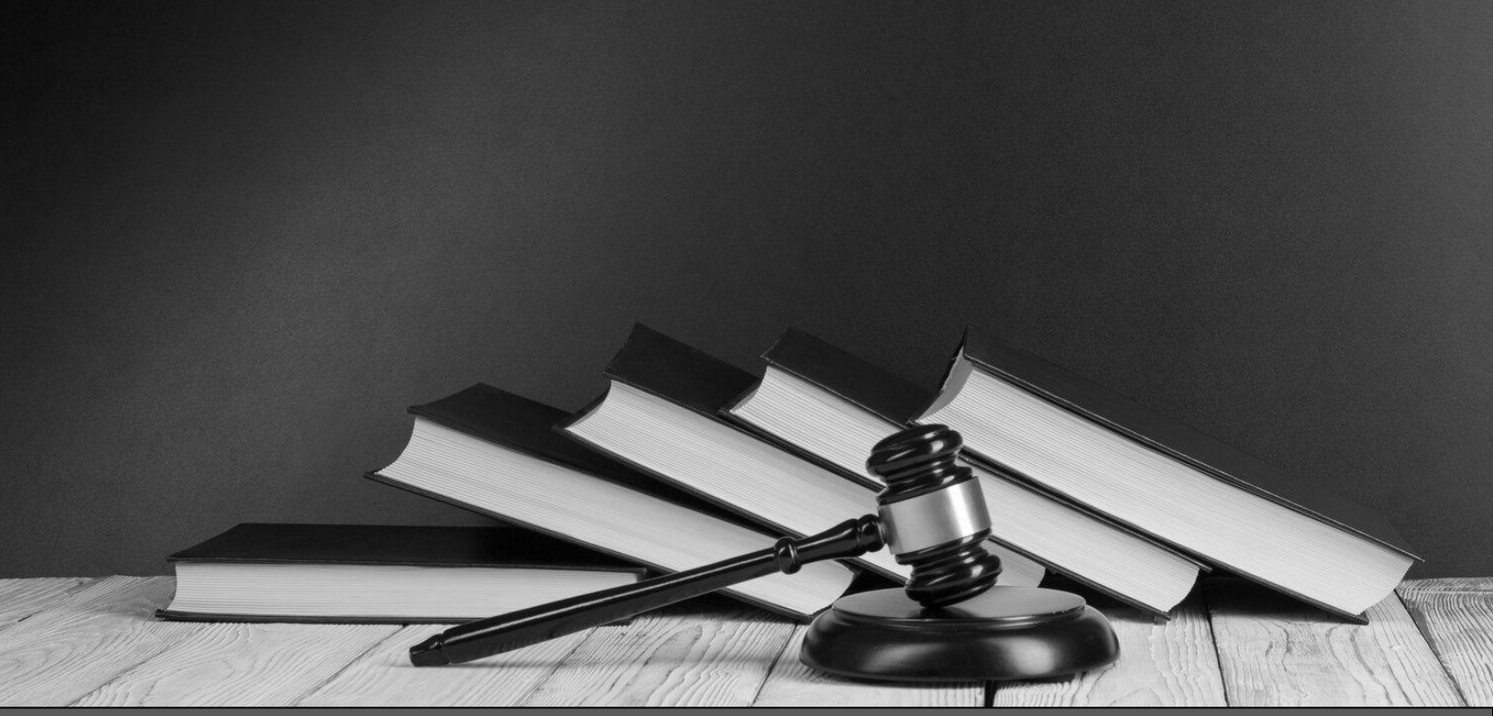

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ARTICLE

The Constitution Bench of The Supreme Court to Decide Upon the Conflict Between 'Existence' and 'Validity' of an Arbitration Agreement

Neil Chatterjee, Senior Associate

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INTRODUCTION

1. On 14.12.2020, a bench of three Judges of the Hon'ble Supreme Court *Vidya Drolia v Durga Trading Corporation*, (2021) 2 SCC 1 held tenancy disputes to be arbitrable. In the process, the Court also decided a question that has been a bone of contention for long – who decides the issue of arbitrability of a dispute, especially in the course of an application filed under Section 11 of the Arbitration & Conciliation Act, 1996 ("Act"). Through a long and winding road, the Court came out in favour of the Arbitrator.

