In bankruptcy proceedings, the procedure to be followed upon the creditor's objection is provided under Article 156(3) of the Enforcement and Bankruptcy Code, No. 2004 ("Bankruptcy Code"):

> *If the debtor objects to the payment order, the proceedings stop, and the creditor can ask the Commercial Court with a petition to lift the objection and decide on the bankruptcy of the debtor.*

Only courts can decide on the bankruptcy of the debtor. This is clear. The controversial point is the first prong of the claim under Article 156(3), i.e., "lifting the objection". To lift the objection, commercial courts must render a decision on the merits and confirm the indebtedness of the debtor to the creditor.

Arbitrators' Jurisdiction

Turkish law is silent on the question whether arbitrators have jurisdiction to lift such objection. In view of this silence, Turkish jurisprudence developed two schools of thought:

- The first school argues that the two prongs of the claim (i.e., "lifting the objection" and "deciding on bankruptcy") are intrinsic and thus not separable. Given this, and as it is established that only courts can decide on bankruptcy, it must also be the same commercial courts to decide on whether the objection would be lifted ("First Approach"). The argument follows that, since Article 156(3) is mandatory and concerns public policy, the parties cannot sever this intrinsic structure with an arbitration agreement to confer jurisdiction on arbitrators to decide on lifting the objection. There are precedents following this approach (e.g., the decision of the 19th Civil Chamber of Court of Appeal dated 13 October 2005, and numbered K. 2005/10004).
- The second school argues that the claims are separable. As such, if there is a valid arbitration agreement, the decision on bankruptcy can be rendered by the courts only after the arbitrators decide on the merits that the debtor is indebted ("Second Approach"). This is mainly based on the premises that (i) Turkish law does not prevent the arbitrators from deciding on lifting the objection; and (ii) Turkish arbitration law (including Article II of the New York Convention) requires the courts to refer this matter to arbitration. The Court of Cassation has also rendered decisions in line with the second school of thought (e.g., the decision of the 23rd Civil Chamber of Court of Appeal dated 28 June 2013, and numbered E. 2013/4113.).

The Decision

The dispute subject to the Decision is based on the loss of revenue claims of the employer under the construction agreement due to the contractor's delay in completing the work. The parties

agreed their disputes to be resolved by arbitration in accordance with the Rules of Arbitration of the Istanbul Chamber of Commerce Arbitration and Mediation Center (also known as ITOTAM).

The employer (creditor) initiated bankruptcy proceedings against the contractor (debtor). The debtor objected and the creditor filed a claim before the court of first instance under Article 156(3) of the Bankruptcy Code. The court dismissed the claim based on the Second Approach. The Court of Appeal upheld this decision. Having referred to the First Approach, however, the 15th Chamber of Court of Cassation quashed these decisions. On remand, the court of first instance resisted and reiterated its initial decision. Following this, the Court decided that the arbitrators shall not have jurisdiction to decide on lifting the objection claims under Article 156(3) of the Bankruptcy Code.

Going forward

The Court's Decision is final and binding on the parties. However, it is not a binding precedent for Turkish courts, and they can still render decisions based on the Second Approach. Having said that, traditionally, Turkish courts rarely deviate from the precedents of the Court unless and until it is changed by the Court itself. In other words, although the Turkish courts have been divided on this issue, this may no longer be the case and the First Approach might be practically more decisive in questions surrounding arbitrators' jurisdiction in cases where the bankruptcy proceedings are initiated.

If applied by the Turkish courts, the Decision will have significant impacts. This is because, by initiating bankruptcy proceedings, a claimant can effectively circumvent arbitration proceedings (and in fact jurisdiction of the foreign courts, if chosen) and facilitate Turkish courts to decide on the merits of the dispute as part of the lifting the objection claim.

On a final note, we would like to underscore two possible mitigants against such impacts.

First, as a practical mitigant, the disadvantages of the bankruptcy proceedings from a creditor perspective are likely to limit the number creditors who would be inclined to follow such bankruptcy route. That is to say; a creditor may not be willing to take the risk of competing with other creditors as they might end up empty-handed if the entire bankruptcy estate is allocated to the receivables of, for instance, preferred creditors.

Second, another mitigant might be found within the Decision itself. The Court noted, *obiter dictum*, that "*[…] the parties have not stipulated a limitation that no bankruptcy proceedings shall be initiated in the event of a dispute"* (par. 38). This implies that the Court might have decided differently if the parties explicitly agreed to exclude the jurisdiction of Turkish courts in respect of the bankruptcy proceedings. Out of an abundance of caution, the parties may wish to provide such exclusion in their agreements. It is doubtful, however, whether this will be an effective mitigant. This is mainly because Article 156(3) of the Bankruptcy Code is a mandatory rule concerning Turkish public policy and thus cannot be excluded by the parties, this being one of the main arguments of the First Approach and the Decision itself.

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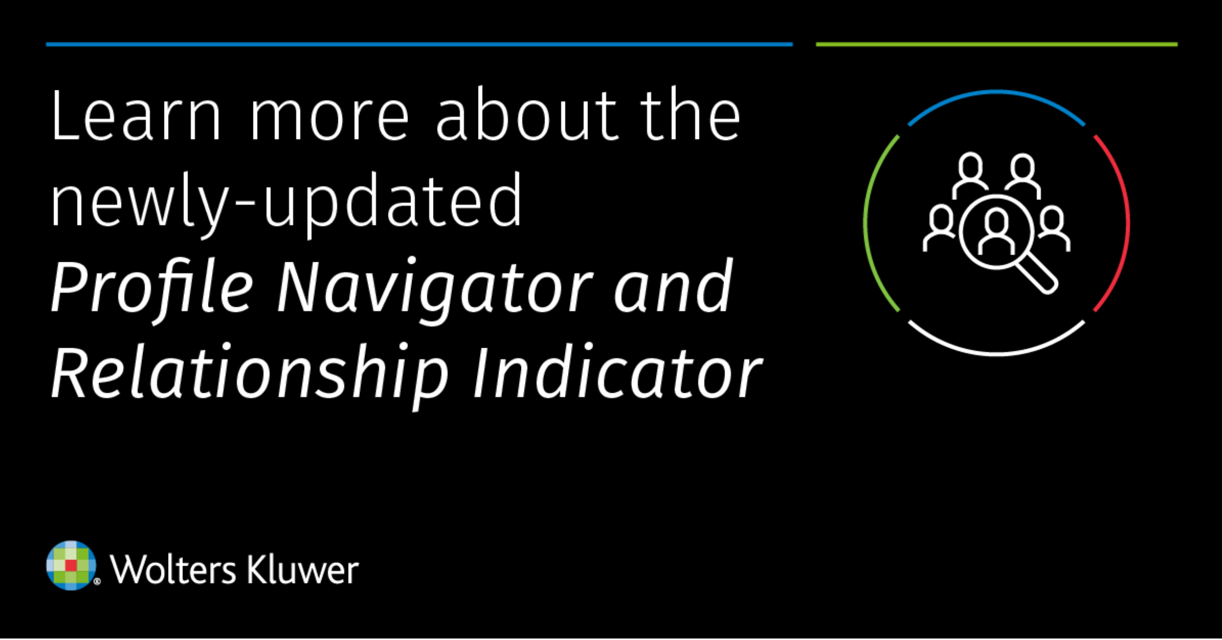

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