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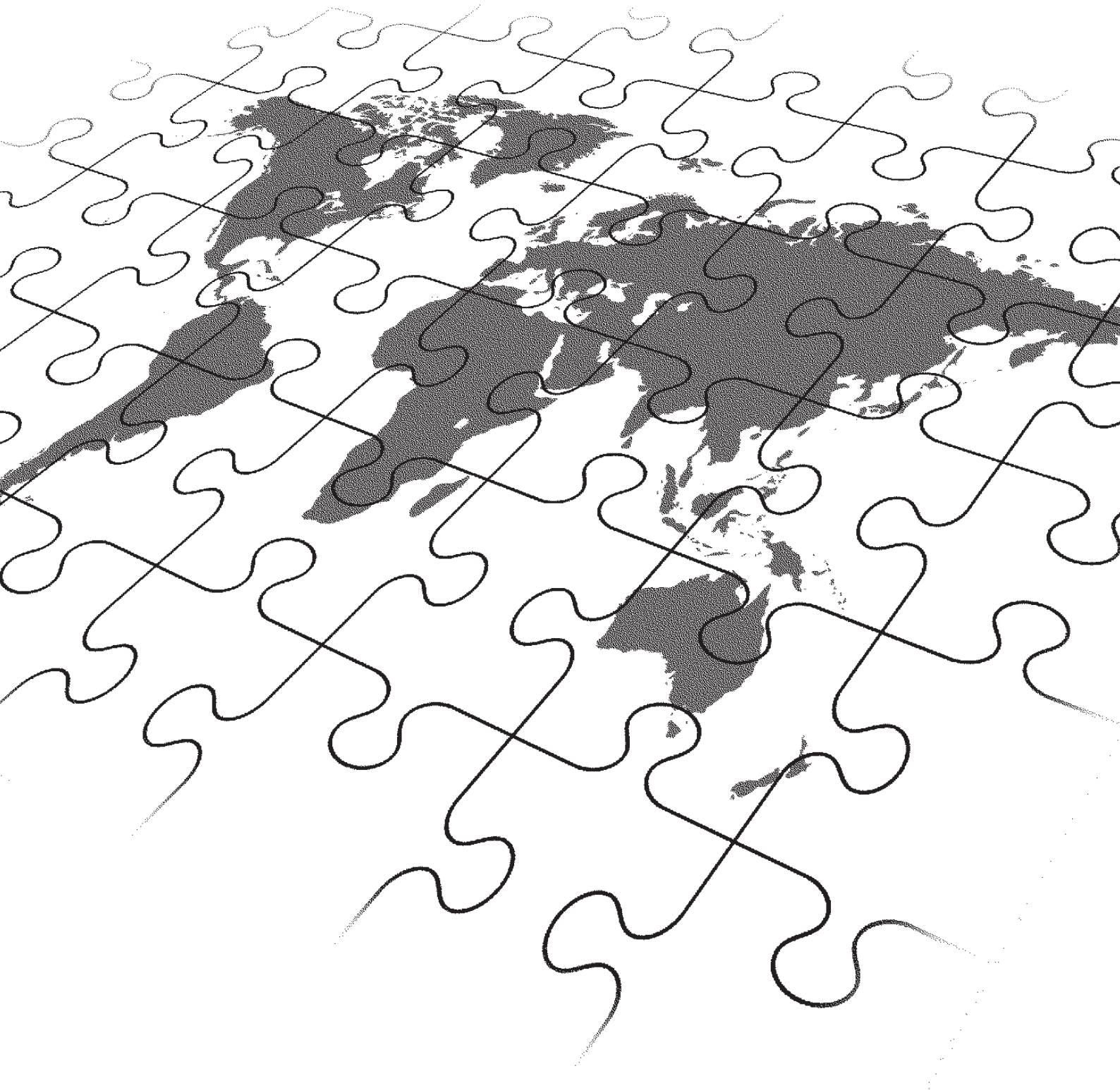

Midnight Express meets international arbitration: United States federal court denies enforcement of CIETAC award where the underlying contract was procured by police confinement

UNITED STATES

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In the first decision of its kind, the United States District Court for the Central District of California recently refused to enforce an international arbitration award because the contract containing the arbitration provision was entered into under duress.[1] The case illustrates the complex interplay between the New York Convention's respect for arbitration and limited protection of the parties when the process goes far awry.

