Chapter 10

Formalism in Arbitration – Good or Evil?

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I. INTRODUCTION: THE EXTASI CASE

I would like to start my presentation with a personal experience made with German state courts. It shows how formalism can lead to extensive proceedings and how a formalistic system may be abused.

Jean-Pierre M. was a young successful Swiss entrepreneur when he sold his electronics device company for 4 million Swiss Francs shortly after his 30th birthday. With this early earned fortune, he fulfilled his personal dream. He had a 76-foot luxury sailing catamaran built for him, his family and ten paying passengers. For the next eight years, Jean-Pierre M. spent a life as full-time skipper and scuba diving instructor in the Caribbean Sea. He had no land-based residence anymore and was fully dependent on his new tourist business. His dream ship, SS Extasi, was now home as well as the basis of his living.

On November 1, 1998, at the fall of the night, about 300 nautical miles from St. Thomas, the dream came to an abrupt end: SS Extasi was destroyed by a heavy board fire. The accident started slowly with unspecified smoke in the deep body of the ship. But then, the fire developed so aggressively that the skipper (who was alone aboard) could not even emit an SOS emergency signal, nor could he rescue anything of his personal belongings. After a first explosion, M. had to jump overboard to save his naked life. Sitting in his life raft, M. suddenly realized that nobody knew of his accident, that he was drifting in the middle of the ocean, and that he had no appreciable water and food reserves to reach land. M. was prepared to die when he saw his ship sink in about one hour's time, after a spectacular series of explosions in the night sky caused by bursting scuba tanks.

Certainly, it was pure luck that M. was found and rescued only one day later by a US Coast Guard plane which was searching for drug smugglers in the area. All that M. still possessed at this point was a scorched pair of shorts and a T-shirt. He lost all his personal belongings, including cash, passport and personal papers and the like. The sea being 3'000 meters deep at the place of the accident, there was

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no chance of rescuing any debris of his ship or cargo. M. was completely down and out.

But then, he remembered, there was one remaining asset: An insurance policy placed with a German insurance consortium that promised in its advertising campaign: "We care for you at all times" and "whatever happens, we are here for you". M. filed a claim for his total loss. The insurers denied liability. They asserted "negligence" in fire fighting and "violations of seaman's duties". Some of the reproaches were truly ridiculous such as that M. failed to shut down the electricity when he noticed the fire (remember, it was dark when the accident happened!), or that he allegedly failed to "flood" the ship by drilling a whole into the body (thereby causing himself to sink his ship).

Under German insurance law, Art. 12 para. 3 VVG, the formal denial of coverage by the insurers triggered a *six months' period for filing* a law suit before the competent German court in Hamburg.

II. A FORMALISTIC NIGHTMARE BEGINS

Upon receipt of the insurer's rejection letter, M. immediately instructed a German lawyer to file the law suit within the above mentioned six months period. The lawyer filed the claim *ten days prior to the expiration of the said six months period*, but he forgot to sign the document. He did bring the complaint personally to the court-house and had, at the same time, his office pay a substantial cost advance for the claim. But instead of a signature, the complaint only carried a stamp "gezeichnet. G." ("signed G.").

20 days later, a District Judge read the complaint for the first time. He noticed the missing signature and called up the lawyer who immediately rushed to the court house to sign the document. Another 30 days went by and the (now signed) complaint was served upon the insurance consortium.

The insurance companies became suspicious about the delay. They checked the file at the court house and found a hand-written note by the judge recording that the complaint initially was not signed. From then on, the insurers challenged the validity of the complaint mainly on the ground that an unsigned complaint, under extremely strict German precedents, is considered to be "unintentional" and thus "null and void". The insurers argued that the late signature of the attorney could not retroactively validate the unsigned document and that they thus were freed from any obligations under the insurance contract.

The lawyer who created the mess had no adequate insurance to cover the damage. He said he was sorry about this but could do nothing to help M. in his misery. The lawyer later shut down his practice and was no more seen.