2. However, a doubt raised by a subsequent coordinate Bench of the Court in *N.N. Global Mercantile Pvt. Ltd. v. Indo Unique Flame Ltd*, 2021 SCC Online SC 13 on a finer point of "existence and validity" of an arbitration agreement has raised eyebrows. The point is now ready to be brewed before a Constitution Bench of the Supreme Court. By way of this article, an attempt has been made to first clear the air on the issue of arbitrability as determined in *Vidya Drolia.* Thereafter, the point doubted in *N.N. Global Mercantile* has been clarified along with its impact on Indian arbitration.

VIDYA DROLIA v DURGA TRADING

3. The judgement arose out of a reference by a bench of two-judges in *Vidya Drolia-I*, (2019) 20 SCC 406) on 28.02.2019 doubting the legal ratio expressed in *Himangi Enterprises v Kamaljeet Singh Ahluwalia*, (2017) 10 SCC 706 that landlord-tenant disputes governed by the Transfer of Property Act, 1882 ("TP Act") are not arbitrable, being contrary to public policy. Two question were framed for consideration:

   (a) To what extent does a Court decide the question of arbitrability under Section 11 of the Arbitration & Conciliation Act, 1996 ("The Act").

   (b) Whether tenancy disputes are capable of being resolved through arbitration.

4. Briefly put, the dispute arose out of a tenancy agreement whereby prior to the expiry of the agreement, the landlord requested the tenant to vacate the premises. This was not met. Aggrieved, the landlord invoked the arbitration agreement and subsequently approached the Calcutta High Court under Section 11 of the Act for appointment of an arbitrator. Rejecting the objection of non-arbitrability of the dispute, the High Court proceeded to appoint an arbitrator.

5. Post this order, the Supreme Court passed its judgment in *Himangi* (supra). Relying upon this, the tenant sought reconsideration of the Order passed by the High Court under Section 11. This was dismissed. Consequently, it approached the Supreme Court.

6. Carving a distinction between 'existence' and 'validity' of an arbitration agreement, the matter was referred to a larger bench on the issue of whether while determining the existence of an arbitration agreement under Section 6-A of the Act, inserted by the 2015 Amendment, would the Court also consider weeding out claims of inarbitrability, which ideally ought to be left to the arbitrator given the language of Section 16(1)(b) of the Act, which embodies the principle of 'Separability", which essentially means that invalidity of the main contract does not *ipso jure* invalidate the arbitration agreement.

7. Justice Ramana, and correctly in my opinion, answered the first question in favour of the arbitrator, thereby leaving the second to be answered by it. However, given that Justice Khanna had proceeded to answer the second question first by holding in the affirmative, the reference was answered on both counts.

LEGAL RATIO

8. On the question of arbitrability, the Court stated that a dispute was not arbitrable when its subject-matter:

   (a) relates to actions *in rem*, that do not pertain to subordinate rights *in personam* that arise from rights *in rem* [tenancy disputes governed by the TP Act, not having implications *in rem*, arise as subordinate right *in personam* and therefore, arbitrable.]

   (b) affects third party rights; have *erga omnes* effect [i.e., the arbitration affects the rights and liabilities of persons not bound by it]

   (c) requires centralized adjudication, and mutual adjudication would not be appropriate and enforceable [i.e., where certain disputes as a class, of if the facts so necessitate, ought to be resolved through a collective litigation, like class-actions proceedings]

   (d) relates to inalienable sovereign and public interest functions of the State and hence mutual adjudication would be unenforceable [for instance, monopoly rights granted by the State, or disputes pertaining to the legitimacy of marriage, citizenship, winding-up of companies, grant of patents, *inter alia*]

   (e) when the subject-matter of the dispute is expressly or by necessary implication non-arbitrable as per mandatory statute(s) [i.e., if a statute creates a special right or liability and provides for the determination of each right or liability by the specified court or the public forum so constituted and where the remedies beyond the ordinary domain of the civil courts are prescribed, then the dispute is inarbitrable. Arbitration in the absence of special reason is contraindicated.

