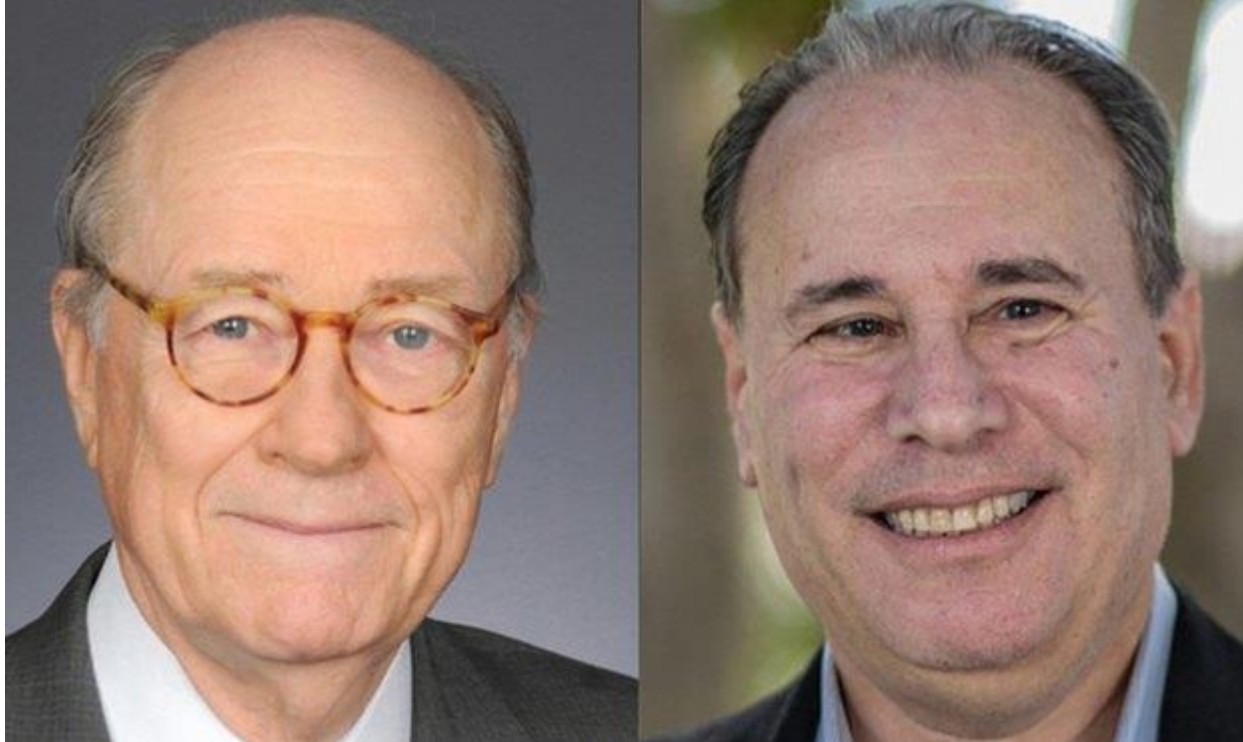


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The Perils of the Nonexistent Arbitral Institution

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By **Lawrence W. Newman and David Zaslow** | July 24, 2024 at 10:00 AM



Your client gives you a contract and tells you that the counter-party has materially breached the agreement and amicable resolution is no longer an option. The contract includes an arbitration clause and there is no question that the dispute arises thereunder. However, the clause calls for arbitration before an institution that does not exist. What should you do?

The impetus for this column was the recent decision in *Spineway SA v. Strategos Group*, No. 22-mc-00604-JLH (D. Del. Mar. 1, 2024), in which parties acknowledged that they had agreed to arbitrate their dispute, but disagreed about the arbitral institution and corresponding rules. The contract said: “Any dispute resulting from or relating to this Promise will be resolved via a final decision issued in accordance with the Mediation and Arbitration Rules of the Geneva International Chamber of Commerce...”

There is no such institution.

Spineway commenced an arbitration against Strategos before the Swiss Chambers’ Arbitration Institution (SCAI) in Geneva pursuant to the SCAI Rules. Strategos believed that the intended arbitral institution was the International Chamber of Commerce (ICC) and therefore did not appear in the arbitration. Nonetheless, a sole arbitrator appointed by SCAI—who attempted to persuade Strategos to participate—issued a final award, holding that he had jurisdiction over the dispute and awarding damages to Spineway.

