POTENTIALLY CONFLICTING ARBITRATION AND FORUM SELECTION CLAUSES IN COMMERCIAL AGREEMENTS

Posted on August 14, 2024

Categories: Insights, Publications

Do you have an asset or share purchase agreement requiring that certain disputes be resolved by arbitration (e.g., post-closing purchase price adjustments, such as to working capital or in respect of earnouts), and that any other suit, action or proceeding arising under the agreement be resolved by the courts of a different jurisdiction? Such provisions are relatively common in commercial agreements. A recent Ontario case (*Tehama Group Inc v Pythian Services Inc*, 2024 ONSC 1819 ("*Tehama*")) provides guidance as to where any subsequent challenge to an arbitral award made under the agreement should be brought. It also highlights the importance of having a litigator experienced in arbitration provide input on your arbitration and forum selection clauses.

The Facts

Pythian (a Delaware company) purchased a business from Tehama (an Ontario company) pursuant to an asset purchase agreement. Like many such agreements, the one in *Tehama* included provisions that dealt with the following:

- certain purchase price closing adjustments (to working capital and the like) (s. 1.07). Section 1.07 goes on to provide that if the parties cannot resolve the disputed accounting issues, they will be resolved by arbitration by an Accounting Firm (defined in the agreement to mean "the Toronto office of PricewaterhouseCoopers LLP" ("PwC")) and that such determination would be final and binding. The arbitration procedure set out in s. 1.07 provided only for written submissions to PwC with no oral hearings or any testimony being taken under oath. Notably, however, s. 1.07 did not expressly state that the arbitration is "seated" in Toronto;
- a $10 million earnout payment to Tehama if the business generated a certain amount of earnings in a particular year (s. 1.08). Section 1.08 goes on to provide that the arbitration "dispute resolution procedures set forth" in s. 1.07 apply "*mutatis mutandis*" to an earnout dispute;
- a forum selection clause requiring that "any suit, action or proceeding arising out of this Agreement" be exclusively resolved by the state or federal courts of New York (s. 7.08). Notably, s. 7.08 expressly provides that it does "not apply to any dispute under s. 1.07 that is required to be decided by the Accounting Firm"

but does not refer to disputes under s. 1.08; and
- a choice of law provision stipulating the agreement be governed by and construed in accordance with the laws of New York (s. 7.09).

Following closing the parties disagreed as to whether the business had generated enough earnings to warrant the $10 million earnout payment to Tehama (Pythian saying the target was not met). Tehama disagreed with Pythian's calculations and, in accordance with s. 1.08 of the agreement, the parties submitted the earnout dispute to PwC. PwC ultimately agreed with Pythian's calculations and issued an award concluding that the earnings threshold had not been met, so the $10 million was not owed to Tehama.

Tehama then commenced an application in the Ontario Superior Court of Justice to have the arbitral award set aside (largely on procedural fairness grounds) under Ontario's *International Commercial Arbitration Act*, *2017*, SO 2017 c 2 (the "ICAA"). Pythian, in turn, brought a motion to stay Tehama's setting aside application based on the forum selection and choice of law provisions in ss. 7.08 and 7.09 (arguing that any such application must be brought in New York under New York law). The primary issue to be resolved on Pythian's motion is whether the choice of forum and law clauses in s. 7.08 and s. 7.09 of the agreement require Tehama to bring its setting aside application in New York under New York law or, instead, in Ontario.

The Decision

The Court dismissed Pythian's motion for a stay (meaning Tehama's application to set PwC's award aside will move forward to be heard on another day by the Ontario Superior Court).

The Forum Selection Clause Excludes Arbitrations Under Both s. 1.07 and 1.08 From its Application

The Court began by addressing whether a dispute under s. 1.08 (the earnout provision) is subject to the exception in s. 7.08 of the agreement (that the requirement for all disputes arising from the agreement be resolved by the courts of New York does not apply to disputes under s. 1.07). Pythian argued that s. 1.08 disputes are not subject to the exception from the forum selection clause because s. 7.08 only expressly excepts disputes under s. 1.07 and does not refer to s. 1.08. The Court rejected this argument, holding that s. 1.08 expressly incorporates the dispute resolution procedure set out in s. 1.07. Reading s. 7.08 to not include disputes resolved under s. 1.08 would lead to a commercial absurdity, something to be avoided when interpreting contracts (earnout disputes would be required to be resolved by the Accounting Firm and, at the same time, by the New York courts).

The Court also noted that Pythian's argument ignored the fact that s. 1.08 expressly incorporates the dispute resolution procedures set out in s. 1.07 *mutatis mutandis* (meaning with necessary changes). While the Court did not expressly state this, it appears to have interpreted this to mean that necessary changes to s. 7.08 should

be made such that the exception can be read to include earnout disputes under s. 1.08. In any event, the Court noted that the parties had expressly submitted the earnout dispute to PwC under both s. 1.07 and s. 1.08, leading it to conclude that the exception in the forum selection clause applied to PwC arbitral award.

