The effect of invalidity of underlying contract on the Arbitration Clause: A Critique on the Doctrine of separability in Arbitration

The effect of invalidity of underlying contract on the Arbitration Clause: A Critique on the Doctrine of separability in Arbitration

by Shwetank Tripathi and Pallavi Verma*

Cite as: (2011) PL October S-22

Introduction

An arbitration agreement may be in the form of an arbitration clause in a contract or in the form of a separate agreement.1 It is a very common modality to include arbitration clause in a detailed contract, in India and the world over. In case of any dispute, the arbitrator appointed as per the arbitration clause, has the competence2 to separate the arbitration clause from the underlying contract, and decide the issue. The Indian Arbitration and Conciliation Act, 1996, also recognises the same principle and provides that the Arbitral Tribunal may rule on its own jurisdiction, including ruling on any objections with respect to the existence or validity of the arbitration agreement, and for that purpose, an arbitration clause which forms part of a contract shall be treated as an agreement independent of the other terms of the contract; and a decision by the Arbitral Tribunal that the contract is null and void shall not entail ipso jure the invalidity of the arbitration clause.3 This is widely recognised as the doctrine of separability in the international commercial arbitration legal regime. It necessarily entails that the arbitration clause contained in a contract remains valid, even if the contract becomes null and void.

However, at the same time, it could give rise to some serious conflict of laws, when applied in international commercial arbitration. If we consider a hypothetical situation that a contract was entered into between two different nationals containing an arbitration clause, providing for the dispute to be resolved by a mutually agreed arbitrator in some different country. In this situation the doctrine of separability gives competence to the appointed arbitrator to adjudicate upon the issue as per the arbitration clause. But if the contract that was entered into, was patently illegal as per the laws of the country of one of the parties, still the arbitrator have the competence to adjudicate upon the illegal contract, which would create a very perplexed situation, in which the arbitration would transcend the municipal laws of the States concerned, which could ultimately give rise to sovereignty issues in future.

In light of the above difficulties that inadvertently may arise, this article is a critical analysis of the extent and scope of applicability of the doctrine of separability, in the international commercial agreements containing therein the arbitration clauses, with special reference to the UNCITRAL Model Law on arbitration and Indian arbitration law regime, also duly analysing its applicability in different jurisdictions.

Purpose of the doctrine of separability The golden thread that runs through the whole institution of arbitration is the “party autonomy”, whereby the parties are free to include any term, and to agree for any law to govern their agreement, but obviously subject to the public policy of the country they seek to enforce their agreement into. It depends upon the intention of the parties as expressed in their agreement. Only the agreement can tell you what kind of disputes they intended to submit to arbitration. Businessmen in particular are assumed to have entered into agreements to achieve some rational commercial purpose and an understanding of this purpose will influence the way in which one interprets their language. They agree for arbitration clauses in their commercial agreements, so that if any dispute arises, it could be easily resolved through arbitration, without undergoing the rigorous courtroom litigation. But when a dispute so arises, the parties at the receiving end normally resort to dilatory tactics of challenging the nuances of the underlying contract, and subsequently pleading that since the underlying contract is voidable, the arbitration clause also becomes inoperative, and thus the matter no more remains arbitrable. It is in this context, that the role of doctrine of separability holds importance. According to this doctrine, that arbitration clause would have to be considered separate and independent from the underlying contract, and therefore, any infirmity in the latter does not ipso jure invalidates the arbitration clause.

