

EFFECTS OF BANKRUPTCY ON ARBITRATION

PROCEEDINGS

By

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Abstract

Commercial arbitration is dispute settlement procedure created by parties' agreement that provides parties with neutral forum for resolution of their disputes. However, parties' autonomy is subjected to certain restrictions imposed by public law rules. One of them is bankruptcy law. This paper analyzes the influence of the bankruptcy law on arbitration. It provides summarized overview of the choice of law problem with which the arbitrators are encountered due to the lack of *lex fori* and analysis of the relevant provisions that can affect the arbitration proceedings.

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CHAPTER 1: INTRODUCTION

By concluding an arbitration agreement parties aim to submit their disputes under jurisdiction of neutral, territorially “floating” tribunal. However, access to arbitration can be limited. Not every dispute can be subjected to prorogation of national court’s jurisdiction. Certain legal issues are still reserved for resolution before national courts. Disputes involving bankrupt party can seem to be one of them. This paper will analyze whether they really are.

Bankruptcy proceedings are court proceedings for collective enforcement of creditors’ claims or reorganization.¹ Its main characteristics are centralization of the claims and equal treatment of the creditors.² Arbitration as being a dispute settlement mechanism can interfere with these two principles. Arbitration is based on principle of parties’ autonomy and privity, while bankruptcy proceedings are judicial and collective one.³ Different nature of these two proceedings imposes the question of their possible conflict and resolution of the same. One of the most extensive works that has been done on this area is the work of Vesna Lazić in her paper “Insolvency Proceedings and Commercial Arbitration”. She provided comparative analysis of national systems regarding the relation between insolvency and arbitration, elaborating the possible effects from the point of view of the national courts.

Different perspective will be given in this paper. This paper will elaborate effects of bankruptcy proceedings on arbitration from arbitrators’ point of view. To be more specific, it will provide analysis of specific effects of liquidation of corporations on arbitrability of the dispute, the conduct of the same and validity of arbitration agreements. Due to the fact that perspective taken is perspective of the arbitrators, this paper will provide adequate overview of the choice of applicable law as well.

¹VESNA LAZIĆ, *INSOLVENCY PROCEEDINGS AND COMMERCIAL ARBITRATION*, Kluwer Law International, 155, 1998.

² Sara Nadeau-Séguin, *When Bankruptcy and Arbitration Meet: A Look at Recent ICC Practice*, *Dispute Resolution International* 82, 79-102 (2011).

³ *Ibid.* at 82.

Certain remarks should be made regarding terminology and the scope covered by this paper. Term “bankruptcy” is chosen instead of its very closely related term “insolvency” because it indicates procedure commenced under bankruptcy law rather than just the state of financially inability to pay one's debts and obligations as they become due.⁴ For most of the discussed matters it is required for procedure to be commenced in order to have effects on arbitration. Insolvency itself does not conflict with arbitration, although, as it will be addressed in this paper, there is evolving view that insolvency itself can influence the validity of arbitration agreement. However, until now most of the effects are taking place subject to commencement of bankruptcy proceedings. Bankruptcy proceedings include both liquidation and reorganization proceedings.⁵ This paper will cover liquidation proceeding, also known as “straight bankruptcy”⁶, focusing only on corporations’ bankruptcy and the fact that corporations, unlike in reorganization proceeding, cease to exist once liquidation is done. Methodology used will be comparative analysis of national systems and solutions provided in their bankruptcy laws and case study in order to support or contravene those findings.

What I will attempt to provide is theoretical overview of the possible issue that arbitrator can confront in a case when one of the parties goes bankrupt. The first Chapter will deal with one of the crucial conflict points – the question of arbitrability of the dispute. However, in order to be able to answer whether the dispute is arbitrable one should determine the applicable law on the effects of bankruptcy first. Therefore, first part of the first chapter will address the choice of law problem, or in other words which law should govern the effects of the bankruptcy (2.1). The second part contains comparative analysis of national provisions which can influence the arbitrability of the dispute (2.2). However, the question of arbitrability is not the only possible conflict between arbitration and bankruptcy. The Second Chapter will

⁴ „bankruptcy“ Black's Law Dictionary (9th ed. 2009), available at *westlaw.com*, March 28, 2012.

⁵ KENNETH W. CLARKSON, ROGER LEROY MILLER, GAYLORD A. JENTZ, FRANK B. CROSS, WEST'S BUSINESS LAW 582 (Thomson 9th Edition, 2003).

⁶ Ibid. at 583.

show that even if the dispute is found to be arbitrable, it is possible that applicable law demands certain other effects on the conduct of the arbitration. Two effects mainly discussed in literature are stay of the arbitration proceedings (3.1) and possible effects on the content of the award (3.2) and they will be addressed in this paper as well. Third Chapter is explaining possible effects that opening of bankruptcy proceedings can have on validity of arbitration agreement which can be either provided in national provisions (4.1) or created by courts' practice in a case of impecuniosity (4.2).

Fifth Chapter of this paper explains solutions under Croatian law regarding the relation between arbitration and bankruptcy proceeding. It will attempt not only to provide analysis of provisions of Croatian Bankruptcy Code but also compare them to solutions found in other national systems and provide certain recommendations.

CHAPTER 2: ARBITRABILITY OF THE DISPUTE INVOLVING A BANKRUPT PARTY

This Chapter will analyze choice of law applicable to the effects of the bankruptcy made by arbitrators (2.1) and how certain provisions of that law influence arbitrability of the dispute (2.2). Prevailing opinion and practice today opt for possibility for arbitrators to resolve the dispute concerning public policy matters.⁷ After almost 25 years from *Mitsubishi Motors Corporation v. Soler Chrysler-Plymouth case* (hereinafter: Mitsubishi case)⁸, one of the most accepted and appropriate methods for deciding upon arbitrability of the dispute is “second look” doctrine.⁹ In other words, public policy rules are not anymore excluded from the application by arbitral tribunals, but this application is subjected to subsequent control by national courts.¹⁰ Antitrust law claims, corruption claims and other claims arising from fraud allegations and claims regarding intellectual property law which were all once held to be outside of the reach of the arbitration, now are found to be arbitrable.¹¹

Bankruptcy law is one of the possible areas of confrontation between public law and arbitration. Bankruptcy is found to be a combination of both private and public law.¹² For purposes of this thesis, we will adopt “the public view” of the bankruptcy due to great involvement of public authorities in bankruptcy proceedings.¹³

Before we enter the issue of arbitrability of contested claims, we should first clarify the possibility of subjecting the whole bankruptcy proceedings to arbitration. There is prevailing

⁷ Laurent Lévy, *Insolvency in Arbitration – Swiss Law*, in *FINANCIAL CAPACITY OF THE PARTIES- A CONDITION FOR THE VALIDITY OF ARBITRATION AGREEMENTS?*, 97, (German Institution of Arbitration ed., 2004); Stavros L. Brekoulakis, *On Arbitrability: Persisting Misconceptions and New Areas of Concern*, in *ARBITRABILITY – INTERNATIONAL AND COMPARATIVE PERSPECTIVES*, 21, (Kluwer Law International 2009)

⁸ *Mitsubishi Motors Corporation v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, United States Supreme Court, 1985.

⁹ WILLIAM W. PARK, *ARBITRATION OF INTERNATIONAL BUSINESS DISPUTES - STUDIES IN LAW AND PRACTICE*, Oxford, 116, 2006.

¹⁰ *Ibid.* at 123-131.

¹¹ Brekoulakis, *supra* note 7, at 21.

¹² LAZIĆ, *supra* note 1, at 11.

¹³ *Ibid.*

opinion that core bankruptcy issues such as appointment of the trustee, verification of the claims, reorganization etc. cannot be submitted to arbitration.¹⁴ This means that these issues will not be resolved in arbitration even under the condition of subsequent judicial control. One of the most plausible reasons why this is so the fact that third parties are usually denied the participation in arbitration proceedings which renders arbitration not to be efficient mean for conducting bankruptcy proceedings.¹⁵

This paper does not even suggest such a solution, but it rather focuses on the arbitrability of the contested claims. Contested claims are claims subject of which “is not only a claim for payment, but rather the determination of the validity or existence of such a claim”¹⁶. These claims are covered by definition of non-core bankruptcy issue because they only relate to bankruptcy proceedings for jurisdictional purposes.¹⁷ Therefore, proceedings regarding these claims would usually be heard before the national court or even before arbitral tribunal.¹⁸ The question is does the commencement of bankruptcy proceeding renders the dispute regarding those claims to be inarbitrable as it does in a case of core bankruptcy issues.

Since perspective taken in this thesis is the perspective of arbitrators, in order to answer whether the disputes are arbitrable requires first from arbitrators to decide upon law governing the effects of the bankruptcy on arbitration. This will be addressed under the first subsection (2.1) The fact whether the arbitration proceedings are already pending or just going to be commenced is not relevant at this point of argumentation. As is going to be elaborated below, authorities suggest choice among several laws based on different reasons.

¹⁴ Christopher Liebscher, *Insolvency and Arbitrability*, in *Arbitrability – International and Comparative Perspectives*, 166 (Kluwer Law International, 2009); Nadeau-Séguin, *supra* note 2, at 92; LAZIĆ, *supra* note 1, at 154; For definition of core bankruptcy proceedings see: LAZIĆ, *supra* note 1, at 173; Linda Coco, *Stigma, Prestige and the Cultural Context of Debt: A Critical Analysis of the Bankruptcy Judge's Non-Article III Status*, Michigan Journal of Race and Law, 19, (2011)

¹⁵ Brekoulakis, *supra* note 7, at 33.

¹⁶ Liebscher, *supra* note 14, at. 169.

¹⁷ Wendell H. Adair, et al., Limitations upon a Bankruptcy Court's Subject Matter Jurisdiction to Determine a Debtor's Class Action Lawsuit, (March 26, 2012), <http://www.turnaround.org/Publications/Articles.aspx?objectID=1380>

¹⁸ LAZIĆ, *supra* note 1, at 173.

