ARBITRABILITY OF FRAUD RELATED DISPUTES: INDIAN COURT'S ATTEMPT TO SOLVE THE INTRIGUING PUZZLE

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ABSTRACT

In overcoming the frustration caused by litigation the progression of arbitration from an 'alternate' to the preferred mode of settlement of dispute has taken its way. The evolving jurisprudence of arbitrability of has always been a subject for discussion amongst the legal enthusiasts. The paper takes best shot to draw a careful insight into arbitration and examines the issue of 'arbitrability' in India with context to fraud. Arbitrability of fraud has been a subject of immense judicial scrutiny. The findings of the research will provide answer to the question: Does fraud vitiate arbitration? . The authors in the paper seek to analyse the conspectus of Indian precedents and also find whether the judgment laid down in the matter of Vidya Drolia and N. N. Global Mercantile is the final judgement in solving the puzzle as to the matter of research. Also, the unsolved tensions between the judiciary and tribunal despite paradigm shift from litigation to arbitration has been in question constantly. The first part of the paper undertakes understanding of arbitrability followed by the evolving problematic jurisprudence with related cases and judgements. The further section pinpoints the prevailing confusion as to matter of fraud related dispute.

Keywords: Arbitration, Dispute, Fraud, Arbitrability, Jurisprudence

INTRODUCTION

When will mankind be convinced and agree to settle their difficulties by Arbitration- -Benjamin Franklin[1]

Globally, arbitration has been considered as the most prominent and conducive system for dispute resolution due to wide range of advantages which arbitration provides. The progression of arbitration law from a preferred mode to thriving mode of dispute resolution is remarkable. In arbitration, parties to a dispute refer to an adjudicator or arbitrator also known as the third party whose decision is binding on both the parties. Arbitration is the alternative mechanism to the courts which is neutral and flexible and also ensures considerations of being confidential. It basically allow the parties to exercise substantial degree of autonomy by enabling them to appoint neutral forum of adjudication. There are various categories of disputes such as antitrust, insolvency, intellectual property rights, criminal matters etc which are considered to be non-arbitrable[2]. Arbitration refers to determining which types of disputes may be resolved by arbitration and what kind of disputes shall be exclusively dealt by the courts[3] . In *Booz Allen and Hamilton Inc. SBI Home Finance Ltd.*, the supreme court bifurcated the disputes concerning with right in rem with rights in personam and held that the latter was arbitrable and the former was non-arbitrable because they affect the society at large[4]. As per Article V(2)(a) of the New York Convention, the arbitration award may be refused recognition or enforcement if the subject-matter of the difference is not capable of settlement by arbitration under the law of that country[5]. Arbitration values the autonomy of the party and ensures that the parties aren't discerned and discriminated which is an outstanding feature of arbitration as a means of dispute resolution which enjoys its standing. With wide range of advantages still, arbitration isn't vulnerable to the difficulties that arises constantly and which results in judicial intervention which burdens the bar and lightens the scope of arbitration. Fali S Nariman in one of his lecture has rightly said in this context,

"The development of arbitration in India isn't attributable to the success in arbitration, rather

[1] Letter from Benjamin Franklin to Joseph Banks (July 27, 1783), in 1 THE PRIVATE CORRESPONDENCE OF BENJAMIN FRANKLIN 132, (3 ed., 1818).
[2] See O.P. Malhotra on *The Law and Practice of Arbitration and Conciliation*, Third Edn. authored by Indu Malhotra.
[3] Nigel Blackaby, Constantine Partasides et al., *Redfern and Hunter on International Arbitration*, 110, (5th Edn. 2014).
[4] Booz Allen and Hamilton Inc v. SBI Home finance Ltd, (2011) 5 SCC 532
[5] Article V(2) NYC, United Nations Commission on International Trade Law, UNCITRAL Model Law on International Commercial Arbitration 1985: With amendments as adopted in 2006 (Vienna: United Nations, 2008), Available at: www.uncitral.org/pdf/english/texts/arbitration/ml-arb/07-86998_Ebook.pdf , (Accessed: June 13, 2022)

to the failures of the Court".

