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Arbitration and Insolvency: A Difficult Relationship

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I. The Case Law

In 1994 the Italian company Gardenia entered into a contract with another Italian firm, Interpianti, for the construction of an industrial factory. Among various contractual provisions, there was an arbitration agreement.

Afterwards, a dispute on interpretation and execution of the contract arose, Gardenia S.n.c. submitted a claim to the arbitral tribunal seeking a declaration of breach of contract, damages and the return of securities.

After the appointment of the arbitrators, but before the signature of the award, the bankruptcy of Interpianti was declared. With the award deliberated a month later, the arbitral tribunal upheld Gardenia’s claims and ordered Interpianti, i.e. the Bankruptcy, to pay the sum of Italian Lire 32,199,005.

The award was promptly appealed by the Bankruptcy Trustee, asking for a declaration of voidance or, subordinately, for an order of discontinuance of the pending proceedings shall be discontinued and that the action be brought instead within the bankruptcy proceedings.

The Court of Appeal of Rome upheld the appeal, dismissed the proceedings and, consequently, declared that the award was not enforceable.

Gardenia appealed to the Italian Supreme Court of Cassation (the “Supreme Court”), claiming violation of law and lack of reasoning. In particular, Gardenia complained that: a) the Court of Appeal incorrectly declared the dismissal of the proceedings despite the lack of the requirements for the stay of the proceedings, since the arbitral tribunal was not promptly informed of the declaration of bankruptcy; b) the decision of the Court was ill-grounded, as it stated that the continuance of the proceedings could have been requested solely by the appealed party, even if an interruption had never occurred; c) the award could not have been declared null and void, since specific grounds for nullity are provided by the law.

1 Pursuant to Article 829 of the Italian Code of Civil Procedure, the grounds for setting aside (nullity) an award are: 1. if there is an invalid arbitration agreement, provided that said objection has been raised in the first submission after the arbitrator’s acceptance of the appointment; 2. if the arbitrators have not been appointed according to the provisions of the Code of Civil Procedure, provided that said objection has been raised during arbitral proceedings; 3. if the award has been rendered by a person who could not be appointed as an arbitrator, as provided by Article 812 of the Code of Civil Procedure; 4. if the award exceeds the scope of the arbitration agreement, provided that said objection has been raised during the arbitral proceedings; or if the award decides the merits of the dispute when the merits could not be decided; 5. if the award does not include the “reasons” on which the award is based, the arbitrators’ decision (relief) and the arbitrators’ signature; 6. if the award has been rendered after the expiring of its deadline; 7. if the formalities required by the parties - under express sanction of nullity – have not been complied with, and the nullity has not been cured; 8. if the award is contrary to a previous award or judgment having the force of res judicata between the same parties, provided that said award or Court decision has been brought to the attention of the arbitrators during the proceedings; 9. if the principle of due process has not been observed during the arbitration proceedings; 10. if the award concludes the arbitral proceedings without deciding the merits of the dispute and the merits had to be decided; 11. if the award contains contradictory provisions; 12. if the award has not pronounced on some of the claims and counterclaims falling under the scope of the arbitration agreement.
The Supreme Court dismissed the appeal, stating that the arguments raised by the appellant were unfounded. Indeed the Supreme Court reasserted - agreeing with a previous statement of the Supreme Court (Judgment of June 6, 2003, n. 9070) - that public purposes, that characterize bankruptcy proceedings, do not permit to reserve to arbitration proceedings - which are private proceedings based on the parties’ autonomy - claims for which the law dictates a mandatory and exclusive jurisdiction of a certain court.

Comment

Insolvency and arbitration are two legal procedures of different type and nature. Aims and principles are absolutely different.

Insolvency proceedings are proceedings for the collection and distribution among the creditors of the assets of a debtor or proceedings providing for reorganization of a debtor’s business in certain situations. Insolvency proceedings are based on a system of ranking the claims and guaranteeing to the greatest possible extent equal treatment among member of each class of creditors (par condicio creditorum). Thus, insolvency law has features of both public and private nature and its underlying principles are the equality of the creditors, the centralization of all claims, the high degree of state control and the mandatory substantive and procedural national law provisions affecting the insolvent party’s assets, and governing the conduct of the insolvent party, of the creditors and of the trustee until the proceedings come to an end.