Spineway sought to enforce the award in federal court in Delaware. Looking to the text of the arbitration clause under French contract law, which the parties agreed governed the agreement, the court first noted that, as Strategos contended and Spineway could not rebut, countless French courts interpreted similar references to “the Geneva International Chamber of Commerce” to refer to the ICC and its rules, with an arbitral seat in Geneva.

Extrinsic evidence bolstered this conclusion in that, while every draft of the agreement contained references to the “International Chamber of Commerce,” there were no such express references to the SCAI. The court therefore denied Spineway’s request to enforce the award, relying on Article V(1)(d) of New York Convention, which allows a court to refuse recognition if the “composition of the arbitral authority or the arbitral procedure was not in accordance with the agreement of the parties...”

The unusual aspect of this case is that the issue of the non-existent arbitral institution was raised at the enforcement stage. It is much more common for the issue to be raised at the front-end. But those cases are far from uniform in their outcome.

The National Arbitration Forum (NAF) was a fairly popular arbitral institution at the turn of the century. However, it stopped accepting new consumer cases for arbitration in July 2009, when it settled a suit by Minnesota’s Attorney General, who believed that the NAF was biased in merchants’ favor. This turn of events resulted in numerous cases in which courts faced the very issue that is the subject of this article: they had to decide what should happen with consumer disputes under contracts that included an NAF arbitration clause but that the NAF could no longer accept.

One such case was *Khan v. Dell*, 669 F.3d 350, 353 (3d Cir. 2012), in which the U.S. Court of Appeals for the Third Circuit said it was addressing a matter of first impression for its circuit in deciding whether to appoint a substitute arbitrator when the arbitrator designated by the parties is unavailable.

The Third Circuit noted that the issue implicated Section 5 of the Federal Arbitration Act (“FAA,” 9 U.S.C. § 5), which states, in relevant part:

[I]f no method be provided therein [naming or appointing an arbitrator], or if a method be provided and any party thereto shall fail to avail himself of such method, or if for any other reason there shall be a lapse in the naming of an arbitrator or arbitrators or umpire, or in filling a vacancy, then upon the application of either party to the controversy the court shall designate and appoint an arbitrator...

The court explained that, in determining the applicability of Section 5, courts have focused on whether the designation of the arbitrator was “integral” to the arbitration provision or was merely an ancillary consideration.

The arbitration clause said that disputes “shall be resolved exclusively and finally by binding arbitration and administered by the” NAF. The court held the clause was ambiguous because “exclusively” could modify “binding arbitration,” the NAF or both, and noted also that the ambiguity was confirmed by conflicting decisions by other courts. This ambiguity meant it was not clear whether the designation of the NAF was ancillary or was as important a consideration as the agreement to arbitrate itself.

With a lack of clarity, the court held it was compelled to answer the issue in accordance with the Supreme Court’s oft-stated preference in favor of arbitration. This led the court to conclude that the district court should appoint a substitute arbitrator.

Flagg v. First Premier Bank, 644 Fed.App’x. 893 (11th Cir. 2016) was also a case in which there was a dispute under a contract with an NAF arbitration clause. The court’s analysis, as was the case in *Khan* and many of the decisions on this issue, centered on the “integral part” rule, which the court said means that the unavailability of the parties’ chosen forum precludes arbitration if “the choice of forum is an integral part of the agreement to

arbitrate, rather than an ancillary logistical concern.” Making that determination turns on “how important the term was to one or both of the parties at the time they entered into the agreement.”

Looking to the facts of the case, the court said the clause specified that disputes “shall” be resolved by the NAF under its Code of Procedure in effect at the time of the claim, and “did not appear to contemplate arbitration before any other forum.” The court also pointed to the fact that, even after the NAF stopped taking consumer cases, the defendant continued to use arbitration agreements designating the NAF and made no provision for the appointment of an alternate arbitrator. It took this to mean that the NAF was integral to the defendant, a seemingly odd conclusion in that arbitrating consumer disputes before the NAF was no longer possible.

The court also noted the choice of using the NAF Code of Procedure, which said that the parties can go to court if they are denied arbitration before the forum. For all these reasons, the court concluded that the choice of NAF was integral and refused to appoint a substitute for the NAF.

