CORPORATE
SWISS ARBITRATION

Don't act surprised

As a recent decision by the Swiss Federal Tribunal has shown, written stipulations are not always what they seem

It can happen that written stipulations in a contract are not what they seem: a clear obligation cut in stone. This may hold especially true if contracts are governed by Swiss substantive law. Under Swiss law, contracts are primarily interpreted in line with the actual intent of the parties. Only if such actual intent cannot be established, the contract will have to be interpreted on the basis of good faith, i.e. based on what a reasonable person would have understood when entering into the contract under the given circumstances.

Applied to a specific case, the use of either of the two interpretation methods may lead to significantly different results. In particular, subjective contract interpretation may take into account the individual conduct of the parties after entering into the contract. If the parties do not follow the provisions of the contract closely, such deviation from the contract might be interpreted as a modification and, hence, has the potential to override what was originally agreed upon by the parties in writing.

Especially in international arbitrations with their seat in Switzerland, parties and their legal representatives are well advised to keep the possibility of subjective contract interpretation in mind. Recent jurisprudence of the Swiss Federal Tribunal shows that it is very difficult to appeal successfully against an arbitral award which has its basis on a subjective contract interpretation, even if this was neither addressed by the parties nor the arbitral tribunal in the course of the proceedings. An appeal for a violation of the right to be heard – on the basis that a party had not anticipated the application of the subjective contract interpretation, and such had not made the corresponding pleadings – is hence likely to be rejected by the Swiss Federal Tribunal.

Legal framework

Swiss international arbitration law provides that the arbitral tribunal shall accord equal treatment to the parties and their right to be heard

1 MINUTE READ

Prager Dreifuss lawyers Urs Feller and Andreas Schregenberger discuss the limited scope of the parties' right to be heard in Swiss arbitrations when the tribunal engages in subjective contract interpretation, although no submissions were made on this legal issue. They give an overview of the legal framework governing an appeal to the Swiss Federal Tribunal against an award based on legal considerations which were neither addressed by the parties nor the tribunal during the proceedings. Underlying the article is a recent decision by the Swiss Federal Tribunal dealing with an award based on such a "surprise" application of the subjective contract interpretation.

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in adversarial proceedings (Art. 182(3) Swiss Private International Law Act (PILA)). A violation of the right to be heard by the arbitral tribunal can be challenged only before the Swiss Federal Tribunal (Art. 190(2)(d) PILA). In any event, pursuant to Swiss jurisprudence the parties' right to be heard refers mainly to the level of facts rather than to legal grounds.

The background to such lower scrutiny of the right to be heard on legal questions in Switzerland is the principle of *iura novit curia*. This principle entails that the procedural responsibilities between the parties and the court are strictly divided: the parties are responsible for the gathering, presentation and proof of the facts, whereas it is the court's responsibility to apply the law to the facts submitted by the parties. In consequence, the principle of *iura novit curia* empowers the courts to apply the law sua sponte, i.e. without being bound to the legal arguments by the parties. The relevance of the *iura novit curia* principle in international arbitrations depends primarily on the place of arbitration. While generally countries with common law traditions have not adopted this principle, it is strongly observed by the Swiss Federal Tribunal.

Accordingly, the right of the parties to be questioned on legal issues by international arbitral tribunals is recognised only restrictively by the Swiss Federal Tribunal. As a rule, according to the principle of *iura novit curia*, arbitral tribunals freely assess the legal significance of the facts and may also decide on the basis of rules of law other than those pleaded and relied upon by the parties. Unless the arbitration agreement provides otherwise, the arbitral tribunal does not have to hear the parties specifically on their legal assessment of the applicable rules of law. Moreover, the parties have to anticipate that the arbitral tribunal will consider every aspect of a legal issue at the core of the parties' dispute, including the introduction of new legal concepts.

In exceptional circumstances only is the arbitral tribunal required to inform the parties and provide them an opportunity to present their views on a legal concept it intends to adopt. This is the case when such legal concept was not alleged by either party during the proceedings and the parties could not have foreseen the importance of such legal concept. While it may by nature not be an easy task to assess what might be unforeseeable for the parties of international arbitration proceedings, the Swiss Federal Tribunal is very restrictive in accepting a lack of foreseeability. This shall be demonstrated on the basis of a recent decision of the Swiss Federal Tribunal regarding the subjective interpretation of contracts under Swiss law.

SFT 4A_136/2016

In its decision SFT 4A_136/2016 (decision of November 3, 2016), the Swiss Federal Tribunal had to decide whether it was permissible for the arbitral tribunal to consider the parties' conduct subsequent to the conclusion of the contract in order to determine the parties' intentions. Although this issue had not been addressed in the course of the proceedings, neither by the parties nor by the arbitral tribunal.

Facts

In 2004 and 2009, two companies (principals) entered into three consultancy agreements with another company (consultant), according to which consultant was to assist the principals in the preparation of tender offers for public infrastructure projects. Under the consultancy agreements of 2004 (agreements number one and two), the principals made various payments to the consultant between 2006 and 2008. Since 2009, the principals did not make any payment under these consultancy

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agreements; neither did they make payments under the third consultancy agreement that had been entered into in 2009 (agreement number three).

The background to such refusal of payment was, according to the principals, their alleged own involvement in criminal investigations led by the US Department of Justice (DoJ) and the UK's Serious Fraud Office (SFO). These investigations related to suspicions of corruption in connection with infrastructure projects in which the principals were engaged. Therefore, the principals argued, they had no choice but to suspend any payments under the consultancy agreements to avoid serious sanctions as a consequence of the ongoing criminal investigations (which allegedly also concerned the consultant). According to the principals, this would be evident as the consultant had violated the principals' internal anti-corruption/compliance rules, which formed part of the consultancy agreements. In 2013, the consultant initiated arbitral proceedings against the principals, claiming the outstanding commission payments under the consultancy agreements. The principals submitted that the claims should be entirely rejected.

In its final award the arbitral tribunal upheld the claims in part and ordered the principals to pay to the consultant outstanding commission payments under agreements number one and two. First, the arbitral tribunal assessed the submitted documentation in terms of the alleged involvement of the consultant in corruption. It held that while the burden of proof was on the principals, there was no evidence of any corruptive acts by the consultant. In a second step, the arbitral tribunal analysed the principals' argument that the consultant had, in violation of the terms of the consultancy agreements, failed to provide sufficient proof of its services and therefore was not entitled to further remuneration.

While the arbitral tribunal found that agreements number one and two each contained a specific clause concerning the proof of the services rendered by the consultant (the clause), it also held that the clause had to be interpreted with a view to the behavior of the parties after it had been concluded. On such basis, the arbitral tribunal concluded that the parties showed by their conduct that they had not intended to interpret the clause literally. Rather, the principals had for several years accepted the documentation submitted by the consultant despite the fact that it was not in compliance with contractual requirements.

The arbitral tribunal held that the parties had thereby tacitly altered the terms of the clause, precluding any objections by the principals. By contrast, the arbitral tribunal ruled that these considerations did not apply to agreement number three since no payments had been made by the principals under this contract. Consequently, there was no such subsequent conduct by the parties which may have altered the contract.

Argumentation by the appealing principals

The principals filed an appeal against the final award with the Swiss Federal Tribunal. They argued that the arbitral tribunal issued an award incompatible with public policy and that it had violated their right to be heard (due process). The principals' public policy argument (which is not the subject of this article) was rejected by the Swiss Federal Tribunal, *inter alia* holding that the violation of internal compliance rules does not as such constitute a violation of public policy.

Regarding the due process argument, the principals submitted that the arbitral tribunal had based the final award on legal considerations which they could not have anticipated and, hence, were unforeseeable for the parties. Their argument on the arbitral award's 'surprise effect' was based on three arguments. First, they argued, the parties did not have to anticipate that the arbitral tribunal would restrict the scope of the clause (or even modify its content) on the basis of a subjective interpretation of the parties' intent. This was apparently crucial to the case as the subjective interpretation significantly reduced the requirements imposed upon the consultant as to the proof of services it had rendered. Second, the surprise effect was enhanced by the fact that the arbitral tribunal had specifically sought the parties' comments on two totally unrelated Swiss law questions not dealing with the issue of subjective contract interpretation. Third, the application of the subjective contract interpretation was ultimately not foreseeable because the parties, all foreign to Switzerland, were not represented by Swiss counsel in the arbitration proceedings.

