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Extension of an Arbitration Clause to Non-Signatories (Third Parties)

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Introduction - The Starting Point, and The Problem:

The starting point is simple, or perhaps too simple, i.e.: a contract only binds the parties signing it; this trifle statement is known as the **"privity of contracts"**.

And this notion is taken seriously, very seriously, in all jurisdictions.

Yet, nevertheless, as we will see (and indeed often times!), **notions of the (overriding) principle of good faith** may come into play, and may suggest or militate for extending the scope e.g. of a bilateral arbitration clause to a so-called "non-signatory", i.e. a third party (irrespective of the fact that such party did not itself sign the arbitration agreement or contractual arbitration clause).

But let us see: What are the most typical scenarios?

A FACT PATTERNS

I Assignment - Powerpoint Slides: Case 1

1 CASE 1: Where a claim is **assigned** (a claim which arose under a contract in respect of which there was an arbitration clause), the assigned claim carries with it the arbitration clause embedded in the original contract ***"like a shadow"***, accompanying it the assignment.

2 Here, the doctrine and court practices seem to be unanimous; the arbitration clause follows the destiny of the assigned claim as an ancillary right. Many decisions have confirmed this (e.g. in Switzerland: Swiss Federal Supreme Court in BGE 134 III 565 cons 3.2; also Decision of 19 April 2011, 4A 44/2011, cons. 2.4.1.).

II Third-Party Beneficiary - Powerpoint Slides: Case 2

3 CASE 2: Cross-license "Kiano" and "Sung-sam": Kiano anticipated that it might wish to sell or spin-off the manufacturing division for DRAMs (dynamic random access memories) and agreed with the cross-license partner Sung-sam that the Acquiror X (acquiring the division) shall be entitled to access the cross-license IP-portfolio on FRAND terms. As a third-party beneficiary, the Acquiror X may be entitled the invoke the arbitration clause between Kiano and Sung-sam, although the Acquiror it is not at all a party to the original cross-license contract between Kiano and Sung-sam.

The applicable law might however require that the undertaking between A and B must have intended as providing an independent right to X, unless this would be inferred by customary practice (see e.g. Article 112 (2) of the Swiss Code of Obligations).

4 The underlying rationale for binding a third-party beneficiary to the arbitration clause is, for instance, the argument that a third-party beneficiary cannot have the benefits only; it also must be bound by the corresponding obligations arising under the contract (including the commitment to arbitrate).

III Guarantor / Financing Institution - Powerpoint Slides: Cases 3 and 4

5 Extension to a **guarantor**, or **lender,** or other party in interest:

CAVEAT: The lender (such as a parent company assisting one of its subsidiaries), or a lending bank, where they factually *"pulls the strings"* – as in many financing schemes by big lending institutions, such as EBRD and Word Bank/International Finance Corp!) - might be held liable or co-liable with the principal debtor, and the arbitration clause might get extended to them; I will describe two scenarios from my practice:

6 **Parent Company Guarantee** - CASE 3: Deutz (Parent Co) specifically endorsed a few specific contractual provisions in a Contract of its Subsidiary with GE General Electric. However, the arbitration clause was not among those provisions endorsed by the Deutz Parent Co. GE wants to sue in arbitration not only the Deutz Sub, but also the Deutz Parent Co?

Is this possible? Or would GE have to initiate separate State court proceedings against the Parent Co, in parallel to suing the Deutz Sub before the arbitral tribunal?

In my opinion, each and every provision of the Contract between Deutz Sub and GE had to be read **with a mental *asterix**, i.e. an asterix saying *"in case of dispute in respect of this particular provision: arbitrate, not litigate!"*

It was however decisive to note that the Parent Co was aware of the existence of an arbitration clause, it just did not mention it in the short list of clauses which the Parent Company specifically endorsed, but the latter was irrelevant.

7 **Lending institution** - CASE 4: KAISER (a large US steel-group) has entered into a contract with Nova-Hut, a failing and practically insolvent Czech steel-plant, for the purpose of rehabilitating Nova-Hut's steel-plant, for modernizing its facilities, and for making it fit for steel production.

Nova-Hut had no money to pay for the very costly rehabilitation. However, it obtained financing from the World-Bank, paid out via IFC International Finance Corp. IFC itself

granted the money as a loan to a consortium of Czech Banks (controlled by the State), and the banking consortium provided the loan to Nova-Hut.

