

## **Failure by Arbitrators to Apply Contract Terms from the Perspective of the New York Convention**

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It is common thinking amongst business people that arbitrators will apply carefully negotiated provisions of their contracts during the dispute resolution process. This belief is supported by Article 17(2) of the ICC Rules of Arbitration, which requires that ‘[i]n all cases the Arbitral Tribunal shall take account of the provisions of the contract’. Yet what happens if arbitrators glaringly ignore that rule against the wishes of the parties and argument of counsel? Is the wisdom of the arbitral tribunal such that courts may not review the merits of an arbitral award, since awards—at least according to Article 28(6) of the ICC Rules—are ‘binding’? In this contribution I will attempt to explore that question in relation to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, New York, 10 June 1958 (‘New York Convention’).

### **Some precedents under the New York Convention**

‘No review of the merits’ is a well-established principle of the New York Convention and means that an error in fact or law does not constitute a ground for refusing enforcement of an award. The question is whether this principle prevails in all circumstances and, in particular, where parties have agreed to a provision such as Article 17(2) of the ICC Rules of Arbitration.<sup>1</sup>

There appear to be few decisions in which the question of an arbitral tribunal’s failure to apply the relevant contract terms has been addressed by a court in enforcement proceedings under the New York Convention.

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1 The UNCITRAL Arbitration Rules of 1976 raise a similar question as Article 33(3) requires that ‘the arbitral tribunal shall decide in accordance with the terms of the contract’. The difference is ‘shall take account of’ (ICC) / ‘shall decide in accordance with’ (UNCITRAL). That difference is not addressed in this contribution, which deals with the situation in which arbitrators have left aside relevant contract provisions; such a situation comes within both expressions.

A US district court in Ohio did not accept the assertion that the arbitrators had exceeded their authority by awarding consequential damages, which had been expressly excluded in the contract.<sup>2</sup> The district court declined ‘to substitute its judgment for that of the arbitrators’.

Before the US Court of Appeals for the Second Circuit in the matter of *Overseas v. RAKTA*,<sup>3</sup> the respondent alleged that the arbitrator had awarded US\$ 185,000 for loss of production in excess of his authority, as the contract provided that ‘[n]either party shall have any liability for loss of production’. The Court of Appeals rejected this defence, saying that the construction of the contract, and thus of the clause in question, was a matter for the arbitrator and that it was not apparent that the scope of the submission to arbitration had been exceeded.

Before the Paris Court of Appeal, in the matter of *Saint-Gobain v. FCIL*,<sup>4</sup> Saint-Gobain, against which FCIL was seeking to enforce an award, asserted that the arbitrator had exceeded his authority because his award ordered Saint-Gobain to pay FCIL the indemnity it received from the insurers for material damaged during transport, whereas the parties’ contract provided that the indemnity was to be transferred by FCIL to Saint-Gobain. The court held that this was a simple slip of the pen in the award as the words ‘respondent’ and ‘claimant’ had erroneously been inversed. As this was recognized by FCIL, which was prepared to reimburse Saint-Gobain the amount in question, the court considered the question as moot.

In the Federal Court of Appeal in Winnipeg, Canada, a party resisting enforcement argued that the arbitrators had exceeded their authority by awarding demurrage while the contract provided: ‘[D]emurrage and/or despatch at loading port to be settled between Owners and Charterers. Demurrage and/or despatch at discharging port to be settled between Owners and Receivers.’<sup>5</sup> The court approved the lower court’s reasoning to the effect that ‘[n]o authority has been cited to me, nor does it appear reasonable to conclude, that the failure, real or

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2 US District Court, Southern District of Ohio (Western Division), 9 June 1981 (*Fertilizer Corp. of India et al. v. IDI Management, Inc.*), (1982) VII Y.B. Comm. Arb. 382.

3 US Court of Appeals, Second Circuit, 23 December 1974 (*Parsons & Whittemore Overseas Co. Inc. v. Société Générale de l’Industrie du Papier (RAKTA) and Bank of America*), (1976) I Y.B. Comm. Arb. 205. In the same sense: US District Court, Eastern District of Michigan (Southern Division), 15 March 1977 (*Audi-NSU Auto Union AG v. Overseas Motors, Inc.*), (1978) III Y.B. Comm. Arb. 291.

4 Paris, 10 May 1971 and Président, Trib. gr. inst. Paris, 15 May 1970 (*Comp. de St. Gobain-Point à Mousson v. The Fertilizer Company of India, Ltd.*), (1976) I Y.B. Comm. Arb. 184.

