Detlev Kühner Associé **BMH** AVOCATS

The impact of party impecuniosity on arbitration agreements by Detlev Kühner[1]

A recent decision of the Oberlandesgericht Köln[2] in Germany and two recent decisions of the Paris Court of Appeal[3] and the Court of Cassation[4] in France have reanimated the debate about the impact of party impecuniosity on arbitration agreements. This matter is dealt with quite conversely in France and in Germany: whereas the French Courts consider that impecuniosity shall not affect the arbitration agreement, the German Courts consider that impecuniosity leads to a situation in which the arbitration agreement becomes incapable of being performed, with the effect that the State Courts shall have jurisdiction. The following note will show that there are good reasons to believe that arbitration agreements in an international setting will normally escape that faith not only in France but also in Germany.

In arbitration proceedings, impecuniosity entails the confrontation of two essential legal principles: the binding nature of contracts and the respect of fundamental rights in the form of access to justice and equal treatment of the parties.

French law and jurisprudence are known for their liberal approach to international arbitration and French Courts are generally inclined to give the biggest possible effect to arbitration agreements. This is a logical consequence of the existence of Article 1448 in the French Code of Civil Procedure which enshrines the negative effect of the principle of *competence-competence*[5]. According to that provision, state courts have to decline jurisdiction unless the Arbitral Tribunal is not seized and unless the arbitration agreement is either *manifestly null* or *manifestly inapplicable*.

It appears that the French Courts apply these standards also in situations in which one party is impecunious. In other words, the impecuniosity of one party is not in itself sufficient to consider that the arbitration agreement is manifestly null or inapplicable and the matter shall therefore be decided by the Arbitral Tribunal.

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1 Detlev Kühner is partner in the Dispute Resolution Group of BMH Avocats. He is a former Counsel at the Secretariat of the ICC International Court of Arbitration and intervenes in arbitration proceedings as counsel and as arbitrator.

2 OLG Köln, Beschluss vom 05.06.2013 – 18 W 32/13.

3 *„Lola Fleurs Case"* - Cours d'Appel de Paris, Pôle 1 Ch. 1, 26 février 2013, n° 12/12953.

4 *„Pirelli Case"* - Cour de Cassation, 1e civ., 28 mars 2013, n° 11-27770.

5 Article 1458 CPC: *„Lorsqu'un litige relevant d'une convention d'arbitrage est porté devant une juridiction de l'Etat, celle-ci se déclare incompétente sauf si le tribunal arbitral n'est pas encore saisi et si la convention d'arbitrage est manifestement nulle ou manifestement inapplicable. La juridiction de l'Etat ne peut relever d'office son incompétence. Toute stipulation contraire au présent article est réputée non écrite."* - Where a dispute originating from an arbitration agreement is brought before a state court, the latter must decline jurisdiction, unless the arbitral tribunal has not been seized and the arbitration agreement is manifestly null or manifestly inapplicable. The state court may not raise *sua sponte* its lack of jurisdiction. Any agreement to the contrary is null and void.

By contrast, the German Courts traditionally granted to each party a right of termination of the arbitration agreement in case of impecuniosity of one of the parties. For that to happen, the impecunious party had to set a time limit to the other party to determine and declare whether it was willing and able to bear the full costs of the arbitration. The solvent party consequently had the benefit of an option whether to accept termination and do without arbitral proceedings or to shoulder the costs of the arbitral proceedings in full where it entertained a strong interest in having the case decided by an Arbitral Tribunal rather than by a State Court.

In a decision rendered on 14 September 2000[6], i.e. shortly after the entry into force of the revised German arbitration law in 1998[7], the *Bundesgerichtshof* [8] even considered that in case of party impecuniosity, the arbitration agreement becomes incapable of being performed and that termination of the arbitration agreement was therefore no longer necessary.

This decision was based on the then newly adopted provision of Article 1032 ZPO which, in relevant parts, provides the following:

"A court before which an action is brought in a matter which is the subject of an arbitration agreement shall, if the respondent raises an objection prior to the beginning of the oral hearing on the substance of the dispute, reject the action as inadmissible unless the court finds that the arbitration agreement is null and void, inoperative or incapable of being performed."[9]

It is true that the threshold under Article 1032 ZPO for the German State Courts to consider that an arbitration agreement is void or incapable of being performed is lower than for the French Courts under Article 1448 CPC, which requires in addition, that such nullity or incapability be *manifest*.

Does this mean that, unlike arbitration agreements which provide for a place of arbitration in France, arbitration agreements which provide for a place of arbitration in Germany cannot longer be considered to be safe and enforceable?