A dispute arose regarding the rehabilitation program, and KAISER threatened to initiate proceedings not only against Nova-Hut, but also against the Czech Banking consortium, against the Czech Republic (responsible for its state-controlled banks) and against IFC in Washington.

KAISER's argument: the contract chain provided that Nova-Hut can decide virtually nothing itself, except after prior approval by the Czech Banks. And the Czech Banks could decide virtually nothing without the former approval by IFC. And, hence, KAISER argued that the IFC/World Bank **is pulling all the strings**, and therefore must be taken as the co-liable party, alongside with the Czech banking consortium and Nova-Hut.

Economically, therefore, KAISER proceeded against the World Bank as the financing institution.

If you want to avoid this: explicitly draft against this in the contractual documents!

IV Typical Joint-Venture Situations

8 Extension from a **joint-venture co**. to the partners controlling it (ex.: type: Westland Helicopters Case (ICC 3879), and many others). Typical issue: are the partners/shareholders of a JV-Co personally bound and liable towards a third party, or only the fronting JV-Company (which might have totally insufficient means to meet any "serious" claims, for instance by the Employer)?

Of course, this is the overall most crucial issue in thousands of joint-ventures formed for a particular project.

V Mulitple Contracts: - Powerpoint Slides: Case 5

9 CASE 5: Group of Contracts: Extension in the frame-work of **group of contracts** (see the ICSID case in SOABI, and similar types of situations: parallel contracts between the same parties, only one contains an arbitration clause, not the other; the arbitration clause in one contract may however suffice to also cover claims under the parallel contract, if an ***unité économique*** would justify that, or if overriding notions of good faith would justify it.

10 See hereto the example in ICC 7375, Iran v/ Westinghouse: 9 separate contracts were concluded between 1971 and 1978 for erecting and operating a radar protection system in Tehran, covering in stages the entire territory of Iran. Only the first contract contained an arbitration clause in favour of ICC arbitration seated in Switzerland.

Was the arbitration clause "good enough" to also cover (and become extended) to Contracts 2 to 9? This was one of the jurisdictional issues before us. See the discussion on the slides.

VI "Marionette" Companies, and Extension to Organs of a Company

11 Looking behind the curtain, i.e. behind a mere „marionette-company": the principal is held responsible, not the „slave"! [This, by the way, is also a *dictum* of the European Commission and the ECJ when holding a party responsible for antitrust violations.]

12 Extension to the **CEO** or other persons who served as organs (directors) and **factual organs** of the company bound by an arbitration clause (type: ICC 5730 and 5721 etc.; Swiss Federal Supreme Court in BGE 129 III 727; BGE of 5 Dec 2008).

13 Sometimes, **also States** use clandestine marionette-structures to conceal non-official dealings. I got involved in one of these, where the Panamanian company (controlled by one State) initiated arbitration proceedings against the Liberian company (controlled by another State), and the claim was extended to the State behind the Liberian company.

VII Group of Companies - Powerpoint Slides: Case 6 - 12

1 General Comments

14 Extension from the subsidiary (party to a contract) to the **parent** co., or even to the entire Group, and vice versa, or to a sister co. (type: Isover St.Gobain/ Dow Chemical; Andersen Worldwide Organization, many other cases, particularly in the USA, France, other civil law countries -- but rare under English law, which is traditionally hostile to the concept). See further references below and under the bibliography.

15 My comment: Under French law, the economic notion of a group of companies seems to suffice for affirming the extension of an arbitration clause to a parent company, whereas under Swiss law (and many others) and extension must not be assumed or affirmed lightly; instead, the law allows to recognize the judicial independence of legal entities to prevail over the economic notion of a Group, but - however – subject to the notions and requirements of the good faith-principle/*bona fides*.

16 However, an extension (e.g. to a parent co.) on the basis of the *bona-fides* principle is excluded where the claiming party knew that it is only bargaining with the sub., or must be taken to have known this, and – under the circumstances – must be taken to have accepted this. E.g. my "Kazachstan decision" (CASE 7).

17 Compare also the extremely robust and "sporty" practice in holding a parent company liable in **antitrust cases**; see e.g. the decisions of the Commission and ECJ in *Commercial Solvents*, *Stora Kopparsbergs Berglas AG, Feldmühle,* and more recently: *Akzo Nobel NV* – ECJ Decision of 10 Sept 2009.

> [In *Stora*, for instance, the parent company argued before the European Court of Justice that it in no way exercised and kind of influence on its subsidiary, and thus was not responsible/liable; however, the ECJ rejected that argument and basically said that Stora (Parent Co) did not deny that it could have taken influence on its subsidiary, which it failed to do, and - by the way - that it also benefitted from the dealings of its subsidiary by cashing dividends! – hence, the parent co was held liable.