The ICAA Applies to the Earnout Arbitration

Next, the Court analyzed where Tehama's setting aside application should properly be brought by considering the *ICAA*, which incorporates the UNCITRAL Model Law on International Commercial Arbitration (the "Model Law"). On this issue, Pythian argued that:

- the selection of PwC's Toronto office was not where the arbitration was seated, but merely a choice of the arbitrator;
- where the arbitration happens to occur is not dispositive of where it is seated; and
- in any event, no hearing occurred because there was no *viva voce* evidence and no oral submissions were made in Toronto.

Accordingly, Pythian argued that the choice of forum and law provisions in s. 7.08 and 7.09 should prevail, meaning that Tehama's setting aside application should be resolved in New York. The Court dismissed these arguments, holding that the earnout arbitration was seated in Ontario and that any application to set aside the award must therefore be brought in Ontario.

In doing so, the Court observed as follows:

- the choice of where an arbitration is "seated" (or the "place" of the arbitration) is not a geographical choice as much as it is a legal choice, because it determines the arbitral law applicable to the arbitration (which is separate and apart from the substantive law of the contract);
- article 1(2) of the Model Law provides that its provisions only apply if the "place of arbitration is in the territory of" Ontario;
- article 20(1) of the Model Law provides that the parties are "free to agree on the place of arbitration" and, failing such agreement, it shall be determined by the arbitral tribunal "having regard to the circumstances of the case, including the convenience of the parties"; and
- by virtue of articles 6 and 34(2) of the Model Law, an application to set aside an award to which it applies may only be made to the Ontario Superior Court.

The Court went on to determine that Ontario was the "place" or "seat" of the arbitration. Although the agreement nowhere expressly states where the arbitration is seated, ss. 1.07 and 1.08 stipulate that the earnout dispute be resolved by "the Toronto office of PwC". On a plain reading of the agreement, the Court found this indicated the parties had chosen Toronto, Ontario as the seat for the earnout arbitration. Moreover, the Court

noted that the parties directed their written submissions to the Toronto office of PwC and the award was rendered on PwC's Toronto office letterhead. The Court consequently held that, by virtue of article 31(3) of the Model Law (which stipulates that an award must state its date and the place of arbitration as determined in accordance with article 20(1) and "the award shall be deemed to have been made at that place"), Toronto, Ontario is the place of arbitration.

Finally, Pythian also argued that the Court should apply a *forum non conveniens* test to assess whether New York is the proper jurisdiction for Tehama's setting aside application. The Court rejected this, noting that the question before it was whether Ontario had jurisdiction to hear Tehama's application, and not whether New York was a more convenient forum.

Key Take Aways

1. The "place" or "seat" of an arbitration has important legal consequences as it determines the law that applies to the arbitration (the *lex arbitri*). The law that applies to an arbitration includes the process for setting aside arbitral awards and provides for court intervention in the arbitration process more generally. Had the agreement in this case expressly stated that any arbitration under s. 1.07 or 1.08 would be seated in Ontario, Pythian would likely would not have brought its stay motion and the delay and costs of same could have been avoided. This underscores the advisability of having a litigator experienced in arbitration provide input on any arbitration and forum selection clauses, along with the interplay between them, in commercial agreements. Doing so can assist in ensuring that the various dispute resolution avenues adopted by the parties are carried out as they intended.
2. Where parties do not stipulate the seat of the arbitration in their agreement, they should ask the arbitrator to determine same as part of his or her mandate. As noted above, article 20(1) of the Model Law permits the arbitrator to do so. Had the parties asked PwC to determine the seat of the earnout arbitration in its award, this too would have obviated the need for Pythian's motion.
3. The Court's refusal to accept Pythian's "formalistic" argument that a court challenge to the earnout dispute arbitration decided under s. 1.08 of the agreement must be brought in New York (on the basis that the forum selection clause in s. 7.08 only excepted from its application disputes under s. 1.07 but not s. 1.08) is consistent with the more modern approach to contract interpretation enunciated by the Supreme Court of Canada in *Sattva Capital Corp. v Creston Moly Corp.*, 2014 SCC 53 ("*Sattva*"). As noted in Sattva, the proper approach to contract interpretation should be to determine the intentions of the parties by considering the contract as a whole, giving the words used their ordinary and grammatical meaning consistent with the surrounding circumstances known to the parties when the contract was signed. It is a practical, common-sense approach, not dominated by technical rules of construction. The *Tehama* Court clearly followed this approach when determining the parties' intentions with respect to

the “seat” or “place” of the earnout arbitration.

by W. Brad Hanna, FCIArb

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.