FINDINGS

9. As stated above, relying on para (a), the Court held tenancy disputes to be arbitrable, unless they are covered by any of the Rent Control Legislations. In that case, only the forum designated therein can adjudicate upon such a dispute. This, the Court reasoned, was because of public policy concerns where the State has sought to protect the rights of certain stakeholders through relief that cannot be granted by an arbitrator, such as fine, imprisonment, contempt etc. This is even though a dispute under such Rent Control legislations are not actions *in rem*. Clearly, the reasoning adopted by the Court was vague although the objective was sound. In doing so, however, the Court overruled its decision in *Himangi (supra)*.

10. On the same lines, the Court also overruled its decision in *N. Radhakrishnan v Meastro Engineers,* (2010) 1 SCC 72 insofar as it has held allegations of fraud to be inarbitrable. The reference was answered by stating that allegations of fraud *simpliciter* would not preclude arbitration since arbitrators are normally experts in the subject and perform their tasks by referring to facts, evidence, and relevant case law and therefore, mere complexity is not sufficient to ward off arbitration.

11. Vis-à-vis the second question, the reference was first answered by referring to the decisions in *SBP & Co. v Patel Engineering*, (2005) 8 SCC 618 and *National Insurance Co. Ltd. v Boghara Polyfab*, (2009) 1 SCC 267. Justice Ramana rightly stated that the Court therein was caught in the obfuscated distinction between judicial and administrative power of the Court while deciding a Section 11 application.

12. However, reference was made by the Justice Khanna to the ratio in *SBP* to the extent that in a Section 11 application, the Court ought to look into "whether there is an arbitration agreement". As such, the distinction between 'existence' and 'validity' of an arbitration agreement is not material since an arbitration agreement cannot exist if it is not valid in law.

13. For instance, reference was made to the decision in *Garware Wall Ropes Ltd. v Coastal Marine Construction & Engg. Ltd.*, (2019) 9 SCC 209, which had quoted with approval *SMS Tea Estates P. Ltd. v Chandmari Tea Co. P. Ltd.*, (2011) 14 SCC 66 and *United India Insurance Co. Ltd. v Hyundai Engg. & Construction Ltd.*, (2018) 17 SCC 607, wherein the issue arose of whether an arbitration agreement can be given effect to in an unstamped main agreement. There, the Court held that an arbitration clause containing in a contract would not exist as a matter of law until the contract was duly stamped. Therefore, even though the clause did "exist" so to speak, it did not in law and was therefore not valid. 'Existence' and 'Validity', held by Justice Khanna, had to be seen in light of this.

14. Therefore, although Clause 6-A was inserted into Section 11 of the Act by the 2015 Amendment Act to mean "*The Supreme Court or, as the case may be, the High Court, while considering any application under sub-section (4) or sub-section (5) or sub-section (6), shall, notwithstanding any judgment, decree or order of any court, confine to the examination of the* ***existence*** *of an arbitration agreement*", Justice Khanna held that such existence would include a determination of the issue of validity, which includes determining arbitrability. This is despite the a coordinate bench of the Court in *Mayavati Trading P. Ltd. v Pradyuat Deb Burman*, (2019) 8 SCC 714 holding that Clause 6-A had legislatively overruled the prior position in *SBP* and *Boghara Polyfab*.

15. However, by approving *Mayavati Trading*, Justice Khanna course corrected by holding that in view of the principle of separability, competence-competence, Clause 6-A and its subsequent omission by the 2019 Amendment Act, which was done for limited purpose of transferring the power of appointment of arbitrators from the Court to the arbitral institutions to be graded under the Act and not to resuscitate the position adopted in *SBP* and *Boghara Polyfab*, ordinarily, "*the Arbitral Tribunal is the preferred first authority to determine and decide all questions of non-arbitrability. The court has been conferred power of "second look" on aspects of non-arbitrability post the award in terms of sub-clauses (i), (ii) or (iv) of Section 34(2)(a) or sub-clause (i) of Section 34(2)(b) of the Arbitration Act.*".