On the other hand, arbitration is a private method of dispute resolution, chosen by the parties themselves as an effective way of putting an end to disputes between them, without recourse to the courts of law. Thus, the underlying principle of arbitration is the freedom of the parties. The jurisdiction of the arbitrators finds is foundation in the will of the parties and in the arbitration agreement.

Given the above, it is evident that arbitration and insolvency do not coexist easily. Therefore, the main question is: what happens when arbitration meets insolvency (and when insolvency meets arbitration)? In particular, can the arbitral tribunal ignore the insolvency proceedings or should the arbitration be stayed or terminated? Is the arbitration agreement affected? Which issues, related to insolvency, are “arbitrable” and which are “not-arbitrable”?

The above decision has no original character in Italian case-law. Indeed the Supreme Court moves along with several precedents⁵. However, the cited decision provides a starting point for dealing with the relationship between arbitration and bankruptcy.

The problem on which scholars and courts have debated concerns the “destiny” (not of the arbitral proceedings but) of the arbitration agreement. However, with this decision, the Supreme Court maintains that arbitral proceedings dealing with a claim for money owed by the bankrupt must be dismissed as the principle stating that all claims in respects of the bankrupt’s debts must be brought before the bankruptcy court (which has exclusive jurisdiction over monetary claims arising from the bankruptcy) is mandatory and the parties cannot derogate to it. In other terms, public interest and the principle of the *par condicio creditorum* “freeze” any exceptions made by the parties in favor of arbitration.

Trying to extract from the decision of the Supreme Court a principle governing the relationship between the bankruptcy and the arbitration agreement, it seems that the Supreme Court accepts that the arbitration agreement is enforceable against the bankruptcy, but seems to exclude that this principle may be applied to cases involving claims related to bankrupt’s debts, considering the reasons upon which such decision was based (public interest and *par condicio creditorum*). Thus it seems that the Supreme Court, in order to find a solution of the problem of the “destiny” of pending arbitration proceedings when bankruptcy is declared, makes a distinction on the basis of the claims (petitum) of the arbitration proceedings. Therefore, the Supreme Court does not affirm the absolute incompatibility between arbitration and bankruptcy, but a relative incompatibility depending on the subject-matter of the dispute. However, this solution reflects a provision of the Italian Bankruptcy Law⁶ which states that creditors must file their claims against the debtor with the bankruptcy judge and cannot exercise collective actions in the courts of ordinary jurisdiction. The bankruptcy order grants the Bankruptcy Trustee the administration power over the debtor’s estate and, consequently, all the actions referring to the debtor’s assets must be filed against the bankruptcy and the Trustee has the legitimate standing to act for all credits and to enforce rights of the debtor.

II. The Relationship after the 2006 Italian Reforms

Guidelines

The two 2006 reforms, one on bankruptcy (Law-Decree 5/2006) and one on arbitration (Decree-Law 40/2006), were meant to clarify the treatment of the disputes arising from a contract containing an arbitration clause where one of the parties has gone bankrupt.

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⁶ Article 52.
However, before starting the analysis of different hypotheses that may occur, one must focus on some crucial points which could be considered as “guidelines”. The first one is the compatibility between bankruptcy and arbitration as confirmed by case law. If it were not so, the provisions of Italian Bankruptcy Law dealing with arbitration matters would be meaningless. Secondly, we deal with the growing favor arbitrati which has marked the latest Italian reforms, but which can be detected also with scholars and courts. Last but not least, the arbitral award has now the same effects as a judgment rendered by a national court.

i. Validity of an Award Issued Before Bankruptcy was Declared

Is an award issued before the declaration of bankruptcy enforceable against the bankruptcy? In general the answer is affirmative, considering that, as said above, the award has the same effects as a judgment rendered by a national court. In other terms, if an award is issued before the declaration of bankruptcy and becomes final, its ruling is binding on both parties, including the Bankruptcy. If there is still time for an appeal, either party may file an appeal in the ordinary way; the final outcome is binding on both parties. If the creditor’s claim is established, the relevant proof of the debt must be filed with the bankruptcy court because there are no exceptions to the rule which requires creditors to file claims with the bankruptcy court.