18 Looking at **US case law**: the following *indicia* were considered **sufficient** to pierce the corporate veil, or otherwise to extend the scope and reach of an arbitration clause:

- the parent and subsidiary have common directors;
- the parent and subsidiary have common business departments;
- the parent and subsidiary file consolidated financial statements and tax returns;
- the parent finances the subsidiary;
- the parent caused the incorporation of the subsidiary;
- the subsidiary operated with grossly inadequate capital;
- the parent pays the salaries and other expenses of the subsidiary;
- the subsidiary receives no business except that given to it by the parent;
- the parent loses the subsidiary's property as its own;
- the daily operations of the two corporations are not kept separate; and
- the subsidiary does not observe the basic corporate formalities such as keeping separate books and records and holding shareholders' and board meetings.

19 **Factual parameters** to be looked at when considering whether such extension to non-signatories can (or under the circumstances must be) operated; one *indicium* will not be sufficient, but multiple *indicia* will; e.g.:

- What were the **prequalification requirements** for (e.g.) choosing a particular company, supplier; in other words: what were the expectations of the other side when entering into the contract?
- Was a particular "***Konzernvertrauen***" nourished? ➡ see in Switzerland e.g. the *Swissair* case (BGE 120 II331); *Motor-Columbus* (BGE 124 III 297); and: should the contract be qualified as a so-called "*Konzernvertrag*"? (*Konzernvertrag* or Group-Contract means a contract or contractual commitment which, by its nature and size, not only ties a particular subsidiary, but indeed ties the resources of entire Group. Numerous cases had to be analysed under this concept in the aftermath of Dow Chemical/Isover St. Gobain Case (ICC 5721). I am specifically discussing this concept in connection with the Ceska Sporitelne/UNISYS arbitration which I had to chair.
- Hence, a general *caveat* is justified where the importance of a contract requires means beyond the capabilities of the particular subsidiary.
- Further elements to be considered: Where did the contract **negotiations** take place? If at the premises of the Parent Co, this might create a certain understanding and expectation!
- Discussions during contract negotiations: were certain **expectations** created? ➡ For instance, the representatives of a subsidiary should not speak on behalf of the

Group or the Parent Co., in order not to nourish an expectation that the parent company will also be involved.

- For all negotiators, it is important to make sure that there is a clear understanding as to the parties that should be bound!

- *Caveats* are also justified where **assurances** are given which only the Group as such, or the parent co., can fulfill (such as in case of guarantees, use of or access to IP, marketing services etc.).

- After the conclusion of the contract: the **actual behaviour during contract implementation** is very important and may be legally significant, because **behaviour can step up to creating obligations.**

- **Creating (legitimate) expectations** (in the mind of the other contracting party) **may translate into obligations** (as this was the case in numerous arbitration cases!).

- Moreover: **Tolerating** a certain behaviour without objections may create a legitimate expectation, and a legitimate expectation may create liability (like in the Leobersdorfer/China case; or in the Bridas/Turmenistan case referred to below).

- **Interference** by the Parent co., or other subsidiary, may create liability, and may step up to making it a party to the arbitration agreement; cases in Germany: *"existenzvernichtende Eingriffe"* (interferences by the parent which might ruin the existence of its subsidiary), for instance by imposing on the subsidiary to provide onerous up-stream guarantees, or stiffening-off all liquidity into a cash-pool etc.

- A typical interference we have seen is the **silent liquidation of a party** during the implementation of a contract, or during an arbitral process (many examples in practice!), which may directly entail the liability of those orchestrating such steps. Similar situations have occurred in arbitrations with State controlled entities; see below regarding the Libya-case.

- Agency concepts are used for the purpose of analyzing the legal implications, such as the concepts in Germanic/Swiss law of "***Duldungsvollmacht***" (granting an implicit power of attorney, or power to represent, by tolerating that someone, the agent, acts on behalf of a principal), "***Anscheinsvollmacht***" (granting an implicit power of attorney, or power to represent, by creating an appearance that someone, the agent, has the power and authority to act on behalf of a principal), **"ostensible authority"** under English law, *le mandat apparent* (under French law), all of which provide indicators that not only the agent or mandatory will be bound, but also the principal instructing the "fronting" person (agent) or party.