16. Justice Khanna then went on to state that "*rarely as a demurrer the court may interfere at Section 8 or 11 stage when it is manifestly and ex facie certain that the arbitration agreement is non-existent, invalid or the disputes are non-arbitrable, though the nature and facet of non-arbitrability would, to some extent, determine the level and nature of judicial scrutiny. The restricted and limited review is to check and protect parties from being forced to arbitrate when the matter is demonstrably "non-arbitrable" and to cut off the deadwood. The court by default would refer the matter when contentions relating to non-arbitrability are plainly arguable; when consideration in summary proceedings would be*

insufficient and inconclusive; when facts are contested; when the party opposing arbitration adopts delaying tactics or impairs conduct of arbitration proceedings. This is not the stage for the court to enter into a mini trial or elaborate review so as to usurp the jurisdiction of the Arbitral Tribunal but to affirm and uphold integrity and efficacy of arbitration as an alternative dispute resolution mechanism." Justice Ramana concurred.

17. By this decision, the Court pass certain ancillary findings as well:

(a) The court overruled the decision of the Full Bench of the Delhi High Court in *HDFC Bank Ltd. v. Satpal Singh Bakshi*, which had held that matters covered under the DRT Act are arbitrable. The Reference Court found that banks and financial institutions covered under the Debt Recovery Tribunal Act ("DRT Act", now "RDDB Act") have specific rights including the modes of recovery specified in the DRT Act. Therefore, it held that "*To hold that the claims of banks and financial institutions covered under the DRT Act are arbitrable would deprive and deny these institutions of the specific rights including the modes of recovery specified in the DRT Act. Therefore, the claims covered by the DRT Act are non-arbitrable as there is a prohibition against waiver of jurisdiction of the DRT by necessary implication*".

(b) Dovetailing with the subject-matters ordinarily considered inarbitrable, the Court went on to hold insolvency or *intracompany* disputes to be inarbitrable as well, stating that they "*have to be addressed by a centralised forum, be the court or a special forum, which would be more efficient and has complete jurisdiction to efficaciously and fully dispose of the entire matter. They are also actions in rem*" and therefore would have *erga omnes* effect.

However, in doing so, a vital aspect was possibly omitted from consideration - within the sphere of company disputes, there lies a subset of dispute that do not require exercise of NCLT's jurisdiction. These very well form part of arbitrations across the globe. They are, thus, rights *in personam* arising out of right *in rem* and therefore, ideally, arbitrable.

(c) Similarly, while arbitral tribunals may not possess DRT's power of contempt, banks and NBFCs still, with full knowledge, prefer arbitration for various reasons. This is a conscious choice reflecting party autonomy. The Supreme Court has failed to explain why a bank or NBFC may not possess the remedy of election between an arbitral tribunal and a statutory forum, when in *Emaar MGF Land Limited v. Aftab Singh*, (2019) 12 SCC 751, such a right was granted to Consumers. Without overruling *Emaar MGF*, the Court could not have in one straight stroke deprived a similarly placed party.

(d) Interestingly, in *HDFC Bank* (supra), while stating that claims under the RDDB Act were essentially money claims, the Delhi High Court had held as under:

> "*...11. What follows from the above? When arbitration as alternate to the civil courts is recognized, which is the common case of the parties before us, creation of Debt Recovery Tribunal under the RDB Act as a forum for deciding claims of banks and financial institutions would make any difference? We are of the firm view that answer has to be in the negative. What is so special under the RDB Act? It is nothing but creating a tribunal to decide certain specific types of cases which were earlier decided by the civil courts and is popularly known as "tribunalization of justice". It is a matter of record that there are so many such tribunals created...*"

(e) In an application under the RDDB Act, the Tribunal can pass the following directions under Section 19 (18), which can be passed by an arbitrator as well:

> "*(18) Where it appears to the Tribunal to be just and convenient, the Tribunal may, by order—*
> *(a) appoint a receiver of any property, whether before or after grant of certificate for recovery of debt;*
> *(b) remove any person from the possession or custody of the property;*
> *(c) commit the same to the possession, custody or management of the receiver;*
> *(d) confer upon the receiver all such powers, as to bringing and defending suits in the courts or filing and defending application before the Tribunal and for the realization, management, protection, preservation and improvement of the property, the collection of the rents and profits thereof, the application and disposal of such rents and profits, and the execution of documents as the owner himself has, or such of those powers as the Tribunal thinks fit; and*
> *(e) appoint a Commissioner for preparation of an inventory of the properties of the defendant or for the sale thereof.*"