M., faced with this situation, decided to continue his battle against the insurance companies in spite of the above mentioned very unfavourable court precedents regarding unsigned complaints.

District Court and Supreme Court Decisions

At first, things went rather well for Mr. M. Both, the District Court ("Landgericht") as well as the Appellate Court ("Oberlandesgericht") of Hamburg considered the claim to be valid. They based their decisions on two alternative grounds and also rejected all negligence arguments raised by the insurers.

The Appellate Court specifically held that the missing signature was not harmful because it was established that a cost advance of DM 42'000.—(€ 21'000.--) was paid by the handling attorney within the filing deadline and that this was sufficient proof for an "intentional" claim.

Holding of the German Federal Supreme Court (BGH IV ZR 458/02)

The insurance companies took the case to the highest ordinary German court, the Federal Supreme Court ("Bundesgerichtshof", hereinafter: "BGH"). This court, on March 3, 2004, reversed the lower court's ruling with incredibly formalistic arguments. The decision said, in essence: "*The receipt of the cost advance within the deadline, including a reference to the file number, indeed shows that the money was intended for … a complaint. However, whether the payment was initiated by counsel or, on his behalf, by his office staff, remains unclear. Also, the payment voucher did not mention the filing date.*" Thus, for the German Federal Supreme Court, it was "*not proven that counsel himself took responsibility for the contents of the (unsigned) complaint and that the complaint was intentional.*"

On this speculative basis, without even looking at the merits of the case, M.'s claim (and all his hopes) were dismissed. He was financially and personally a broken man after this verdict. The lawyer who was responsible for this total mess had no money, no adequate professional insurance and was unavailable. Result: M. was immediately bankrupt. Even worse, due to the decision, he had to pay hundreds of thousands of Euros in attorney's fees to insurers that

dramatically let him down in his misery. No need to say that M. lost all faith in justice and a fair proceeding.

III. THE RESCUE: A LANDMARK DECISION OF THE GERMAN CONSTITUTIONAL COURT (1BVR 894/04)

As a result of this BGH decision and having reached the rock bottom of his life, M. decided to seek relief from the German Constitutional Court ("Bundesverfassungsgericht"). According to the webpage of this court, only 2 to 3 cases out of 100 are likely to succeed.[1]

Yet, the case before the German Constitutional Court was heard in a record time on October 22, 2004. It ended with a sweeping victory of M. The German Constitutional Court said the following regarding the formalism of the BGH (translation by the author):

> "The German Constitution (Grundgesetz) guarantees litigation parties a 'fair proceeding'. Courts have a fiduciary duty to handle formal requirements of a proceeding in such a way that the substantive law questions can be decided. They should not evade such duty by setting unreasonable legal formalities.
>
> Relevant is that the Claimant unambiguously expressed his will to file the claim. The Bundesgerichtshof requirement that the payment voucher did not specifically refer to the filing date [albeit mentioning a file number] is incomprehensible. The judgement of the Federal Supreme Court is annulled [being unconstitutional]."

IV. WHAT ABOUT THE ARBITRATION WORLD?

The German BGH's ruling stands for an attitude found at many state court levels. Cases are rejected easily on formalistic grounds.

Arbitration proceedings are said to be different, i.e. "less formal". Is this true? Is this fair? And is it just to be less formal? Or, is the "search for truth" better served if arbitrators act like (some) state judges by being very formalistic?

In the following, I shall undertake to look at these issues more thoroughly, both from an academic point of view as well as in my capacity as an arbitration practitioner. At the end, I will give my own recommendations—hopefully to some benefit of the audience.

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[1] http://www.bundesverfassungsgericht.de/organisation/gb2008/A-IV-2.html.

Prevailing Academic View

According to some writers, procedural formalism assures:

a. the equal treatment of litigation parties;

b. the equal application of the rule of law ("Rechtsstaatlichkeit");

c. the predictability of the proceedings;

d. the legal stability of law ("Rechtssicherheit"); and

e. it enables control by higher courts.

According to these authors, procedural formalism is a must in any civilised culture. It cannot be dispensed with.