The problem arising in this case is the certainty of the date. The arbitration reform clarified that arbitrators are not officers of the public service. Consequently, the signature and the date are not sufficient to grant the certainty of the date of the award. This last effect could be granted only through the filing of the award for its enforceability or through the service of process of the award from which the deadline for the application for nullity starts to elapse.

ii. Effect on Arbitration Proceedings if Bankruptcy was Declared

The first significant provision to refer to is Article 43 of the Bankruptcy Law, amended by the reform, to which a last part was added stating that <<the declaration of bankruptcy causes the stay of the proceedings>>. However scholars consider the interruption a mechanism unrelated to the arbitration proceedings itself, so the solution must be focused elsewhere.

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7 The provisions (introduced by the Decree-Law 5/2006) of Italian Bankruptcy Law in which one can find references to arbitration are: Article 25 n. 7, Article 35 comma 1 and Article 83-bis.
8 Article 824-bis of the Italian Code of Civil Procedure, introduced by Decree-Law 40/2006, put an end to the long debate on the real effectiveness of Italian arbitral awards.
11 Article 829 of the Italian Code of Civil Procedure. The application for nullity is considered the ordinary way to challenge an arbitration award, while revocation and third party opposition (Article 831) are “extraordinary” ways to appeal an arbitration award.
As the declaration of bankruptcy causes the loss of the party’s legal capacity, it seems correct to use a provision resulting from the arbitration reform (Article 816-sexies of the Code of Civil Procedure) stating that <<in case of death or termination and/or loss of legal capacity of a party, the arbitrators provide for adequate measures to guarantee the due process for the continuation of the proceedings. The arbitrators may stay the proceedings. If none of the parties complies with the order of the arbitrators for the continuation of the proceedings, the arbitrators may withdraw from the office>>.

Another approach is to consider the possible actions of the Bankruptcy Trustee with respect to the pending contracts, thus with respect to the arbitration agreement (see the two following hypotheses).

iii. Effect on the Arbitration Clause if the Trustee in Bankruptcy Terminates the Contract
The matter is regulated by the recently enacted Article 83-bis of the Bankruptcy Law\textsuperscript{13}, pursuant to which if the trustee elects to terminate the contract under the relevant bankruptcy provisions, arbitration proceedings may not be initiated or continued (if already commenced). This rule applies if the contract in question had not been fully performed when bankruptcy was declared. The Bankruptcy Trustee may decide whether to continue with the contract or whether the performance should be suspended in the meantime. The other party may apply to the bankruptcy court to put the Trustee on notice; on the expiration of such deadline, the contract is automatically terminated.

If the arbitration proceedings were pending when bankruptcy was declared and the Trustee decides to terminate the contract, an award issued in the meantime (i.e., after the declaration of bankruptcy) is not binding on the bankruptcy. However, such an award is not null and void, and may be binding on the debtor after the conclusion of the bankruptcy proceedings.

The related dispute must be brought before a court. Then it depends upon the nature of the dispute: if the dispute relates to a claim against the bankrupt, the creditor must file a proof of debt with the bankruptcy court; if the claim is against the creditor, it must be brought before the ordinary court having jurisdiction.

iv. Validity of the Arbitration Clause if the Trustee in Bankruptcy Continues the Contract
If the Trustee in Bankruptcy continues the contract in place of the bankrupt, the arbitration clause applies in the event of a dispute. The arbitral tribunal has jurisdiction to hear both claims and set-off counterclaims. The award is final and binding.