The parties try to settle a dispute, pre-arbitration

Eastern Tools & Equipment Inc ('Eastern Tools') is an importer of gasoline powered generators and related equipment. Its principal supplier was Changzhou AMEC Eastern Tools & Equipment Co, Ltd ('Changzhou AMEC'), a joint venture of which Eastern Tools was a 40 per cent owner. A dispute arose between Eastern Tools and Changzhou AMEC; Eastern Tools claimed that Changzhou AMEC shipped non-conforming, defective goods and sought various damages. Changzhou AMEC denied the claim and demanded payment for the goods.[2] In December 2006, the parties entered into an agreement settling the dispute; Eastern Tools negotiated an agreement to keep the merchandise and pay Changzhou AMEC US$2m. The agreement was never signed, however, and Changzhou AMEC filed for bankruptcy in the People's Republic of China in February 2007.[3]

Arrest as commercial dispute resolution 'by other means'

In April 2007, the Changzhou Public Security Bureau ('police') arrested Eastern Tool's president, Guoxiang Fan, putting him in a detention facility and confiscating his phone. While Mr Fan was jailed, Changzhou AMEC's bankruptcy administrator, Xuchu Dai, came to meet with Mr Fan to discuss a new agreement between the parties. An attorney was permitted to visit Mr Fan in jail, but was only allowed to advise Mr Fan to sign the new agreement. When the attorney client discussion turned to the charges against Mr Fan, the attorney was forcibly removed from the room.

Four days later, Mr Fan was told that the police had completed their investigation, but he would not be released until he signed an agreement. The terms of that agreement were worse for Eastern Tools than the earlier, unsigned agreement: Eastern Tools was to pay US$2.5m to Changzhou AMEC, including US$300,000 almost immediately, and the remainder in equal installments for six months ('April 2007 Agreement'). Mr Fan was named a guarantor of Eastern Tools' obligations. If Eastern did not pay on time, it would be required to pay Changzhou AMEC more than US$6m.

Mr Fan was released from custody only after he signed the agreement and the US$300,000 payment was made. Notwithstanding the fact that Changzhou AMEC had received payment under the April 2007 Agreement, Changzhou AMEC's creditors rejected it. Despite this rejection, Mr Fan was repeatedly pressured by the

police to re-sign the April 2007 Agreement after his release. In July, Mr Fan was ordered by the police to return to Changzhou to sign a slightly revised agreement ('July 2007 Agreement'). Mr Fan thought that he would be detained again if he did not sign the July 2007 Agreement, so he returned to Changzhou and signed it. Changzhou AMEC's creditors subsequently approved the renewed agreement, which had terms nearly identical to that of the April 2007 agreement. Both agreements contained an arbitration clause providing that disputes would be submitted to the China International Economic and Trade Arbitration Commission (CIETAC) in Shanghai.

The CIETAC arbitration and award

Eastern Tools made one more payment, of US$250,000, to Changzhou AMEC in February 2008. Thereafter, Changzhou AMEC commenced CIETAC arbitration to enforce the July 2007 Agreement. Eastern Tools raised its claim of duress in the arbitration, and the arbitrators rejected it. At the end of 2009, the arbitrators awarded Changzhou AMEC US$5.6m because Eastern Tool had failed to make the payments in a timely manner, with Mr Fan jointly liable with Eastern Tools.

The US Court considers the case

In March 2011, Changzhou AMEC brought a proceeding in a US federal court in California against Eastern Tools and Mr Fan to confirm the award under chapter 2 of the Federal Arbitration Act[4] and the New York Convention.[5] Eastern Tools and Mr Fan opposed confirmation, arguing that the July 2007 Agreement, which contained the arbitration provision, was entered into under duress and was therefore invalid.

The Court, after discovery and motion practice, agreed with the defendants' position and denied enforcement. The Court recognised that there were no US cases directly dealing with the issue here, where the contract containing the arbitration clause was alleged to have been procured by physical duress. The Court therefore proceeded through each of the defences to enforcement of an arbitration award under Article V of the New York Convention.

The New York Convention defences

The New York Convention provides three potentially relevant defences:

- Article V(1)(a) – that, under the law applicable to the parties, a party was 'under some incapacity', the agreement was not valid under the law chosen by the parties or, absent a choice, where the award was made.
- Article V(2)(a) – that the 'subject matter of the difference is not capable of settlement by arbitration under the law' of the country where recognition and enforcement are sought.
- Article V(2)(b) – '[t]he recognition or enforcement of the award would be contrary to the public policy' of the country where recognition and enforcement are sought.

