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Arbitral Clauses and the Blue Pencil: Doctrine of Separability

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ABSTRACT

The concept of 'Expedient justice' is almost interchangeably perceived with the term 'Alternative Dispute Resolution' in India, for the state of affairs of the third, and most often regarded as the one and only independent Organ, the Indian Judiciary, has not been up to the mark in terms of expedient justice, calling for alternative methods to perform the same. Arbitration is one such method whereby disputes of commercial or corporate nature, an inexhaustive list, are disposed of through discretion of the parties thereto. The general principle followed in India is one of the exclusion of criminal matters or any other matters that even meekly attract any form of criminal liability or penalty, although the Arbitration and Conciliation Act, 1996 does not specifically exclude any class of matters from the scope of arbitrability. The Arbitration and Conciliation Act ("the Act", for brevity) is the procedural consolidation governing the rules of arbitration proceedings in India, being analogous to the Codes of Civil and Criminal Procedure to civil suits and criminal proceedings respectively. However, there are several decisions holding that judicial intervention may be allowed by the unambiguous, explicit language of an arbitral clause to that effect, and to that extent as contained therein. For instance, a conjoint reading of section 34 and section 48 of the Act reveals that an award arrived at may be set aside if the Court finds that the "subject matter of the dispute is not capable of settlement by arbitration under the law for the time being in force". Based on the above premise, this article seeks to explore the ratio behind the exceptional endurance of the arbitral clause in a contract beyond the life of the contract itself, and those cases in which the basics of law of contract regarding intention of parties would apply. Further spotlight is on the scope and recognition of arbitration clauses by Courts of other countries, and the position in India, and iterates the non-absolute nature of the law of contract thus putting forth the perspective that the completion or voidability of a contract with an arbitration clause inherent to it shall neither render the clause expedient nor diminish the arbitrability of the dispute in itself.

Keywords: *Arbitral clause, Blue-pencil rule, generalia specialibus non derogant, novated agreement/clause, reference contract, superseded agreement.*

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I. INTRODUCTION

The Convention on the Recognition and Enforcement of Foreign Arbitral Awards, 1959 (the NY Convention hereinafter) lays down the following conditions for the validity of an arbitral clause in an underlying contract or that of an arbitration agreement on the whole.

- The agreement must be in written form and it must be express.
- A legal relationship is a term far too vague to define and difficult to restrict in scope. Regardless of whether the contract creates a contractual relationship or not, the parties thereto must bear a legal relationship as amongst themselves.
- Moreover, the characteristic of an arbitral clause arises only when such a contract contains any matter that may, by the law of the land, be subject to arbitration.
- The next principle is a crown jewel of the general law of contract – the parties to the contract must be competent.
- Finally, the agreement must be legally recognised, valid, and not voidable or illegal according to the mutually consented law chosen to be abided by, by the parties thereto.
- In absence of such chosen law, the agreement must be in consonance with the law of the land where the arbitral award is or is purported to be made.

Section 7 of the Act defines an "arbitration agreement" and follows up with the conditions for the validity thereof. Such an agreement must be entered into by parties "sharing a defined relationship, whether contractual or not, the subject of which must be all or certain disputes which have arisen or may arise between them." It is also laid down that such an arbitral clause should be written down to hold good in law. The NY Convention as well as most arbitration laws dictate an essential element of the form of an arbitration agreement, i.e., "it must be in writing". The NY Convention states that an *"agreement in writing shall include an arbitral clause in a contract or an arbitration agreement, signed by the parties or contained in an exchange of letters or telegrams"*[2]. However, most domestic laws in concurrence with the UNCITRAL Model Law on Arbitration broaden the scope of a written document. "Encompassing telexes, emails and all other means of communication which generate a record, etc." fall within the scope of an 'agreement in writing'. By all means, the doctrine of impossibility of performance binds arbitration contracts vide Article II.3 of the NY Convention, within the bounds of "null and void, inoperative, or incapable of being performed". Subsequent

[2] The New York Arbitration Convention on the Recognition and Enforcement of Foreign Arbitral Awards, New York, 10 June, 1958, art. 2.

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sections of this article elucidate more on the life on an arbitration agreement inherent to a contract.

(A) Materials and Methods:

The components of arbitration law included in this paper are the general relation law arbitration law to law of contract. Sources like Hein Online, Jstor, and Supreme Court Cases were relied upon for the doctrinal research and analysis. The samples include the position and life of arbitral clauses, their separability or inherent nature to an underlying agreement, and the element of judicial intervention in deciding the presence and effect of such clauses in countries like England, the United States of America, France, Switzerland, and India. The judgements cited in this paper are the most relevant and commemorate major landmarks in arbitration and contract law. The collection of data was done using secondary sources of law such as precedent.

