Court finds state not bound by arbitration clause signed by state-owned entity (Swiss Supreme Court)

by Prof. Dr Nathalie Voser (Partner) and Marco Vedovatti (Associate), Schellenberg Wittmer Ltd

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In decision 4A_636/2018, the Swiss Supreme Court rejected a set aside application aimed at annulling a partial award that had declared that a state was not bound by an arbitration clause signed by a state-owned entity.

Speedread

In a recently published German-language decision, the Swiss Supreme Court rejected an application to set aside a partial award where the tribunal had refused to extend an arbitration clause signed by a state-owned entity in Libya (respondent 1) to the non-signatory state (Libya) (respondent 2).

The underlying dispute arose from a contract entered into in 2006 by two Turkish companies, their joint venture company (appellants) and respondent 1 which was created to carry out a major infrastructure project, the "Great Man-Made-River". Following riots in Libya in 2011, the appellants suspended the execution of the project. The parties subsequently failed to continue the works and the appellants eventually initiated International Chamber of Commerce (ICC) arbitration proceedings with a seat in Geneva against both respondents 1 and 2. However, the latter was not a signatory to the contract.

In a partial award rendered by a majority decision, the tribunal, amongst other things, declared that it lacked jurisdiction in respect of Libya. In its application to set aside before the Swiss Supreme Court, the appellants argued that the landmark "Westland" case (P 1675/1987 of 19 July 1988) denying the extension of an arbitration clause signed by a state-owned entity to a state was outdated and therefore, Libya should become a party to the arbitration.

The Swiss Supreme Court recalled that, under Swiss case law, non-signatory third parties could be bound by an arbitration clause in exceptional circumstances. However, in the present case, the Swiss Supreme Court confirmed the partial award. It rejected the appellants’ allegation that under Libyan law respondent 1 was a simple organ or auxiliary of Libya. It also confirmed the tribunal’s decision under Swiss law not to extend the arbitration clause based on Libya’s unproven involvement in the contract, despite respondent 1 being a state-controlled entity. It thereby confirmed that under the Swiss lex arbitri, the fact that a party is a state-owned entity is not sufficient, per se, to extend an arbitration clause to a non-signatory state. (Decision 4A_636/2018 (24 September 2019) (Swiss Supreme Court).)

Background
According to Article 190(2)(b) of the Swiss Act on International Private Law (PILA), an award can be set aside when the arbitral tribunal has wrongly accepted or denied jurisdiction. The Swiss Supreme Court has full power to review the legal assessment of the tribunal’s acceptance or denial of jurisdiction, including the tribunal’s application of foreign law. On this front, pursuant to Article 178(2) of the PILA, an arbitration clause is valid as to the substance when it complies with the law chosen by the parties, the law applicable to the merits (in particular the one that governs the main contract) or with Swiss law. The validity of an arbitration clause as per Article 178(2) includes also both the objective and subjective scope of the arbitration clause.

Under Swiss law, in principle, a non-signatory third party can be bound by an arbitration clause in exceptional circumstances. Swiss case law has accepted exceptions to the principle of privity of contracts in cases such as assignment of an obligation, assumptions of debts or transfer of a contract, where the arbitration clause is accessory. In addition, under Swiss law, when a non-signatory third party regularly participates in the performance of the contract, it is treated as if it had become party to the contract and has accepted the arbitration clause, when by its conduct it expressed the willingness, or gave the impression under the principle of good faith, of being party to the arbitration clause.

**Facts**

In April 2005, two Turkish companies and their joint venture company (appellants) were awarded a project in Libya for the construction of a 383km water pipeline (the project). The appellants signed the relevant contract on 6 June 2006, with a Libyan state-controlled entity (respondent 1).

In February 2011, following riots in Libya, the joint venture company suspended its works at a time when the project was 70% finished. No agreement could subsequently be reached to restart the works and consequently, the appellants initiated International Chamber of Commerce (ICC) arbitration proceedings against respondent 1 and the Libyan State (respondent 2). Libya had not signed the arbitration clause and objected to the tribunal’s jurisdiction. By a partial award of 22 October 2018, the tribunal denied jurisdiction in respect to Libya. The partial award was issued by a majority decision.

The appellants filed a setting aside application against the partial award invoking a violation of Article 190(2)(b) of the PILA, and, more precisely, an incorrect denial of jurisdiction in respect to Libya. The appellants invoked a twofold violation of Article 190(2)(b). First, they alleged that under Libyan law, respondent 1 was identical to Libya and that Libya was liable for its conduct because of its position as supervisor of it. Second, they alleged that under Swiss law, the arbitration clause should have been extended to Libya because of the latter’s involvement in the performance of the contract. In particular, they alleged that the landmark "Westland" case (P 1675/1987 of 19 July 1988), where the extension of an arbitration clause to a non-signatory state had been denied, was outdated.

Another investment treaty arbitration arising from the same dispute under the Organization of Islamic Cooperation (IOC) treaty of 1981 was run in parallel at the ICC and, according to publicly available information, is still pending.

**Decision**

The Swiss Supreme Court dismissed the appellants arguments.

First, on the argument that respondent 1 and Libya was identical, the Swiss Supreme Court recalled the tribunal’s findings that there was no evidence that Libya participated in the performance of the contract in a way that could have led the appellants to think that the state was party to the contract. In particular, the Swiss Supreme Court pointed out that the tribunal had established the following:
• Respondent 1 was not exclusively financed by the state but also through the sale of water.

• The State's General People's Committee did not participate in the organisation of the tender and execution of the contract, which was under the responsibility of respondent 1's People's Committee.

• Respondent 1 could not exercise sovereign authority.

• The involvement of the Libyan Minister of Waters was necessary because Libya was supposed to compensate for the machinery and equipment that was destroyed during the riots.

• The fact that the Libyan State Attorney had been granted a power-of-attorney in the parallel investment arbitration was irrelevant because respondent 1 was not party to that arbitration.

• The Libyan Administrative Contracts Regulations were not applicable to the contract and it was not proven that the state's Audit Bureau participated in the negotiations of the contract.

• Any supervision during the tender was aimed at avoiding corruption.

• The contract had not been reviewed or authorised by the General People's Committee or the Prime Minister.

The Swiss Supreme Court recalled that it was bound by these tribunal's findings.

Second, in relation to the incorrect application of Libyan law, the Supreme Court confirmed the tribunal's finding, that even if a principle of Libyan law existed according to which the contractual liability of a state-supervised entity could be transferred onto the state, this is not sufficient to conclude that the state is bound to the arbitration clause. Indeed, the Supreme Court upheld the tribunal reasoning, namely that a finding of an extension of substantive liability had no bearing on the tribunal's jurisdiction and was not sufficient to derogate from the jurisdiction of the state courts.

Third, concerning the purported violation of Swiss law, the Supreme Court rejected the existence of an alleged newer practice deviating from the Westland case and confirmed the tribunal's finding that state-owned legal persons are separate legal entities and that therefore, an arbitration clause they enter into cannot, per se, be attributed to the controlling state that has not signed it. The court expressly confirmed that the principle of privity of private law contracts also applies to arbitration agreements. It further pointed out that it was unproven that Libya had entered into the contract and rejected the appellant's arguments that the arbitration clause had to be extended based on the principle of good faith because of Libya's involvement in the performance and negotiations of the contract.

Finally, the Supreme Court stated that the fact that Libya was an authoritarian regime at the time the contract was concluded, and that the project was of particular importance for Libya, was not sufficient to create any legitimate expectation that Libya was party to the contract.

**Comment**

This decision confirms that under the Swiss lex arbitri, the fact that an entity is controlled by a state is not, per se, sufficient to extend the arbitration clause to the controlling state, unless the state's involvement in the negotiations or the performance of the underlying contract can be proven. It goes without saying that the enforcement of the favourable award that was issued in favour of the appellants against the state itself would be more promising than seeking to enforce only against a state-controlled entity and thus the ruling of the Supreme Court has far reaching consequences.
The Supreme Court does not discuss the principle of an abuse of rights as it was not argued before it. It can be assumed that the rather formalistic approach of the Supreme Court in the present case would have its limits if it could be established that the independent, state-controlled legal entity was set up in order to shield the state from directly becoming a party to legal proceedings.

Case

*Decision 4A_636/2018 (24 September 2019)* (Swiss Supreme Court).