The UNCITRAL Model Law does not provide that the non-existence, invalidity, illegality or termination of the parties’ underlying contract never affects the associated arbitration clause, it merely provides that the invalidity of the underlying contract does not entail ipso jure the invalidity of the parties’ arbitration clause—recognising that there may be circumstances where such a result may nonetheless follow. The practical importance of the doctrine of separability lies in the fact that the arbitral proceedings may generally be continued even though the contract is found to be null and void, which helps to make the arbitral proceedings more effective, and thus, an initial defect is not automatically a ground for the nullity of the arbitration clause.4

Thus, this doctrine was recognised mainly in the context of ensuring jurisdiction of the Arbitral Tribunal so appointed, to adjudicate upon the matter, irrespective of the challenges to the underlying contract. This basically protects the institution of arbitration from unnecessary courtroom litigation, but at the same time it is not an absolute rule of law, and there can be circumstances in which the invalidity of the underlying contract would have repercussions on the underlying contract.

The doctrine of separability in different jurisdictions Owing to the varied interpretation and utility of this doctrine of separability, it would be most apt to examine its application, as well as the limitations in some of the important arbitration jurisdictions.

Switzerland Switzerland seems to be the first major arbitration country to have acquired a fixed separability doctrine in this area. In 1931, the Federal Supreme Court declared that the invalidity of the main contract could not affect the arbitration clause. This view has been consistently applied ever since and is enshrined in the Swiss Private International Law Act, 1987. But at the same time, the Swiss Federal Tribunal has repeatedly held that the separability doctrine is not applicable in cases where the grounds for the invalidity of the underlying contract likewise affect the arbitration clause. According to the decisions, it is particularly true for deficiencies in assent, such as duress or lack of capacity.5

England The doctrine of separability was first recognised in England, through the landmark decision in Heyman v. Darwins Ltd.6 Later in the year 1996, it was inculcated under Section 7 of the Arbitration Act, 19967 of England.

In a recent decision of the House of Lords in Premium Nafta Products Ltd. v. Fili Shipping Co. Ltd.8, the Court categorically observed that the principle of separability enacted in Section 7 means that the invalidity or rescission of the main contract does not necessarily entail the invalidity or rescission of the arbitration agreement. 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.

But, what is more relevant for the present purposes is that the House of Lords also observed that of course there may be cases in which the ground upon which the main agreement is invalid is identical with the ground upon which the arbitration agreement is invalid. For example, if the main agreement and the arbitration agreement are contained in the same document and one of the parties’ claims that it never agreed to anything in the document and that his signature was forged, that will be an attack on the validity of the arbitration agreement. But the ground of attack is not that the main agreement was invalid. It is that the signature to the arbitration agreement, as a “distinct agreement”, was forged. Similarly, if a party alleges that someone who purported to sign as agent on his behalf had no authority whatever to conclude any agreement on his behalf, that is an attack on both the main agreement and the arbitration agreement.9

USA The US Courts have also duly recognised the doctrine of separability, but mainly in the context that merely alleging infirmity in the underlying contract should not frustrate the arbitration proceedings. The validity, existence or effectiveness of the arbitration agreement is not dependent upon the effectiveness, existence or validity of the underlying substantive contract unless the parties have agreed to this. The purpose of these provisions, as the United States Supreme Court observed in Prima Paint Corpn. v. Flood & Conklin Mfg. Co.10, is that the arbitration procedure, when selected by the parties to a contract, should be speedy and not subject to delay and obstruction in the courts. The statutory language, it said, did not permit the court to consider claims of fraud in the inducement of the contract generally. It could consider only issues relating to the making and performance of the agreement to arbitrate.

In a later decision in David L. Threlkeld & Co. Inc. v. Metallgesellschaft Ltd. (London)11, the Court observed that federal arbitration policy required that any doubts concerning the scope of arbitral issues should be resolved in favour of arbitration and that arbitration clauses should be construed as broadly as possible.

But in other decisions12, the courts also observed that when the contract is void, however, for example, because the signatory had no authority to sign or mental incapacity or lacking the age of majority, the decision of the validity of such a ground would not be with the Arbitral Tribunal but with the courts.