(B) Scope of arbitrability in India:

In this section, certain legal lacunae regarding arbitrability of disputes in the Indian scenario will be discussed. The ***Booz Allen case***[3] is a standing precedent on this point. The Supreme Court illustrated some non-arbitrable disputes like "disputes relating to rights and liabilities which give rise to or arise out of criminal offences, matrimonial disputes relating to divorce, judicial separation, restitution of conjugal rights and child custody, etc., matters of guardianship, insolvency and winding up of a company, eviction or tenancy matters governed by special laws", whereby the rule in *generalia specialubus non derogant* will apply. Further, the Supreme Court held in another case[4] that "where there were serious allegations of fraud against any party to the case, the matter shall not be referred to arbitration but should be decided by the civil court." The power of the civil court in Section 8 was primarily discussed in this case. Further reliance is placed on the decision in the ***Abdul Kadir case***.[5] Clearing all confusions on the point, the Apex Court in the case of ***A. Ayyasamy v. A. Paramasivam***[6] clarified that "mere allegation of fraud simpliciter may not be a ground to nullify the effect of arbitration agreement between the parties." "Where the Court is dealing with Section 8 of the Act and in the process finds that several allegations of fraud therein are serious enough, it will constitute a 'virtual case of criminal offence' which only a civil court may adjudicate upon on production of sufficient evidence, the court may dismiss the application under Section 8 and decide the suit on merits."[7] The Supreme Court held that certain "serious allegations of fraud" cannot be

[3] Booz Allen & Hamilton Inc. v. SBI Home Finance Ltd., (2011) 5 SCC 532.
[4] N. Radhakrishnan v. Maestro Engineers, (2010) 1 SCC 72.
[5] Abdul Kadir Shamsuddin Bubere v. Madhav Prabhakar Oak, AIR 1962 SC 406.
[6] (2016) 10 SCC 386.
[7] *Ibid.*

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arbitrated in conformity with two tests[8]. Reliance was placed on the ***Swiss Timing decision***[9] which found persuasive value in this case. The Court held that earlier decisions on this point erred by not evaluating the combined perusal of Sections 5, 8 and 16 of the Arbitration Act. Such a reading would state, verbatim from the judgement, that *"when a judicial authority is shown an arbitration clause in an agreement, it is mandatory for the authority to refer parties to arbitration bearing in mind the fact that the arbitration clause is an agreement independent of the other terms of the contract and that, therefore, a decision by the arbitral tribunal that the contract is null and void does not entail ipso jure the invalidity of the arbitration clause."*[10]

II. VALIDITY OF THE CLAUSE BASED ON A 'REFERENCE CONTRACT'

It is not an unknown fact that the intention of the parties supersedes, at times of ambiguity, even the words of the contract. The 'intention test' is similarly applied even in the case of arbitration clauses. It was firstly laid down in ***M.R. Engineers & Contractors (P) Ltd. v. Som Datt Builders Ltd.***[11] The Apex Court stated the necessity of an acceptance of arbitral clause in consonance with the intention of the parties. "If the main contract states that all clauses of a particular document will be a part of the contract and the arbitration clause is inherent to those documents, then the mode of dispute resolution will be arbitration". Where such explicit terms cannot be read into, he incorporation of the clause and the extent thereof will be analysed. If the external document has been referred specifically for any particular details, the document will be interpreted to be adopted entirely and hence a 'special reference' to the arbitration clause is required. This test is built on solid grounds but a light quake in the name of the true knowledge of the parties in light of the reference contract, in the sense that there may take place a plausible deniability or ignorance of words by the opposite party who waives the "duty to read", thus rendering the element of intention essentially irrelevant. But the Court's role in holding or denying the validity of an arbitration clause based on that Hon'ble Bench's assessment on the knowledge of the parties is rather arbitrary. Thus, it is proposed that a 'reference' in the general sense be defined by codifying the 'intention test' to implement it uniformly. Yet another decision[12] held the familiarity requirement all the more irrelevant. The general contract law already stipulates a duty to notify a general reference clause in a standard form contract. The above proposal may be implemented to remove such confusions.

