

Dispute Resolution Hotline

November 07, 2013

THE BOMBAY HIGH COURT REAFFIRMS SEPARABILITY OF AN ARBITRATION CLAUSE

- The Court held that, for the arbitration agreement to be null and void, inoperative or incapable of performance the doctrine of separability requires a direct impeachment of the arbitration agreement and not simply a parasitical impeachment based on a challenge to the validity or enforceability of the main agreement.
- By applying this principle, it upheld the validity of arbitration agreement within a share purchase agreement declared null and void by a settlement agreement entered by the parties.

The Hon'ble Bombay High Court ("Court") on August 16, 2013 in *Mulheim Pipe coatings GmbH* ("Appellant") v. *Welspun Fintrade Ltd* ("1st Respondent") and *Anr.*¹ formulated the principles of the doctrine of severability and held that an arbitration clause in a share purchase agreement could survive annulment of the share purchase agreement by the parties.

FACTS

1st Respondent as 'Transferor', the Appellant as 'Transferee' and Welspun-Gujrat Stahl Rohren Limited ("2nd Respondent") as the Company entered into a Share Purchase Agreement dated December 10, 2004 ("SPA").

As per the terms of the SPA, a joint venture company by the name of Eupec-Welspun Pipe coatings (India) Limited (EWPL) was promoted inter alia by the Appellant and the 1st Respondent. EWPL was proposed to be merged with the 2nd Respondent. Pursuant to the merger, the 2nd Respondent issued shares to the shareholders of EWPL, including the Appellant in accordance with an agreed swap ratio.

As per clause 8 of the SPA the 1st Respondent had a Right of First Refusal ("ROFR") in case the Appellant decided to transfer its shareholding in the 2nd Respondent.

On October 6, 2009 Appellant issued a notice to the 1st Respondent, intending to sell its shares in 2nd Respondent at the market price as defined in the SPA and called upon the 1st Respondent to exercise its ROFR within fifteen days in accordance with the SPA ("Notice").

By its reply dated October 21, 2009, the 1st Respondent contented the validity of the Notice and informed the Appellant that notice of offer was not in accordance with the SPA.

A dispute arose between the parties and the Appellant invoked the arbitration agreement contained in Clause 11.13 of the SPA ("Arbitration Agreement") and proposed the nomination of a sole arbitrator to conduct the arbitration under the Rules of Arbitration of the International Chamber of Commerce ("ICC").

Subsequently, the 1st Respondent moved an application under Section 9 of Arbitration and Conciliation Act, 1996 ("Act") before the Court, and obtained an ex-parte order restraining the Appellant from alienating the shares in the 2nd Respondent.

Thereafter a Memorandum of Understanding ("MoU") was entered on March 17, 2010 between Appellant and 1st Respondent by which parties recorded a settlement.

As per the MoU, out of 8.5 Million shares of the Appellant in the 2nd Respondent, the 1st Respondent was to purchase 5 million shares and for the balance 3.5 Million Share, the Appellant could sell in monthly installments of 100,000 shares over period of 3 years. Importantly, upon signing this MoU the SPA stood null and void.

Post signing of the MoU, certain dispute arose between the Appellant and 1st Respondent pertaining to tax liabilities in relation to the transfer of 5 Million shares. The Appellant moved a Request for Arbitration (RFA) before ICC on May 25, 2011, *inter alia* seeking a declaration to sell shares to any third Party and claimed damages from the 1st Respondent. Thereafter the 1st Respondent filed a suit before the Court, *inter alia* praying for a declaration that SPA stood terminated and to declare the MoU valid and binding over the terminated SPA.

Appellant subsequently moved a petition under section 45 of the Act ("Petition") *inter alia* seeking a reference of the dispute to arbitration under clause 11.13 of the SPA. The single Judge rejected the Petition and held that parties have substituted the SPA upon the execution of the MoU *'in toto by recording fresh terms'* ("Impugned Judgment").

As a challenge to this order by the single judge the Appellant filed the present appeal before the two judge bench in the Court ("Appeal").

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ISSUE

The issue which was required to be deliberated by the Court was whether the single judge was justified in holding that the arbitration clause in SPA perished upon signing of the MOU and hence a reference under Section 45 of the Act could not be made?