(f) In fairness, however, Clause (17) of Section 19 also provides as follows:

> "*(17) In the case of disobedience of an order made by the Tribunal under sub-sections (12), (13) and (18) or breach of any of the terms on which the order was made, the Tribunal may order the properties of the person guilty of such disobedience or breach to be attached an may also order such person to be detained in the civil prison for a term not exceeding three months, unless in the meantime the Tribunal directs his release.*"

(g) Interestingly, on 11.01.2021, a coordinate bench of the Supreme Court in *N.N. Global Mercantile Pvt. Ltd. v. Indo Unique Flame Ltd*, 2021 SCC Online SC 13, speaking through Indu Malhotra J., has disagreed with the distinction carved by Justice Khanna between the 'existence' and 'validity' of an arbitration agreement. The issue is this case was whether an arbitration agreement would be non-existent in law, invalid or unenforceable, if the underlying contract was not stamped as per the relevant Stamp Act.

(h) Justice Malhotra held that by virtue of the principle of separability, a defect as to the main agreement vis-à-vis non-stamping or inadequate stamping would not affect the validity of the arbitration agreement. It flows that the Court in a Section 11 application ought to only consider whether the formal conditions for the *existence* of an arbitration agreement exist in accordance with Section 7 of the Act, and not enter into the realm of its validity, which is to be left to the arbitrator.

(i) As such, Justice Malhotra, speaking for the Bench, held the decision in *Garware Wall Ropes and SMS Tea* (and implicitly, *Hyundai Engg.*) as not being good in law. However, given that these had been cited with approval by a coordinate bench in the present

case, speaking through Justice Khanna, the following question was referred to a Constitution Bench of the Court for an authoritative settlement:

> "*Whether the statutory bar contained in Section 35 of the Indian Stamp Act, 1899 applicable to instruments chargeable to Stamp Duty under Section 3 read with the Schedule to the Act, would also render the arbitration agreement contained in such an instrument, which is not chargeable to payment of stamp duty, as being non-existent, un-enforceable, or invalid, pending payment of stamp duty on the substantive contract/instrument?*".

Conclusion

- While the decision in *Vidya Drolia* may be well received in terms of relegating jurisdiction to decide arbitrability back to the Arbitrators, the Court invariably answers more than it was required to. In doing so, Justice Khanna nullifies the distinction between 'existence' and 'validity' of an arbitration agreement to justify the issue of 'arbitrability' as being one hitting at 'validity', and thus, at 'existence'.

- However, in international arbitration, there exists a material distinction between 'existence' and 'validity' of an arbitration agreement. The former points more towards the formal requirements which help satisfy the existence of an arbitration agreement. This includes the requirement of an agreement being in writing or contained in any other form of communication, and signature. This formal validity is determined by the law of the seat of the arbitration. It is this that Justice Malhotra sought to refer to in *N.N. Global Mercantile.*

- Substantive validity hits more at the requirement of subject-matter arbitration / arbitrability and capacity of a party to enter into arbitration. This is governed by the law chosen by the parties to govern the arbitration agreement, law governing the subject-matter of dispute under the main contract or failing which, the law of the seat of the arbitration. In the case of an issue of capacity, tribunals tend to refer to the law of the nationality of the party claimed to be acting without capacity.

- Section 6 (A) to the Section 11 of the Act was notified to do away with determination of substantive validity. Ideally, the Supreme Court should have stopped at this, given that ultimately, it gave power back in the hands of the Arbitrator. The difficulty is that in doing so, it retained control in those limited circumstances where claims are in the nature of a "deadwood".

- In such circumstances, the reference to the Constitution Bench becomes vital. The Bench should clarify and approve the position adopted in *N.N Global Mercantile* because as Justice Malhotra rightly puts it, doing otherwise would render the principle of Separability a nullity. A claim that the main Contract is invalid should not invite an examination by the Court as to whether the Arbitration Agreement is substantively invalid/non-existent as well, barring checking the formal validity of the arbitration agreement.