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Concurrent arbitration and litigation about a good leaver-bad leaver provision in a shareholders' agreement

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The Madrid High Court (MHC) rendered a judgment on 2 May 2017 upholding an arbitral award that had been challenged on the basis of *prejudiciality.*

One of the minority shareholders of a portfolio company of a well-known Spanish private equity fund, was also its managing director. The portfolio company's shareholders had entered into a shareholders' agreement that included a good leaver-bad leaver provision and an arbitration clause. However, the company's by-laws were subject to the commercial courts.

The company's board of directors decided to dismiss its managing director and terminate his contract. This board resolution was eventually declared null by the competent commercial court, following a challenge brought by the managing director on the basis that the required majorities had not been met. The company appealed the commercial court judgment.

Arbitration proceedings were also initiated about whether the managing director was a good or a bad leaver, i.e. whether his contract had been terminated for or without cause.

While the appeal of the commercial court judgment was pending, the arbitral award declared (i) that the managing director's contract had been terminated for cause, and (ii) the obligation of the latter to sell his shares to the company or a third party nominated by it for the bad leaver consideration provided for in the shareholders' agreement.

The managing director challenged the award before the MHC on the grounds that the arbitrator should have stayed the proceedings until a final judgment had been rendered by the appeals court on the validity of the board resolution. By not doing so, according to the managing director, the arbitrator had decided on a matter outside the scope of the arbitration agreement.

The MHC dismissed the challenge and said the following:

- The Spanish Arbitration Act (SAA) does not expressly contemplate the suspension of arbitral proceedings on the basis of *prejudiciality*, i. e. a concurrent judicial lawsuit about a question that is a logical premise of the decision to be taken by the arbitrator; but it is equally true that the SAA does not either prohibit suspension on those grounds.
- Arguably, arbitrators must render the award within the relevant (legal or contractual) timeframe, as otherwise they may become liable *vis-à-vis* the parties.

- Both arbitral and judicial proceedings may be affected by *prejudiciality*, and there may be circumstances in which public policy requires the suspension of arbitral proceedings, namely when there is a risk that two contradictory decisions about the same subject matter are rendered (legal certainty and *res judicata*).
- Suspension in those circumstances may therefore be justified, but only at the request of at least one of the parties; this is consistent with the Spanish Procedure Act (SPA).
- The MHC deliberately did not spell out the theoretical criteria to determine how to resolve *prejudiciality*, and even said that it is likely that there is no one-size-fits-all answer to it.
- In principle, it would appear that the arbitrator may decide *incidenter tantum* on any question that is a premise of his decision, provided it is an arbitrable matter (as otherwise the arbitrator would have to stay or terminate the arbitration proceedings).
- In the case at hand the arbitrator was right in not staying the arbitration, but rather deciding *incidenter tantum* on the validity of the termination of the relationship with the managing director; and the fact that he did not include the conclusion that the termination had been validly made in the award's decisions (*dispositif*) means that the award did not rule on such matter and therefore did not pose any risk of creating two contradictory decisions.

In our opinion, some of the above conclusions are questionable, for the following reasons:

- The SAA does not contemplate any solution to *prejudiciality-like* situations and the rule on this matter laid down by the SPA is not applicable to arbitration; in fact, the SPA altogether is not applicable to arbitration.
- When the arbitrator is confronted with a matter that is not within his remit but is being decided in a different arbitration or by judicial courts, the only legal options under the SAA are to stay the proceedings -provided all the parties agree- or terminate the proceedings.
- The judgment we are discussing does not give sufficient details of the case, but it is difficult to understand why the MHC found that the annulment by the commercial court of the board decision to dismiss the managing director and terminate his contract did not affect the decision to be taken by the arbitrator and why the latter was entitled to decide -*incidenter tantum*- that the termination of the contract was valid.
- In fact, it seems that the appeals court is, at the time of this writing, still due to render its judgment, and it could happen that it upheld the commercial court judgment; in that case there would be two decisions (the award and the commercial court judgment), both of them final (*res judicata*) and contradictory.

In any case, this precedent shows the importance of incorporating the same disputes resolution provision (arbitration or courts) in all contracts, including the corporate by-laws.