[8] Avitel Post Studioz Ltd. v. HSBC PI Holdings, 2014 SCC OnLine Bom 102.
[9] Swiss Timing v. Organising Committee, Commonwealth Games, (2014) 6 SCC 677.
[10] *Supra*, note 8.
[11] (2009) 7 SCC 696.
[12] Giriraj Garg v. Coal India Ltd., 2019 SCC Online SC 212

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(A) The arbitral clause and its separability – persuasive value:

The increasing trend of parties to a contract including an arbitral clause therein in the event of disputes between them holds it imperative to examine the necessary conditions of such a clause in the most contracts. The '*blue-pencil rule'* of contract finds its application to the arbitration clause. Essentially, by applying this rule, the adjudicating arbitrator, according to agreement, separate the arbitration clause using *the blue pencil* from the remainder of the contract for his decision. It is an accepted ruling that the clause empowering arbitrability of dispute has life even after the legal ruling extinguishing the contract itself. In other words, the arbitration clause is not rendered ipso jure invalid even after the contract in which it is contained is declared null and void. This is prominently referred to as the "doctrine of separability" in a commercial perspective and is the brainchild of an English decision[13].

The House of Lords categorically observed, in ***Premium Nafta Products Ltd. v. Fili Shipping Co. Ltd.***[14], the presence of this doctrine in Section 7. Their Lordships ruled that act of rescinding the underlying contract cannot automatically render the arbitral clause invalid. "The life of the arbitration agreement extends beyond that of the contract of which it is an inherent part." Moreover, *"The arbitration agreement must be treated as a 'distinct agreement' and can be void or voidable only on grounds which relate directly to the arbitration agreement"*[15]. One instance, as observed by the Court, where the grounds of invalidity of the main agreement are identical to that of the arbitration agreement, is when "the main agreement and the arbitration agreement are contained in the same document and one the parties claims that it never agreed to anything in the document, and that the signature thereon was forged." In such a case however, the contention is that the signature on the "distinct agreement" is forged and thus the entire document is invalid due to unlawful object. One other instance could be where a party whose agent signed on his behalf without authority in that regard. The principle-agent special contract suffers defects and again, this does not void the arbitration agreement or the main document in itself. Due to factors foreign to the separability issue, both the agreements are rendered invalid.

The doctrine of separability has also been duly recognised by the US Courts. The background of such recognition is that the arbitration agreement should not be frustrated merely because of infirmities in the underlying contract. The case in point is ***Prima Corpn. v. Flood & Conklin Mfg. Co.***[16] wherein the Supreme Court of USA held that the main purpose of selection by the

[13] Heyman v. Darwins Ltd., 1942 AC 356.
[14] 2007 UKHL 40, Session 2006-2007.
[15] *Ibid.*
[16] 388 US 395 (1966).

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parties of arbitration procedure is to avoid obstruction in the courts and entail speedy justice. The statutory language did not permit hearing contentions of fraud by inducement but merely issues concerning entering into and performing the arbitration agreement. In another decision[17], the Court observed that the intention of the federation in passing the arbitration policy was that even the "doubts concerning the scope of the arbitral clause should be resolved in favour of arbitration." Such clauses should be given the broadest interpretation and its validity itself should be decided through arbitration. But in some other decisions[18], the courts have aligned their views with the observations of the House of Lords in the above cases, on the point of invalidity of agreements due to lack of authority of signatory, mental incapacity, lack of age or minority, etc. Such grounds would render the agreements (both main and arbitration agreement) invalid, and the authority to decide the invalidity lies with the Courts, not the Arbitral Tribunal.

The standpoint taken by the French Courts is interesting as they have prescribed limits to the separability. The position remains the same as to the separability of the arbitration agreement even if the underlying contract is defective. But where the assent of either party to refer any dispute to arbitration is lacking, it is held that the arbitration clause, along with the main contract would be invalid. *"The contract has not been formed, and the arbitration clause has not been agreed to any more than the other clauses, for there was no specific mutual agreement with respect to that clause."*[19]

The position in Switzerland was clarified by the Federal Supreme Court in 1931[20]. The Court held *"… that the invalidity of the main contract could not affect the arbitration clause."* This principle bears application, has been consistently followed, and it takes a special place in the Swiss Private International Law Act, 1987. However, in cases of duress, lack of capacity, defects in assent, etc., the underlying contract may be invalidated and that would invalidate the arbitration agreement for all purposes.

