

Mexico Supreme Court of Justice rules on public policy grounds to set aside award

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The First Chamber of the Supreme Court of Justice of Mexico (Supreme Court) issued a final ruling under case docket no. 755/2011, holding that public policy, as a ground to set aside an award, should be restrictively interpreted. Although the judgment is not yet binding, state and federal courts will most likely adhere to the Supreme Court's view on a restrictive interpretation of public order.

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Background

Article 1457 of the Commerce Code provides the legal grounds upon which a party may request the annulment of an award. It provides:

"Awards may only be annulled by the competent judge when:

I. The party making the application proves that:

- a) a party to the arbitration agreement was under some incapacity; or the said agreement is not valid under the law to which the parties have subjected it or, failing any indication thereon, under Mexican law; or
- b) the party making the application was not given proper notice of the appointment of an arbitrator or of the arbitral proceedings or was otherwise unable to present his case; or
- c) the award deals with a dispute not contemplated by or not falling within the terms of the submission to arbitration, or contains decisions on matters beyond the scope of the submission to arbitration, provided that, if the decisions on matters submitted to arbitration can be separated from those not so submitted, only that part of the award which contains decisions on matters not submitted to arbitration may be set aside; or
- d) the composition of the arbitral tribunal or the arbitral procedure was not in accordance with the agreement of the parties, unless such agreement was in conflict with a provision of this Title from which the parties cannot derogate, or, failing such agreement, was not in accordance with this Title; or

II. The judge finds that:

- a) The subject-matter of the dispute is not capable of settlement by arbitration; or the award is in conflict with the public policy."

Facts

A dispute arose out of a distribution and sales agreement for monitoring and alarm systems in exchange for a sales commission (Agreement). The Agreement provided for all disputes to be submitted to arbitration under the rules of the Mediation and Arbitration Center of the Mexican Chamber of Commerce (CANACO).

Party A terminated the agreement and commenced arbitration proceedings before CANACO, seeking (among other things) a declaration from the arbitral tribunal that it had legally terminated the Agreement. On 2 March 2007, the arbitral tribunal rendered an award ruling that Party A had not legally terminated the Agreement. Party B then initiated a second arbitration before CANACO, seeking damages from Party A for the illegal termination of the Agreement and for the payment of unpaid commissions.

The arbitral tribunal rendered an award on 12 October 2009 (Final Award), whereby it decided that Party B had failed to prove its actions for damages and lost profits, while Party A was liable towards Party B for the payment of unpaid commissions.

Party B filed proceedings for the annulment of the Final Award before the First Mexico City Civil court (a state court). Party B alleged (among other things) there had been a breach of public policy:

Based on the non-admission of evidence filed after the proceedings closed.

Because the arbitral tribunal had allegedly exceeded its powers in its decision.

Because the arbitral tribunal supposedly failed to observe the *res judicata* effect of the award dated 2 March 2007.

Mexico City court decision on annulment of the award

The First Mexico City Civil court granted Party B's petition and annulled the award on the grounds that the proceedings were not in accordance with the parties' arbitration agreement and that the award breached Mexican public policy rules because the arbitral tribunal had failed to:

Admit evidence filed by Party B (violation to due process).

Examine the *exceptio non adimpleti contractus* defence (defence of non-performance of the contract) raised by Party B.

Appoint an expert to provide an independent opinion in view of the contradictory reports submitted by the party-appointed experts.

Observe the fact that certain decisions in the March 2007 arbitral award were *res judicata*.

Appropriately decide the claim for damages and lost profits.

The state court set aside the award and remanded the arbitration back to the arbitral tribunal for further proceedings, ordering it to admit the evidence and comply with Mexican public policy.

Party A filed *amparo* proceedings before the Fourth Federal District Civil court, seeking to reverse the First Mexico City Civil court decision to set aside the award.

Federal District Court decision

The Fourth Federal District Civil court (acting as an *Amparo* constitutional review court) overturned the First Mexico City Civil court's decision to remand for further proceedings. Instead, it ordered the award be partially vacated on the grounds of:

The tribunal's failure to observe the *res judicata* principle with respect to certain decisions contained in the first award.

The tribunal's failure to award damages and lost profits to Party B.