When the decision on applicable law is made, arbitrators step into the shoes of the predictable courts that will conduct subsequent control over their award. Consequently, there are certain provisions of applicable law they should pay due attention to and try to anticipate the findings of the courts. First of all there are provisions regarding the exclusive jurisdiction of the bankruptcy court which may have impact on arbitrability of disputes related to bankruptcy proceedings. (2.2) Even if they find provisions regarding jurisdiction are not to be decisive on this issue only by themselves, arbitrators decision powers may be limited if the exclusive jurisdiction is combined with the provisions which give bankruptcy courts competence to decide upon contested claims. (2.3)

2.1 Applicable Law on Effects of Bankruptcy

This subsection provides summarized analysis of scholars' opinion about choice of law governing the effects of bankruptcy. One should bear in mind that law applicable to the effects of bankruptcy is not necessarily law applicable on arbitrability. As it will be explained *infra* the dispute can be arbitrable, but still under certain impact of bankruptcy proceedings. That is because a question of the effects of bankruptcy proceeding on arbitration is not only a question of arbitrability, but also question of application of mandatory rules of a third country. Therefore, laws analyzed in this subsection cover all the possible effects discussed in this thesis.

Summarized overview given in this part will address next laws:

- the law of the seat of arbitration¹⁹ or the law of the state of anticipated proceedings for recognition and enforcement of the award²⁰, both under the condition that bankruptcy proceeding is pending in that country, (2.1.1)
- the law of the state where the bankruptcy proceedings are pending which is neither of the first two²¹ (2.1.2)
- applicable substantive law chosen by parties²² (2.1.3)
- general principles of bankruptcy law²³ (2.1.4).

When deciding on their jurisdiction, prudent arbitrators should be aware of each one of the enumerated laws as a possible applicable law in their case. However, there are certain arguments for and against the application of each of these laws that should be considered as well. There is no clear-cut solution either in theory or in case law regarding the question which law arbitrators should observe and more importantly they should obey. During this analysis one should bear in mind that arbitral tribunal does not have *lex fori* and consequently provisions of all these laws are considered to be foreign to it²⁴.

2.1.1 Law of the Seat of Arbitration and Law of the State of Anticipated Enforcement

¹⁹Domitille Baizeau, Arbitration and Insolvency : Issues of Applicable Law, 101, (March 26, 2012), http://www.lalive.ch/data/publications/dab_Arbitration_and_Insolvency_-_Issues_of_Applicable_Law.pdf;

Stavros Brekoulakis, *Law Applicable to Arbitrability*, in *ARBITRABILITY – INTERNATIONAL AND COMPARATIVE PERSPECTIVES*, 112, (Kluwer Law International 2009); Phillip K Wagner, When International Insolvency Law Meets International Arbitration, 67, (March 26, 2012),

http://www.weitnauer.net/uploads/downloads/aufsätze/Wagner_article.pdf.

²⁰ Stavros Brekoulakis, *Arbitrability and conflict of jurisdictions: The (diminishing) relevance of lex fori and lex loci arbitri*, in *CONFLICT OF LAWS IN INTERNATIONAL ARBITRATION*, 129, (Franco Ferrari, Stefan Kröll eds., 2011) ; Philipp Wagner, *Insolvency and Arbitration: A Pleading for International Insolvency Law*, 195, (March 26, 2012) http://www.weitnauer.net/uploads/Wagner_article.pdf

²¹ Ibid.

²² Nadeau-Séguin, *supra* note 2, at 85.

²³ Ibid. at 12; Wagner, *supra* note 19, at 201.

²⁴Stefan Kröll, *Arbitration and Insolvency – Selected conflict of laws problems*, in *CONFLICT OF LAWS IN INTERNATIONAL ARBITRATION*, 220 & 252, (Franco Ferrari, Stefan Kröll eds., 2001); Wagner, *supra* note 19, at 62.; Baizeau, *supra* note 19, at 98.

Both *lex loci arbitri* and law of the place of predicted enforcement of the award become relevant for arbitrators deciding upon the arbitrability of the dispute due to the fact that under each of these laws there is a possibility to challenge the award.²⁵ Arbitrators are interested in rendering enforceable award and award that will not be set aside. However, this is not always an easy task. While there is always one *lex loci arbitri* there are usually several predictable places for enforcement of the award.²⁶ Neither of these laws should be, however, considered to be applicable automatically. There are certain criteria that should be satisfied in order for arbitrators to apply those laws in a case of bankruptcy of one of the parties.

There are two possible situations in which arbitrators should observe and apply bankruptcy laws of the country of the seat of the arbitration or of the country of the possible enforcement:

1. if either the state of the seat of arbitration or state of possible enforcement is also a state of bankruptcy proceeding²⁷ (in that case these laws are also *lex concursus*) or
2. in a case in which these laws are not *lex concursus*, but their provisions are being applied by national courts due to the recognition of the foreign insolvency proceedings.²⁸

Both situations should be observed.

2.1.1.1. Bankruptcy Proceedings Commenced in the State of the Place of Arbitration or the State of the Enforcement of the Award

Definition of arbitrability is usually provided by national arbitration acts. The prevailing definition today is that the dispute is considered to be arbitrable if the parties can conclude

²⁵Brekoulakis, *supra* note 19, at 100-101.

²⁶Wagner, *supra* note 20, at 198.

²⁷ Brekoulakis, *supra* note 20, 126.

²⁸ Baizeau, *supra* note 19, at 105.

the settlement.²⁹ Although, the preempt question of arbitrability seems to be the possibility to resolve the dispute by settlement, for the purposes of this thesis bottom line of the problem is more of jurisdictional nature. Namely, the question of arbitrability resolves the division of jurisdiction between national courts and arbitral tribunals.³⁰ When applying their national laws on setting aside or recognition and enforcement of the award, courts will find disputes to be not arbitrable only in a case when they would reserve jurisdiction over certain type of claim in that particular case.³¹ Significance of that fact for arbitrators is that when deciding whether to apply *lex loci arbitri* or the law of the place of the enforcement they should first find jurisdictional connection with these states. One possible jurisdictional connector is the fact that bankruptcy proceedings are commenced in these states. The reason is simple, when deciding upon arbitrability, courts will find dispute not to be arbitrable if their own law reserved jurisdiction for them or in this particular case if the claim would have to be filed in bankruptcy proceedings pending in that country. In other words, they will not be concerned with jurisdiction of foreign courts and, consequently, arbitrators should not be concerned either.³² Only under this condition arbitrators are asked to observe and subsequently apply these laws.

Besides this perspective, there is also one more situation in which national courts of these countries would not usually have jurisdiction over the claim, but arbitral tribunal is still required to pay attention and apply the bankruptcy law of these states. This will be addressed under next subsection.

²⁹ Lazić, *supra* note 1, at. 143-146; Alan Uzelac, Nove granice arbitralnosti prema Zakonu o arbitraži, (March 26, 2012), http://alanuzelac.from.hr/Pdf/nove_granice_arbitralnosti.pdf.

³⁰ Brekoulakis, *supra* note 20, 126.

³¹ *Ibid.*

³² *Ibid.* at 128

2.1.1.2 Bankruptcy Proceedings Recognized in the State of the Seat of Arbitration or the State of Anticipated Enforcement

Recognition of foreign bankruptcy proceedings is a characteristic of principle of universality, which is lately more and more adopted in bankruptcy law. Principle of universality opens the possibility that bankruptcy proceedings opened in one country extend to debtor's assets situated in another country.³³

Two most important instruments who adopted this principle are UNCITRAL Model Law on Cross-Border Insolvency³⁴ [hereinafter: Model Law on Insolvency] and EC Regulation 1346/2000 on Cross Border Insolvency³⁵ [hereinafter: European Insolvency Regulation].

Under Model Law on Insolvency once bankruptcy proceeding is recognized in the state of the seat of the arbitration, this will create necessary jurisdictional connector which can be basis for certain effects of bankruptcy proceedings on arbitration as well.

For example, under adopted Article 20 courts of the states which have adopted Model Law on Insolvency will be obliged to stay “*commencement or continuation of individual actions or individual proceedings concerning the debtor's assets, rights, obligations or liabilities*”.

In that way, as we can see, although the bankruptcy proceedings take place in a foreign country, it is the national law that governs the effects in, for example, the state of the seat of arbitration. Therefore, the situation is not different than the one already described, i.e. when the bankruptcy proceedings are commenced in the state of the seat or possible enforcement. National courts are applying their national rules and consequently, arbitrators should observe those rules when deciding upon the effects of bankruptcy on a case before them as well.³⁶

³³ Nadeau-Séguin, *supra* note 2, at 88.

³⁴ UNCITRAL Model Law on Cross-Border Insolvency, 30 May 1997, 36 I.L.M. 1386.

³⁵ Council Regulation No. 1346/2000 on Insolvency Proceedings, 29 May 2000, Official Journal of the European Union 2000 L 160/1

³⁶ Brekoulakis, *supra* note 20, 127

Both of these approaches can be criticized for their too territorial element³⁷ which is inconsistent with the nature of arbitration. Arbitral tribunals are considered not to have *lex fori*. By obliging them to observe the bankruptcy proceedings or recognition of the same in the country of the seat or enforcement of the award, arbitration is given certain territorial frame.

2.1.2 The Law of the State Where the Bankruptcy Proceedings are Pending

Under this subsection the relevant question that will be discussed is whether there is obligation for arbitrators to observe and apply *lex concursus* if this law is neither the law of the seat of arbitration nor law of the possible place of enforcement.

There are two possible grounds to claim such an obligation:

1. application of *lex concursus* as an applicable law determined under European Insolvency Regulation;
2. application of the *lex concursus* rules as mandatory rules, or to be more specific as rules of immediate application.

2.1.2.1 Application of *Lex Concursus* as an Applicable Law Determined under European Insolvency Regulation

Recital 22 of the Preamble of the European Insolvency Regulation provides for the automatic recognition of bankruptcy proceedings among the Member States. Application of the European Insolvency Regulation itself implies that the state of the seat of arbitration is not

³⁷ Fernando Mantilla-Serrano, *International Arbitration and Insolvency Proceedings*, Arb.Int'l, 60, 51-65 (1995)

the state of bankruptcy proceedings as well, meaning that we lack jurisdictional link required for observation of bankruptcy law of that particular state. Moreover, the European Insolvency Regulation itself in Articles 4 and 15 does not provide any special rule about effects of the bankruptcy proceedings but rather the conflict of laws rules upon which applicable law is determined.

In order to promote principle of universality emphasis made in European Insolvency Regulation under Article 4 is on the application of *lex concursus* as applicable law on effects of bankruptcy proceedings.³⁸ Article 15 provides the only exception to Article 4 and provides that applicable law for the effects of bankruptcy proceedings on lawsuits pending should be the law of the place of pending proceedings. Application of this provision would mean application of the law of the seat of arbitration, which brings us back to the previous subsection under which it is explained that application of the law of the state of the seat even in a case that bankruptcy proceedings are commenced in another state, obliges the arbitrators to observe it.