III. INDIAN POSITION ON ARBITRATION AGREEMENTS – A BINDING NATURE

Before considering the Indian scenario, it is pertinent to note the absence of specific statutory guidance in this regard. The Act of 1996, which is technically the brainchild of the UNCITRAL Model Law, contains the doctrine of separability under Section 16. Also, the procedure of

[17] David L. Threlkeld & Co. Inc. v. Metallgesellschaft Ltd. (London), 923 F 2d 245 (2nd Cir 1991).
[18] Sandvik AB v. Advent International Corporation., 220 F 3d 99 (3rd Cir 2000); See also Spahr v. Secco, 330 F 3d 1266 (10th Cir 2003).
[19] Mayer, *The Limits of Severability of the Arbitration Clause*, in A. van den Berg (Edn.); See also ICCA Congress, *"Improving the Efficiency of Arbitration Agreements and Awards: 40 Years of Application of the New York Convention"* 261, 264 (ICCA Congress Series No. 9, 1999).
[20] National Power Corporation v. Westinghouse, DFT 119 II 380.

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arbitration stands as an explicitly mentioned exception to restraining legal proceedings as seen under Section 28 of the Indian Contract Act, 1872. The difficulty in understanding courts' decisions arises where courts have conveniently relied on the principle of separability to answer jurisdictional challenges or questions of maintainability, but these decisions do not account for superior regard because they lack a compelling application of the presumption of separability. In the case of ***National Agricultural Coop. Mktg Federation India Ltd. v. Gains Trading Ltd.***[21], the arbitral clause was considered as a clause collateral to the main contract. The clause was held to survive although the main contract could not, due to frustration, repudiation, or non-performance by parties thereto. The object of such an arbitral clause was the resolution of disputes, which had a wider construction than the rights and liabilities under the contract. The Supreme Court has taken stand on the validity and life of the dispute resolution agreement in an MoU, in a recent case[22]. The primary issue considered by the Court was "whether the MoU was a concluded contract, and if not, whether the arbitration clause survives and continues to bind the parties being a standalone provision." There was no consent on appointment of Sole Arbitrator to decide a dispute arising out of the MoU. The Court observed that although the MoU proved to be a full-fledged contract, "the arbitration clause, must be construed as an independent agreement because the parties to the MoU consented to refer all disputes arising out of, or in connection with the MoU, to arbitration." In that instance, Section 11 of the Act may be invoked.

In another landmark decision[23], the Supreme Court traversed above and beyond and declared the true meaning behind previous decisions on this point. The Court believed that the true object of the previous decisions was to decide issues of a jurisdictional nature, but when the question is regarding vitiation of contract due to fraud of a very high magnitude, courts were to afford the issue more care and concern. The Court noted Part II of the Act of 1996 containing a provision for judicial intervention, and Section 45 containing a non-obstante clause. The Court finally declared that "courts may refer the issues to arbitration proceedings except in cases where the court notes that the agreement in full is null and void, or incapable of performance or inoperative to the extremes."

The Supreme Court[24] spoke to the validity of the arbitration clause in superseded contracts. Standing in contradiction to a recent observation of the Bombay High Court[25], the Apex Court

[21] (2007) 5 SCC 692.
[22] Ashapura Mine-Chem Ltd. v. Gujarat Mineral Development Corporation, 2015 (5) SCALE 379.
[23] India Household and Healthcare Ltd. v. LG Household and Healthcare Ltd., (2007) 5 SCC 510.
[24] M/s. Young Achievers v. IMS Learning Resources, 2013 (1) SCC 535.
[25] Mulheim Pipecoatings v. Welspun Fintrade, 2014 (2) ABR 196.

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held verbatim:

> *"... an arbitration clause in an agreement cannot survive if the agreement containing the arbitration clause has been superseded/novated by a later agreement."*

The *non-est* nature of superseded agreements was pointed out therein as reason for invalidity.

IV. CONCLUSION

The doctrine of separability is an ancient one and serves as a useful technicality in dispute resolution mechanisms like arbitration. It can be resorted to in cases where either party unnecessarily alleges minor defaults in a contract and eventually seeks judicial intervention. The intention of the parties so to say, the courts unanimously agree, "where there is an arbitration clause, is to resolve disputes through arbitration"[26] unless there is a specific exclusion of certain disputes or a category thereof from the scope of arbitration. But courts have been careful not to afford the principle too wide a berth as doing so could violate basic principles of voidability contract. The essence of the doctrine is to adjudicate upon disputes arising from the underlying contract in the most effective manner possible, concurrent with the intention of the parties; but this tool may be easily exploited by reckless application thereof.

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[26] *Supra*, note 24.

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