The above quoted statement vehemently express the development of law concerning arbitration in India. The Indian jurisprudence has noticed a constant development in the applicability of concepts and principles related to arbitration and the changes in the jurisprudence has to be attributed to the judicial understanding. Since arbitration isn't open for all kind of disputes which means non-arbitrability of certain cases related to nuptial cases, felonious cases, marital cases etc. There are wide range of contentions regarding controversies related to fraud. Section 17[6] of Indian Contract Act, 1872 defines fraud as the active concealment of facts. Fraud in wider dimension which may be serious or less serious. In the world of legal jurisprudence fraud has also been recognized by stringent measures as well as precedents. Since the arbitral bench exercised governance over allegations of fraud but the horizon of similar adjudication has always been a pressing issue. The Arbitration and Conciliation, 1996 enacted was to consolidate and amend the law relating to international commercial arbitration, domestic arbitration and enforcement of foreign arbitral awards. The object of the Act was aimed at bringing the existing laws on arbitration parallel to the UNCITRAL 1985 Model Laws on Commercial Arbitration and fulfilling India's quest for prosperity which could only be possible by making the existing legal regime in consonance with international laws on dispute resolution. Thus, making minimum intervention of courts thereby reducing the burden, severability principle of arbitration agreement from main contract and principle of *kompetenz-kompetenz*.

The question whether fraud can be addressed under the arbitration process has agonized arbitration. The reason due to which the problem occurs is because arbitration only decides on *rights in personam* i.e. against specific person and not *right in rem* i.e. against public programs. For case, the parties under several businesses suffer from fraud related dispute which is a rising issue and pinpoints the profitable crimes in the country. The Covid-19 pandemic has resulted in use of internet by the consumer which allowed fraudsters to take advantage of people's fiscal necessity. As a result of fast globalisation of the frugality, business conflicts and competitiveness have arisen. The trust in the judicial system has completely been eroded due to several undetermined cases businesses over the country has expeditiously modified their processes for the purpose to accommodate new digital services to meet client prospects. But the rapid-fire growth of digital services has handed the fraudsters with new possibilities which

[6] https://indiankanoon.org/doc/299780/

has enlarged the threat of fraud as well as data breaches for the companies. Fraud has resulted in a variety of viewpoints and has created a big problem for the arbitration system.

THE EVOLVING JURISPRUDENCE OF ARBITRABILITY OF FRAUD

Arbitrability refers to the banning of certain dispute from the from the ambit of arbitration. Arbitrability of fraud continues to be a controversial issue under the Indian law. In India, the concept of arbitrating fraud has undergone tempestuous pronouncements over the times. Meanwhile, some analytical developments in the position of arbitrability of fraud on the judicial front can be witnessed. Numerous developments in the jurisprudence of arbitrability of fraud resulted in diverging the legal positions adopted by the judiciary. The arbitrator or the arbitral tribunal as per the arbitration provisions may or may not have the competent authority to deal with the issues related to fraud. The vast concept of arbitrability of fraud related disputes has been a source of disputes in India as well as United states. The issue and question of arbitrability of fraud arose first in the case of *Russel v, Russel*, wherein the court held that "*if there exists prima facie evidence to support the existence of fraud the court can refuse to refer the matter to Arbitration"*[7]. The judgement has been the basis of various decisions of High court and the Supreme court and has marked the beginning of an era.

After this, a series of decisions in convergence to the arbitrability of fraud started in the year 1962 with the case of *Abdul Kadir Shamsuddin Bubere v. Madhav Prabhakar Oak*[8], wherein the Supreme court held that cases which comprises of severe allegations pertinent to fraud were to be decided by the court and not referring the matter to Arbitration was considered valid. In the case the reference was under section 20[9] of the act which gave wide discretionary power to court regarding the matter to be adjudicated via arbitration.

Likewise in *N. Radhakrishnan v. Maestro engineers*[10], wherein the case involved severe allegation of fraud, the Supreme court held that the issue of fraud is not arbitrable and such disputes should be settled by the courts through evidence. The decisions of the case led to arbitration clauses being affected and thus increased the dimensions of judicial hinderance.

[7] Russel v. Russel (1880) 14 Ch D 471
[8] Abdul Kadir Shamsuddin Bubere v. Madhav Prabhakar Oak AIR 1962 SC 406
[9] https://indiankanoon.org/doc/811701/
[10] N. Radhakrishnan v. Maestro engineers (2010) 1 SCC 72

In *A. Ayyasamy v. A. Paramasivam*[11], the Hon'ble Supreme court held that the court has no discretion to depart from compelling parties to proceed towards arbitration once there was arbitration agreement amongst the parties. Hence, in this case the burden lied upon party who tried to avoid arbitral proceedings trying to show that the dispute was non-arbitrable.

