THE INDESTRUCTIBLE ARBITRATION CLAUSE

by The Honourable Mr Justice Rogers
and Rachel Launders*

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In *IBM Australia Limited v National Distribution Services Limited* (1991) 22 NSWLR 466, two members of the Court of Appeal suggested that an arbitrator had no jurisdiction to determine whether a contract, pursuant to a provision of which the arbitrator was appointed, was void *ab initio*. In *QH Tours Limited v Ship Design & Management (Australia) Pty Limited* (1991) 105 ALR 371, the Federal Court declined to adopt this view.

It is inimical to the proper working of the arbitral system that there should be doubt on the point. In the writers' opinion, the conclusion arrived at by Foster J in *QH Tours* is consonant with modern principle. First, the statements in *IBM* are in conflict with the law of Australia with respect to international arbitrations to which the International Arbitration Act 1974 (Cth) (hereafter referred to as "the Commonwealth Act") applies. Second, the law in other countries and a developing approach in England suggest that in relation to domestic arbitrations also, the statements in *IBM* are outdated.

The statements in *IBM* ignore the concept of separability, also known as severability, or autonomy, of the arbitration clause. The arbitration clause is treated as a separate contract. Provided the arbitration clause is not alleged to be tainted by the claimed clause of the invalidity of the principle contract, an arbitrator has jurisdiction to determine whether the principal contract is void. The arbitration agreement will be ineffective, or void, if the misconduct or fraud affects the entirety of the agreement. If the principal agreement alone is challenged, the arbitrator has jurisdiction to determine the dispute.

Separability is accepted in international arbitration, in the United States and in a number of countries in Europe. Recently, there have been signs of its acceptance by the English courts. It is largely untested in Australia. It was not referred to in *IBM*.

In *IBM*, National Distribution Services Limited ("NDS") claimed that computer equipment supplied by IBM Australia Limited ("IBM") was not suitable for

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its needs and sought arbitration as was required by the agreement between them. The points of claim alleged breaches of the contract and of section 52 of the Trade Practices Act 1974 (Cth) ("the Act"). NDS claimed damages pursuant to section 82 and further relief, which it did not particularise, under section 87. Section 87 provides, *inter alia,* for a declaration that a contract is void *ab initio.* IBM sought a stay of the arbitration in so far as it involved the Act.

IBM submitted that the range of remedies available under section 87 of the Act was so wide that the parties could not have intended an arbitrator to have those powers. In that context, Clarke JA said (pp. 485-486):

> Particular reliance was placed in these submissions upon the power now granted to the court under s. 87 of the Act to declare contracts void ab inito. The significance of this power is that the effect of a declaration that a contract, which contains an arbitration clause, is void ab initio is that there never was a contractually valid submission to arbitration: see *Heyman v Darwins Limited* [1942] AC 356 at 367, 383 and 395; *Codelfa Constructions Pty Ltd v State Rail Authority of New South Wales* (1982) 149 CLR 337 at 364; 41 ALR 367 . . . [p. 486] . . . an arbitrator is not able to decide, or make a declaration, that the contract containing the submission is void ab initio for that would be tantamount to deciding that he had no jurisdiction at all. *That this is the law has been long understood and there is no reason that principle should not operate to exclude from the ambit of an arbitrator's powers the authority to make a declaration under s. 87 that a contract is void ab initio.* (emphasis added).

Handley JA agreed (p. 487):

> I agree that an arbitrator, whose jurisdiction arises under a submission which is a term of a contract, cannot exercise a power to avoid that contract ab initio. Such an award would destroy his jurisdiction or authority to make any award at all.

In *International Arbitration: Three Salient Problems* (Grotius Publications, Cambridge, 1987), Judge Schwebel, of the International Court of Justice, said (pp. 2-3):

> If it is inherent in the arbitral (and judicial) process that a tribunal is the judge of its own jurisdiction, that it has competence de la competence, it is no less inherent in that process that an arbitral tribunal shall have the competence to pass upon disputes arising out of the agreement which is the immediate source of the tribunal's creation *even where those disputes engage the initial or continuing validity of that agreement. This essential doctrine of modern arbitration* is called that of the severability, separability or autonomy of the arbitration agreement. (emphasis added).

According to Schwebel (pp. 3-6) separability can be justified in four ways: first, the intention of the parties. If they choose an arbitration clause in wide terms, as in *IBM,* they intend *all* disputes connected with the transaction to be resolved through arbitration. They would be unlikely to intend that part of a dispute be arbitrated and part heard in the courts.

Second, if a party could avoid arbitration merely by asserting that the principal agreement is invalid, it would be a very simple way to avoid arbitation or to delay the resolution of the dispute. A court would have to determine whether the contract was valid at its inception. Then parties would need to arbitrate the rest of the dispute. The advantages of arbitration would be lost.