Outside if this exception, solution provided by European Insolvency Regulation means that arbitrators will be introduced with the third law which is not the law of the place of the seat of the arbitration. Justification for its application reflects the adoption of the principle of uniformity by arbitrators in a true sense. It is considered that issues that European Insolvency Regulation addresses and laws which are applicable according to it are of such importance that they represent *ordre publique communautaire*.³⁹ This basically means that every time arbitral tribunal sitting in one of the Member States of EU and facing bankruptcy of the party should observe not only the law of the state of the seat, but also law applicable under the Regulation. In other words, it basically means that bankruptcy proceedings should be automatically recognized by any arbitral tribunal sitting in EU. This tends to be extremely

³⁸Laurent Lévy, *Arbitration and Bankruptcy: Bankruptcy of Arbitration?*, Dispute Resolution International 106, 103-112, 2011.

³⁹Wagner, *supra* note 19, at 220 and 252.

territorial approach to arbitration in which, as I have already mentioned *lex fori* does not exist. Under previous subsection I have explained the need for arbitrators to observe certain laws in order to render award which will not contain any basis for annulment or refusal of enforcement. The same principle can be tested in this case as well. If we assume that place of arbitration or enforcement is not place of bankruptcy proceedings, the question is on what ground we can require arbitrators to apply *lex concursus* as a third law. The Convention on the Recognition and Enforcement of Foreign Arbitral Awards⁴⁰ (hereinafter NY Convention) is very clear - Article V 2(b) provides applicable law for arbitrability and public policy to be law of the place of enforcement. Same approach in Article 34(b) of UNCITRAL Model Law on International Commercial Arbitration⁴¹ [Model Law on Arbitration] regarding these two reasons for setting aside the award. Therefore, when deciding upon the possible grounds for setting aside or refusal of enforcement of the award both courts of the seat as well of the place of enforcement will observe their national laws. If these laws are not at the same time *lex concursus*, courts will not look at the third law – being *lex concursus* - to decide whether their public policy has been violated.

However, European Insolvency Regulation is national law of each of Member States. Although it does not by itself provide provisions regarding the effects of bankruptcy proceedings, it is still considered to be *ordre publique communautaire* and more importantly courts were already ready to apply it in proceedings for setting aside the award⁴². Due to these facts, arbitrators should be advised to apply *lex concursus* under Regulation.

⁴⁰ Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 330 U.N.T.S. 38.

⁴¹ UNCITRAL Model Law on International Commercial Arbitration, 21 June 1985.

⁴² *Vivendi/Elektrim Cases* include both proceedings before English and Swiss courts. English courts when deciding upon the challenge of the award applied European Insolvency Regulation in order to determine applicable law to the effects of bankruptcy of one of the parties which were commenced in Poland, party's home country. Cases are thoroughly discussed in literature. See: Kröll, *supra* note 24; Gabrielle Nater-Bass/Olivier Mosimann, *Effects of Foreign Bankruptcy on International Arbitration*, Austrian Yearbook on International Arbitration, 163-180, (2011); Vesna Lazić, Cross-Border Insolvency and Arbitration, in INTERNATIONAL ARBITRATION AND INTERNATIONAL COMMERCIAL LAW: SYNERGY, CONVERGENCE AND EVOLUTION, (S. Kröll, L.A. Mistelis, P. Perales Viscasillas & V. Rogers eds., 2011).

2.1.2.2 Application of the *Lex Concursus* Rules as Mandatory Rules

Justification of application of the *lex concursus* as mandatory rules covers the situation in which neither the place of the seat nor the place of enforcement are at the same time place of bankruptcy proceedings. This can easily be explained by an example. In a hypothetical case the arbitral tribunal is sitting in Switzerland, the possible place of enforcement is US, and one of the parties is declared bankrupt under Finish law. European Insolvency Regulation would not be applicable since both Switzerland and US are not Member States, but we still need to deal with the question whether arbitral tribunal should apply *lex concursus*, in this case Finish law. Would Swiss or US courts care about application of the mandatory rules of a third country, i.e. in this case Finland? On one side, one could say that if we say they would not care, this opens the possibility for parties to evade the mandatory rules of certain country.⁴³ On the other side, when observing this situation we should also consider parties' autonomy and predictability since parties are allowed to expect that the law they have chosen will be one that will be applied.⁴⁴ In that line one could also argue that by applying these rules, there is possibility for award to be set aside due to the "manifest disregard of the law".⁴⁵ Enforcement of the award can be as well be jeopardized under Article VI (d) of NY Convention that provides as a ground for refusal of recognition that the "*arbitral procedure was not in accordance with the agreement of the parties, or failing such an agreement was not in accordance with the law of the country where the arbitration took place*". This shows that parties' autonomy is a touchstone of the procedure under which arbitration is conducted.

⁴³Jay Lawrence Westbrook, International Arbitration and Multinational Insolvency, (March 27, 2012), <http://www.law.utoronto.ca/documents/conferences2/IACCLI0-Westbrook.pdf>

⁴⁴Nater-Bass, *supra* note 42, at 179.; Georg Naegeli, *Bankruptcy and Arbitration- What Should Prevail? The Impact of Bankruptcy on Pending Arbitral Proceedings*, Austrian Yearbook on International Arbitration 193, 193-207 (2011)

⁴⁵PARK, *supra* note 9, at 130.

Therefore, by applying bankruptcy law of a third state that is not the law of the place of the seat can be both the reason for an award to be set aside or not enforced.

As one of the possible justification scholars suggest that these provisions should be considered to be *rules of immediate application*, and consequently, they should be applied by arbitrators.⁴⁶ Rules of immediate application are reflection of public policy, i.e. they are so important for particular state that they should always apply.⁴⁷ That means that in this case, they would protect public policy of the country where the bankruptcy proceedings are commenced.

Once again we are returning to the question whose public policy arbitrators should observe and prevent violation of. Since courts deciding about setting aside or enforcement of award will be concerned only with public policy of their country, the question is whether public policy is plausible reasoning for arbitrators to apply rules of a third country even though they are considered in that country to be the rules of immediate application. The answer should be no, however, this does not mean that application of these rules cannot be justified in some other way. For example, if non-application of these rules would prevent trustee as a successor of a bankrupt party to present his case, this would be a solid reason for arbitrators to apply rules of *lex concursus*. However, this application would not be based on the fact that *lex concursus* is applicable law to all the effects of the bankruptcy, but on the principle of guaranteed protection of the due process as a part of public policy as it will be explained in Chapter 3.

⁴⁶Naegeli, *supra* note 44, at 204.

⁴⁷ Lévy, *supra* note 38, at 106.

2.1.3 Applicable Substantive Law to the Dispute

One of the possibly applicable laws introduced by scholars is law applicable to the dispute (*lex causae*).⁴⁸ If we assume that *lex causae* is not at the same time subsumed under any of the previous two subsections, I find no ground for justification of it as a law applicable to the effects of the bankruptcy. There are several reasons for such a conclusion. First, *lex causae* is applicable substantive law, while bankruptcy is mostly procedural law. By choosing *lex causae* parties are agreeing on the law under which arbitrators should resolve the disputes arising out or in connection with the main contract. Bankruptcy laws do not provide substantive provisions on these issues. They contain mostly procedural provisions which govern the procedure of enforcement of the claims in a case of bankruptcy of the debtor.⁴⁹ Application of these laws is either requested due to the certain jurisdictional link with the dispute itself or due to public policy demands as discussed in previous subsections. If *lex causae* does not fulfill any of these conditions it should not be applied as a law governing the effects of the bankruptcy on arbitration proceedings.⁵⁰

2.1.4 Application of General Principles of Bankruptcy Law

Last suggestion regarding applicable law could be addressed as to be opposite to the territorial approach discussed under first subsection. In this case there is no concrete suggestion of the country which law should be found to govern effects of the bankruptcy proceedings, but rather the arbitrators should apply general principles common to bankruptcy

⁴⁸ Baizeau, *supra* note 19, at 99; Nadeau-Séguin, *supra* note 2, at 3-4.

⁴⁹ Lazić, *supra* note 1, at 13.

⁵⁰ Brekoulakis, *supra* note 19, at 126.

laws.⁵¹ This solution should be welcomed especially in situation in which we have more possible places of enforcement and *lex concursus* is not the law of the place of the seat. Arbitral tribunal has in its discretion to create the procedure of the arbitration.⁵² Since arbitral tribunal does not have its *lex fori*, in this way the necessary balance would be achieved. On the one side, no particular national law would be applied, while on the other side, certain recognition of “efficient legal cooperation with bankruptcy courts”⁵³ would be achieved.

2.2 *Effects of Specific National Provisions (Comparative Analysis)*

Mitsubishi case answered the question whether arbitrators can apply public policy related rules and it answered it positively. Completely different question is whether they should apply them what will be discussed under this subsection. Application or non-application of these rules will be subjected to the “second look” of the courts either in the proceedings for setting aside or enforcement of the award. Arbitrability differs from one national system to another⁵⁴ which means that after arbitrators has decided which law should govern the effects of the bankruptcy they should look into the specific provisions of that particular law to see whether they would in any way impair arbitrability of the dispute. This basically means that there are not clear cut solutions. Cases like this can be decided only on case by case basis. However, not every provision of bankruptcy laws should be considered relevant. As it was already said, “pure” bankruptcy issues, i.e. conduct of the bankruptcy proceedings, are

⁵¹ Lévy, *supra* note 38, at 110; Lazić, *supra* note 42, at 362.

⁵² Wagner, *supra* note 19, at 62.

