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In a chain of contracts transferring ownership, the arbitration clause is automatically transferred

In order to deny the jurisdiction of the Commercial Court of Saint-Malo before which proceedings had been initiated against one of our clients, a Swedish company, the Court of Appeals of Rennes, with which we filed a jurisdictional objection, ruled that an arbitration clause was enforceable against our opponent event though it had not signed said clause.

In a judgment date September 11, 2018, the Court of Appeals of Rennes thus applied the so-called competence-competence principle and recalled that in a chain of contracts transferring ownership, the arbitration agreement is automatically transferred as an accessory to the right of action.

This judgment has not been appealed against within the prescribed timeline and it has now become final and irrevocable.

This case provides the opportunity to review the two aforementioned principles which are very protective of arbitration clauses.

Article 1199 of the French Civil Code establishes the principle of privity of contracts as it stipulates that *"A contract creates obligations only as between the parties. Third-parties may neither claim performance of the contract nor be constrained to perform it (…)"*.

As such, it is forbidden to invoke against a third-party the clause of a contract that the latter has not accepted and to which it is not a party. This fundamental principle in contract law ensures a degree of certainty in the rights and obligations of the parties to a contract.

There are only very few exceptions to the principle of privity of contracts.

Yet, there is one that we pursued in a case where we defended a Swedish manufacturer sued by one of its distributor's clients before the Commercial Court of Saint-Malo.

- **Fact and procedure**

Our client manufactures and sells its technology across the globe through a network of authorized distributors.

To this end, it had entered into a distribution contact with a French distributor.

This distribution contract included an arbitration clause drafted as follows:

"Any dispute, controversy or claim arising out of or in connection with the Contract, or the breach, termination or invalidity thereof, shall be finally settled by arbitration ***in accordance with the Arbitration Rules of the Arbitration Institute of the Stockholm Chamber of Commerce.*** *The seat of arbitration shall be Stockholm, Sweden. The language to be used in the arbitral proceedings shall be English. However, notwithstanding the aforementioned, either Party shall be entitled to seek preliminary injunction."*

This was the standard arbitration clause recommended by the Arbitration Institute of Stockholm.

The French distributor went bankrupt.

One of the clients of the French distributor who had bought the Swedish technology argued that the product was defective and summoned the Swedish manufacturer before the Commercial Court of Saint-Malo, i.e. the court having jurisdiction over the territory where this client (the sub-purchaser) was based.

In order to seek the liability of our client, the dissatisfied purchaser relied on the so-called **direct action theory** under which in a group of contracts (i.e. a chain of contracts in the case at hand) a party (for example a sub-purchaser) may bring an action in contract against another party (for example the manufacturer) **even though they have not personally entered into any contract**.

As such, using the direct action theory, the sub-purchaser initiated an action in contract against the manufacturer of the product even though it had not concluded any contract with such manufacturer. As a matter of fact, the sub-purchaser had entered into a contract with the French distributor of our client.

Before the Commercial Court of Saint-Malo, we raised *in limine litis* (i.e. before any defense on the merits) a plea of lack of jurisdiction and invoked the aforementioned arbitration clause.

The Commercial Court of Saint-Malo rejected our plea and held that it was competent to hear the dispute. The first-instance judges considered that a clause that was binding between the manufacturer and its distributor, that had not been accepted by the sub-purchaser and that had not even been brought to its knowledge was not enforceable against it.

We filed a jurisdictional objection against this decision before the Court of Appeals of Rennes. It sustained our objection.

The Court of Appeals held that the arbitration clause was enforceable against the sub-purchaser and recalled that *"in a chain of contracts transferring ownership, the arbitration clause is automatically transferred as an accessory to the right of action which is itself an accessory to the substantial right being transferred"*.

- **The arbitration agreement is automatically transferred as an accessory to the right of action**

The Court of Appeals of Rennes applied an established case-law according to which the benefit granted to the one who has the right to exercise a direct action in contract (the sub-purchaser) against the ultimate contractual party (the manufacturer) – even though there is no contract between the two – is compensated towards the sued defendant (the manufacturer) **by virtue of the clauses stipulated in the latter's contract** (i.e. the contract between the manufacturer and the distributor).