In *Vidya Drolia v. Durga Trading Corporation*[12], the Hon'ble Supreme initiated an assessment on arbitrability of law in the contemporary jurisprudence. The final judgement of the case emphasized that it would be absolutely wrong to mistrust arbitration as inferior adjudication process and not fit to deal with public policy legislations. Thus, it was held that allegations of fraud arbitrable in case it relates to civil dispute. The court further analysed that arbitration aims at securing effective and fast resolution of dispute in an expedient manner and considered arbitration as a private dispute resolution mechanism.

In *N. Global Merchantile Pvt. Ltd*[13]., the Hon'ble Supreme court bolstered the position in the area of contemporary arbitration jurisprudence and further emphasized that the criminal aspect of fraud that attracted criminal sanctions can be adjudicated only by the court of law. The court also focused on the non- arbitrability of fraud and stated that fraud was non- arbitrable and prevalent because it entails extensive evidence and is too complicated to be decided in arbitration.

Further in *Rashid Raza v. Sadaf Akhtar*, the Supreme Court formulated a two-step test to determine what constitutes a complex nature of fraud. It was held that firstly, it has to be seen that whether the plea permeates the entire contract specifically the arbitration agreement, thus rendering it void and secondly, the courts have to see whether the allegations of fraud are pertinent to the internal affairs of the parties and have no such implication in the public domain and such case would be arbitrable[14]

The extant jurisprudence highlights the intricacies with which the issue of arbitrability of fraud has been dealt with. The various tests have made this more prone for judicial intervention. There is no sound logic for differentiating fraud simpliciter and fraud complex. The distinction between the terms is superfluous. This is aptly evident by the fact that the supreme court even after suggesting this distinction in *Ayyasamy* case has suggested new factor to the same. Thus,

[11]A. Ayyasamy v. A. Paramasivam (2016) 10 SCC 386
[12] Vidya Drolia v. Durga Trading Corporation (2021) 2 SCC 1: 2020 SCC OnLine SC 1018
[13] N.N. Global Merchantile v, Pvt. Ltd. 2021 SCC OnLine SC 13
[14] Rashid Raza v, Sadaf Akhtar, (2019) 8 SCC 710

this has been erratic. Further in the case of *Avitel Post Studioz Ltd. v. HSBC PI Holdings (Mauritius) Ltd.*, the Supreme court observed that disputes become non-arbitrable when court comes to the conclusion that the serious allegations of fraud that makes the arbitration agreement is vitiated by fraud and is inexistent or in the cases where the allegations are levelled against the instrumentalities of the state relating to male fide conduct, arbitrary, fraudulent, raising the question of public law as supposed to the question related to contractual relationship between the parties whereas rest all the allegations of fraud are arbitrable[15].

SIGNIFICANT CONTEMPORARY DEVELOPMENT

The Indian Arbitration Act, 1899 opened the way for Arbitration and Conciliation Act 1940 which was replaced by the 1996 act. The 1996 Act contained tetrad i.e. series of four major judgements that has shaped the understanding of arbitrability of fraud. The first amongst the four decisions came in the year 2009 wherein ,the supreme court considered the origination under section 8[16] of 1996 Act. Sec 8 of the Act provides that if the arbitration clause contained in the agreement which is produced in the original form provided that at a later stage of filing a written statement, the court shall relegate the party to the arbitration. Despite such an absolute command that sec 8[17] provides, the supreme court chooses not to refer the parties to the arbitration reason being that it came under the ambit of serious allegation of fraud.

The supreme court's 1962 decision in the Abdul Kadir case which held that allegation of fraud should be solved by civil court and cannot be resolved through arbitration. The decision in the case was a major setback in the Indian arbitration case. The decision of the case also displayed a deficit of trust on the part of court when it comes to reposing faith in arbitral tribunal in adjudicating certain categories of dispute.