Considerations by the Swiss Federal Tribunal

The Swiss Federal Tribunal held that under Swiss law, the right to be heard relates primarily to the finding of facts. Generally, arbitral tribunals would not be required to seek the parties' views on legal issues. Pursuant to the principle of *iura novit curia*, arbitral tribunals – in the same way as state courts – would be free in assessing the legal bearing of facts. Hence, arbitral tribunals may also decide on the basis of rules of law other than those invoked by the parties. Consequently, as long as the arbitration agreement does not limit the task of the arbitral tribunal to the legal arguments raised by the parties, they would not have to be heard specifically as to the scope to be given to applicable rules of law.

According to the Swiss Federal Tribunal, the arbitral tribunal has to seek the parties' views on legal issues only under very narrow circumstances. This is the case if the arbitral tribunal intends to base its decision on a rule of law or a legal consideration that was not invoked in the course of the proceedings and the pertinence of which the parties could not anticipate. The Swiss Federal Tribunal applies this exception restrictively. From a Swiss law perspective, it is a discretionary decision whether or not the parties are in a position to anticipate the legal operation envisaged by the arbitral tribunal.

Generally, arbitral tribunals would not be required to seek the parties' views on legal issues

Hence, there is no clear-cut answer as to when a party may be taken by surprise. Against this background, the Swiss Federal Tribunal takes a restrictive approach when considering the arbitral tribunal's (implicit) decision that the parties could anticipate its legal reasoning. Moreover, the Swiss Federal Tribunal strictly adheres to the principle that

The position of the Swiss Federal Tribunal stands firm

the argument of violation of the right to be heard may not – as a matter of fact – be used to obtain a substantive review of the arbitral award.

In the present case, the Swiss Federal Tribunal held that, in light of these rules governing the scope of the right to be heard, the principals' argument as to the 'surprise effect' of the arbitral award appeared to be baseless. According to the Swiss Federal Tribunal, the subjective interpretation was one of the two pillars on which the interpretation of contracts rests in Swiss law, the second being the objective interpretation (based on good faith). In particular, the Swiss Federal Tribunal confirmed that coherent conduct of the parties subsequent to the conclusion of the contract may be used to determine their actual (mutual) intent. The Swiss Federal Tribunal reasoned that such subsequent conduct serves as an authentic source for interpreting the contract to which the parties are the very signatories. Consequently, such subsequent conduct may even – depending on the circumstances of the case – lead to a subsequent amendment of the contract or (ultimately) to its termination.

In the case at hand, the Swiss Federal Tribunal ruled that one of the essential building blocks of the dispute was the scope of the clause, establishing the required proof which the consultant needed to furnish. Accordingly, the Swiss Federal Tribunal was not convinced that the principals had been taken by surprise when the arbitral tribunal limited the applicability of this contractual provision at the very heart of the dispute. In the view of the Swiss Federal Tribunal, the fact that the arbitral tribunal had invited the parties to comment on unrelated issues had no impact on such conclusion.

Finally, the Swiss Federal Tribunal clarified that the argument that defendants were not represented by Swiss counsel was not admissible: First, the application of the principle of *iura novit curia* could (reasonably) not be dependent on the nationality of the parties' counsel; and second, it was the parties who chose not to be represented by Swiss counsel despite the applicability of Swiss law. Under such circumstances, consequently they bear the risk of not being represented appropriately (and not the counterparty or the arbitral tribunal).

The position of the Swiss Federal Tribunal stands firm: parties to international arbitrations in Switzerland must anticipate a subjective interpretation – based on the parties' actual intent – of contracts governed by Swiss law. In this context it is not surprising that the parties conduct subsequent to the conclusion of the contract can lead to an (implicit) modification of the contract at issue.

The application of the subjective method of interpretation to contracts governed by Swiss law has to be expected, irrespective of whether the parties' legal representatives are Swiss-qualified lawyers or not. As a result, parties whose counsel will only rely on a contract interpretation based on good faith will not be able to argue in an appeal that an award based on subjective contract interpretation comes as a surprise for them and hence their right to be heard has been violated.

In particular, non-Swiss parties should be aware of the existence of this jurisprudence and the significant consequences for the outcome of potential arbitration proceedings in Switzerland. As a rule, the need to consider the subjective interpretation method will also broaden the scope of facts which may need to be pleaded, substantiated and evidenced. This holds particularly true for post-closing issues. Against this background, Swiss representation in cases with a strong focus on contracts governed by Swiss law and their interpretation may be crucial to success in Swiss arbitration proceedings.