In return for the benefit thus granted to the sub-purchaser who may exercise a direct action, the manufacturer may invoke the clauses set forth in its contract and, more generally, all defenses that it could have used against its own contractual partner, i.e., in the present case, the distributor.

This principle that applies to a chain of contracts was set out in a decision of the First Chamber of the *Cour de Cassation* (French Supreme Court) dated June 7, 1995:

"The manufacturer of the sold product is entitled to use against the sub-purchaser that brings an action in contract all the defenses that it may use against its own contractual partner"[1]***.***

This general rule concerning the clauses set forth in the initial contract also applies to arbitration clauses that confer jurisdiction to an arbitration tribunal to settle disputes, as per an established case-law according to which:

"In a chain of contracts transferring ownership, ***the arbitration clause is automatically transferred*** *as an accessory to the right of action which is itself an accessory to the substantial right being transferred"*.[2]

As such, **in a chain of contracts transferring ownership**, an arbitration clause entered into between two contractual partners is automatically transferred to the other parties to the chain of contracts as an **accessory to the right of action**, and the fact that these other parties are unaware of this clause or have not expressly accepted it does not in any way exclude the application of this rule.

In a decision dated July 9, 2014, the *Cour de Cassation* reaffirmed this rule as follows:

"Having pointed out the existence of a ***chain of contracts transferring ownership*** *that followed the conclusion of the initial contract dated June 8, 2000, whenever the dispute concerns defective products falling within the scope of the arbitration clause that provides that any dispute arising from or in connection with this contract ought to be settled by way of arbitration,* ***the Court of Appeals rightly inferred therefrom that the arbitration agreement – that is automatically transferred as an accessory to the right of action*** *– was not manifestly inapplicable as the presence of a jurisdiction clause in one of these contracts does not affect the jurisdiction of the arbitration tribunal to rule on the existence, validity and scope of the arbitration agreement"*[3]***.***

In order to challenge this well-established case-law, our opponent referred to a judgment of the Court of Appeals of Versailles[4] that refused to enforce against a third-party an arbitration clause set forth in an **insurance contract**.

However, an insurance contract is not a contract that transfers ownership. In that particular case adjudicated by the Court of Appeals of Versailles, there were neither a chain of contracts nor a contract that transferred ownership.

As such, the Court of Appeals of Rennes before which we had brought our case rightfully disregarded this decision and made a strict application of the *Cour de Cassation*'s case-law.

- **The competence-competence principle**

In adjudicating the case, the Court of Appeals of Rennes also applied the so-called competence-competence principle ignored by the first-instance judges, and ruled as follows:

"As the existence of an arbitration clause that is not manifestly inapplicable to the relationships between the parties is established, the arbitral tribunal has, as per Article 1465 of the [French] *Code of Civil Procedure, exclusive jurisdiction to rule on objections to its jurisdictional power. It follows therefrom that the national court, if the matter has not yet been referred to the arbitral tribunal, must decline jurisdiction, unless the arbitration agreement is manifestly void."*

The Court of Appeals of Rennes thus applied Article 1465 of the French Code of Civil Procedure according to which "*the arbitral tribunal has exclusive jurisdiction to rule on objections to its jurisdictional power*" and Article 1448 of the same Code that further stipulates:

"Where a dispute, referred to an arbitral tribunal pursuant to an arbitration agreement, is brought before a national court of law, ***the latter must decline jurisdiction,*** *unless if the case has not yet been brought before the arbitral tribunal* ***and if the arbitration agreement is manifestly void or manifestly inapplicable****."*

These two Articles apply the competence-competence principle according to which the arbitrator has exclusive jurisdiction to rule on its jurisdictional power.

As such, if the arbitral tribunal has not yet been constituted, the arbitrator alone is competent to rule on the validity of the arbitration clause unless the national judge finds that **said clause is manifestly void or inapplicable**.

An extensive and consistent line of decisions regularly recalls this principle.