The Court refuses to enforce the award

The Court determined that Article V(1)(a) did not apply, as the determination of validity of the contract under the law applicable to the arbitration was for the arbitrators to determine. That determination was subject to a 'manifest disregard' standard – not just that the arbitrators erred, but that the arbitrators knew of the applicable law and ignored it.[6] In this case, the panel had applied Chinese law to Eastern Tools' claim and rejected it. It had therefore not manifestly disregarded applicable law.

The Court found that Article V(2)(a) applies only to 'disputes which under domestic law would be entrusted to the exclusive competence of the judiciary'.[7] Here, the underlying dispute, over the sale of non-conforming goods, was arbitrable under US law, and Article V(2)(a) did not apply.

The Court finally turned to Article V(2)(b). Although there were no prior cases addressing duress, a number of cases in dicta had considered that deprivation of fundamental due process – such as coercion or duress – would constitute violations of 'this country's most basic notions of morality and justice'.[8] The Court compared Article V(2)(b)'s strictures on enforcement of awards with Article II(3), which permits a court to refuse to enforce an agreement to arbitrate where the agreement is 'null and void, [or] inoperative'.[9] The court also looked to decisions reviewing arbitration agreements with foreign choice of law provisions. US courts will apply US law in the first instance to determine the validity of such clauses.[10] Under the FAA, courts will look in the first

instance to the law of the state in which the court is located, which in this case was California. Under California law, duress 'generally exists whenever one is induced by the unlawful act of another to make a contract or perform some other act under circumstances that deprive him or her of the exercise of free will.'[11]

The Court had little difficulty finding that Mr Fan's jailing and the follow-up calls from the Changzhou police constituted duress. It further had little difficulty imputing the duress to Changzhou AMEC, which knew of and benefited from Mr Fan's durance, vile, so that the July 2007 agreement was invalid.[12] Moreover, Eastern Tool's subsequent payment of US$250,000 in early 2008 was infected by the same duress – threat of police action – as the July 2007 Agreement, and Eastern Tools therefore did not ratify the agreement by making the payment.[13] The court denied confirmation of the award.

Issues of duress in arbitration

Duress in the form and scale practised on Eastern Tools appears to be a rarity in international arbitration.[14] Nonetheless, the case demonstrates a real risk to parties to arbitration agreements that seat the arbitration in places where the impartial administration of justice is compromised. China ranks 80th (with a score of 39 out of 100) in Transparency International's *Corruption Perceptions Index 2012*.[15] Many countries offering arbitration facilities also rank low (below 50 points) on the index. Counterparties may thus be put to the unpleasant contemplation of the risk of government-aided duress (or a myriad of other forms of corruption) that might be glossed over in arbitration. Conducting arbitration outside the country may not be a business option, and it may be practically impossible to enforce an international award, obtained elsewhere, in that place.

As a matter of arbitration practice, the *Changzhou AMEC* case also points out that, notwithstanding the risk of corruption and unfairness, the issue of duress will likely be decided by the arbitrators in the first instance. Under the FAA, because duress claims normally go to the validity of the entire contract rather than just the arbitration clause, the issue of whether the contract was entered into under duress will normally be for the arbitrators.[16] That deference was apparent here, where the Court reviewed the arbitrators' decision concerning duress under Chinese law under the highly deferential 'manifest disregard' standard. Indeed, had this been a US domestic arbitration, there might well not have been grounds to vitiate the award.

Article V(2)(b), then, is a last resort for fairness in international arbitration, and its effect is limited only to the country in which enforcement is denied. That its use has been rare is a tribute to the effectiveness of international arbitration. If and as more arbitration is seated in countries where corruption is endemic and examples of duress of the nature of that seen in this case, however, it may become a more frequently used tool.

Notes

* Celinda Metro, an associate at Seward & Kissel, assisted in the research and preparation of this article.

1 *Changzhou AMEC Eastern Tools & Equip CP, Ltd v Eastern Tools & Equip, Inc*, No EDCV 11-00354 VAP, 2012 US Dist LEXIS 106967 (CD Cal 30 July 2012). Some background facts, not addressed in the opinion, are taken from documents filed in the case, available on the US courts PACER system.

2 2012 US Dist LEXIS 106967 at *16–17.

3 *Ibid*.

4 9 USC sections 201-208.