The tribunal's failure to appoint an expert to provide an independent opinion in view of the contradictory reports submitted by the experts appointed by the parties.

Both parties appealed the Federal District Court's decision and it was heard by the Tenth Collegiate Circuit Court of Mexico City (a federal appellate court). Following a party request, the case was removed to the Supreme Court.

Decision

The First Chamber of the Supreme Court overturned the Federal District Court's decision. Furthermore, it ordered the Federal District Court to issue a new resolution, revoking entirely the Mexico City court decision to annul the arbitral award.

The First Chamber overturned the Federal District Court's decision to uphold the state court's ruling to annul the award on grounds that the arbitral tribunal had failed to properly resolve the claims for damages and lost profits. The First Chamber reasoned that the annulment procedure did not grant any court the power to review the merits of the arbitral award, but it did grant the power to annul an award that goes against Mexican public policy.

With respect to the allegations regarding a breach of public policy, the Supreme Court held that:

The tribunal's failure to award damages and lost profits cannot be held as a breach of Mexican public policy.

The tribunal's failure to appoint a third expert in light of the contradictory opinions of the parties' expert witnesses did not breach Mexican public policy.

The tribunal's mere dismissal of, or failure to entertain, an allegation of *res judicata* was not, of itself, a violation of public policy or a sufficient ground for annulment of an award.

Findings relevant to annulment actions

Article 1457 of the Commerce Code provides the legal grounds upon which a party may request the annulment of an award. The Supreme Court held that the annulment of an award is sought through an incidental action, initiated *ex parte* before state or first instance federal courts in Mexico, provided the seat of the arbitration is Mexico. If the plaintiff prevails, the consequence is that the award becomes ineffective as from the date on which the judge declares it void.

Furthermore, the court held that an award may be set aside on the grounds set out in section I of Article 1457 of the Commerce Code, or *ex officio*, when the judge holds that the award breaches Mexican public policy, irrespective of any party allegations. The judgment clarifies that an award breaches public policy when its subject-matter is non-arbitrable or when the award conflicts with public policy.

The court also held that the grounds for annulment of an award in Article 1457 of the Commerce Code are exhaustive. Therefore, parties are barred from seeking annulment based on grounds not specified in Article 1457.

The Supreme Court ruling is consistent with the UNCITRAL **Model Law** (www.practicallaw.com/7-205-6044) on. The *UNCITRAL 2012 Digest of Case Law on the Model Law on International Commercial Arbitration* specifies that in recent cases it has been determined that under the Model Law, the grounds for setting aside an award are exhaustive and should be construed narrowly, so that courts should not apply similar causes.

The judgment further holds that the annulment procedure under Article 1457 of the Commerce Code does not grant judges the power to review the merits or correctness of an award's findings. Instead, courts are restricted to deciding whether an award is valid under the grounds set out in Article 1457.

The court's attempt to provide a Mexican public policy concept

Pursuant to Article 1457, section II, of the Commerce Code, public policy stands as a standard under which awards must be reviewed to determine their validity, recognition and ultimate enforcement.

On a motion to annul an award, the judge must assess whether the award breaches public policy, regardless of what the parties allege or prove. Since the public policy standard involves a high degree of subjectivity from the judge, a public policy definition is of the utmost importance, to allow all cases to be resolved according to similar criteria. The judgment in this case provides guidance in this respect.

The Supreme Court ruled that a failure to allocate damages and lost profits does not breach Mexican public policy, because such failure only affects personal interests. It does not affect fundamental interests of society and does not harm collective rights.

The court also held that a failure to appoint a third expert in light of contradictory opinions of party-appointed experts does not breach Mexican public policy rules. Such failure does not violate fundamental principles of society.

Moreover, the court held that the mere dismissal of, or failure to entertain, an allegation of *res judicata* was not, of itself, a violation of public policy, because it does not constitute a serious departure from a fundamental rule of procedure, nor does it affect the state's legal institutions.

Supreme Court reasoning

The Mexican regulatory framework fixes the concept and notion of public policy under which the judge has to study the award. This holding provides to the judges and practitioners that the international or transnational standard of public policy does not apply as a Mexican standard for annulment of awards; instead, courts must look for the Mexican notion of national public policy as determined by domestic law.