⁵³ Andreas Reiner, *Impecuniosity of Parties and its Effect on Arbitration-From the Perspective of Austrian Law*, in FINANCIAL CAPACITY OF THE PARTIES- A CONDITION FOR THE VALIDITY OF ARBITRATION AGREEMENTS?, 66 (German Institution of Arbitration ed., 2004)

⁵⁴ LAZIĆ, *supra* note 1, at 143.

outside of arbitration. Other provisions are not of the same relevance. There are two of them that can influence arbitrability of the dispute. These are:

1. provisions regarding exclusive jurisdiction of the national courts (2.2.1)
2. provisions regarding competence of bankruptcy courts (2.2.2)

2.2.1 Exclusive Jurisdiction of Bankruptcy Courts

Most of the national bankruptcy acts contain provisions that provide for exclusive jurisdiction of their national courts. German Insolvency Act⁵⁵, for example, provides in Section 2 paragraph 1 “*the local court in whose district a regional court is located shall have exclusive jurisdiction for insolvency proceedings as the insolvency court for the district of such regional court*“. At first sight it might seem as a plausible conclusion to say that exclusive jurisdiction of national courts renders dispute to be non-arbitrable. And this might as well be true from the perspective of courts. National courts while deciding on issue of arbitrability will of course apply their national rules on jurisdiction and decide whether the intention of the legislator was or was not to preserve that particular dispute for its courts exclusively.⁵⁶

However, I find arbitrators' perspective to be quite different. Arbitrators do not have *lex fori*, but that does not mean that in certain situations they should not observe certain national rules regarding jurisdiction. As it was explained before, if national rules of the country of the seat or possible enforcement provide for exclusive jurisdiction of their courts, this would create territorial link as a necessary condition for arbitrators to apply their laws while deciding on

⁵⁵Insolvency Statute, October 5, 1994 (Federal Law Gazette I page 2866), as last amended by Article 3 of the Act of 9 December 2010 (BGBl. I page 1885)

⁵⁶ Brekoulakis, *supra* note 19, at 122.

the general effects of bankruptcy, and consequently, effects on arbitrability as well. If, on the other side, law of the third country provides for exclusive jurisdiction, this should not be found relevant by arbitrators.⁵⁷ This is in accordance with the view that the question of arbitrability is not about banning the arbitration, but preserving national courts' jurisdiction in certain situations.⁵⁸

However, this only answer the question of applicable law for effects of bankruptcy on arbitrability, but it does not automatically render the dispute to be non-arbitrable. Provisions regarding exclusive jurisdiction regulate only jurisdictional relations among the courts and not between national courts and arbitral tribunals.⁵⁹ Relations dealt with in these provisions are rather of local competence nature, which just confirms the conclusion that they do not impact the jurisdiction of arbitral tribunals.⁶⁰

What is more relevant when discussing the arbitrability of such cases is the scope of competence courts have in that situation. Therefore, arbitrability is much easier to decide on basis of certain dispute that has arisen then to claim certain dispute is not arbitrable *per se*. Under next subsection I will elaborate on provisions providing for certain decision making powers of national courts that can in combination with their exclusive jurisdiction render the dispute to be non-arbitrable.

2.2.2 Competence of Bankruptcy Judges

If we observe the nature of both arbitration and bankruptcy proceedings, we can say that these two procedures have completely different purpose. Bankruptcy proceedings are

⁵⁷ Brekoulakis, *supra* note 19, at 126.

⁵⁸ Ibid. at 122.

⁵⁹ Liebscher, *supra* note 14, at 170.

⁶⁰ Lévy, *supra* note 7, at 99.

collective execution proceedings which purpose is to collect and distribute debtor's assets.⁶¹ In order to get paid, unsecured creditors are in almost every system requested to file their claims in bankruptcy courts.⁶² Arbitration, on the other side, is dispute settlement mechanism. Pure bankruptcy issues such as commencement of the proceedings, collection and distribution of the assets, verification of the claims are clearly outside the scope of arbitration.⁶³ In that context one would say that there are no overlapping areas between these two procedures. But there are certain types of claims possible in bankruptcy proceedings regarding which the question of arbitration is imposed. One type of these claims is contested claims which are the addressed by this paper. Contested claims are creditors' claims which legality or existence or amount is contested and parties are referred on dispute settlement.⁶⁴ In that case, question is who has jurisdiction to solve such disputes - bankruptcy courts or arbitral tribunals. There are three types of approaches adopted in different national legal systems:

1. First type of national systems find these claims to be in competence of bankruptcy courts, (2.2.2.1)
2. Second type of national systems find that allows these kind of claims to be heard before an arbitral tribunal, i.e. to be arbitrable (2.2.2.2), and
3. Third type which is an American approach which leaves the issue of arbitrability to discretion of national courts on case by case basis (2.2.2.3).

⁶¹ Lazić, *supra* note 1, at 155.

⁶² Ibid. 158.

⁶³ LAZIĆ, *supra* note 1, at 173.

⁶⁴ Liebscher, *supra* note 14, at 169.

2.2.2.1 National Systems under which Contested Claims are Arbitrable

German law can be taken as an example of one of the most liberal systems in that regard. Bankruptcy courts have jurisdiction only regarding bankruptcy issues, other issues are arbitrable, and contested claims among them.⁶⁵ Same approach is adopted under Swiss law which considers that there is no public policy consideration imposed regarding the non-core issues which would preclude arbitration proceedings regarding certain types of claims.⁶⁶ French law on the other side on the first side grants broad jurisdiction to bankruptcy courts.⁶⁷ However, French case law has restricted this meaning that jurisdiction of bankruptcy courts “extends only to issue originating from insolvency proceedings, or matters which have their source in the application of the provisions of insolvency law, or where insolvency law affects the resolution of the dispute”⁶⁸. This means that contested claims are considered to be arbitrable under French law, but there are still some provisions that can render the dispute to be non-arbitrable. Therefore, award rendered in a case of contested claim can still not be enforced but not due to non-arbitrability but due to other public policy reasons. This will, however, be discussed under next Chapter.

2.2.2.2 National Systems under which Contested Claims are Non-arbitrable

Much more restrictive in this regard is Dutch law. Dutch law provides for “split of competence”⁶⁹ regarding arbitrability of the contested claims. Dutch law distinguishes two

⁶⁵ Ibid. 164.; Liebscher, *supra* note 14, at 175; KARL-HEINZ BÖCKSTIEGEL, STEFAN MICHAEL KRÖLL & PATRICIA NACIMIENTO, ARBITRATION IN GERMANY – THE MODEL LAW IN PRACTICE 123 (Kluwer Law International, 2007)

⁶⁶ Lévy, *supra* note 7, at 99.

⁶⁷ Lazić, *supra* note 1, at 160.

⁶⁸ Ibid. at 162.

⁶⁹ Ibid. at 164-165.

situations – case of monetary and non-monetary claims. Non-monetary claims are considered arbitrable, while monetary, i.e. claims for damages are not.⁷⁰

Similar approach is adopted in Austrian Insolvency Act⁷¹. Section 111 paragraph 1 provides for exclusive jurisdiction of bankruptcy courts when it comes to decision of disputes on the contested and the class of insolvency claim. Deciding the class of the claim is not that questionable, as the decision upon contested claims is. There are two interpretations of this provision:

- 1) first one which reads this provision as contested claims are arbitrable without any condition and
- 2) second on which conditions the arbitrability of these claims to the consent of the third parties.

Regarding the first interpretation, if we read this provision together with the Section 113 of Austrian Insolvency Act which gives the right to creditor who commenced the proceedings against the debtor before the later went bankrupt to continue this proceedings before the same court and not start new one before bankruptcy court, we could say that the same principle should be applied to the pending arbitration. This means that if arbitration is already pending at the moment of the opening the bankruptcy proceedings, the creditor should also be given an opportunity to continue this proceedings and not to lose cost and time already wasted on it.⁷² In other words, contested claims should be unconditionally arbitrable. In a case when arbitration is not yet commenced, suggested way to answer this question is analogy of international jurisdiction clauses and arbitration agreements.⁷³ Since the first ones would be considered valid and enforceable notwithstanding the fact that party went bankrupt, there is no reason why arbitration agreements should not be held the same way.

⁷⁰ Ibid.

⁷¹ Insolvency Act, Imperial Gazette No. 337 of 1914.

⁷² Andreas Reiner, *supra* note 53, at 60.

⁷³ Ibid. at 61.

However, the second approach says that if the subject of the claim is validity or existence of such a claim, the dispute is arbitrable only if all persons who could be affected if the claim is found valid give their consent to arbitration.⁷⁴ This can be an example where the argument of the **protection of third parties** is used in order to ban the arbitration. Arbitration proceedings are by its nature considered to be closed for the participation of the third parties.⁷⁵ However, this argument seems to be more plausible when we talk about application of substantive laws related to public policy matters such as anti-trust laws rather than it comes to application of bankruptcy laws which are mostly of procedural nature. In case of antitrust laws, third parties are considered to be private attorneys general and due to that it can be argued that they as well as public did not agree to arbitration agreement.⁷⁶ In a case where one of the parties went bankrupt it is hard to come to the same conclusion. Of course, rights of the third persons may be affected with the decision of the arbitral tribunal that the claim is valid. But the fact that this is arbitral tribunal's decision should not be relevant. As we can see, in other national systems decision on contested claims is reserved for national courts rather than for bankruptcy courts. Even the Austrian law preserved the same approach when it comes to other types of claims- the second paragraph of the Section 111 of the Austrian Insolvency Law provides for the jurisdiction of national courts regarding claims of rights of segregation, separate satisfaction or general claims. Separate satisfaction can also affect the rights of the other creditors even more by allowing secured creditors to seek for separation of certain assets for bankruptcy estate⁷⁷, but for some reason this type of claims is not excluded from the competence of national courts and they are found to be arbitrable even without the consent of the third parties⁷⁸. One should also be aware that arbitration

⁷⁴ Liebscher, *supra* note 14, at 169.

⁷⁵ Stefan M. Kröll, *Arbitration and Insolvency Proceedings- Selected Problems*, in PERVASIVE PROBLEMS IN INTERNATIONAL ARBITRATION, 367, (2006)

⁷⁶ See dissenting opinion of Justice Stevens in *Mitsubishi case*, *supra* note 8; Park, *supra* note 9, at 122.

⁷⁷ KENNETH ET AL., *supra* note 5, at 190.

⁷⁸ Liebscher, *supra* note 14, at 169.

proceedings do not interfere with enforcement proceedings in any way. Creditor holding an award still needs to file this award in verification proceedings before bankruptcy court which and this procedure is found to be pure bankruptcy issue completely outside of arbitration. In that way, we can say that creditor who is holding an award is in no better position than other creditors. In conclusion, this argument seems not to justify reservation of the competence over the contested claims only to bankruptcy courts banning in that way arbitration.

Other possible argumentation might be **the incompetence of arbitrators** to render decision in public policy related matters⁷⁹. This might be true when we talk about conduct of bankruptcy proceeding or application of antitrust law. However, arbitrators in a case in which one of the parties went bankrupt are neither required to apply different substantive law (as they would be in case of antitrust claims) nor they are asked to verify claims. In other words, bankruptcy of one of the parties does not render them not to be trust-worthy in application of substantive law initially chosen by parties. In conclusion, there seems not to be any plausible reason for arbitrators not to be competent to decide upon contested claims.