On the other hand, the downside of formalism has also been described in the literature. Some authors criticize that excessive formalism as it:

a. can be patently unjust;

b. can constitute a denial of justice;

c. may contradict the spirit of law;

d. can be harmful to the search for the substantive truth; and, sometimes,

e. can lead to outright unlawful results—see "Extasi" case (where the formalism applied by the BGH was found to be contradicting constitutional guarantees);

f. may contradict article 6 para 1 of the European Convention on Human Rights.

New York Convention

As for almost every question in arbitration proceedings, the New York Convention is the measure of all things. It establishes the minimum standards applicable in arbitration procedures worldwide. As to the particular question, how much formalism is appropriate in arbitration proceedings, the New York Convention is silent—at first view. Yet, it contains some extremely helpful guidelines in this context.

Art. V (1) NYC provides that recognition and enforcement of an award may be refused (amongst other grounds):

a. if the underlying arbitration agreement (art. II of the Convention) is not valid;

b. if the party against whom the award is invoked was not given proper notice or has been unable to present its case;

c. if the arbitration went beyond the scope of the arbitration agreement;

d. if the composition of the arbitral authority or the arbitral procedure was not in accordance with the agreement of the parties; or

e. if the award has not yet become binding on the parties.

Also, according to Art. V (2) NYC, an arbitral award cannot be enforced if the subject matter is not arbitrable or contrary to the public policy of the enforcement state.

So, the New York Convention does not dictate procedural rigidity. It seems not to address the tension between legal formalities and the right to be heard. But the New York Convention values the right to be heard extremely highly, and places it basically above anything else: No sanctions are imposed in case procedural formalities are *not* rigidly applied by arbitrators. On the other hand, if a party was not given proper notice or has been unable to present its case (for instance due to excessive procedural formalism), then the ensuing arbitral award is not enforceable under the New York Convention. The conclusion is that the New York Convention is at least favourable to the arbitrators' setting less formalistic standards than state courts.

Typical Arbitration Rules

The same is true for most arbitration rules which rarely address the issue of formalism.

As a typical example, the rules of the Arbitration Court of the International Chamber of Commerce (ICC Rules) may be cited. Art. 15 (2) of the ICC Rules provides that:

> "the Arbitral Tribunal shall act fairly and impartially and ensure that each party has a reasonable opportunity to present its case".

The ICC Rules do not, however, define how a "reasonable opportunity to present its case" is to be shaped. If one party misses a deadline, or fails to sign a document, like in the Extasi case, has the "reasonable opportunity to present its case" been granted by an arbitral tribunal declining to consider the (delayed) document? The rules are silent on this particular question.

The Swiss Rules of International Arbitration, art. 15 (1) are similarly unspecific on this issue:

> "Subject to these rules the Arbitral Tribunal may conduct the Arbitration in such a manner as it considers appropriate, provided that it ensures equal treatment of the parties and their right to be heard."

Is the "right to be heard" sufficiently granted if arbitrators decide not to accept a submission that was sent to the arbitral tribunal one or two days after expiration of the deadline, or which has not been signed?

While, in the old days of arbitration, it was quite clear that substance came before formality, things have become less clear in the recent past.

Creeping Legalism in Arbitration

Today, complaints are common that major arbitration proceedings are more and more resembling large scale litigations. Many large and medium sized companies that previously were faithful users of the arbitration process are considering or shifting away to other alternative dispute resolution mechanisms such as mediation, expert determination or the like. One of the reasons is the "creeping legalism" that is allegedly affecting arbitrations.

Legalism means that arbitration proceedings become more and more formalistic. The once "lean" proceedings have become a playing field for procedural battles between lawyers much in the same way as proceedings before state courts. Contributing factors to this development are:

a. the globalisation of business, along with a decreasing trust of business partners in each other, and in the arbitrators;
b. common law "discovery methods" influencing arbitration procedures, such as the ones defined in the IBA Rules on the Taking of Evidence;
c. written witness statements, coupled with Anglo-Saxon style cross-examination of witnesses;
d. motion practise of some counsel, similar to US proceedings;
e. a trend to challenge arbitrators more easily, sometimes on extremely frivolous grounds;
f. larger disputes; and finally,
g. a generally more litigious society.

