

Dispute Resolution Hotline

December 18, 2019

ARBITRABILITY OF FRAUD – ‘SIMPLY’ PUT BY SUPREME COURT

- Simple allegations of fraud which do not vitiate the underlying contract and arbitration clause are arbitrable.
- Allegations of fraud which do not have an implication in the public domain are arbitrable.

INTRODUCTION

The Supreme Court in its judgment in the case of *Rashid Raza vs. Sadaf Akhtar*¹ clarified the scope of arbitrability of disputes involving allegations of fraud. Relying upon the Supreme Court's landmark ruling in the case of *A. Ayyasamy vs. A. Paramasivam* ("Ayyasamy"),² Justice R. F. Nariman set out the working tests for determining whether an allegation of fraud is arbitrable. In the present case, the Supreme Court held that since the dispute pertains to a 'simple allegation of fraud', the same is arbitrable.

BACKGROUND

The dispute arose out of Partnership Deed dated January 30, 2015 ("Partnership Deed") between the parties. An FIR was lodged by the Respondent alleging siphoning of funds and other business improprieties by the Appellant. On the other hand, the Appellant filed an arbitration petition before the High Court of Jharkhand at Ranchi ("High Court") under Section 11 of the Arbitration and Conciliation Act, 1996 ("Act") for appointment of an arbitrator pursuant to an arbitration clause in the Partnership Deed.

Before the High Court, the Respondent argued that the matter pertains to a serious case of fraud which is not fit to be decided in arbitration. *Inter alia*, the Respondent argued that the Petitioner (Appellant) had utilized the assets of the partnership firm (S.R. Coating) in another firm run by his father; created proprietorship firm with a same name, S. R. Coating, and introduced it to one of the firm's existing business partners, Reliance Industries Ltd.; opened a new bank account on the basis of a fake agreement; and transferred money into the Petitioner's personal bank account and his father's bank account.

Without commenting on the merits of the dispute, and relying on the principles laid down by the Supreme Court in *Ayyasamy*, the High Court held that the dispute included serious allegations of fraud of a complicated nature which are not fit to be decided in arbitration proceedings. The Court further held that the dispute may require voluminous evidence to be presented by the parties, and a finding on such evidence can be properly adjudicated only by a court. Consequently, the High Court dismissed the application for appointment of arbitrator.

Aggrieved by the High Court's ruling, the Appellant approached the Supreme Court by way of a special leave petition.

JUDGMENT

The Supreme Court analyzed the law laid down on arbitrability of disputes involving fraud in the case of *Ayyasamy*. In *Ayyasamy*, the Supreme Court held that a simple allegation of fraud may not be a ground to nullify the effect of an arbitration agreement. However, when serious allegations of fraud are involved, the Supreme Court held that courts can dismiss an application to refer a dispute to arbitration under Section 8 of the Act. Serious allegations of fraud would involve:

- Allegations which would make a virtual case of criminal offence;
- Allegations of fraud so complicated that it becomes essential that such complex issues can be decided only by civil court on the appreciation of the voluminous evidence that needs to be produced;
- Serious allegations of forgery/fabrication of documents in support of the plea of fraud;
- Where fraud is alleged against the arbitration provision itself or is of such a nature that permeates the entire contract, including the agreement to arbitrate, meaning thereby in those cases where fraud goes to the validity of the contract itself of the entire contract which contains the arbitration clause or the validity of the arbitration clause itself.³

In *Ayyasamy*, the Supreme Court had further held that in the scenario where there are simple allegations of fraud touching upon the internal affairs of the parties *inter se* without any implication in the public domain, the arbitration clause need not be avoided and the parties can be relegated to arbitration.⁴

Applying the relevant principles from *Ayyasamy* to the instant allegations of siphoning and improprieties, the Supreme Court held that a distinction must be drawn between 'serious allegations' of forgery or fabrication supporting the plea of fraud, and 'simple allegations' - to determine arbitrability. It culled out two working tests from *Ayyasamy* to determine this distinction as follows:

"(1) does this plea permeate the entire contract and above all, the agreement of arbitration, rendering it void, or

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(2) *whether the allegations of fraud touch upon the internal affairs of the parties inter se having no implication in the public domain*⁵

Applying the aforementioned tests to the facts of the present case, the Supreme Court held that:

- i. There is no allegation of fraud which vitiates the Partnership Deed as a whole, including the arbitration clause:
- ii. The allegations pertain to the affairs of partnership and siphoning of funds, which do not pertain to matters in the public domain.

The Supreme Court held that the allegations are arbitrable as they fall within the ambit of 'simple allegations'. It set aside the judgment of the High Court and proceeded to appoint an arbitrator under Section 11 of the Act to resolve the disputes between the parties.

ANALYSIS

Upon an examination of the principles laid down in *Ayyasamy* and the twin tests set out in the instant case, one could argue that the Supreme Court has potentially narrowed down the thresholds to identify 'serious allegations of fraud', when courts are approached with an application for appointment of an arbitrator under Section 11 of the Act.

However, it must be noted that *Ayyasamy* involved an application under Section 8 of the Act. Section 8 provides a wider ambit to the Court to evaluate allegations of fraud for the purpose of referring the matter or denying reference to arbitration.⁶ In contrast, in an application under Section 11 of the Act, courts have a narrow purview to examine merely the *existence* of an arbitration agreement while appointing an arbitrator.⁷ It is therefore debatable as to whether the working tests suggested by *Ayyasamy* to determine the arbitrability of the allegation *in depth* propel courts to go beyond merely examining the *existence* of an arbitration agreement and conduct an enquiry upon the seriousness or simplicity of the allegations of fraud.

One could suggest that the Supreme Court has indeed assessed the existence of the arbitration agreement while laying out the first working test *i.e.* whether the existence of the arbitration agreement itself has not been vitiated by the allegation of fraud. However, the second working test hinges upon the effect of fraud either *inter se* the parties or in the public domain. A blanket application of this test to commercial disputes would always entail an effect *inter se* between the parties. However, since fraud by its very nature is both a civil action and a criminal offence, this enquiry would be a matter of fact in each case.

In any event, the Supreme Court's ruling does set a positive precedent ensuring cautioned and minimum interference by courts in matters involving arbitration and allegations of fraud. It also reposes faith in the arbitral tribunal to determine these allegations to fruition.

— Bhavana Sunder, Kshama A. Loya & Vyapak Desai

You can direct your queries or comments to the authors

¹ Civil Appeal no. 7005 of 2019 ("**Order**").

² A. Ayyasamy vs. A. Paramasivam, (2016) 10 SCC 386

³ A. Ayyasamy vs. A. Paramasivam, (2016) 10 SCC 386 at Paragraph 25.

⁴ *Id.*

⁵ Page 4, Order.

⁶ Section 8, Arbitration and Conciliation Act, 1996.

⁷ "(1) A judicial authority, before which an action is brought in a matter which is the subject of an arbitration agreement shall, if a party to the arbitration agreement or any person claiming through or under him, so applies not later than the date of submitting his first statement on the substance of the dispute, then, notwithstanding any judgment, decree or order of the Supreme Court or any Court, refer the parties to arbitration unless it finds that **prima facie no valid arbitration agreement exists.**" (emphasis supplied)

⁷ Section 11(6A), Arbitration and Conciliation Act, 1996.

⁷ "(6A) 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.**" (emphasis supplied)

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