This is confirmed by one of the theories presented in the literature according to which, when we have claim which is contested in bankruptcy proceedings, the real issue is who contested it. Under Austrian law this possibility is given both to trustee and other creditors.⁸⁰ The role of trustee is not questionable. He is considered to be legal successor of the debtor and therefore obliged by arbitration agreement.⁸¹ Under this approach, other creditors are considered to be legal successors of the debtor as well.⁸² Therefore, when one or more of them contest the claim it is considered that they are obliged by arbitration agreement and no explicit consent is needed.

⁷⁹ Brekoulakis, *supra* note 7, at 26.

⁸⁰ Reiner, *supra* note 53, at 58.

⁸¹ *Ibid.* at 54.

⁸² *Ibid.* at 59.

2.2.2.3 American approach - Arbitrability Left to Discretion of National Courts

United States law adopted different approach than European laws. US Bankruptcy Code⁸³ itself does not provide rules regarding the relation between bankruptcy courts and arbitral tribunals. It addresses, however, the division of competence between district courts and bankruptcy courts.⁸⁴ Bankruptcy Code adopts so-called two-tier system of competence between these two.⁸⁵ District courts are given initially the jurisdiction on all bankruptcy cases and bankruptcy courts are considered to be a mere division of district courts to which district courts can refer bankruptcy cases⁸⁶. There is a difference between core bankruptcy issues which are considered to be actions that have “as its foundation the creation, recognition, or adjudication of rights which would not exist independent of a bankruptcy environment”⁸⁷ and non-core issues which are civil proceedings “related to” a bankruptcy case, for jurisdictional purposes, when the action between the parties affects how much property is available for distribution to creditors of the bankruptcy estate or allocation of property among such creditors, or if the outcome could alter the debtor’s rights or liabilities”⁸⁸. Relevance of distinguishing core from non-core cases when it comes to decision-making powers of

⁸³ United States Bankruptcy Code, November 6, 1978, available at <http://www.law.cornell.edu/uscode/text/11>

⁸⁴ Lazić, *supra* note 1, at 171.

⁸⁵ Coco, *supra* note 14, at. 18.

⁸⁶ *Ibid.* at 5, 18.

⁸⁷ *Ibid.*

⁸⁸ Wendell H. Adair et al., *supra* note 17.

bankruptcy courts is that they cannot render a judgment in non-core cases without the consent of the powers⁸⁹.

Once bankruptcy courts are given jurisdiction over bankruptcy case by district courts what happens rather automatically⁹⁰, they are the ones that need to decide whether the dispute is arbitrable. In other words, it is left in their discretion to decide whether the case can be referred to arbitration or not. However, the question of arbitrability is not imposed by itself by mere observation whether the case is the core or non-core bankruptcy issue, but it is inherent with the question of automatic stay. Automatic stay is provided under Section 362 of Bankruptcy Code and it should be applied in case of “*the commencement or continuation, including the issuance or employment of process, of a judicial administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title*”. Decisions regarding arbitrability under US are actually treated as relief from the mentioned stay. If the courts do not grant the relief, it will decide the by itself banning in that way arbitration on the same issue.

Therefore, when finding American law to be possible applicable law to arbitrability of the dispute before them, arbitrators should observe abundant case-law rendered on this issue and criteria set in those cases when deciding upon their jurisdiction.

After the court in *Mitsubishi case* resolved possibility for arbitral tribunals to apply public policy related provisions, this opened the door for changes in other areas besides application of antitrust laws. In that case Court set a two steps rule regarding application of public policy related provisions which was regularly cited by courts when deciding upon the relief from automatic stay in a case of bankruptcy of one of the parties. First step provided by the court is to decide whether the issues in question are in the scope of arbitration agreement, while the

⁸⁹ Coco, *supra* note 14, at 18.

⁹⁰ Ibid.

second one is whether there is any legal constraint, external to the parties' agreement to arbitrate, that is prohibiting arbitration of the claims. I will not address the question whether the courts are at all competent to decide upon automatic stay of arbitration proceedings nor will I elaborate on the first step question from the Mitsubishi case. For the purposes of this thesis, let us assume that the courts are competent and that the claims are in the scope of arbitration agreement. After that, only question arbitrators should observe is the relation between Bankruptcy Code and Federal Arbitration Act⁹¹, in other words, the question is are the bankruptcy courts competent to decide the cases in which one of the parties went bankrupt. One thing is sure about American courts in this respect and that is that there is no clear cut rule whether they will find the case to be arbitrable or not. Question of arbitrability is inherent with the question of automatic stay, so basically what courts are deciding is whether to give or not to give a relief. Under Section 362 Bankruptcy Code provides for automatic stay “*the commencement or continuation [...] of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title*”. The same Section provides as well for a relief from the automatic stay. Courts found reasons both for granting one and not granting. This case study will try to evaluate both. *In re Springer-Penguin case*⁹² court stated as one of the elements to observe was “*nature and extent of litigation and evidence makes judicial forum preferable to arbitration*”. Observing that particular element the court found that since the proceedings will require the witnesses to travel from US to Yugoslavia where arbitration proceedings should have been held it would be more expeditious solution if court would have decided the case. Next to more expeditious procedure, court also took into consideration the fact that neither creditors nor trustee

⁹¹ Federal Arbitration Act, July 30, 1947, available at http://www.law.cornell.edu/pdf_sup_exp/lii_usc_TI_09.pdf

⁹² *In re Springer-Penguin, Inc.*, 74 B.R. 879 (1987)

consented to the contract containing arbitration clause and general importance of the bankruptcy proceedings. Similar approach regarding the efficiency of bankruptcy proceedings can be found *In re Braniff Airways case*⁹³ where the court said that the purpose of giving the bankruptcy court exclusive jurisdiction over all the claims is to give “*the debtor and his creditor body a full, fair, speedy, and unhampered chance for reorganization*”. In both cases courts found that arbitration should not take place in that particular case and decided not to grant a relief from automatic stay. Reasoning taken by both courts can be overridden by other decisions. *In re Statewide Realty Company case*⁹⁴ and *In re Mor-Ben Insurance Markets Corporation case*⁹⁵ courts explicitly stated that the fact that arbitrations would not be more expeditious does not justify refusal to enforce arbitration clause. Argument regarding non-consent of the trustee to arbitration agreement will be much more thoroughly addressed under next chapter while regarding non-consent of the creditors the question is why it would matter in the first place. Right of the creditors are not impaired by the non-core proceedings itself, but rather in core proceedings which are held to be outside the arbitration. Moreover, in *Transmarittina Sarda Italnavi Flotte Ruiniti S.p.A. v. Foremost Insurance Company case*⁹⁶ court held that enforcement of arbitration proceedings does not harm protection of creditors and their right to be treated equally in liquidation procedure. One of the most common proarbitration arguments is definitely the principle of predictability. Parties’ autonomy and their right to choose the forum for their disputes as universally accepted feature cannot that easily be overridden by provisions of national system. Court came to similar conclusion in *In re Fotochrome case*⁹⁷ by emphasizing the importance of respecting the private agreement such as arbitration agreements which parties negotiated and they are expecting to be enforced. Different conclusion can have serious

⁹³ *In re Braniff Airways, Inc.*, 33 B.R. 33

⁹⁴ *In re Statewide Realty Company*, 159 B.R. 719 (1993)

⁹⁵ *In re Mor-Ben Insurance Markets Corporation*, 73 B.R. 644 (1987)

⁹⁶ *Transmarittina Sarda Italnavi Flotte Ruiniti S.p.A. v. Foremost Insurance Company*, 482 F.Supp. 110 (1979).

⁹⁷ *In the Matter of Fotochrome, Inc.*, 377 F.Supp. 26 (1974).

consequences on international trade. Protection of international commerce is exactly the second argument adopted by courts in favor of arbitration. Not enforcing arbitration agreements can have “chilling effects” regarding conclusion of such agreement which can influence international trade.⁹⁸ What courts are mostly suggesting is congressional decision on arbitrability of certain types of claims.⁹⁹ This would definitely provide much more predictability not only for the American courts and generally arbitrators, but more importantly for the parties themselves. Until then, arbitrators should observe the existent case law trying to predict possible decision by courts. There is no clear cut rule or assurance what kind of decision will be made. However, it can be said that international nature of the dispute is more often found to be in favor of arbitration. This was confirmed by *Societe Nationale Algerienne v. Distrigas Corporation case*¹⁰⁰. The same case addressed the importance of the bankruptcy law itself by saying “it would be unrealistic indeed to argue that bankruptcy principles are qualitatively more fundamental to our capitalistic democratic system than either the securities laws or anti-trust policy”. In other words, after the moment when the court in Mitsubishi case has allowed antitrust law to be applied by arbitrators, the same line should be followed regarding bankruptcy law.

⁹⁸ Societe Nationale Algerienne Pour La Recherche, La Production, Le Transport, La Transformation et La Commercialisation des Hydrocarbures, An Algerian National Corporation v. Distrigas Corporation, 80 B.R. 606 (1987)

⁹⁹ See: In re Mor-Ben Insurance Markets Corporation, *supra* note 97; In re Statewide Realty Company, *supra* note 96.

¹⁰⁰ See *supra* note 101.

CHAPTER 3: EFFECTS OF BANKRUPTCY ON CONDUCT OF ARBITRATION

3.1 *Provisions on Stay or Prohibition of Commencement of Arbitration*

Previous section dealt with the question of arbitrability of the dispute after one of the parties went bankrupt. National provisions of bankruptcy acts can address this question by reserving the jurisdiction of their national courts regarding the claims related to bankruptcy proceedings. As we could see, there are three types of approaches adopted in different national legal systems:

1. First type of national systems finds these claims to be in competence of bankruptcy courts;
2. Second type of national systems which allows these kind of claims to be heard before an arbitral tribunal, i.e. to be arbitrable, and
3. Third type which is an American approach which leaves the issue of arbitrability to discretion of national courts on case by case basis.

In the first type of national solutions, when contested claims are clearly left to be decide by national courts and this law is found to be applicable law for the effects of bankruptcy proceedings, it is advisable not to continue the arbitration.

Second and third types open the possibility to continue the proceedings before arbitral tribunal. However, this does not mean that bankruptcy proceedings should have no effects on arbitration at all. There is still possibility that certain provisions should be respected.

It is generally accepted that parties and arbitrators are true “creators” of the procedure in arbitration.¹⁰¹ Once parties have agreed upon on arbitration they have assumed that the

¹⁰¹ Nater-Bass, *supra* note 42, at 179.

chosen laws, both for resolution of the dispute and procedure, will be applied.¹⁰² However, this principle is not unlimited. Certain national provisions outside the scope of the anticipated procedural should be applied. Arbitrators are not required to apply those rules on the basis of the mere fact that these are mandatory rules applicable on arbitration proceedings, but on the basis that non application would constitute violation of public policy or party's right to present the case.

Violation of public policy is generally accepted ground for setting aside the awards in national laws¹⁰³ and also provided in Article V(2)(b) of the NY Convention as a reason for refusal of the enforcement of the award. Public policy is not the only ground that may come into the question. Right to present the case, which is as well presented as a ground for refusal enforcement of the award by NY Convention in its Article V(1)(b), may also be violated if certain rules are not applied.

National provisions regarding stay of the proceedings in a case of bankruptcy are one of the provisions which non application can violate either public policy or party's right to present a case. Qualification of the ground that can be invoked depends on the national law that is applicable on effects of bankruptcy proceedings. Therefore, this thesis will provide summarized overview of national provisions regarding the stay of the proceedings when one of the parties goes bankrupt. Provisions regarding stay of the proceedings can be qualified as provisions regarding arbitrability of the dispute, public policy issue or the provision protecting party's right to present case. First qualification is accepted under US law which was already discussed under previous subsection. Similar approach is adopted under English Insolvency Act 1986¹⁰⁴ which provides in Section 130 (3) that “*when an order has been made for winding up a company [...] no action or proceeding shall be commenced or*

¹⁰² Melinda M. Massoff, *Authority of United States Bankruptcy Courts to Stay Arbitral Proceedings*, Fordham International Law Journal 159, 148-164 (1987)

¹⁰³ LAZIĆ, *supra* note 1, at 278.

¹⁰⁴ Insolvency Act 1986, available at <http://www.legislation.gov.uk/ukpga/1986/45/contents>

proceeded with against the company or its property or any contributory of the company, in respect of any debt of the company, **except by leave of the court**, and subject to such terms as the court may impose”, meaning that in case of liquidation of the company, stay of the proceedings is automatic and proceedings can only be continued with the permission given by the court.¹⁰⁵

Second approach is French approach. Namely, although French law finds contested claims to be arbitrable, there are certain provisions of the French insolvency law should be considered to be part of public policy *per se* meaning that real violation of any of the party’s procedural rights is not required. French case law confirms this finding that stay of the proceedings is part of both domestic and international public policy and that arbitrators should stay the arbitration even though they are not requested by any of the parties.¹⁰⁶ For example in *Liquidateurs of Sté Jean Lion v. Sté International Company for Commercial Exchange Income case*¹⁰⁷ although Court of Appeal decided that “in order to be unlawful, the recognition or enforcement of an award should constitute **an effective and concrete violation of international public policy rules**”, Cour de Cassation confirmed again that not staying the proceedings in a case of bankruptcy is breach of public policy *per se*. However, this does not impair the arbitrability of the dispute since the dispute can be resumed after filing the claim and no court relief is required.¹⁰⁸

Third approach is the most liberal one. Under this approach provisions regarding stay of the proceedings are providing neither for the permission of the court in order to proceed nor are they considered to be part of the public policy *per se*. This approach is adopted, for example, in German law and Swiss law. Under German law there is no provision addressing the stay of

¹⁰⁵ LAZIĆ, *supra* note 1, at 295.

¹⁰⁶ Lévy, *supra* note 7, at. 101.

¹⁰⁷ For commentary of th case see: Dany Khayat, Coexistence Between Bankruptcy and Arbitration Laws in France, (March 29, 2012), <http://www.mayerbrown.com/lawyers/profile.asp?hubbardid=K957088649>

¹⁰⁸ Lazić, *supra* note 1, at 288.

arbitration explicitly. Section 240 of the German Code of Civil Procedure¹⁰⁹ states that “*in the event of insolvency proceedings being instituted against a party, the proceedings shall be interrupted to the extent they concern the insolvent estate until they can be resumed in accordance with the rules applying to the insolvency proceedings, or until the insolvency proceedings are terminated [...]*”. It is held that this provision is only applicable to state court proceedings¹¹⁰, meaning that it does not affect arbitration proceedings, at least not directly. When applicable law is the law that adopts this approach, arbitrators should observe other possible grounds on which stay can be based on. As was already mentioned one of these grounds is party’s right to present the case.

Under Article V (b) of NY Convention one of the grounds for refusal of enforcement is proof that “*the party against whom the award is invoked was not given proper notice of the appointment of the arbitrators or the arbitration proceedings or was otherwise unable to present his case*”. When bankruptcy proceeding is commenced initial party – debtor is “substituted” by trustee. Trustee is legal successor of debtor’s right and obligations and he overtakes the debtor’s proceedings.¹¹¹ Since trustee is a “new” party, his right to present the case should be protected as well, meaning he should be given enough time to prepare. Purpose of staying the proceeding is exactly that one. However, this can depend on different circumstances, for example, at which stage arbitration is. If arbitrators have to only render the award, there is no need for any stay, and no right will be violated by that.

Swiss law contains mandatory provision regarding the stay of court proceedings in a case of bankruptcy.¹¹² However, this provision is not considered to be a part of public policy *per*

¹⁰⁹ Code of Civil Procedure as promulgated on 5 December 2005 (Bundesgesetzblatt (BGBl., Federal Law Gazette) I page 3202; 2006 I page 431; 2007 I page 1781), last amended by Article 3 of the Act dated 24 September 2009 (Federal Law Gazette I page 3145)

¹¹⁰ BÖCKSTIEGEL ET AL., *supra* note 66, at 61 and 295.

¹¹¹ Reiner, *supra* note 54, at 54.; Gerhard Wagner, Poor Parties and German Forums: Placing Arbitration under the Sword of Damocles, in FINANCIAL CAPACITY OF THE PARTIES- A CONDITION FOR THE VALIDITY OF ARBITRATION AGREEMENTS?, 21, (German Institution of Arbitration ed., 2004).

¹¹² Lévy, *supra* note 7, at 101.

*se.*¹¹³ Arbitrators are considered to be free to determine by themselves whether they should stay the proceedings or not by considering the true policy behind it – giving trustee enough time to prepare the case.¹¹⁴ If they consider this right will be suppressed in amount that the principle of due process will be violated, only in that situation the rule of staying the proceedings becomes mandatory for them as well.

Due attention should be given to the reasoning of all of these three approaches. Namely, there are valid arguments on both sides. On one side we have policy that requests strict application of the national provisions regarding stay, notwithstanding whether the proceedings later can be continued only with or even without the permission of the court. This approach is recognized in US and France, for instance. Reasoning behind is strong policy regarding the principle of concentration of the bankruptcy proceeding in order to protect the equality of the creditors. It is held that equal treatment of the creditors in bankruptcy proceedings can be as well impaired by the fact that they didn't have the opportunity to gain executory title due to the stay or forbearance of commencement of the judicial proceedings.¹¹⁵ Protection of the creditors can also be invoked by saying that he should also be given reasonable time to file his claim in bankruptcy proceedings.¹¹⁶ In connection with that argument one may also claim that it could be waste of costs for both parties if arbitrators would proceed with the proceeding. This could happen if the claims would be admitted in bankruptcy proceedings which would render all the proceedings to be in vain.¹¹⁷

On the other side, third approach which leaves practically freedom for arbitrators to decide whether to stay or not the proceedings. This freedom is, however, limited, but not with provisions giving the decision making power regarding stay to national courts or with

¹¹³ Ibid. at 102.

¹¹⁴ Ibid. at 103.

¹¹⁵ LAZIĆ, *supra* note 1, at 257.

¹¹⁶ Nater-Bass, *supra* note 42, at 179.

¹¹⁷ LAZIĆ, *supra* note 1, at 257.

provisions violation of which is considered to be *per se* against public policy, but rather with real, concrete violation public policy. This approach is supported with both principle of predictability and parties' autonomy. Arbitrators are considered trust worthy to decide by themselves whether the proceedings should be stayed.¹¹⁸ When parties negotiate and conclude the arbitration agreement, they are entitled to expect that it will be executed under the procedure they have agreed upon.¹¹⁹ Putting the execution of these agreements in the courts' hands or demanding the stay without real threat with violation of due process would seriously violate parties' autonomy as well as the principle *pacta sunt servanda*.¹²⁰ Not staying the arbitration proceedings regarding the contested claims would not in any way impair the position of other creditors, since party in arbitration would still be required to file its claim in bankruptcy proceedings in order to receive the payment. Arbitration does not in any way substitute the true nature of bankruptcy proceedings and this is payment of the debts. Main policy behind the principle of centralization is applied in order to achieve efficient and equal distribution of the assets¹²¹ and not to centralize the disputes related to bankruptcy estate. This conclusion is also supported by already discussed topic in previous subsections- that in most national systems contested claims are considered arbitrable or they remain in jurisdiction of the general national courts and not bankruptcy court. Therefore, if there is no real violation of the due process, it is hard to claim that debtor's rights or rights of other creditors would justify in any way stay of proceedings. One should also bear in mind that stay is not only provided for the protection of debtor, but as well for the protection of creditor.¹²² Therefore, unilateral interpretation of these provisions which would put the debtor's rights in spotlight and completely neglect creditor's interest can be found equally unfair.

¹¹⁸ Nater-Bass, *supra* note 41, at 166.

¹¹⁹ Massoff, *suora* note 105, at 159.

¹²⁰ Kröll, *supra* note 24, at 253.

¹²¹ Nadeau-Séguin, *supra* note 2, at 80.

¹²² Massoff, *supra* note 103, at 154.

In the end, what should be emphasized is that arbitrators are not able to choose freely among these two sides. This serves only as summary of the arguments invoked by both approaches. Even though arbitrators do not have *lex fori* they are still bound by law which they find applicable on effects of bankruptcy proceedings as described above. They should observe and obey the approach that particular law is providing. This can be criticized in a way that “localizes” arbitration too much.

3.2 Effects of Bankruptcy on the Content of the Award

As it was already stressed out, once arbitrators found the dispute to be arbitrable, their concern regarding the effects of bankruptcy it is not considered to be finally solved. In previous section I have explain one of the possible situations in which bankruptcy law can still have impact on the conduct of arbitration proceedings. When not considered to be part of the issue of arbitrability, stay of proceedings can still be required on the basis that forms part of public policy *per se* or that its application is needed in order to preserve the right of the party to present its case.