The answer is: it depends.

The decisions of the German Courts were rendered in domestic cases in which two German parties were involved and these decisions must therefore be seen in that context. Like the French Courts, the German Courts have to balance two major principles of law, i.e. the binding nature of contracts and the right of access to justice. It is understandable that the right of access to justice may prevail more easily over the principle of *pacta sunt servanda* in a

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6 BGHZ 145,116.

7 Codified in Articles 1025 to 1066 of the Code of Civil Procedure - Zivilprozessordnung („ZPO").

8 Federal Supreme Court as the highest German Court in civil matters.

9 Wird vor einem Gericht Klage in einer Angelegenheit erhoben, die Gegenstand einer Schiedsvereinbarung ist, so hat das Gericht die Klage als unzulässig abzuweisen, sofern der Beklagte dies vor Beginn der mündlichen Verhandlung zur Hauptsache rügt, es sei denn, das Gericht stellt fest, dass die Schiedsvereinbarung nichtig, unwirksam oder undurchführbar ist.
The German arbitration law is in essence based on the UNCITRAL Model law and Article 1032 ZPO is in large parts identical with Article 8 of the UNCITRAL Model law.

domestic setting, in which both parties will be confronted with their national judges in case the arbitration clause is set aside. In that setting, the fact that the state courts retain jurisdiction is perfectly neutral for both sides, since neither party must fear to be judged by a foreign jurisdiction.

It is however submitted that the threshold for the access to justice principle to prevail cannot be the same in an international arbitration setting, in which the results of quashing an arbitration agreement may lead to a situation in which the matter will ultimately have to be dealt with by a foreign state court from the viewpoint of one of the parties. Clearly, this is not what parties who entered into an arbitration agreement wanted. One of the most important reasons for parties to enter into an arbitration agreement is the fact that it provides, among other things, a neutral forum for both sides.

It is submitted that in international arbitration proceedings, the better choice therefore is to give a maximum effect to the arbitration clause. Let us not forget that there may well be cases in which one side might be tempted to invoke or create a situation of impecuniosity without sufficient objective grounds, all the more if the party knows that the arbitration clause may in that event be considered improper of being performed under the applicable case law. Consequently, besides all other issues to be dealt with in the arbitration, the issue as to whether a party is actually impecunious or not, should, at least in an international context, be looked at by the Arbitral Tribunal.

In fact, international arbitration proceedings and institutional arbitration rules provide a number of safeguards. Thus, it happens frequently that a Claimant is willing to substitute for a defaulting Respondent and pay the Respondent's share of the costs of the arbitration in order to make sure that the arbitration may proceed.[10]

In addition, due consideration must be given to the fact that some institutional arbitration rules encourage parties which have paid their share of the advance on costs to also pay the other party's share of the advance on costs by allowing payment through a bank guarantee[11].

Likewise, parties having also paid the other party's share of the advance on costs may consider starting parallel proceedings before the state courts in order to force the defaulting party to pay its share of the advance on costs. In the alternative, the paying party may seek an order from the Arbitral Tribunal, once constituted, instructing the defaulting party to pay its share of the advance on costs[12]. These proceedings may be accompanied by additional requests for security for costs which one or the other side may submit in order to prevent or reduce any potential enforcement problem.

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[10] Often times the true reason for a party not to pay its share of the advance on costs is not a situation of impecuniosity but of procedural strategy. In exceptional cases, also a Respondent and Counterclaimant may be willing to pay for a defaulting Claimant.

[11] Article 1(7) of Appendix III to the ICC Rules of Arbitration provides the following: *"A party that has already paid in full its share of the advance on costs fixed by the Court may, in accordance with Article 36(5) of the Rules, pay the unpaid portion of the advance owed by the defaulting party by posting a bank guarantee."*

[12] The share of the advance on costs paid by the requesting party will normally be sufficient to cover the costs and expenses (arbitrator's fees and expenses and any expenses of the arbitration institution) incurred until that stage of the proceedings.

Even though many cases will not fulfil the strict requirements for third party funding, it remains an additional option which a party may think of.

In summary, efficient devices and solutions exist in international arbitration practice. Consequently, only little situations exist in which one or both parties must be considered as impecunious and/or in which neither side is able or willing to substitute for the defaulting side.

It cannot be said with certainty what the approach of the German Courts would ultimately be in the context of an international arbitration, but there is a high likelihood that the German Courts would apply their former practice and would at least grant the solvent party the possibility to pay for the defaulting party before considering that the arbitration clause is incapable of being performed. This would help to save the arbitration clause in the majority of cases on German soil.