5 Federal Court of Appeal, Winnipeg, Manitoba, 20 November 1991 (*Northern Sales Company Limited v. Compañía Marítima Villa Nova S.A.*), (1993) XVIII Y.B. Comm. Arb. 363.

hypothetical, of the plaintiff to enforce its claim against the receiver precluded any determination by the arbitrators that the defendant was liable for a portion of the plaintiff's claim'. The lower court also observed that the arbitration clause 'was to govern "all disputes from time to time arising out of this contract"'. The contested liability of the defendant for demurrage was surely the "dispute" referred to the arbitrators: that was the very matter they were authorized to decide and did decide.'

The reported cases are therefore not very helpful in addressing the question. This may be because respondents do not raise their arguments in the context of the New York Convention's 'no review of the merits' principle. Or perhaps the arguments have not been raised in their proper perspective under the Convention.

### **The exceptional case**

With respect to the diligence of arbitrators in carrying out their duty to apply the terms of the contract, arbitrators do generally follow the terms of the contract or construe them as may be required under the circumstances. Those cases can certainly not be questioned in enforcement proceedings under the Convention. However, there are some cases in which arbitrators have blatantly ignored the terms of the contract. Of course, where there is uncertainty, arbitrators should have the benefit of the doubt; otherwise, courts would be acting as appellate bodies in disguise. But in those exceptional cases where, even with the benefit of the doubt, the arbitrators' failure cannot be justified, should arbitrators be able to get away with being manifestly derelict in their duty?

The following example may illustrate the point. Assume that arbitrators have to determine the fair market value of shares. Assume also that the contract provides for two valuation methods (DCF and multiples of comparable transactions), and that the parties plead both valuation methods (with extensive expert reports). At the outset of their award, the arbitrators explicitly acknowledge that both valuation methods are to be applied (the second as a verification of the first). However, the arbitrators go on to apply only the DCF method and ignore the other.<sup>6</sup> They arrive at a DCF figure that is more than twice as high as the previous valuations of the same shares (US\$ 100 million as against US\$ 50 million).

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6 For determining fair market value of shares, the DCF (Discounted Cash Flow) method is quite popular these days. That method, however, is to be used with the utmost care as it is highly sensitive to the assumptions made. For example, a small change in the discount rate can have enormous consequences in the outcome.

To make matters worse in our example, imagine that the arbitrators provide evidence that they applied only the first valuation method, in the form of an Excel sheet attached to their award and presented as their reasoning and decision.<sup>7</sup> Let us then also assume that the arbitrators are not very adept electronically and not proficient in their use of Excel, with the result that the same row has been counted twice in the Excel calculation.

The claimant then requests rectification for computational errors. Suppose the arbitrators choose to comply with the request. Excel produces what you put into it: the corrected Excel calculation triples the value of the shares (now US\$ 150 million) and that is what the arbitrators issue as a ‘correction’ of their award.<sup>8</sup>

Can enforcement of the award as corrected in the above example be refused in countries other than the place of arbitration under the New York Convention? The ‘no review of the merits’ principle seems a formidable obstacle. However, I believe that hope is not entirely lost for the party that suffers at the hands of those arbitrators in the above example. There may be three grounds under the New York Convention on which that party may attempt to resist enforcement. They are: (a) overstepping of the arbitrators’ mandate (Article V(1)(c)); (b) violation of the agreement of the parties on the proceedings (Article V(1)(d)); and (c) violation of public policy (Article V(2)(b)). These possible grounds will be examined in turn below.

### **Overstepping of the arbitrators’ mandate (Article V(1)(c))**

Article V(1)(c) of the Convention provides:<sup>9</sup>

Recognition and enforcement of the award may be refused, at the request of the party against whom it is invoked, only if that party furnishes to the competent authority where the recognition and enforcement is sought, proof that: . . .

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7 Most DCF calculations are made using Microsoft Excel or a comparable programme.

8 The request should of course have been denied or declared inadmissible. One could reason that the DCF calculation in the award has implicitly been verified by the multiples method at the time of the award, for which reason the result of the award could not be changed, irrespective of the counting error in the Excel sheet. One could also reason that the correction would require the application of the multiples method as yet, which is not allowed to be done in proceedings for rectification of a computational error. The fact that the arbitrators comply with the request not only makes matters worse in monetary terms; it also confirms that they failed to apply verification by the multiples method as agreed upon. The result of the latter method cannot vary by some 50 per cent.

9 The expression ‘submission to arbitration’ in the English text of Article V(1)(c) may be a cause of difficulties when it comes to interpreting the provision. The same can also be said of the French wording of the expression.

*Failure by Arbitrators to Apply Contract Terms  
from the Perspective of the New York Convention*

(c) The award deals with a difference not contemplated by or not falling within the terms of the submission to arbitration, or it contains decisions on matters beyond the scope of the submission to arbitration.

The question of whether a failure by arbitrators to take into account the provisions of a contract may fall under Article V(1)(c) of the Convention requires an analysis of this somewhat textually murky ground for refusal of enforcement.