As such, in a decision dated September 5, 2018, the *Cour de Cassation* ruled that "*Where a dispute, referred to an arbitral tribunal pursuant to an arbitration agreement, is brought before a national court of law, the latter must decline jurisdiction, unless if the case has not yet been brought before the arbitral tribunal and if the arbitration agreement is manifestly void or manifestly inapplicable*"[5].

In another case, the First Civil Chamber of the *Cour de Cassation* had already held that "*the national judge who finds that the arbitration agreement **is not manifestly inapplicable**, can only decline jurisdiction*"[6] or that "*the arbitrator must, as a matter of priority and under the control of the annulment judge, rule on the existence, validity and scope of the arbitration agreement*"[7].

In addition, the *Cour de Cassation* is also very strict when it comes to assessing whether an arbitration clause is manifestly void or inapplicable.

In a decision dated September 21, 2016, the First Civil Chamber of the *Cour de Cassation* held that "*By carrying out a substantial and in-depth examination of the contractual negotiations between the parties to conclude that they had not made any commitments towards each other*", the Court of Appeals had ruled "*on the basis of grounds that were inappropriate to characterize the manifest inapplicability of the arbitration clause*".[8]

In another decision, the First Civil Chamber of the *Cour de Cassation* quashed a judgment that "*held that the claim for indemnification brought (…) in tort in relation to the sudden breach of discussions do not concern in any way the distribution contract that used to govern the relationships between the parties*" (contract that contained the arbitration clause).

The *Cour de Cassation* considered that "*by determining so on the basis of grounds that were inappropriate to characterize the manifest voidness or inapplicability of the arbitration clause – which alone is likely to challenge the jurisdiction of the arbitrator to rule on the existence, validity and scope of the arbitration agreement – the Court of Appeals has breached the principle [according to which the arbitrator must as a matter of priority rule on his own jurisdictional power]*".[9]

As a matter of fact, the arbitration clause has been found manifestly void or inapplicable in a very limited number of cases.

There exists, however, one particular case that deserves attention. In a decision dated July 6, 2016, the *Cour*

de Cassation ruled that an arbitration clause was manifestly inapplicable.

In that specific case, the Ministry of the Economy had initiated proceedings before the Court for the purpose of putting an end to illegal practices, as per Article L. 442-6 III of the French Commercial Code.

The *Cour de cassation* considered that "*The action thus brought* [by the Minister] *as part of its mission to act as the guardian of the economic public policy to protect the functioning of the market and competition is an autonomous action which, because of its nature and object,* ***may only be adjudicated by national courts***".

The *Cour de Cassation* inferred therefrom that "*the arbitration clause set forth in the distribution contract was* ***manifestly inapplicable*** *to the dispute (…) as the Ministry acted neither as a party to the contract nor on the basis on such contract.*"[10]

The cases in which arbitration clauses are held manifestly inapplicable remain, however, isolated and unusual.

The decision of the Court of Appeals of Rennes dated September 11, 2018 and commented in this article comes as a new illustration thereof.

[1] First Civil Chamber of the *Cour de Cassation*, June 7, 1995, JurisData n° 1995-001538

[2] First Civil Chamber of the *Cour de Cassation*, March 27, 2007, n°04-20842; First Civil Chamber of the *Cour de Cassation*, January 9, 2008, n°07-12349

[3] First Civil Chamber of the *Cour de Cassation*, July 9, 2014, n°13-17402

[4] Court of Appeals of Versailles, May 2, 2017, n°16/01166

[5] First Civil Chamber of the *Cour de Cassation*, September 5, 2018, n°17-13837

[6] First Civil Chamber of the *Cour de Cassation*, February 12, 2014, n°13-10.346

[7] First Civil Chamber of the *Cour de Cassation*, July 11, 2006, n°05-18.681

[8] First Civil Chamber of the *Cour de Cassation*, September 21, 2016, n°15-28941

[9] First Civil Chamber of the *Cour de Cassation*, April 25, 2006, n°05-15528

[10] First Civil Chamber of the *Cour de Cassation*, July 6, 2016, n°15-21811

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