France The French Courts have long held that, as a consequence of the separability presumption, various defects in the parties’ underlying contract will not affect the associated arbitration clause. However, it has also set the limits to the separability presumption and observed that the scenario in which an arbitration clause most clearly would not be severed, and hence would be invalid, is where the assent of one of the parties is lacking. If the person to whom the offer is made does not affect it, then no contract has been formed, and the arbitration clause contained in the offer has not been agreed to any more than any of the other clauses, for there was no specific mutual agreement with respect to that clause.13

India The Indian Arbitration and Conciliation Act, 1996, being reproduction of the UNCITRAL Model Law on Arbitration, contains the doctrine of separability under Section 16. The Indian courts have frequently relied upon the separability presumption to reject jurisdictional challenges, but these decisions cannot properly be considered final, substantive application of the separability presumption.

In National Agricultural Coop. Mktg. Federation India Ltd. v. Gains Trading Ltd. 14, the Supreme Court held that an arbitration clause is a collateral term in the contract, which relates to resolution of disputes, and not performance. Even if the performance of the contract comes to an end on account of repudiation, frustration or breach of contract, the arbitration agreement would survive for the purpose of resolution of disputes arising under or in connection with the contract.15

However, in a landmark decision in India Household and Healthcare Ltd. v. LG Household and Healthcare Ltd.16, the Hon’ble Supreme Court observed that the decisions upholding the separability doctrine rather reflect principles of competence-competence and a procedural allocation of competence to render an initial decision on the jurisdictional dispute. But, the question would be different where the entire contract containing the arbitration agreement stands vitiated by reason of fraud of a very large magnitude. It may be noticed that Part II of the 1996 Act contains a provision for approaching the court. Section 45 of the 1996 Act contains a non obstante clause. A judicial authority, therefore, may entertain an application at the instance of a party which alleges that there exists an arbitration agreement whereupon judicial authority may refer the parties to arbitration, save and except in a case where it finds that the said agreement is null and void, inoperative and incapable of being performed.

Limitations to the applicability of the doctrine of separability On the basis of the analysis of the doctrine of separability in the aforementioned jurisdictions, it is quite evident that the courts in different countries have set forth certain limitations and conditions under which the doctrine is applied. It is pertinent to observe that if an agreement contains an obligation to arbitrate disputes arising under it, but the agreement is invalid or no longer in force, the obligation to arbitrate disappears with the agreement of which it is a part. If the agreement was never entered into at all, its arbitration clause never came into force. If the agreement was not validly entered into, then, prima facie, it is invalid as a whole, as must be all of its parts, including its arbitration clause.17

It is a doubtful proposition as to whether the Model Law treats the separability presumption as a general rule of substantive validity of the arbitration agreement or only an allocation of competence-competence for particular purposes. Article 16(1)’s second sentence emphasises that an arbitration clause shall be treated as “independent”, but only for the purpose of tribunal’s competence-competence.18 Also, leading awards have almost uniformly recognised that the separability of the arbitration agreement is not absolute and that there are instances in which the non-existence or invalidity of the parties’ underlying contract will affect the associated arbitration clause. The Indian Act refers to the separability presumption only in the context of recognising an Arbitral Tribunal’s competence-competence, and particularly the arbitrator’s jurisdiction to consider challenges to the existence or validity of the underlying contract, and not in the context of the substantive validity of the arbitration agreement.19

As has been observed in the aforementioned court decisions, the doctrine does not give substantive validity to the arbitration clause, rather it is merely useful in setting up the machinery for arbitration, and precluding inordinate constraints to the jurisdiction of the arbitrator. The doctrine wholly extinguishes, when there is fundamental infirmity in the underlying contract i.e. if there was no consent, or fraudulent intention, etc.

Conclusion The doctrine of separability is a useful tool to maintain the sanctity of the institution of arbitration, and the arbitrator’s jurisdiction. It has been mainly applied in circumstances wherein one of the parties has resorted to undue court’s interference, merely by alleging certain defaults in the underlying contract, and thereby frustrating the arbitration proceedings. The courts have unanimously agreed that unless expressly or by necessary implication, the parties have excluded certain disputes from the ambit of arbitration, the parties intend to resolve the dispute through arbitration, if the contract contains a specific arbitration clause. In the same sync, this doctrine has been invoked giving thereby, the jurisdiction to the arbitrator to adjudicate upon the dispute, on the basis of the arbitration clause. But at the same time, it should be carefully borne in mind that it should not be available in all situations of arbitration clause being part of the contract.