- Hence, a subsidiary concluding a particular contract could - under the circumstances - be considered as **being the agent for the Parent Co.**, or for the entire Group (an argument which frequently was used in the USA).

- And similar concepts also apply in State arbitration cases; see below.

20 However, for lawyers, there is a **very simple "recipe"** to avoid any such (undesired) situations to occur: ➡ if you want avoid any such undesired extension, just draft against it! If you want the opposite, require appropriate language!

2 Some Further Comments Regarding Particular Cases - Powerpoint Slides Cases 6 - 10

21 In CASE 6: Ceska Sporitelna Banka/Unisys International B.V., we as arbitrators affirmed that the huge contract entered into by Ceska Sporitelna Banka (for providing computer systems, hardware and software for more than 1'000 banking branches in the Czech Republic) not only bound the Dutch subsidiary Unisys International BV (essentially a letter-box company), but indeed tied the entire resources of the Unisys Group. Of course, many factual elements were considered, but in essence we considered Unisys USA, i.e. the parent company as being bound. Contract negotiations had taken place at the Unisys headquarters in the USA.

22 In CASE 7, Air Kazachstan, on the basis of the facts, reached the opposite decision, and declined the extension of the arbitration clause from the Panamanian (or Aruba Island) SPC (special purpose company) to its deep-pocket US sister company belonging to General Electric, because evidence was shown that, in the aircraft leasing business, it was/is customary (in similar situations) that for each and every aircraft a "Banana-Republic"-company is used as the lessor. This was clearly known to the legal advisors of Air Kazachstan (which were the most prominent US lawyers for aviation law, based in New York), and their knowledge had to be imputed on their client, i.e.on Air Kazachstan. Hence, if Air Kazachstan and/or its lawyers had concerns, or had intended to extend any potential liability to a deeper-pocket entity, they should have bargained for that in the contract.

23 In CASE 8, Leobersdorfer (Austria) vs. a Chinese industry (as buyer), located in the Anhui Province, negotiations for the Contract had taken place in the premises of the Chinese parent organization in Peking (CMEC). All subsequent contract correspondence was addressed to the nationwide organization CMEC in Beijing, was received there and was answered there (on behalf of AMEC/Anhui). Business cards of the representatives also hardly allowed a distinction as to whether a person is acting for CMEC or for AMEC.

In a detailed factual analysis, the Arbitral Tribunal reached the decision that an overriding confidence was nourished, in the minds of the Austrian executives representing Leobersdorfer, and that the nationwide organization would be responsible for the correct implementation of the Contract. AMEC unsuccessfully argued that the signatories of the Contract were only representatives of the provincial organization AMEC and that AMEC on the basis of its organizational charter had no authority whatsoever to act for or bind the nationwide organization CMEC.

Hence, the Arbitral Tribunal affirmed the liability of the nationwide organization, as an emanation of the good faith principle.

The Arbitral Award was then attacked by a setting aside procedure before the Swiss Federal Supreme Court, but the Swiss Federal Supreme Court discarded the challenge and clearly confirmed the decision of the Arbitral Tribunal in its published decision of 1 September 1993.

24 In CASE 9, Saudi Butec vs. Saudi Arabia Saipem and Saipem SpA, the Lebanese company Butec had entered into a construction contract with Saudi Saipem (a local company of Saipem SpA (Italia) established in Saudi Arabia). All negotiations took place in Milan. In that case, the Arbitral Tribunal, on the basis of some very particular factual elements, did not allow Butec to extend its claims to the Saipem parent company. However, absent such particular elements, an extension would most probably have been justified because, in fact, the local Saudi Arabian Saipem company only had to be formed as a matter of Saudi law requirements, which were known to the parties, but as such was merely an empty shell and "post-office" which could be served with the Saudi governmental mailings.

25 In CASE 10, BW/Murablack and an Indian Buyer, the situation basically was as follows: Murablack Ltd operated a carbon black plant in Switzerland which, due to high operating costs, was no longer commercially viable. However, an Indian company agreed to buy the entire plant, such that the plant in Switzerland had to be dismantled and had to be re-erected in India (in an industrial area of Mumbai). EW (headquartered in Basle, today known as IMPLENIA) had a 60% shareholding in Murablack, and agreed to provide some guarantees in favour of the Indian buyer.

What actually happened was that the supervision of the re-erection of the carbon black plant in India (which supervision had to be performed by Murablack) proved to be much more difficult than anticipated by Murablack, and more and more BW (as the 60% shareholding company) had to deploy its own resources in terms of financing and personnel to supervise the erection in India and to make the plant fit for accepting tests. Based on this situation, the Indian buyer not only directed its monetary claims (in an LCIA arbitration) against Murablack, but also against BW.

