

The need for prudence when including arbitration clauses in agreements

By: Neerav Merchant, Partner and Head of the Disputes Practice, Majmudar & Partners

Brief background

Recent trends show an increase in the preference and popularity of arbitration as an alternative mode of dispute resolution. While, indisputably, arbitration has its merits, certain category of disputes may not be arbitrable. However, there are multiple instances where the arbitrability of potential disputes isn't evaluated, while opting for arbitration as the alternate mode of dispute resolution in a particular agreement. Such conflicting inclusions cause legal impediments, which increase the time and cost of dispute resolution. Thus, it is imperative that the contractual parties should cautiously consider the nature of the agreement, the potential disputes that may arise from it, and their intention, before determining which form of dispute resolution to adopt.

Recently, in the matter of *Welspun One Logistics Park Fund v. Mohit Verma*, the Delhi High Court (DHC) decided upon one such instance of a contradictory inclusion of a binding arbitration clause in a non-binding term sheet.

In this case, the DHC identified two issues: (i) whether an arbitration clause in a non-binding term sheet would be binding on the parties as an independent agreement; and (ii) if so, whether such an arbitration clause would be enforceable (as the other clauses of the term sheet were non-binding).

On these issues, the DHC ruled that the arbitration clause should be construed as a separate agreement altogether and should, therefore, not automatically imbibe the characteristics of the parent agreement.

Facts

Sometime in November 2021, the Petitioner and the Respondent executed a non-binding term sheet for the transfer of land to the Petitioner. The term sheet explicitly mentioned the term "non-binding" in its preamble. However, the term sheet contained an arbitration clause, which the parties had stipulated as being binding.

Thereafter, disputes arose between the parties and the Petitioner invoked the arbitration clause of the term sheet. However, the Respondent refused to appoint an arbitrator contending that as the term sheet was not binding on the parties, the arbitration clause was not enforceable.

The Petitioner filed a petition under Section 11(6) of the Arbitration and Conciliation Act, 1996, before the DHC and submitted that: (i) the term sheet stipulated that the arbitration clause was binding; and (ii) the Respondent's objection as regards the validity of the term sheet itself, or the arbitrability of the subject matter, could be adjudicated by the arbitrator.

The Respondent argued that, notwithstanding the stipulation rendering the arbitration clause as binding, the other clauses of the term sheet which captured the substance of the dispute were not binding. Therefore, the subject matter was non-arbitrable. Placing reliance on the findings of the Supreme Court (SC) in the cases of *Vidya Drolia* and *N.N. Global Mercantile (P) Ltd.*, the Respondent further argued that it was the duty of the DHC to take note of the *prima facie* invalidity of the underlying agreement and refuse to refer the parties to arbitration.

After considering the parties' arguments in detail, the DHC proceeded to examine the findings of the SC in the cases of *Vidya Drolia* and *N.N. Global Mercantile (P) Ltd.*

In *Vidya Drolia (supra)*, the SC held that the issue of whether parties must be referred to arbitration depends on two aspects: (i) the arbitrability of the subject matter; and (ii) the determining authority, i.e., whether the arbitrability of a subject matter is to be determined by the court or arbitrator.

Arbitrability of the subject matter: The SC proposed four tests that, when applied holistically, would indicate the arbitrability of a subject matter to a high degree of certainty. The SC held that a matter would be non-arbitrable if: (i) the cause of action and subject matter of the dispute related to an action *in rem*, which created no subordinate rights *in personam*; (ii) the private adjudication of the subject matter of the dispute between the parties would affect the rights of any third party being incapable of intervening in such dispute; (iii) the cause of action and subject matter of the dispute related to inalienable sovereign and public interest functions of the State; and (iv) the subject matter became, expressly or by necessary implication, non-arbitrable as per a mandatory statute.

Determining authority: The SC held that the scope of judicial review vested in the courts is limited, and the courts must only determine the non-arbitrability of an issue when this can be ascertained *prima facie* without delving into the facts of the matter.

In *N.N. Global (supra)*, the SC placed reliance on the Doctrine of Separability to conclude that an arbitration agreement, independent from the parent agreement, would not be affected by the invalidation, novation, or termination of the underlying parent document.

In view of the arguments and cases relied on by the parties, the DHC held that the arbitration agreement was an independent agreement despite being a clause in the parent agreement. Additionally, the DHC observed that the arbitrability of the subject matter was not discernible *prima facie*, and an arbitral tribunal was empowered by the Doctrine of Kompetenz-Kompetenz to rule on its own jurisdiction. Therefore, acting on the principle of “when in doubt, do refer,” the DHC appointed an arbitrator on behalf of the parties, directing the arbitrator to determine the arbitrability of the subject matter of the dispute, including the contentions raised by the parties, without any reference to the DHC’s present order.

Analysis

Based on the DHC's judgement, it is imperative for contracting parties to exercise careful consideration and caution when determining the exact mode of dispute resolution for any particular transaction. Simpliciter, adding an arbitration clause in a non-binding agreement or a contract can have either of the following repercussions, namely:

The parties may have to arbitrate in relation to obligations that are not intended to be binding; or

The parties may need to incur substantial costs of arbitration until the tribunal eventually determines whether the subject matter is arbitrable.

Therefore, arbitration clauses inserted in contracts without mindful consideration may lead to cost escalations, and in most cases, an increase in litigation before the courts, which can be avoided by prudent assessment of whether opting for arbitration as an alternative means of dispute resolution is in consonance with the nature of the transaction and the intent of the parties to the contract.