To determine what is comprised under public policy in Mexico, the Supreme Court analysed public policy in light of other contemporary national legislation and cited judgments of foreign courts in Spain, Colombia, France and the Bolivarian Republic of Venezuela.

After comparing the definitions of public policy given by foreign courts with the Mexican definition, the Supreme Court, unsurprisingly, concluded there is no consensus regarding public policy. The concept of public policy is indeterminate and variable because it depends on the place where the annulment is sought and is subject to a specific time frame. Therefore, the judgment categorises public policy as a temporal and case-specific concept. The court defined public policy as follows:

Notwithstanding the different meanings of public policy in different legal systems, the essential core of the concept, common to all international interpretations of public policy, is that all definitions are built upon legal principles.

The principles that constitute public policy could be both substantive rights and procedural rules. The former safeguard and preserve legal institutions (for example the constitutional concepts of "family", "Nation", "basic education"), while the latter concern procedural rights which parties cannot transcend or renounce (that is, the right to due process).

Public policy aims to protect legal institutions and does not stand as a principle in and of itself. Rather, it harmonises all legal principles. In this regard, the Supreme Court conceptualised public order as a mechanism through which the state prevents particular acts from affecting fundamental interests of society, and consequently holds that public policy contributes to the peaceful co-existence of community members.

Finally, the Supreme Court held that an award violates public policy, if the violation alleged by the plaintiff transcends the community and affects the fundamental interests of society.

Comment

In the Mexican forum, the public policy concept, as a ground to set aside an award, has been highly controversial because of the lack of a clear standard against which to test it. The ambiguity of the concept has encouraged parties to whom an award is not favourable to demand its annulment before Mexican courts, alleging any violation to be contrary to public policy.

The judgment provides guidance on the meaning and scope of public policy. Nevertheless, the court's definition falls short of a practical application, because it does not provide a list of specific factors to test whether an award breaches the Mexican notion of public policy. Instead, public policy was defined

as an indeterminate and variable concept that includes a group of undefined principles (either substantive rights or procedural rules) that prevent affecting fundamental interests of society.

In this regard, judges, have a difficult task because there is no practical test that objectively enables them to weigh up and decide whether an award contravenes public policy. Instead, the Supreme Court's only reference is that a public policy violation must affect both the community and the fundamental interests of society (both concepts almost as ambiguous as public policy itself). Without a clear test to apply, parties' uncertainty remains undesirably high.

The Supreme Court apparently provided some concepts that might assist in understanding what "fundamental interests of society" means. In the judgment, the Supreme Court mentioned "family", "Nation" and "basic education" as substantive principles that might be breached by an award, but did not state how an award could breach those principles.

Also, the Supreme Court mentioned the "determination of quantum" and "jurisdiction of courts and tribunals" as examples of procedural principles that might be breached by an award, but again did not specify how.

However, the judgment provides examples of conduct that does not breach Mexican public policy:

Failure to award damages and lost profits.

Failure to appoint a third expert if there are contradictory party-appointed expert opinions.

Failure to entertain an allegation of *res judicata*.

According to the court, these only affect private interests and do not transcend to the community or affect the fundamental interests of society.

In conclusion, we believe the Supreme Court decision should be interpreted in the sense that, unless an award breaches substantial and/or procedural principles transcending the parties' interests and harming both "Mexico's community" and "fundamental interests of society," a court should uphold the award. Therefore, the general rule is to uphold all awards that affect exclusively individual interests.

Practitioners should also note that the judgment is not yet binding. In Mexico, a holding is binding when it becomes *jurisprudencia* (jurisprudence). *Jurisprudencia* can be formed in three ways:

By confirmation of holdings (produced by Collegiate Circuit Courts).

By unification of interpretations (produced only by the Supreme Court).

By unconstitutionality actions and constitutional disputes (produced only by the Supreme Court).

In the case of confirmation of holdings, it takes five uninterrupted holdings (*tesisaisladas*) to form *jurisprudencia*. In other words, once courts have held the same holding in five different cases, that holding becomes jurisprudence under Mexican law.

Case

Docket no. 755/2011 (www.practicallaw.com/5-523-9051).

Resource information

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