26 In CASE 11, Peterson Farms v/ C&M Farming, the US seller Peterson Farms sold infected products to the Indian buyer C&M, i.e. to the Indian parent company holding numerous subsidiaries allover India. The infected products were distributed by C&M parent company to its subsidiaries.

Due to the defectiveness, C&M did not pay the outstanding purchase price to Peterson Farms. Peterson Farms initiated arbitral proceedings in London against C&M. C&M, thereafter, counterclaimed not only its own damage but also raised a counterclaim for the damages suffered by its numerous subsidiaries.

In its decision, the Arbitral Tribunal, sitting in London and applying English law, however, denied to exercise jurisdiction over the counterclaim insofar as the damages suffered by the subsidiaries are concerned, thereby ruling that a group of companies doctrine is not part of English law. That decision gave rise to intensive debates, and many articles were written on the subject.

I was not involved in that arbitration. From an economical point of view, however, the decision of the Arbitral Tribunal appears to be wrong, for a very simple reason: If the numerous Indian subsidiaries suffered a damage due to the defective deliveries, the losses also translate into losses of the parent company C&M, be it that the parent company may have had to support the subsidiaries, or got less upstream dividends, or suffered a loss in the value of its shareholding in the subsidiaries. However, obviously, much depends on how C&M did plead its case before the Arbitral Tribunal (of which I am not sufficiently informed).

27 In CASE 12, Mouawad v/ Radian and URS, the situation basically was as follows: Right in the center of Beirut, a large area had to be rehabilitated by removing huge quantities of waste so as to make the area fit for new urban development. The Lebanese Government, via Solidère, invited tender offers from international contractors which (as usual) had to satisfy detailed prequalification requirements. The US firm Dames & Moore, with its subsidiary Radian USA did win the campaign, and the Prime Contract was then entered into between Solidère and Radian USA.

Having been awarded this major contract, Radian USA, in turn, delegated the waste-cleaning and earthworks to a local Lebanese company, i.e. Mouawad, and a sub-contract was concluded. Mouawad performed a huge waste-cleaning job during which it started to claim for additional payments on numerous grounds (including, for instance, that much more work had to be undertaken than contractually agreed etc.). As such claims for additional payments were not satisfied, Mouawad initiated ICC arbitration against Radian USA (and its local subsidiaries in Beirut), and also against URS CORP (USA), which meanwhile had taken over the Dames & Moore Group.

Could Mouawad extend the scope and reach of the arbitration clause in its Contract with Radian to the new parent company URS CORP (a Fortune 500 company). This question had to be analyzed very carefully in a jurisdictional award rendered by the Arbitral Tribunal having its seat in Paris.

In its jurisdictional Award, the Arbitral Tribunal identified three reasons why extension of the arbitration clause and a liability of the new parent company UAS Corp. should be denied, against almost twenty strong reasons suggesting that, indeed, an extension of the scope and reach of the arbitration clause to the new parent company UAS Corp. would appear to be justified. Without setting out all of these reasons in detail, it suffices here to mention that, for instance, URS Corp during the ongoing earthworks in Beirut, reduced the staff of the local Radian company from several thousands to half a dozen, and removed the financial strength of Radian as such. Furthermore, the parent company (URS CORP) exchanged the Radian directors, and caused the election of its own appointees (such that most directors served in both, in URS and in Radian). Salaries and expenses of Radian became paid by the parent company (since the subsidiary was virtually stripped of its assets, and was carried along with an inadequate capital-base). Moreover, URS CORP channeled new business to other group companies, no longer to Radian.

Hence the expectations and confidence which initially had inspired Solidère (and the Lebanese Government) to select Radian as a qualified contractor on the basis of the prequalification documentation, became frustrated due to acts of the parent company. These are some of the elements which the Arbitral Tribunal considered when affirmed arbitral jurisdiction over the US parent company URS CORP.

An interesting aspect is that, unbeknownst to the Arbitral Tribunal deciding the Mouawad/Radian case, a parallel arbitration took place between Solidère and Radian (presided by a Belgian chairman), which other tribunal reached exactly the same conclusions, although with some different motivations.

VIII Extension to the State

28 Already in one of the most famous cases, in **SPP v/Egypt** (ICSID Case No. ARB/84/3, Award of 20 May 1992, ICSID Review Vol 8 (1993), at p 351), it was held: