

(2015) 3 NIBLeJ 6

Bankruptcy, Arbitration Agreements and the Access to Justice

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Introduction

1 The interaction between insolvency proceedings and arbitration agreements has many aspects. It would go beyond the purpose of this contribution to discuss all the possible issues of what is sometimes called the “collision” between arbitration and insolvency.¹ Instead, I will focus on a particular problem which is challenging in itself but also gives the opportunity to explore, or at least to point towards wider perspectives. In honour of Professor Fletcher, I will deal with the subject from a broad comparative perspective.

2 The question I want to raise is whether the courts can decline the enforcement of an arbitration agreement due to the arbitration costs posing an excessive burden on the bankrupt estate. To narrow the discussion we will only deal with bankruptcy, meaning proceedings that are aimed at liquidation and entail the divestment of the debtor; an arbitration agreement entered into prior the opening of proceedings; the bankrupt estate as a creditor/plaintiff and making the distinction between pending arbitration and arbitration that was not initiated before the opening of the insolvency proceedings.

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¹ See V. Lazic, “Arbitration and Insolvency Proceedings: Claims of Ordinary Bankruptcy Creditors” (1999) 3 (Dec) *Electronic Journal of Comparative Law*, available at: <<http://www.ejcl.org/33/abs33-2.html>>; G. Born, *International Commercial Arbitration* (2009, Kluwer Law International, New York), at 809-816; S. Kröll, “Arbitration and Insolvency Proceedings - Selected Problems”, in L. Mistelis and J. Lew (eds), *Pervasive Problems in International Arbitration* (2006, Kluwer Law International, Alphen aan den Rijn, Netherlands), at 357-376; F. Mantilla-Serrano, “International Arbitration and Insolvency Proceedings” (1995) *Arbitration International* 51-74; R. Merkin, *Arbitration Law* (3rd rev ed) (2004, Informa Law, London), at 87-89. See for Belgian law: M. Huys and G. Keutgen, *L'Arbitrage en Droit Belge et International* (1981, Bruylant, Brussels), at 49-50; F. t’Kint, “Convention d’Arbitrage et Faillite”, in *L’Arbitrage dans la Vie des Sociétés* (2000, Bruyant, Brussels), at 218-228; V. Thielman, “Arbitrage en Faillissement” (1990-91) *Rechtskundig Weekblad* 875-880.

3 The following Belgian case dealt with this question.² The administrator of a bankrupt company filed a lawsuit against a debtor of the company before the commercial court. The defendant argued that the court did not have jurisdiction as the parties had entered into an arbitration agreement prior to the opening of the insolvency proceedings. The administrator argued that the bankrupt estate did not provide for sufficient financial means to fund the arbitration proceedings and that the defendant by insisting on arbitration was abusing his rights. Furthermore, it was argued that there was an infringement of Article 6 of the ECHR, which guarantees the access to justice. The court dismissed these arguments: an arbitration agreement is binding on the bankrupt estate and the mere fact that arbitration proceedings are more costly did not prove the alleged abuse of rights by the defendant.

Arbitration and Insolvency: Conflicting Aims and Principles

4 There are multitude of questions raised by the interaction between arbitration and insolvency. This is understandable, since both institutions are determined by conflicting principles. On the one hand: individual interests, contractual freedom and party autonomy. On the other hand: centralisation of claims, equal treatment of creditors, and mandatory rules protecting the collective interests of the proceedings.

5 In order to explore the balance between these opposite objectives, one must also bear in mind that most European jurisdictions are favourable towards arbitration. This is especially the case in an international context. To uphold arbitration agreements goes beyond the particular interests of the parties. It is regarded as an important tool to enhance international commerce.

Overview of Some Effects of Insolvency Proceedings on Arbitration Agreements

6 A comparative overview of different European jurisdictions of the consequences of insolvency proceedings in arbitration gives a very diverse picture. In most continental jurisdictions there are no specific provisions in the bankruptcy codes or arbitration acts on the issue (e.g. The Netherlands and Belgium). Whether the problem is addressed by legislation or case law, the outcome is very diverse: invalidation of arbitration agreements (e.g. Poland), suspension during insolvency proceedings (e.g. Spain) or based on the discretion of the courts (e.g. USA, United Kingdom).

² Court of Appeal of Gent 21 February 2006, *Rechtskundig Weekblad* 2009-2010, 279; the appeal before the Supreme Court (*Cour de cassation/Hof van Cassatie*) was unsuccessful (Cass. 29 May 2009, C.06.0264.N).

7 Things become more complicated when the law governing the insolvency proceedings (*lex concursus*) differs from the law applicable in the lawsuit or the arbitration. Very often, the arbitrators will be inclined to reject arguments regarding the invalidity or the stay of arbitration based on a foreign bankruptcy law. The Achilles heel will then be the possible non-recognition of the arbitral award in the said foreign State.

8 According to Article 15 of the European Insolvency Regulation the effect of insolvency proceedings on a pending lawsuit is governed solely by law of the state in which that lawsuit is pending. This means that in case the *lex fori arbitri* does not know of any limitation on arbitration where one of the parties is subject to an insolvency procedure, a pending arbitration cannot be stopped on grounds based on the foreign *lex concursus*. This principle was applied by the English Court of Appeal in *Syska v. Vivendi Universal*.³ An investment agreement between a Polish company and Vivendi which was governed by Polish law contained an arbitration clause which was governed by English law. Vivendi started arbitration proceedings alleging that the Polish company was in breach of its obligations under the agreement. The Polish company was declared bankrupt and the Polish insolvency court appointed Mr. Syska as the administrator. The administrator filed a counterclaim stating that according to Polish law, the opening of insolvency proceedings deprives the arbitral tribunal of any jurisdiction. The Court of Appeal ruled in favour of the *lex fori arbitri*. Since there was no provision of English law annulling the arbitration agreement, the arbiters were correct in their argument that the arbitration could and should proceed.

Basic Principles regarding Arbitration and Bankruptcy

9 Since the type of proceedings we are examining entail the dispossession of the debtor, arbitral proceedings can only be initiated or continued by the administrator in order to be effective against the debtor's estate. Given the collective dimension of the insolvency process and the objective of centralizing litigation, most legal systems limit the possibility for administrators to enter into arbitration agreements.

10 It is generally accepted that the so-called "core" aspects of insolvency are excluded from arbitration. "Pure insolvency issues" remain outside the domain of arbitration. Under the notion of "core" aspects are understood all issues that have a direct connection with the insolvency proceedings. Very often the question whether an issue is to be regarded as a "pure" insolvency is self-evident. One can think of the powers of the administrator or the rules pertaining to the distribution of the proceeds. The enumeration under Article 4(2) of the European Insolvency Regulation is a useful indicator. Further guidance is given by the preamble of the Regulation which states that the scope of the Regulation should be confined to

³ [2009] WLR 236.

provisions governing jurisdiction and judgments which are delivered directly on the basis of the insolvency proceedings and are closely connected with such proceedings (sixth recital). Accordingly, it was held by the European Court of Justice in *German Graphics Graphische Maschinen GmbH*⁴ that the regulation does not apply to an action based on a retention of title clause brought by a seller against the insolvent buyer, even when the goods are situated in the Member State where the insolvency proceedings have been instigated. Such a claim is not based on the insolvency law and requires neither the opening of such proceedings nor the involvement of a liquidator.

11 In a majority of examined jurisdictions it is accepted that an arbitration clause entered into by the debtor prior to the opening of the insolvency proceedings and that does not impede on the core aspects of the insolvency proceedings is binding to the administrator. An arbitration agreement is thus not invalidated simply by the opening of the proceedings. An arbitration clause is therefore in principle considered “insolvency proof”. This is the approach in most European jurisdictions (e.g. France, Germany,⁵ Switzerland,⁶ The Netherlands⁷ and Belgium⁸). This is also the case for the USA, where case law is clearly developing in favour of the enforcement of arbitration agreements within bankruptcy proceedings.⁹

Limitations on the Effectiveness of Arbitration Agreements in the *Lex Concursus*

12 A common feature of insolvency proceedings is that the creditors have to submit their claim to the bankruptcy court or the administrator in order to be entitled to participate in the distribution of the assets. To centralize the claims, all ordinary creditors are required to file their claim in order to be verified in the proceedings. Only then can the claim be taken into account in the later distribution of the debtor’s estate. This is also clearly stated in the *Principles of European Insolvency Law* that reflect the common core of European insolvency law. According to § 3.3 of these Principles, a claim against the debtor existing at the time of the opening of

⁴ ECJ C-292/08, 10 September 2009.