In 2014, in the matter of *Swiss Timing Ltd. V. Common Wealth Games*[18]**.** While adjudicating upon Section 11 the adjudicatory body adopted an opposite view. The apex court appointed a sole arbitrator after rejecting the arguments that allegations of fraud bereaved the jurisdiction of arbitral tribunal and held that lodging of a criminal case does not bar reference to the tribunal. The decision was two-fold and progressive. Firstly, it prevented the parties from utilizing the criminal remedies for initiation of arbitration. Secondly, relying on the *kompetenz – kompetenz*

[15] Avitel Post Studioz Ltd. v. HSBC PI Holdings (Mauritius) Ltd.2020 SCC OnLine SC 656
[16] https://indiankanoon.org/doc/1146817/
[17] https://indiankanoon.org/doc/1146817/
[18] Swiss Timing Ltd. V. Common Wealth Games 2014 SCC 67

principle, it held that all the allegation regarding the jurisdiction can be raised by the aggrieved party.

In 2016, the supreme court in the matter of Ayyaswamy impliedly overruled the decision of Swiss Timing wherein the supreme court created a dual paradigm in adjudicating seriousness of fraud. It was held that fraud simpliciter was capable of being resolved via arbitration whereas fraud complex were incapable of being resolved through arbitration. Further explaining this differentiation, the court stated that fraud only touched upon internal matter of the party without spilling over public domain.

In 2019, Supreme Court in *Raza Rashid v Sadaf Khan*[19] building upon the *Ayyasamy* laid down the dual test for differentiating simple allegations of fraud opposed to complex frauds. It's reasoning was sub- consciously affected by Section 11(6)A of 1986 Act when the decision was rendered on 14th September 2019.

"*And this provision has now been repealed by the 2019 Amendment but for the period that it existed from 2015 till its recent repeal, it restricted the scope of courts in declining references to arbitration. Under the deleted provision, the courts were limited to examine whether the valid arbitration agreement was in place or not. It is specific repeal may enjoin the courts to undertake the inquiry. This shall not advance the cause of arbitration in India, since the courts may start summarily rejecting arbitration petitions by finding that the disputes are non-arbitrable*[20].

The Supreme Court while applying the twin test also held that there were no allegations of fraud that would vitiate partnership deed, in particular the arbitration clause concerned in the said deed. The Court further held that the matter would not fall under the ambit of public domain as the allegations made pertain to affairs of partnership and siphoning funds from the partnership funds.

CURRENT LEGAL POSITION- THE DAWN OF THE CHANGE

The latest episode in the saga of the evolution of arbitrability of frauds in India is the *Vidya Drolia* case. While placing concurrence with its earlier decisions in *Swiss Timings, Ayyasamy,*

[19] Raza Rashid v. Sadaf Khan *(*2019) 8 SCC 710
[20] Shivam Singh, *Arbitrabiliy of Fraud: A Critique of India's Problematic Jurisprudence*, LIVE LAW (June 8, 2022) *available at:* https://www.livelaw.in/columns/arbitrability-of-fraud-a-critique-of-indias-problematic-jurisprudence-148206 ,(Accessed: June 13, 2022)

Rashid Raza, and *Avitel,* the Supreme Court explicitly overruled the dictum and laid down in *N Radhakrishnan* and held that allegations of fraud are arbitrable, provided, they relate to a civil dispute. The Court also held that matters pertinent to fraud can be the subject matter of arbitration proceedings, provided that fraud does not questions that affect *rights in rem* and therefore necessitate adjudication in the public domain. or "*vitiate and invalidate the arbitration clause*".

The Hon'ble Supreme court has reaffirmed the findings of Vidya Drolia case with respect to arbitrability of fraud in NN Global Mercantile case and held that the civil aspect of fraud can only be adjudicated by the arbitral tribunal. The criminal aspects of fraud, forgery can only be adjudicated by the court. The supreme court held that all commercial or Civil disputes which can be adjudicated by civil court can be adjudicated by arbitration unless the arbitral proceedings are excluded by necessary implication or statute.

TESTS FOR DETERMINING FRAUD EXCEPTION

The Arbitration and Conciliation Act 1996 does not exclude any category of cases being non-arbitral. Section 8[21] of the said act states that the judicial authority has the power of referring the cases to arbitration if there exists a valid arbitration agreement. Furthermore, section 34(2)(b)[22] provides for setting aside the arbitral award if the subject matter is not arbitrable by the law. In the law commissions, 246th report various landmark judgments and recommendations were made, there still existed no legislative clarity. Also, the exceptions to the arbitrability of dispute was created by judicial body. Specifically, the *Ayyaswamy* decision being held that serious allegations of fraud were non- arbitrable in order to answer what matters were arbitrable the supreme court in *Avitel* case focused on it. It was laid down that fraud of serious nature would arise only if either of the following situations are satisfied. In the first situation, if the arbitration agreement does not exist and if the arbitration clause so provide the tests would apply.