In *Ranzy v. Tijerina*, 393 Fed.Appx. 174 (5th Cir. 2010), the U.S. Court of Appeals for the Fifth Circuit also applied the “integral part” rule in an NAF case and reached the same result as in *Flagg*, using the same general logic (without referencing the right to go to court).

The U.S. Court of Appeals for the Second Circuit also reached the same result—refusing to appoint a substitute arbitrator—without referring to the “integral part” rule. *Moss v. First Premier Bank*, 835 F.3d 260, 264 (2d Cir. 2016). It said that the language in the clause calling for disputes to be resolved by the NAF, under the NAF Code of Procedure, and without a provision for appointment of a substitute arbitrator should the NAF be unavailable, indicated that the parties intended to arbitrate only before the NAF.

The Second Circuit held that, in the face of an “exclusive” choice like this one, “a court cannot use [FAA] Section 5 to circumvent the clear text of the parties’ agreement and appoint a substitute arbitrator.”

Green v. U.S. Cash Advance Illinois, LLC, 724 F.3d 787 (7th Cir. 2013), was another case dealing with the NAF. The U.S. Court of Appeals for the Seventh Circuit rejected the “integral part” rule. It said that Section 5 tells everyone that arbitration clauses remain enforceable if for “any” reason there is “a lapse in the naming of an arbitrator.” And it noted the direction from the Supreme Court that courts not add to, nor depart from, the standards in the FAA.

According to the Seventh Circuit, when a court declares that a part of an arbitration clause is “integral” and that the clause is therefore unenforceable as a matter of federal common law, it is effectively disagreeing with the direction of Congress in Section 5, saying that a judge can appoint an arbitrator when for “any” reason something has gone wrong. The court also said that, as far as it could tell, no court had ever explained what part of the FAA authorized the “integral part” rule. It thus directed the district court to appoint an arbitrator who would resolve the dispute using the procedures in the NAF’s Code of Procedure (even though the NAF itself would not administer the arbitration).

The takeaway in terms of the likely result of litigating this issue is that it will depend on the court one is in, and, of course, the specific language of the clause. Courts in numerous circuits, using the “integral part” rule, or otherwise, will probably not appoint a substitute arbitrator. The Third Circuit also applies the “integral part” rule but could likely reach the opposite result, and the Seventh Circuit rejects the “integral part” rule in favor of a very strong preference for appointing an arbitrator if the parties’ agreement includes an arbitration clause.

In terms of the takeaway for lawyers advising their clients, the most obvious advice for a case like *Spineway* is to counsel clients at the drafting stage to be careful not to choose an arbitral institution that does not exist. But, of course, as the NAF cases showed, even if a contract chooses arbitration before an actual institution, there remains a real possibility that the institution will no longer exist at the time of arbitration.

A similar situation to the NAF occurred in December 2021, when the government of Dubai issued a decree abolishing the Dubai International Financial Center London Court of International Arbitration and replacing it with the Dubai International Arbitration Center (DIAC). In such a situation, and based on the decisions above, if an arbitration clause includes language indicating that the parties agreed to arbitrate before some comparable arbitral institution if the named one is no longer available, courts in the United States would probably be more likely to appoint a substitute arbitrator. One sees such clauses occasionally, but perhaps they should be used more broadly.

Coming back to the lawyer from the beginning of our article, *Spineway* shows that there is a real risk in simply commencing the arbitration and not having the other side participate, even if the tribunal and an arbitral institution determine that the chosen institution is the proper one.

Faced with an arbitration clause calling for arbitration before a non-existing institution, the first step should be to try to reach agreement with the other side on the institution that should be used. If the parties are unable to reach agreement, it would be wise to bring the issue before the courts before the arbitration takes place and obtain a decision on whether there is a binding clause and, if so, which institution should be used. If the place of arbitration and likely place of enforcement are the same, the determination by the court at the outset should provide a sufficiently binding decision.

While, in a situation such as *Spineway*, where these two places are not the same, a decision by the courts in the country in a comparable position to Switzerland as to the proper institution before which to arbitrate would not necessarily be binding on the U.S. courts, but, under the principle of comity, the decision would likely be given great deference. That is probably the best one could hope for.

Lawrence W. Newman is of counsel and David Zaslowsky is a partner in the New York office of Baker McKenzie. They can be reached at lawrence.newman@bakermckenzie.com and david.zaslowsky@bakermckenzie.com, respectively. The authors express their appreciation to Kelechi Okengwu, an associate in the New York office, for her contributions to this article.