v. Arbitration Subsequent to the Declaration of Bankruptcy
The last hypothesis to be analyzed is an arbitral proceedings to be started after the declaration of bankruptcy. This is certainly possible pursuant the law. In fact, Article 25(7) of the Bankruptcy Law states

\textsuperscript{13} This rule must be connected with Article 72 of the Bankruptcy Law which states that <<the execution of pending contracts at the date of declaration of bankruptcy is suspended>>.
that the delegated judge <<as suggested by the Trustee, appoints the arbitrators, once the legal requirements are fulfilled >> and Article 35 establishes that the Trustee, previously authorized by the creditor’s committee, is entitled to enter into an arbitration agreement.

It is necessary to verify which limits the Trustee meets in concluding arbitration agreements. This matter is related to the choices that the Trustee can and must make on the contracts pending at the date of the declaration of bankruptcy and in the particular case of provisional exercise of business (see, respectively, Article 72 et seq. and Article 104 of the Bankruptcy Law).

In other words, the scope is to detract some actions from the exclusive jurisdictions of the bankruptcy court (the principle of vis attractiva is stated by Article 24 of the Bankruptcy Law) combining two criteria: distinguishing between active actions and passive actions, and distinguishing between actions arising from the bankruptcy and actions arising from the entrepreneur declared bankrupt.

Thus, one must consider as “not-arbitrable” all the disputes arising from the bankruptcy and directly related to its nature and function, in particular those referring to the proceedings of admission of the creditors’ claims. For instance: the claim against the judgment declaring the bankruptcy (Article 18 of the Bankruptcy Law), appeals against the decision dismissing the application for bankruptcy (Article 22 of the Bankruptcy Law), claims against decrees of the delegated judge and/or of the court (Article 26 of the Bankruptcy Law), claims against acts of the Trustee and/or of the creditors’ committee (Article 66 Bankruptcy Law), appeals related to decisions on the verifications of the bankruptcy’s liabilities (Article 98 of the Bankruptcy Law), late creditors claims (Article 101 of the Bankruptcy Law).

Regarding claw-back actions, there are a lot of doubts on their arbitrability. Maybe, it could be one of the next fields of expansion of arbitration.

III. Conclusions

In Italy among the Alternative Disputes Resolutions, arbitration is the only one which may significantly interact with insolvency proceedings. In fact mediation, even if it recently became compulsory for civil and commercial disputes involving a large number of subject-matters,14 can be used only with available and not assignable rights. Thus the limit of the “availability” of rights15 represents a hurdle in the use of mediation in insolvency proceedings.

14 With Decree 28/2010 the Italian legislator introduced the mandatory mediation of certain civil and commercial disputes. The new mediation process is become a “condition precedent” of an action in court. It means that the judge cannot continue to examine and decide the merits of the case unless and until the parties have undergone the mediation process and attempted to reach a conciliation. The matters involved are real estate, division, inheritance, family pacts, leases, loans, leases of going concerns, medical liability, defamation by the press or other advertising means, insurance, and also banking and financial contracts.

Furthermore, insolvency matters are out of the area of <<civil and commercial disputes>> in the EU meaning of the word which the Italian legislator accepted in its new discipline on mediation

The only possible interaction between insolvency and mediation takes place when the Trustee, previously authorized, intends to take a legal action on matters involved in the new mediation whereby the attempt of conciliation is a condition precedent. But no peculiar aspects emerge from such interaction.

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16 The new Italian discipline on mediation was introduced also to comply with EU law. The reference to <<civil and commercial disputes>> is typical of EU law that identifies, in these matters, a strategic sector for promotional policies of internal market for promotional policies of internal market. In particular, Council Regulation (EC) No. 44/2001, concerning the <<jurisdiction and the recognition and enforcement of judgments in civil and commercial matters>>, refers to <<civil and commercial disputes>>; Article 1 states that the <<The Regulation shall not apply to: [...] (b) bankruptcy, proceedings relating to the winding-up of insolvent companies or other legal persons, judicial arrangements, compositions and analogous proceedings>>.