Ground (c) of Article V(1) of the New York Convention is a literal copy of Article 2(1)(c) of the Geneva Convention of 1927. It was adopted without any discussion at the Conference in New York in 1958 when the Convention was being drafted. The legislative history of that provision in the Geneva Convention is unclear.<sup>10</sup>

In the case of an arbitration clause (relating to future disputes), the allegation by a respondent that the arbitrator has overstepped his authority may be of two kinds. The first type is that the arbitrator has dealt with a dispute that does not fall within the scope of the arbitration clause. The second is that he has given decisions on matters that are beyond or outside the questions submitted to him by the parties, which may be called the arbitrator's mandate. The latter type of allegation usually concerns the allegation that the arbitrator has awarded more than, or differently from, what was claimed. The difference between the two types of allegations is that the first is based on the arbitration clause itself whereas the second is based on the mandate given to the arbitrator by the parties. The relevance of this distinction is that the mandate may comprise less than the arbitration clause. Consequently, it is the type of allegation that dictates whether the arbitration clause or the mandate must be taken as the measuring standard for determining whether the arbitrator has exceeded his authority.

In the case of a submission agreement (relating to an existing dispute), on the other hand, there is no need to distinguish between the arbitration clause and the mandate since the mandate is defined in the submission agreement.

As regards the expression 'submission to arbitration' in Article V(1)(c), a difference between the English and French texts of Article V(1)(c)—which are according to Article XVI of the Convention equally authentic—needs to be

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<sup>10</sup> H.-W. Greminger, *Die Genfer Abkommen von 1923 und 1927 über die internationale private Schiedsgerichtsbarkeit* (Winterthur: P.G. Keller, 1957) at 72.

mentioned. The English text reads: ‘a difference not contemplated by or not falling within the terms of the submission to arbitration’; and the French text ‘un différend non visé dans le compromis ou n’entrant pas dans les prévisions de la clause compromissoire’. Wording similar to the French text can be found in the equally authentic Spanish text.<sup>11</sup> The literal translation of the French text is: ‘a difference not contemplated by the submission agreement or not falling within the terms of the arbitration clause’. The same difference between the English and French texts existed in Article 2(1)(c) of the Geneva Convention of 1927, which provision is similar to the first half of Article V(1)(c).<sup>12</sup>

As a result, in the case of an arbitration clause, the expressions ‘submission to arbitration’ and ‘*clause compromissoire*’ must be deemed to have two meanings. The first meaning, which is that referred to by the French text, is the arbitration clause itself. That meaning suits the first type of allegation—i.e. that the dispute does not fall within the scope of the arbitration clause. The second meaning is the delineation of the arbitrator’s authority as established by the questions submitted to him—i.e. the arbitrator’s mandate. The latter meaning suits the second type of allegation—i.e. that the arbitrator has given decisions on matters which are beyond or outside the questions submitted to him by the parties. The English text of the Convention supports the second meaning: whilst, for example, Article V(1)(a) refers to the arbitration agreement in general, Article V(1)(c) specifically mentions the ‘submission to arbitration’. If the intention had been to provide only for the submission agreement and the arbitration clause, Article V(1)(c) could simply have mentioned ‘arbitration agreement’.

Accordingly, the first meaning of the expressions ‘submission to arbitration’ and ‘*clause compromissoire*’ is to be derived from the French text, whilst the second meaning is to be derived from the English text. As far as their interpretation is concerned, both texts are to be read together. Thus, depending on the type of allegation made, if the English text is relied upon, it may be necessary to interpret it by relying also on the French text—i.e. in the case of an arbitration clause—and conversely, again depending on the type of allegation made, if the French text is relied upon, it may be necessary to interpret that text by relying on the English text—i.e. in the case of the mandate.

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11 The Spanish text reads: ‘una diferencia no prevista en el compromiso o no comprendida en las disposiciones de la cláusula compromisoria’.

12 Literature offers no explanation for the difference between the English and French texts of either Article 2(1)(c) of the Geneva Convention or the first half of Article V(1)(c) of the New York Convention.

Does the requirement that the arbitral tribunal take account of the contract provisions fall under either type of allegation? That question does not seem to be answered in the reported cases. Ground (c) refers to ‘a difference’ and ‘decisions on matters’, which seem to suggest that it is concerned with claims only (an award that is *ultra* or *extra petita*). That suggestion may be reinforced by the second part of ground (c), which concerns partial enforcement: ‘provided that, if the decisions on matters submitted to arbitration can be separated from those not so submitted, that part of the award which contains decisions on matters submitted to arbitration may be recognized and enforced’. Moreover, it is a general canon of interpretation that the grounds for refusal of enforcement listed in the Convention should be construed narrowly. Yet, ground (c) does not use the word ‘claims’ but rather ‘matters’, which can be said to comprise more than claims.