ARGUMENTS BY THE PARTIES

Submission by Appellant:

The Appellant submitted that the MOU did not discharge, modify or vary the SPA and in effect, the arbitration agreement which is embodied in the SPA constitutes a separate and independent agreement by virtue of the provisions of Section 16 of the Act and Rule 6(4) of the ICC Rules to which the parties have subjected themselves. Further, the Appellant submitted that the MOU has, in fact, been entered into between the parties in exercise of the right of pre-emption under Clause 8 of the SPA. Moreover, it was submitted that the MOU which was arrived at between the parties arises out of or in connection with the SPA and the dispute which is sought to be raised before the arbitral tribunal is for the tribunal to decide.

Submission by Defendants:

The Defendants submitted that in order to make a reference under Section 45 of the Act there must be a valid, binding and subsisting arbitration agreement between the parties. They contended that the arbitration agreement in the SPA perished with the SPA by reason of the MOU being executed and the MOU has no arbitration agreement. Moreover, they submitted that the MOU put an end to the SPA completely and irrevocably substituted it by separate obligations inconsistent with those of the SPA. The terms of the SPA and MOU are so inconsistent that the two cannot subsist simultaneously and the MOU specifically provides that on its execution, the SPA has become null and void. The rights and obligations between the parties arise out of the MOU alone and not out of the SPA. Finally, they submitted that any dispute under the MOU would have to be resolved without recourse to arbitration as the MOU does not contain an arbitration agreement. The subject matter of the SPA is completely different and the arbitration clause cannot cover disputes under the MOU even if the arbitration agreement subsists.

HELD

The Court allowed the Appeal and set aside the Impugned Judgment. The Court held that, Section 45 incorporates the fundamental principle of the separability of the arbitration agreement, as distinct from the underlying contract between the parties of which the agreement to arbitrate is a part.

The court, to which an application under Section 45 of the Act has been made, has to determine as to whether the parties have made an agreement in writing for arbitration to which the New York Convention applies. If they have, the court has no discretion, but to refer them to arbitration, unless the case falls in the exception which is carved out by the provision. The exception is that the arbitration agreement must be found to be null and void, inoperative or incapable of being performed.

With regards when the arbitration agreement would be null and void, the Court importantly distinguished between termination bringing the further performance of the contract to an end and termination bringing the existence of the contract to an end. It opined that in the former case, like in the case at hand, the arbitration clause would survive whereas it was on in the latter that the arbitration clause would not survive.

Formulating the essential features of the doctrine of separability the Court held that:

1. Upon the termination of the main contract, the arbitration agreement does not ipso facto or necessarily come to an end and would depend upon the nature of the controversy and its effect upon the existence or survival of the contract itself;
2. If the nature of the controversy is such that the main contract would itself be treated as non est in the sense that it never came into existence or was void, the arbitration clause could not operate, for along with the original contract, the arbitration agreement would also be void;
3. Similarly, when the contract was validly executed but parties put an end to it, as if it had never existed, and substitute it with new contract solely governing their rights and liabilities thereunder, the arbitration clause forming a part of the old contract would perish with it;
4. But where only the future performance of the contract has come to an end and the contract is not put to an end for all purposes because there may be rights and obligations which had arisen earlier when it had not come to an end, the contract subsists for those purposes and the arbitration clause would operate for those purposes;
5. The doctrine of separability requires, for the arbitration agreement to be null and void, inoperative or incapable of performance, a direct impeachment of the arbitration agreement and not simply a parasitical impeachment based on a challenge to the validity or enforceability of the main agreement.

Accordingly, the Petition filed by the Appellant was made absolute.

ANALYSIS

The doctrine of separability was first formulated in France in the *Gosset* judgment,² five years later, the US Supreme Court also recognized the separability of the arbitration clause in the *Prima Paint* case³ and modern laws on arbitration confirm the concept. Since then, the doctrine has been widely acknowledged by courts, legislatures and institutionalized arbitration centers.

The '*separability*' doctrine is very essential to preserve the autonomy and integrity of the arbitral process. Without '*separability*', a party to an arbitration agreement would be able to avoid or delay arbitration merely by challenging or terminating the contract in which the arbitration agreement is found.

The Court has very correctly distinguished between termination of future performance of a contract and a contract being treated as non est and its varying impact on the arbitration agreement.

Certainly, this is a welcome judgment and is yet another step towards the ever growing pro-arbitration approach being adopted by the Indian judiciary.

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¹ Appeal (L) No. 206 of 2013 in Arbitration Petition No. 1070 of 2011 in Suit No. 2287 of 2011.

² Cour de Cassation, 1st Chamber, May 7, 1963, Dalloz, p.545.

³ Prima Paint Corp. v. Flood & Conklin Mfg. Co. 388 U.S. 395 (1967)

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