5 Convention on the Recognition and Enforcement of Foreign Arbitral Awards, 10 June 1958, 330 UNTS 38.

6 2012 US Dist LEXIS 106967 at *33–34. 'Manifest disregard' is a legal principle of varying meaning (even existence) in US courts. Within the Ninth Circuit, in which the federal court that decided *Changzhou AMEC* sits, manifest disregard of the law is a form of the excess exercise of power by the arbitrators. See *Comedy Club, Inc v Improv West Assocs*, 553 F.3d 1277, 1290 (9th Cir 2009) (arbitrator must recognise applicable law and proceed to ignore it for the doctrine to apply).

7 *Ibid*, at *34–35 (internal quotation marks omitted).

8 *Ibid*, at *35 (internal quotation marks omitted).

9 The court viewed the proscription in Article II(3) as applying where the entire contract is invalid. There is tension between that view and the principle that a defence to contract validity generally is for the arbitrators, while a dispute as to the validity of the arbitration agreement is for the court. See *Buckeye Check Cashing, Inc v Cardegna*, 546 US 440, 445–46 (2006). The court's failure to address that tension is not, however, relevant to its analysis of whether the award is invalid as against public policy.

10 2012 US Dist LEXIS 106967 at *41.

11 *Ibid*, at *46 (quoting *Tarpy v County of San Diego*, 110 Cal App 4th 267, 276, 1 Cal Rptr 3d 607 (2003)).

12 *Ibid*, at *55.

13 *Ibid*, at *55–56.

14 Claims of economic duress may be more common. See,

for example, *Progress Bulk Carriers Ltd v Tube City IMS LLC*, [2012] EWHC 273 (Comm) (affirming arbitration award for damages for economic duress for conduct in the course of performance of charterparty).

15 By comparison, the United Kingdom and United States are ranked 17th and 18th, with scores of 74 and 73, respectively. The report is available at: **www.transparency.org/cpi2012/results**.

16 See, for example, *Buckeye Check Cashing*, 546 US at 445–46 (fraud in the inducement of the entire contract for the arbitrators)*; In re RLS Legal Solutions, LLC v Rogers*, 221 S W.3d 629 (Tex 2007) (compelling arbitration where duress claim was addressed to entire contract).

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When it rains, it pours: three new cases add to the umbrella clause debate

Over the past decade, a single company's claims have been at the forefront of the debate over umbrella clauses in investment treaties. Société Générale de Surveillance (SGS) brought separate claims against Pakistan and the Philippines under each country's BIT with Switzerland, claiming breach of the treaties' respective umbrella clauses due to the respective state party's alleged breach of the underlying service contracts at issue in both cases. The divergent awards in those two cases[1] marked the respective outer limits of the debate regarding the extent to which an umbrella clause may elevate any breach of contract between an investor and a host state into a breach of the umbrella clause in the related BIT: the *Pakistan* decision was pro-sovereign, refusing to give broad effect to the umbrella clause so as not to risk creating 'far-reaching' and 'burdensome' results for host states, while the *Philippines* decision was more favourable to investors, adopting a 'plain meaning' approach to give the clause full effect, but then held that a forum-selection clause in the same underlying contract rendered the claim inadmissible. Over the next several years, a number of cases were decided, with the analysis in each falling somewhere between the two initial SGS interpretations. Two additional cases, both against Paraguay, were decided more recently and add further to the debate regarding the proper scope of umbrella clauses.

The Paraguay cases

One of the recent cases involved another SGS claim for breach of a service contract, and the other involved an almost identical contract entered into by a Dutch company, Bureau Veritas, Inspection, Valuation and Control (BIVAC).[2] In fact, SGS and BIVAC had been selected by Paraguay from five companies invited by the country's Minister of Finance to bid on providing pre-shipment inspection services as part of an effort to improve the collection of custom duties. The two companies' contracts were executed with the Ministry of Finance, and both contained forum-selection clauses designating the courts of the city of Asunción and providing for the application of Paraguayan law.

Despite this almost identical factual backdrop, nearly indistinguishable contracts and BITs containing fairly similar umbrella clauses, two arbitral panels sitting in essentially parallel proceedings came to different conclusions on the application and effect of those clauses. In *BIVAC v Paraguay*, the tribunal held that the umbrella clause brought the relevant contract within the treaty's protection. Specifically, it held that the treaty's umbrella clause created 'an international obligation for the parties to the BIT to observe contractual obligation[s]', and that any other conclusion would deprive the umbrella clause of 'meaning and practical effect'.[3] After coming to this conclusion, however, the tribunal found BIVAC's claims inadmissible on the basis that all of the obligations contained in the