With respect to the first part of ground (c), an award that ‘deals with a difference not contemplated by or not falling within the terms of the submission to arbitration’ is not confined to consideration of the claims asserted by the parties, but may also include the circumstance that the arbitrators have seriously ignored, in their analysis, the application of the terms of the contract, as pleaded by the parties. Thus, if an arbitrator ignores express provisions in a contract, it can be argued that he fails to deal with the difference between the parties.

### **Violation of the parties’ agreement on the arbitral procedure (Article V(1)(d))**

Ground (d) of Article V(1) of the Convention provides that enforcement of an arbitral award may be refused if ‘the arbitral procedure was not in accordance with the agreement of the parties’. This provision applies to cases in which the arbitrator has conducted the arbitration in a manner that was contrary to the parties’ agreement. An example would be where the arbitrator refuses to hold a hearing, despite the parties’ having agreed that a hearing would take place and notwithstanding an express request to that effect one of the parties.

The agreement of the parties to which reference is made in Article V(1)(d) will usually mean the arbitration rules upon which they have agreed. This is where the question arises. Many of those arbitration rules contain provisions like Article 17(2) of the ICC Rules of Arbitration. Is the reference in Article V(1)(d) to be read as referring to matters of procedure set out in the arbitration rules only? Assuming that the answer to that question is yes, is the requirement that the arbitrator take account of the contract provisions a matter of arbitral procedure?

A similar question arises with respect to the requirement in Article 25(2) of the ICC Rules of Arbitration that the award state the reasons upon which it is based. In the event that an ICC award fails to give reasons (which is unlikely in practice, as all awards are subject to the scrutiny of the ICC International Court of Arbitration and its approval as to their form<sup>13</sup>), would such an award fall under ground (d) of Article V(1) of the Convention? Many would answer that question in the affirmative. If so, there seems little justification for treating any differently an award in which contract provisions are ignored.<sup>14</sup>

### **Violation of public policy (Article V(2)(b))**

Article V(2)(b) of the Convention is generally interpreted as referring to the most basic notions of justice within the forum.<sup>15</sup> Disregard of contract terms by an arbitrator would not appear to come within that category.

However, it may be questioned whether that is always so. Assume, in the above example of the valuation of shares, that all parties and their financial advisers concerned had arrived at a figure of US\$ 45–50 million and that the claimant mentioned US\$ 50 million in its request for arbitration. Assume, further, that during the arbitration the claimant increased the claimed value to US\$ 500 million on the basis of ‘fantasy accounting’, backed up by creative financial experts, without any underlying change in the company itself. Would the award violate public policy if the arbitrators had taken the increased figure of US\$ 500 million? A court may well arrive at the conclusion that such a result hurts its most basic notions of justice, especially if the tribunal arrived at its finding in disregard of express contractual provisions.

### **Conclusion**

The problem addressed in this contribution is not that of an error in law or fact committed by an arbitral tribunal when interpreting and applying a contract. In that respect the New York Convention’s ‘no review of the merits’ principle

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13 Article 27 of the ICC Rules of Arbitration.

14 An interesting question is whether a combined reading of grounds (c) and (d) of Article V(1) of the New York Convention corresponds to the notion of ‘*mission de l’arbitre*’ in French arbitration law, violation of which can lead to the setting aside of the award (Article 1502(3) NCPC: ‘Si l’arbitre a statué sans se conformer à la mission qui lui avait été conférée.’)

15 This provision contemplates situations in which ‘the party . . . was not given proper notice of the appointment of the arbitrator or of the arbitration proceedings or was otherwise unable to present his case’.



need not be revisited. Rather, the problem concerns the situation in which an arbitral tribunal clearly acknowledges the applicability of, but omits to apply, a relevant provision in a contract.

That problem rarely occurs in practice. But are those rare cases the price to be paid for maintaining the principle that courts should not review the merits of an arbitral award in those instances either? Most business people would not think so. Faced with the traumatic experience of arbitrators who totally ignore contract provisions, they may turn away from arbitration for good. It takes only a few inept arbitrators to seriously discredit arbitration and the institutions that administer it. Within the ICC system, most of these isolated cases are avoided by the process of scrutiny of draft awards. However, the scrutiny process cannot involve a full study of the contract and a comparison with what the arbitrators have done. The courts then have the last word.

The New York Convention is written not only for petitioners. It also enshrines rights for respondents who are genuinely aggrieved. The Convention provides grounds for refusal of enforcement that can be used to avert shocking awards, even though these grounds are limited and to be construed narrowly. Whilst the success of the New York Convention is very encouraging, it can be self-defeating if this means granting enforcement in whatever case is presented. I therefore believe that arbitral awards in which arbitrators blatantly ignore clear and relevant provisions of a contract should be refused enforcement in those very limited cases. If not, Article 17(2) of the ICC Rules of Arbitration could be thought by business people to be meaningless or even misleading.

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