Who is at Fault?

Taking the increasing legalism in arbitration as a fact, the question comes up who is at fault? In this connection, the blame is placed on both arbitrators and counsel alike.

Indeed, formalistic arbitrators do exist. I know of some "guillotine" arbitrators who apply, for instance a chess-clock system in connection with witness testimonies very rigidly. If one of the parties runs out of time, it has no chance to continue its questioning, even if crucial witnesses are being interrogated. The formal rule is placed above finding of the truth.

There are other arbitrators who are tolerant of parties filing motion after motion, mainly targeted at delaying the proceeding, without taking corrective actions. They fear being accused of curtailing the right to be heard and thereby get trapped in a procedural battlefield. Finally, there are those insecure arbitrators who appoint one expert after the other, instead of making decisions by their own.

But, even more frequently, formalistic counsel exist in our days. According to the author's subjective observations over many years, their number is increasing. Such formalistic counsel argue with the arbitral tribunal about every insignificant procedural point, or challenge arbitrators for purely tactical reasons, particularly once procedural or other decisions have been made which they consider to be unfavourable to the party they represent. I once experienced a challenge of a whole arbitration tribunal by a lawyer on the grounds that a procedural timetable established "in agreement between the parties and the arbitrators" was allegedly "broken by the arbitral tribunal". The "violation" that the arbitral tribunal was accused for was that it requested one party, 60 days after the alleged "mutually agreed production cut-off date", to submit certain additional documents (namely attachments to a voluminous construction contract which was already on file) to the court appointed expert. The expert had asked for these attachments (such as products lists, building construction maps, flowcharts, and the like) which the party in question had previously offered as a proof but did not file due to the enormous copying expenditure and the technical nature of these exhibits.

The party challenging the arbitral tribunal insisted that neither the arbitral tribunal nor the expert were allowed to see these details as the "agreed production cut-off date had been missed" and that the arbitration tribunal's decision to the contrary showed its bias. No need to say that the challenge was washed away by the arbitration

commission in question but the atmosphere in that particular arbitration became very difficult for the remaining part of the procedure. The exercise was an enormous loss of time and money for nothing.

Other formalistic counsel file motion after motion on almost any conceivable legal grounds. If the arbitral tribunal rejects such motions, or refuses to address them, such counsel complain about bias of the arbitrators or a violation of their right to be heard. In such instances, I have started to charge the costs for futile motions to the party raising them (which has prompted me another unsuccessful challenge in another case). In spite of this danger, I believe this is the right way to react to an exaggerated motion practice by counsel.

The question remains, however, how much "legal legalism" is necessary and reasonable in today's arbitral proceedings?

V. THE SWISS FEDERAL CONSTITUTION

The Swiss Federal Constitution, Art. 29, contains certain basic procedural guarantees. Everyone has the right to "equal and fair treatment in judicial and administrative proceedings". This also includes the right to have "the case decided within the reasonable time" (art. 29, para 1, Swiss Federal Constitution). Each party then has the right to be heard (art. 29, para 2, Swiss Federal Constitution).

These constitutional guarantees also apply to arbitrations taking place in Switzerland.

A. Court Practice in Switzerland

Swiss Courts frequently address issues of excessive formalism, but rarely approve constitutional violations.[2]

Excessive formalism is said to be a special form of denial of justice, characterized by: (i) the establishment of rigorous formal requirements, not genuinely justified under the circumstances; (ii) the application of formal requirements with extreme rigor; or (iii) the setting of excessive standards which prevent the application of the substantive law.