This, however, is not only possible effect of bankruptcy on the conduct of arbitration proceedings. Another possible scenario regards the content of the award. When commencing an arbitration claimant usually does not assume that prior to its ending respondent will go bankrupt. Therefore, relief usually seeked is not declaration of validity and existence of the claim, but rather the also the order for payment. This can be disputed from the standing point of bankruptcy proceedings. Equal treatment of creditors is one of the main principles of bankruptcy proceedings.¹²³ View adopted in French law is that this principle can be

¹²³ Lévy, *supra* note 7, at 106.

jeopardized by letting the arbitral tribunals to render condemnatory award and in that way putting these creditors in a better position.¹²⁴ The question is why these creditors should be considered to be put in the better position. One possible answer is the possibility of enforcement of the condemnatory award in other jurisdictions.¹²⁵ However, although is quite understandable why condemnatory award would not be enforced in the country of the place of bankruptcy proceedings, I find questionable whether this would be the case if the enforcement is sought in another jurisdiction. Moreover, the fact that creditor has the possibility to enforce the award in more than one jurisdiction, in my opinion, should have no influence on enforcement even in a country in which bankruptcy proceedings are pending. There are several reasons I find supportive in that respect. First of all, bankruptcy proceedings are collective enforcement proceedings.¹²⁶ Therefore, creditor has no other possibility but to file his claim in bankruptcy court in order to enforce it. Influence of the bankruptcy proceedings on the possibility for him to seek the enforcement before the courts of other countries, should be the question of cross-border insolvency.¹²⁷ If the court of that country has recognized the effects of bankruptcy proceedings, other creditors will be protected because the award-holding creditor will not be able to escape the restrictions set by principle of equal distribution of the assets. On the other side, if the court did not recognize the effects, I find the request for only-declaratory award to be the attempt to give extraterritorial effect to bankruptcy proceedings even in a case of non-recognition.

Similar scenario can happen under Austrian Insolvency Act as well. Although it addresses only court proceedings, Section 110 of Austrian Insolvency Act imposes similar limits regarding the content of the decisions rendered after the bankruptcy proceedings is commenced that could effect conduct of arbitration as well. Under paragraph 1 of that

¹²⁴ Lazić, *supra* note 42, at 360-361; Lévy, *supra* note 38, at 112.

¹²⁵ Lazić, *supra* note 42, at 360-361.

¹²⁶ Nadeau-Séguin, *supra* note 2, at 80.

¹²⁷ Lazić, *supra* note 1, at 259.

Section creditors whose claims are disputed may “*introduce a declaratory action which is to be directed against all disputing parties*”. In other words, after the commencement of the bankruptcy proceedings, creditors are allowed to request the confirmation of the existence and validity of the claim and requests in already pending proceedings will as well be changed from the order for payment to the request for declaratory judgment.¹²⁸ This approach can be justified in the same way as French one - protection of the other creditors by not allowing the creditor to request the condemnatory judgment and by changing the content of the requests in already pending proceedings. However, one should also consider the possibility that some of the creditors might already be holders of condemnatory judgments or awards before the bankruptcy proceedings are started. Would in that case the result be the same as under the French law – where creditors' awards in that case would not be enforced? If the answer is yes, then the question is how fair that is. That would mean that creditor would be denied the possibility of the enforcement of the award rendered before the bankruptcy of the debtor. That opens the possibility for the debtor to fraudulently evade the enforcement of the condemnatory decisions.

German law takes different approach. Under French law it is not required to prove that enforcement of the award would concretely violate the public policy in order to reject the request for enforcement.¹²⁹ On the other side, under German law if one proves that he will use the award only for the purpose of verification of the existence and validity of the claim in bankruptcy proceedings, the award will be recognized.¹³⁰ In other, scenario, if one does not prove that he will use only for that particular purpose, we can conclude that that would constitute concrete violation of the principle of equality of the creditors, i.e. public policy.

¹²⁸ Reiner, *supra* note 54, at 57.

¹²⁹ Lévy, *supra* note 38, at 112.

¹³⁰ Lazić, *supra* note 42, at 360.

CHAPTER 4: EFFECTS OF BANKRUPTCY ON VALIDITY OF ARBITRATION AGREEMENT

4.1 Provisions Rendering Arbitration Agreement Invalid in a Case of Bankruptcy

Bankruptcy laws rarely provide provisions governing relation between the bankruptcy proceedings and arbitration.¹³¹ One of the exceptions to this rule is Polish Bankruptcy and Restructuring Act which provides in its Article 142 the following:

*“Any arbitration clause conducted by the bankrupt shall lose its legal effect as the date bankruptcy is declared and any pending arbitration proceedings should be discontinued”.*¹³²

It may seem to be a clear that this provision as a part of *lex concursus* should be applied by arbitrators, however, this imposes more problems than they are visible from the first look. The main issue can be regarded as issue of qualification. This is exactly the reason why this provision was in a spotlight in a very vivid discussion over the *Vivendi/Elektrim case*¹³³ in which courts in England and Switzerland deciding in a proceedings for setting aside the award came to completely different conclusions. English court treated the issue as a procedural one, while Swiss court qualified it as a capacity of the party¹³⁴. However, it is quite clear that the provision deals with the situation in which arbitration agreement loses “its legal effect”, i.e. with validity of the same. Under this understanding of provision, it cannot be found to be applicable neither to the effects of bankruptcy on arbitration as qualified in English case nor on capacity of the parties as qualified by Swiss court.

¹³¹ Kröll, *supra* note 24, at 217.

¹³² Naegeli, *supra* note 44, at 194.

¹³³ See *supra* note 42.

¹³⁴ Nater-Bass, *supra* note 41, at 171-172.

Law governing the validity of the arbitration agreement is *lex arbitri*.¹³⁵ *Lex arbitri* in these cases were English and Swiss law. Neither of these contains any similar provision. However, even if they had provided the same solution as contained in Polish provision, I would still find the application of such provision questionable. If the bankruptcy proceedings are not commenced in the country of the seat of arbitration, there is a lack of jurisdictional link which justifies application of the bankruptcy laws of that country. One could argue that jurisdictional link is relevant only for arbitration. On the other side, this provision clearly serves for the purpose to preserve hearing of the cases usually referred to arbitration for national courts. Therefore, I find no interest of the national courts to apply such a provision if the arbitration does not conflict with their jurisdiction. Consequently, only situation in which provision regarding the validity of arbitration agreement in a case of bankruptcy can be considered applicable is in a case where *lex arbitri* is at the same time *lex concursus*.

4.2 Financial Capacity of the Parties as a Condition for Validity of Arbitration Agreements

Combination of a principle that party can rescind the contract due to non-performance of the other party and principle of protection of one's access to justice can in a very summarized way explain the approach taken in German and Austrian under which impecuniosity of one of the parties can lead to the termination of the arbitration agreement.¹³⁶ The notion of impecuniosity should not be found to be a synonym for bankruptcy.¹³⁷ Impecuniosity means

¹³⁵ Ibid. at 172.

¹³⁶ Reiner, *supra* note 54, at. 40; Emmanuel Gaillard, Impecuniosity of Parties and its Effects on Arbitration: A French View, in FINANCIAL CAPACITY OF THE PARTIES- A CONDITION FOR THE VALIDITY OF ARBITRATION AGREEMENTS? 83 (German Institution of Arbitration ed., 2004).

¹³⁷ Wagner, *supra* note 112, at 20.

that party has no enough funds to pay for procedural costs.¹³⁸ Impecuniosity can render party to bankruptcy, but it can exist outside of bankruptcy as well.¹³⁹ On the other side, even in a case of bankruptcy trustee can commence or continue proceedings and if he loses costs will be reimbursed from bankruptcy estate.¹⁴⁰ In other words, the fact that the party is bankrupt does not necessarily mean that arbitration costs cannot be covered from bankruptcy estate. However, when these two notions are realized at the same moment meaning that party is at the same time bankrupt and impecunious, the question is what impact does that have on arbitration proceedings, or being more specific on arbitration agreement itself.

If the dispute is resolved before the court, remedy would be legal aid provided by the court.¹⁴¹ This kind of remedy is not provided in arbitration. One should also be aware of the fact, that bankruptcy itself in this particular case would have an effect on validity of arbitration agreement only if it is provided in special provision as discussed under previous subsection. Nevertheless, because of the extremely high probability that bankrupt party would be also found incapable of paying the costs of arbitration, I find it important to observe the effects of impecuniosity on arbitration agreements as well. German and Austrian law adopted certain solutions giving impecuniosity effects on arbitration.

4.2.1 German law

Approach taken under German law is based on so-called “ipso-iure cessation theory”¹⁴². Section 1032 paragraph 1 of Code of Civil Procedure provides that “*should proceedings be brought before a court regarding a matter that is subject to an arbitration agreement, the*

¹³⁸ Ibid.

¹³⁹ Reiner, *supra* note 54, at 41-42.

¹⁴⁰ Wagner, *supra* note 112, at 23-24.

¹⁴¹ Reiner, *supra* note 54, at 43.

¹⁴² Wagner, *supra* note 112, at 24.

court is to dismiss the complaint as inadmissible [...], unless the court determines the arbitration agreement to be **null and void, invalid, or impossible to implement**". Part of this provision that may be influenced by impecuniosity of the party is impossibility for arbitration agreement to be implemented or using the phrase usually taken in literature and in Article 16 of Model Law on Arbitration as well - *incapable of being performed*.

For example, under Article 36 (6) of ICC Arbitration Rules¹⁴³ „when a request for an advance on costs has not been complied with [...] the Secretary General may direct the Arbitral Tribunal to suspend its work and set a time limit [...] on the expiry of which the relevant claims, or counterclaims, shall be considered as withdrawn [...]". Being aware that legal aid is not institute provided in arbitration, one can say that not being able to pay costs of proceedings renders the arbitration agreement incapable of being performed. This is exactly opinion adopted not only in German literature, but as well German case law.¹⁴⁴ Policy behind this conclusion is protection of the party' right to access to justice.¹⁴⁵

This, however, does not answer the question whether the arbitration agreement is still valid. This answer becomes even more difficult to answer if we have in mind that the other party is always considered to be free to pay the costs instead of the impecunious party.¹⁴⁶ The question is whether we can with certainty say that arbitration agreement is invalid when it depends on the will of the "rich" party to pay for costs. Opinion found in literature leads to conclusion that arbitration agreement should be considered invalid after all.¹⁴⁷ Explanation for this lays in Section 1040 of Code of Civil Procedure which provides that arbitral tribunal „may decide on its own competence, and in this context also regarding the **existence or the validity** of the arbitration agreement". By not mentioning explicitly the possibility that

¹⁴³ ICC Arbitration Rules, January 1, 2012.

¹⁴⁴ See: Liebscher, *supra* note 14; BÖCKSTIEGEL ET AL, *SUPRA* NOTE 66; Wagner, *supra* note 19.