The separability doctrine, as enshrined in English, Scottish, Swiss, German and other statutes around the world, only states that the invalidity of the main contract will not of itself invalidate the arbitration agreement. So, the focus in arbitral jurisdiction cases needs to be on the agreement to arbitrate and nothing else subject only to public policy concerns.20 The doctrine recognises that the purpose of an international arbitration agreement is to resolve disputes relating to the underlying contract in the fairest, most efficient manner possible and that, where the arbitration agreement is invalidated for unexpected reasons, this will ordinarily not provide a basis for concluding that the parties’ underlying commercial transaction would not have been entered into. The survival of an arbitration clause, even if the substantive contract in which it is embedded, is held to be null and void, is a legal fiction essential for efficient working of the arbitral process.21

The doctrine of separability is a presumption, not a fixed rule of law, it does not provide substantive validity to the arbitration clause, and therefore, if there is a fundamental infirmity in the underlying contract in the sense that there is no proper consent or fraudulent intention involved, this doctrine cannot and should not be invoked.

*Fifth year students, BA LLB (Hons.), from Dr. Ram Manohar Lohiya National Law University, Lucknow.

- Section 7(2) of the Indian Arbitration and Conciliation Act, 1996.
- The doctrine of kompetenz-kompetenz, as enshrined under Article 16(1) of the UNCITRAL Model Law on Arbitration.

- Section 16(1) of the Act.
- See, Analytical Commentary, UN Doc A/CN9/264, Article 16, Para 2.

- National Power Corpn. v. Westinghouse, DFT 119 II 380; DFT 121 III 495; DFT 65 I 19 (Swiss Federal Tribunal).
- 1942 AC 356 : (1942) 1 All ER 337 (HL).
- Section 7

7. Separability of arbitration agreement.—Unless otherwise agreed by the parties, an arbitration agreement which forms or was intended to form part of another agreement (whether or not in writing) shall not be regarded as invalid, non-existent or ineffective because that other agreement is invalid, or did not come into existence or has become ineffective, and it shall for that purpose be treated as a distinct agreement.

- 2007 UKHL 40, Session 2006-2007.
- 2007 UKHL 40, para 17.
- 18 L Ed 2d 1270 : 388 US 395 (1966).
- 923 F 2d 245 (2nd Cir 1991).
- Sandvik AB v. Advent International Corpn., 220 F 3d 99 (3rd Cir 2000); Spahr v. Secco, 330 F 3d 1266 (10th Cir 2003).

- Mayer, The Limits of Severability of the Arbitration Clause, in A. van den Berg (Edn.), “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).
- (2007) 5 SCC 692.
- Firm Ashok Traders v. Gurumukh Das Saluja, (2004) 3 SCC 155; Hicare India Properties (P) Ltd. v. Adidas India Mktg. (P) Ltd., Arb Pet No. 370 of 2009 decided by the Delhi High Court on 27-4-2010.
- (2007) 5 SCC 510.
- S. Schwebel, International Arbitration : Three Salient Problems 1 (1987).
- Gary B. Born, International Commercial Arbitration, Vol. 1 (Kluwer Law International Publication, 2009) 335.
- Issues of substantive validity of the arbitration agreement are addressed in Section 8 of the Act.
- Adam Samuel, “Separability of Arbitration Clauses—Some Awkward Questions About the Law on Contracts, Conflict of Laws and the Administration of Justice” (2000) 9 ADRLJ 36.
- Renusagar Power Co. Ltd. v. General Electric Co., (1984) 4 SCC 679.