The reason why excessive formalism is often not found by the superior courts is a relatively moderate application of formal legal

[2] See, for instance: BGE 130 V 183; 128 II 142; 127 I 34f.; 126 III 527; 125 I 170ff.; 115 Ia 17; 102 Ia 308; BGE 1C 89/2007; 2C 297/2007; 1C 77/20071C 194/2007; 9C 186/2008; 2C 418/2008; CAS 2007, p. 229 (Court of Arbitration for Sport).

requirements by Swiss lower courts. The rigidity that was applied by the German BGH in the Extasi case, for instance, would be unthinkable in a Swiss case. In this connection, the new Swiss Civil Procedure Code reflects the standard generally applicable already today in Switzerland:

> "Art. 123 Deficient Submissions
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> [1]Deficiencies, such as a missing signature, missing power of attorney or the like, are to be corrected within a reasonable deadline set by the judge. Failing such correction, the submission is considered to be null and void.
>
> [2]The same is true with respect to unreadable, inappropriate, incomprehensible or overly extensive submissions."

B. Arbitration is Different from Court Practice

State court litigation is open to everyone. It covers a broad range of cases (once referred to as "conveyor belt justice"): commercial claims, personal claims, inheritance matters, divorce proceedings, etc. This requires standard procedures and formal barriers. By contrast, arbitrations are "tailor made" and "consensual". The proceeding is normally discussed with the parties and allows flexibility, always within the boundaries of the New York Convention and applicable rules.

State courts administer state authority against citizens. There is always an element of subordination involved. By contrast, arbitral tribunals derive their authority from a private contract between the parties which is primarily effective *inter partes*. It is true that the arbitration agreement also binds the arbitrators once they accept to act under the arbitration clause, but their role is to resolve a specific dispute, based on the applicable laws and principles. They do not have to find a solution applicable in any other, even comparable, case. In a tailor made proceeding, formal requirements need not be as rigidly applied as in state courts. "Conveyor belt justice" is not desirable in arbitration.

VI. SOUND ARBITRATION PRACTICE

In our days, it is standard practice that procedure is discussed between the parties and the arbitrators at the terms of reference hearing or during an initial organizational conference. Formalities are generally fixed by agreement or at least after consultation with the parties. The law "behind the arbitration" (the *lex arbitri*) certainly

impacts on how arbitrations are carried out, but strict formal requirements which may be applicable in state court proceedings under the *lex arbitri* should not be applied without compelling reasons. The overriding principle—which is vigorously safeguarded by the New York Convention and any arbitration rules—should be that each party is given the proper right to be heard. This contradicts a narrow application of formalities and deadlines such as in the Extasi case. Arbitration should indeed be less formal than state court proceedings.

The German Constitutional Court's holding mentioned earlier should be the guideline for arbitrators as well: they should focus on substance rather than form. The parties once opted for "tailor made" justice, they should not now insist on "conveyor belt" principles that were developed in state court proceedings. Neither should the arbitrators.

Formal standards need to be agreed and adhered to with a view to deciding the merits of a case. Insignificant formal violations should not be sanctioned by a loss of justice. This is particularly true in a multicultural arbitration environment where experiences and expectations of the participants often are totally different. Default mechanisms should and must come into place, but only if a party clearly refuses to abide to the rules or fails to cooperate. Default sanctions resulting in a loss on the merits shall never be automatic and the circumstances should always be looked at individually. As a general rule, there should never be a loss on the merits for failure to observe the form unless appropriate prior warning has been given.

VII. TEN RECOMMENDATIONS TO ARBITRATORS

1. Organize the procedure early, together with the parties.
2. Continuously think ahead.
3. Address procedural issues with the parties as soon as they arise.
4. Prepare a consensual timetable with an early hearing date.
5. If a formality has been violated, decide on its significance in terms of your major duty to decide on the merits (to find the truth).
6. If a formality has been violated, try to remedy the situation by consent rather than by a decision of the arbitral tribunal.
7. Make procedural decisions mainly if the parties cannot agree.

8. Enforce formalities by imposing cost sanctions rather than threatening the parties with loss on the merits.
9. Honour the right to be heard but do not address every remote issue raised by counsel, unless it is relevant.
10. Focus on substance, organization and time, not form!