¹⁴⁵ Lévy, *supra* note 7, at 90; Gaillard, *supra* note 137, at 83.

¹⁴⁶ Wagner, *supra* note 156, at 31.

¹⁴⁷ Ibid. at 28.

arbitration could be found *incapable of being performed*, one should assume that this is included in question of validity.¹⁴⁸

4.2.2 Austrian Law

Austrian approach to this matter resembles the „old“ German approach. Before introducing „ipso-iure cessation theory“, German courts were allowing parties to be released from arbitration agreements by giving them the right of termination in a case of impecuniosity, notwithstanding whether the party itself had financial difficulties or its opponent.¹⁴⁹ Under Austrian law the parties are given right to rescind or terminate the arbitration agreement on two basis:

1. in a case of impecuniosity of respondent, claimant can rescind the arbitration agreement due to the fact that it did not get what he expected under the contract
2. in a case of impecuniosity of claimant, it is given the right to terminate the contract in order to have a „free“ way to submit his claim to the court and in that way not to be denied the access to justice.¹⁵⁰

In that way, both parties are protected from possible impediment caused by impecuniosity of either one. As I have mentioned at the beginning of this paper, this is the example of a case in which insolvency, meaning inability to pay due debts, can have some effect to arbitration proceeding. However, this theory is not yet widely accepted.

¹⁴⁸ Ibid.

¹⁴⁹ Ibid. at 24.

¹⁵⁰ Reiner, *supra* note 54, at 40.

CHAPTER 5: SOLUTIONS UNDER CROATIAN BANKRUPTCY ACT

Croatian Bankruptcy Act¹⁵¹ is one of those rare laws that explicitly addresses the relation between bankruptcy proceedings and arbitration. Article dealing with this matter is Article 178 (5-9) which governs proceedings regarding contested claims.

This article will be analyzed regarding several issues imposed by it:

- 1) arbitrability of the claims under BA and exclusive jurisdiction
- 2) special features of the BA solution
- 3) content of the award under BA.

5.1. *Arbitrability of the Claims and Exclusive Jurisdiction*

General rule on arbitrability is provided by Croatian Arbitration Act¹⁵²[hereinafter AA]. Article 3(2) of this Act provides that regarding arbitration with international element which is the matter of discussion in this thesis the dispute is not arbitrable if there is exclusive jurisdiction of Croatian court. Under Article 301(1) of BA it is provided that bankruptcy courts have exclusive jurisdiction in bankruptcy matters when the debtor has his seat in Croatia. Consequently, that would mean that under Croatian law no claim is arbitrable in a case of bankruptcy of one the parties.¹⁵³

However, it is considered that this strict solution is overridden by BA in its Article 175 (5) which provides that “*bankruptcy court may decide to order the parties to settle their dispute by arbitration at some permanent arbitration court in the Republic of Croatia*”. Next

¹⁵¹ Bankruptcy Act, Official Gazette No. 44/96, 29/99, 129/00, 123/03, 82/06, 116/10, 25/12.

¹⁵² Arbitration Act, Official Gazette No. NN 88/01.

¹⁵³ Uzelac, *supra* note 29, at 10.

paragraph conditions this to submission of the request made by creditor who was instructed to litigate within 8 days from such instruction.

By not subjecting arbitrability of these claims to the general rule provided in AA, this rule presents *lex specialis* regarding arbitrability of the claims in bankruptcy proceedings. Therefore, contested claims are considered to be arbitrable under Croatian law.

5.2. Special Features of Croatian Law

One could notice the similarity between Croatian approach and American one which leaves the question of enforcement of arbitration agreement to the bankruptcy courts. Article 178 (5) provides that “*bankruptcy court may refer parties to settle their dispute in arbitration*”. In other words, if it does not refer, there will be no arbitration. However, while US courts have the power to decide whether to enforce the arbitration agreement under the terms as parties have agreed upon, under the Croatian law it is a question whether this can be called enforcement of arbitration agreements at all.

Namely, there are certain restrictions provided under Article 178 which can be considered to be special features of Croatian law.

First one is provided in paragraph 5 which says that “*parties can be referred to the permanent court in Croatia*”. Since Permanent Arbitration Court of Chamber of Commerce is the only permanent arbitration court in Croatia, this basically means that is the only eligible to decide upon these claims. This solution imposes two questions:

- 1) what if parties did not agree upon this institution
- 2) what if they did not agree upon arbitration at all?

Referring parties on arbitration in these two situations raises the issues regarding party's autonomy and party's right to a fair and public hearing under European Convention on Human Rights.

In the first case, parties' choice of procedure under which the arbitration should be conducted is completely neglected if they are referred to arbitration institution they did not choose. In that case, we could say Croatian courts are not aimed to enforce arbitration agreements at all. Second situation illustrates this even better. Even if parties did not agree upon arbitration, they can still be referred to one. Basis for such referral is court's decision which according to Article 178 (7) **substitutes** arbitration agreement. In other words, there is no agreement at all, meaning there is nothing to enforce after all. As it was already mentioned this imposes the question of violation of party's right to fair and public hearing. Justification of such a solution is that Croatian Permanent Court is considered to be neutral forum which "satisfies the requirements of fairness and impartiality" established by ECHR.¹⁵⁴

In the end, one could conclude that giving this kind of competence to bankruptcy courts makes the bankruptcy proceedings more efficient and less time-consuming.¹⁵⁵ However, one should also ask himself whether this should be considered to be a commercial arbitration in a true sense or it should be rather considered to be a compulsory arbitration provided as an alternative dispute resolution mechanism under bankruptcy proceedings.

Next feature confirms this assumption even more. Under Article 178 (8) of BA any creditor or a debtor may intervene in arbitration procedure. It is provided in order to assure the protection of principle of equality of the creditors. However, by letting them to participate in the proceedings it conflicts one of the basic principles of arbitration which allows no third parties in this dispute settlement mechanism. In that way, arbitration under Croatian BA seems to be even less conducted according to parties' agreement.

¹⁵⁴ Mihajlo Dika, *Arbitration in Bankruptcy*, Croatian Arbitration Yearbook, Vol. 4, 37, 27-38 (1997)

¹⁵⁵ Ibid. at 36.

5.3. Content of the Award under BA

Croatian solution regarding the content of the award is similar to French and Austrian approach. Article 178(9) of BA provides the rule regarding the possible content of the award by saying that award of the arbitral tribunal can be the one “determining the amount of the claim and its distribution order or one determining that the claim does not exist”. From this one can conclude that award ordering payment, i.e. condemnatory awards are not allowed under Croatian law in a case of bankruptcy of one of the parties.

5.4 Proposal for Amendments of Croatian BA

It is quite clear from everything said that arbitration under BA is not in conformity with leading solutions found in other national systems. Main area of non-compliance is Croatian solution regarding non-arbitrability of the contested claims. Although Croatian law may look rather liberal at first look, it can actually be addressed as one of the strictest in that respect. As I have already explained, it adopts solution similar to the US one. Courts are free to decide whether they will refer parties to the arbitration or not. It is surprising that legislator did not decide to accept solutions from for example German law, as being one of the models for Croatian law, but it rather decided for common law approach. Moreover, it made it even stricter in a way that parties can *de facto* referred to only one arbitration court – Permanent Arbitration Court of Chamber of Commerce in Zagreb. Having that in mind, one surely cannot describe Croatian system as being arbitration-friendly due to the fact that not only restricts parties’ autonomy in their choice of arbitral tribunal, but as well bans foreign

arbitration. This can cause “chilling” effect on foreign businessmen dealing with Croatian parties when concluding the arbitration agreements with them. Arbitration is preferred dispute resolution mechanism in business world. Therefore, it would be advisable to find a different solution, more suitable and conforming to today’s approaches in civil law systems.

CHAPTER 6: CONCLUSION

This paper has provided the overview of the possible and the most common effects that bankruptcy can have on arbitration proceeding. The situation in which one of the parties went bankrupt was observed from arbitral tribunals' point of view. Although they are considered to be neutral and territorially independent, their discretion in creating the procedure is still subjected to certain limitations. One of these limitations is public law rules, such as bankruptcy law. However, these rules are not always found relevant. In order for them to be observed and, consequently, applied, arbitrators should find them to be applicable law on effects of bankruptcy. Literature and case law provide for no clear cut solution regarding which law should be applicable. Encountered with choice of law problem in this situation, arbitrators are free to choose which ever method they want. Prevailing opinion is that choice is consistent of five laws: law of the seat of the arbitration, law of the place of anticipated enforcement, law of the place of bankruptcy proceedings, applicable substantive law and general principles of bankruptcy law. Arbitrators should choose which law to apply led with the aim of rendering award with no ground for setting aside or to refuse the enforcement and while stepping into the shoes of relevant courts - the courts of the seat of the arbitration and of the country of predicted enforcement - arbitrators should observe whether there is jurisdictional link between the case before them and the courts of those countries or other justification for their application. Only in that situation they will be required to **observe** them. Arbitrators may assume that parties want to be able to enforce the award. In that respect, the critics regarding this method as being to territorial approach can be overridden by the fact that impliedly parties agreed upon it. However, it was shown that choosing an applicable law on effects of bankruptcy does not necessarily mean that the rules of that **must** be applied. Whether they will be applied depends upon each national system. Countries adopt

different positions regarding the effects of bankruptcy on arbitrability and conduct of arbitration, as well as on validity of arbitration agreement. Once arbitrators have decided upon the applicable law, they are observing certain provisions of these bankruptcy laws in order to decide are they obliged to apply them. Only if the national law which is applicable in the particular case finds those rules to be applicable on the ground of (non)arbitrability of the dispute, protection of public policy or right to be heard.

What I have shown in this paper is the diversity of the approaches taken in national bankruptcy systems and how they, consequently, influence the arbitration. One should notice that although there is tendency of harmonizing bankruptcy proceedings among the countries, the practice shows that principles of bankruptcy laws can be the same, but their implementation can provide different results. In those circumstances, situation for arbitrators trying to balance between both parties' will and public interest as well as between principle of universality and territoriality is not easy. However, they should aim to find the most favorable way by choosing the law and observing the relevant provisions. Arbitration is territorially independent, but is also considered to be more "elastic" procedure than litigation, shaped by the will of the parties and arbitrators. This feature should be used in other to provide the best solution for the parties. As long as the bankruptcy laws are not harmonized in their application in all legal systems, arbitrators can only with help of the parties through their mutual communication and cooperation and with guidance of the rules developed in legal theory and practice which are presented in this paper overcome these issues.

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