⁵ A. Heidbrink and M.-C. Von der Groeben, “Insolvenz und Schiedsverfahren” (2006) *Zeitschrift für Wirtschaftsrecht* 265-272; M. Kück, “Schiedsvereinbarungen und Schiedsabreden im Insolvenzverfahren” (2006) 13 *Zeitschrift für das gesamte Insolvenzrecht* 573-624.

⁶ B. Berger and F. Kellerhals, *Internationale und interne Scheidungsgerichtsbarkeit in der Schweiz* (2007, Stämpfli Verlag Ag, Bern), at 178.

⁷ M. Ynzonides, “De Invloed van Faillietverklaring op Arbitrage” (1991) *Weekblad voor Privaatrecht, Notariaat en Registratie* 390; P. Sanders, “Arbitrage en Faillissement” (1998) *Tijdschrift voor Arbitrage* 170.

⁸ P. de Bourmonville, *Arbitrage* (2000, Brussels), at 110; V. Thielman, “Arbitrage en Faillissement” (1990-1991) *Rechtskundig Weekblad* 875-880.

⁹ A. Gropper, “The Arbitration of Cross-Border Insolvencies” (2012) 86 *American Bankruptcy Law Journal* 201-242, at 238; A. Resnick, “The Enforceability of Arbitration Clauses in Bankruptcy” (2007) 15(1) *American Bankruptcy Institute Law Review* 183-222.

the proceeding can only be pursued through submission and admission under the conditions of the proceeding. The purpose of this is to centralize the competing monetary claims of individual creditors in one procedure which is collective and summary in nature.

13 In most jurisdictions, the opening of bankruptcy proceedings entails the principal of preclusion of individual actions by ordinary creditors. The position of secured creditors may vary from pure “separatist” who are entitled to act as if there were no proceedings, to creditors that in different degrees are forced into the collective proceedings.

14 Most insolvency acts provide for a stay of individual remedies for creditors and of pending lawsuits.¹⁰ If proceedings are already pending against the debtor, these proceedings will be suspended. Although often only judicial litigation is mentioned it is generally accepted in those jurisdictions that the stay applies to both judicial and arbitral litigation. In the French Code of civil procedure this stay of arbitral proceedings in case of insolvency proceedings entailing the dispossession of the debtor is expressly provided for.¹¹ In most jurisdictions, creditors have to file their claims for verification in order to be recognised in the insolvency proceedings. This rule applies also for creditors who entered into arbitration agreements with the debtor and even when arbitral proceedings are already pending.¹² If the claim is contested in the verification process, arbitration can be continued or initiated in order to settle the dispute. However, the arbitral award cannot order the payment by the administrator. It can only determine the existence of the claim and its amount. The French *Cour de cassation* ruled that the equal treatment of creditors is to be regarded as a principle of internal and international public policy. Accordingly, an international arbitration award cannot be recognized by a French court if it requires a payment that is higher than the dividend payable under the principle of equal treatment of creditors.¹³

Options for the Administrator

15 We have seen that an arbitration clause is in principle “insolvency proof”. This means that the administrator who wants to sue an unwilling debtor is under the obligation to initiate arbitration proceedings. But what options are available to the administrator in cases where the bankrupt estate lacks the financial means to fund the arbitral litigation?

¹⁰ E.g. Germany: section 240, Zivilprozessordnung (the “ZPO”); The Netherlands: Article 26, Faillissementswet (the “Fw”) (Bankruptcy Act).

¹¹ Articles 369 and 1471, *Code de Procédure Civile*.

¹² Lazic, above note 1.

¹³ Cass. Fr. 4 February 1992, *D.* 1992, 181 note G. Cas.

16 A common feature of modern insolvency law is the power of the administrator to “reject” executory contracts that are too burdensome for the estate. However, the rejection of the contract will not affect the arbitration clause in such a contract. Furthermore, under most legal systems an arbitration clause is regarded as an autonomous clause. According to Article 1697 of the Belgian Judicial Code the annulment of the main contract does not affect the validity of an arbitration clause.