The second scenario is when the allegation of arbitrariness *malafide* conduct or fraud against the state or its instrumentalities. Such cases would not be arbitrable because the concern is on the matter of public law, the implication of which is not only for the parties but for the public domain. These cases would necessarily be settled in a writ court as issues pertinent to

[21] https://indiankanoon.org/doc/1146817/
[22] https://indiankanoon.org/doc/1146817/

fundamental rights would arise. With respect to public domain ambit of fraud, the Supreme court held that false representations, diversion of funds, allegations of impersonation are the internal matters of the respective parties and thus not to be construed as serious allegations of fraud. The disputes would be arbitrable and not to be adjudicated in the court of law unless such allegations are made against state and its authorities.

FINAL WORDS

While the judgement of this subject matter is not exhaustive and solely depends on the facts of individual case. They do provide a strong indication that courts are steadfast in permitting commercial fraud to be arbitrated. It goes without saying that any serious allegations of fraud cannot be based on just suspicion for the court to consider refusing arbitration. The interdiction imposed in the *N Radhakrishnan* case which was a blatant error hindering the growth of arbitration in India has now finally been dealt by the Supreme Court in the matter of *Vidya Drolia* and *NN Global* by opting for a pro-arbitration approach. Presently, the settled notion and legal position concerning with the arbitrability of fraud in India is that the allegations of fraud that permeates the contract in totality and do not merely affect the internal affairs of the parties but instead affects the *rights in rem* are non-arbitrable. The basis of arbitrability of frauds refined by the courts is contributory. However, as we move forward their effectiveness remains to be seen in the cases where the parties may raise the allegations of fraud to wilfully avoid the arbitral process. This recent judgment of the Supreme Court has cleared its position over the issue of arbitrability of disputes and the controversies concerning serious allegation of fraud and the relation of it to the public policy of India. This is for sure a good stride towards the agenda of the 'pro-arbitration regime'.

Even though in the author's view the Supreme Court has left the matter half way done by holding that "those frauds which vitiate or renders the arbitration clause invalid would still be non-arbitrable", as this still leaves the compass for judicial intervention in arbitration matters where the courts can claw into the question of validity of the arbitration clause and therefore can still intermediate in arbitration matters which is against the introductory principle of arbitration i.e. *Kompetenz-Kompetenz.*

In *Henry Schein Inc. v. Archer and White Sales Co*[23]., the US Supreme Court held that the issue

[23] Henry Schein Inc. v. Archer and White Sales Co 2019 SCC OnLine US SC 1 : 202 L Ed 2d 480 : 139 S Ct 524 : 549 US_____(2019)

of arbitrability must be decided by the adjudicator in all cases and not by the civil courts[24]. It further emphasised that indeed where any party pleads that the reference to arbitration is unwarranted or has no grounds, indeed that plea should be decided by the adjudicator because of the established principle of Kompetenz-Kompetenz.

This approach by the US Supreme Court is in consonance with the introductory principles of arbitration and hence acts as a standard towards establishing and performing a pro-arbitration governance and is a favourable approach than the one proffered by the Indian Supreme Court. Therefore, it can be concluded that though the Indian justice on arbitrability is moving towards a pro-arbitration governance, it cannot be said to be in full consonance with the principle of arbitration like *Kompetenz-Kompetenz*.

Starting from *Russel*[25] to *Avitel*[26] and *N.N. Global*, has been an outstretched journey for arbitrability of fraud. While the courts have heavily relied over the principles introduced in *Russel* to ponder over with questions of fraud, the Supreme Court has laid down tests in *Ayyasam and Avital* have attempted to falsify touchstones for such principles. This will confidently bring in some predictability on how courts would look at the controversial issue of arbitration and fraud and is a major step towards bolstering the arbitration regime in India. This is also aligning with the international trends of the private resolution for inter-party disputes. In a country like India, where the case pendency is a staggering and huge to put it into numbers 3,78,96,456 cases, and which is bound to get even worse due to Covid-19 Pandemic, the importance and bearing of ADR cannot be overlooked. All the efforts should be made by the appropriate authority in giving ADR a boost.

[24] *ibid*
[25] Russel v, Russel (1880) 14 Ch D 471
[26] Avitel Post Studioz Ltd. v. HSBC PI Holdings (Mauritius) 2020 SCC OnLine SC 656