17 Is it possible to consider an arbitration agreement as a separate “executory” contract that could be assumed or rejected independently from the principal contract? In most jurisdictions it is questionable whether an arbitration agreement can be regarded as an “executory” contract. The German Supreme Court ruled that an arbitration agreement is not a “bilateral contract” that falls within the scope of § 103 InsO.¹⁴ This is also the case in the USA where most scholars regard it as unlikely that the courts will consider arbitration agreements as independent “executory” contracts for the purpose of assumption or rejection under the Bankruptcy Code.¹⁵ Even if an arbitration contract could be regarded as a separate executory contract, the outcome of rejection is uncertain. Rejection of a contract means the administrator does not to perform the contract. However, such a rejection does not alter the substantive rights of the parties under that contract.

18 In some jurisdictions the law provides for a discretionary power of the courts. This is the case under English law. According to section 349A (3) of the UK Insolvency Act, the trustee has the power to apply to the court, which has discretion to decide whether to refer to arbitration in accordance with the arbitration agreement.¹⁶

19 Other jurisdictions provide in their codes of civil procedures or arbitration law for specific remedies. Under German law the court can decline the enforceability of an arbitration agreement when it is “void”, “ineffective” or “unworkable” (§ 1032 ZPO). According to the German Supreme Court § 1032 ZPO can apply in cases where the defendant lacks sufficient means to fund the proceedings.¹⁷

20 In the USA, the courts equally have the power to decline the enforcement of arbitration agreements when the cost of arbitration is prohibitively high.¹⁸ The Supreme Court stated that such is possible:

¹⁴ BGH 20 November 2003, (2006) *Zeitschrift für das gesamte Insolvenzrecht*, at 11.

¹⁵ P. Kirgis, “Arbitration, Bankruptcy, and Public Policy: a Contractarian Analysis” (2009) 17(2) *American Bankruptcy Institute Law Review* 503-544, at 521.

¹⁶ Section 349A(3): “If the trustee in bankruptcy does not adopt the contract and a matter to which the arbitration agreement applies requires to be determined in connection with or for the purposes of the bankruptcy proceedings (a) the trustee with the consent of the creditors’ committee, or (b) any other party to the agreement, may apply to the court which may, if it thinks fit in all the circumstances of the case, order that the matter be referred to arbitration in accordance with the arbitration agreement”.

¹⁷ BGH 14 September 2000, *BGHZ* 145, at 116.

¹⁸ Kirgis, above note 15, at 526.

“if the existence of large arbitration costs could preclude a litigant [...] from effectively vindicating her federal statutory rights in the arbitral forum.”¹⁹

21 In civil law jurisdictions, such a control by the courts could be based on the general principle that prohibits any abuse of rights. However, this remedy does not guarantee a successful outcome. The administrator bears the burden of proof of the excessive amount of the incurring costs. Furthermore, the courts are in general reluctant to admit an abuse of rights in such cases as shown in the Belgian case.²⁰ The Dutch Supreme Court ruled also that the mere fact that arbitration proceedings are more costly than ordinary proceedings or that they are disproportioned to the value of the dispute is not sufficient to conclude an abuse of rights.²¹

Conclusion

22 It results from this overview that in most jurisdictions arbitration agreements are upheld notwithstanding the opening of insolvency proceedings. However, it is also mostly accepted that the courts have the possibility to decline the enforceability of an arbitration agreement in cases where the costs of arbitration are prohibitively high. The obligation for the administrator to pay for these costs endangers the equal treatment of creditors in case the estate is not sufficiently funded. More fundamentally, the principle of the recognition of arbitration agreements in insolvency proceedings should not preclude the search for the right balance between the binding force of contracts and right of access to justice.²² This right can come under threat when the costs of the arbitration proceedings would pose an excessive burden to the estate. According to the ECHR the amount of costs and the ability for a party to pay them are factors which are material in determining whether or not a person enjoys the right to access to justice.²³ It is clear that in such cases the principle of access to justice should prevail over the binding force of contract. The outcome that both the access to the courts and arbitration are not available to the debtor is indeed difficult to accept.

¹⁹ *Green Tree Fin. Corp. – Alabama v. Randolph*, 531 US 79, 92 (2000).

²⁰ Above note 1.

²¹ Hoge Raad 21 March 1997 *Nederlandse Jurisprudentie* 1998, nr. 129.

²² See also: J. Kudrna, “Arbitration and Right of Access to Justice: Tips for a Successful Marriage” *NYU Journal of International Law and Politics Online Forum*, February 2013 available at <<http://nyujilp.org/onlineforum>>.

²³ ECHR 19 June 1990 *Kreuz v. Poland*.

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