Third, an arbitration clause is a separate agreement to the main agreement.

Schwebel's reasoning is that (p. 5):

> when the parties to an agreement containing an arbitration clause enter into that agreement, they conclude not one but two agreements, the arbitral twin of which survives any birth defect or acquired disability of the principal agreement.

The use of the legal fiction is both justified and well accepted. If the parties entered a separate arbitration agreement, it would not be affected by the invalidity of the main contract. There is no justification for a different conclusion where the arbitration clause appears in the body of the one agreement. Steyn J relied on this argument in *Paul Smith Ltd v H & S International Holding Inc* [1991] 2 Lloyds Rep 127, 130 (see infra).

Finally without separability a court might be required to consider the substance of the dispute. This would be necessary to determine whether the arbitrator was correct in finding that the agreement was valid and that the arbitrator had jurisdiction. To allow this would conflict with the widespread practice precluding a review of an award on the merits.

Judge Schwebel refers to Article 21 of the UNCITRAL Arbitration Rules and Article 16 of the Model Law on International Commercial Arbitration, which provide that an arbitration clause shall be treated as an agreement independent of the other terms of the contract. The Articles state in terms that a decision by the arbitrator that the contract is null and void does not entail *ipso jure* the invalidity of the arbitration clause.

Commenting on Article 16, Kaplan J of the High Court of Hong Kong in *Fung Sang Trading Ltd v Kai Sun Sea Products & Food Co Ltd* (29 October 1991, unreported) said (p. 21):

> Article 16(1) enshrines the doctrine of separability which English law has partially recognised since *Heyman v Darwins Ltd* [1942] AC 356.

Kaplan J pointed out that the doctrine of separability extends to claims of initial invalidity of contracts. Acceptance of the principle of separability demonstrates "that commercial reality is to be preferred to logical purity" (p. 29).

In 1989, by amendments to the Commonwealth Act (section 16(1)) the UNCITRAL Model Law, including Article 16, was adopted in Australia. It applies to international commercial arbitrations only (Article 1(1)). Thus, at least for international commercial arbitrations, the views expressed in *IBM* do not accurately represent the law. It is submitted that Australian courts should adopt the principle in domestic arbitrations also. Uniformity between international and domestic agreements should be encouraged, to promote certainty. The dispute in *IBM* was between the Australian subsidiaries of two large international organisations. It was purely fortuitous that the dispute did not satisfy the test of being "international".

There are other international instruments which endorse separability, either expressly or impliedly. (Cf, the Rules of Court of the Court of Arbitration of the International Chamber of Commerce; Svernlov, "What Isn't, Ain't" (1991) 8 J.Int.Arb.37; Schwebel, pp. 13-23). The principle of separability is also supported by international arbitration practice. (Cf *Texaco Overseas Petroleum Company*

v The Government of the Libyan Arab Republic (1975) 53 ILR 393).

There is national support for separability.

(i) United States of America

In *Robert Lawrence Co Inc v Devonshire Fabrics Inc* 271 F. 2d 402 (1959), Medina J., for the Court of Appeals for the Second Circuit, said (p. 410) that illegality, breach and repudiation of the main agreement will not affect an arbitration clause, as it is separate from the rest of the contract. The parties may define the extent of the arbitrator's jurisdiction, in the arbitration clause. In *Prima Paint Corp v Flood & Conklin Manufacturing Co* 388 US 395 (1967), Fortas J, delivering the opinion of the Supreme Court of the United States, held that an arbitration clause was separable unless the parties intended otherwise.

(ii) England

Until very recently, separability had made restricted headway in English law. Prior to *Heyman v Darwins Ltd* [1942] AC 356, it was accepted that an arbitration clause fell with an accepted repudiation or frustration of the contract. In *Heyman*, the House of Lords unanimously held that the abitrator had jurisdiction to decide whether the contract was brought to an end by an accepted repudiation.

It was accepted that repudiation, breach and termination of the principal agreement do not destroy the agreement to arbitrate. A difficulty arises because the majority, Viscount Simon LC (p. 366) and Lord Macmillan (p. 371), with whom Lord Russell agreed, went on to express the opinion that if a party claims that a contract is void *ab initio*, an arbitration clause cannot operate on that claim. In a careful analysis, Steyn J has recently shown these comments by their Lordships to be *obiter*.

Lord Wright took a broader view (p. 384):

> It is all a question of the scope of the submission. Hence, if the question is whether the alleged contract was void for illegality, or, being voidable, was avoided because induced by fraud or misrepresentation, or on the ground of mistake, it depends on the terms of the submission whether the dispute falls within the arbitrator's jurisdiction.

Lord Porter also held that the scope of the arbitration clause determines whether an arbitrator has jurisdiction to hear a dispute in which one party alleges that the contract was void *ab initio*. In his opinion also, there is no reason why the parties cannot agree in advance that the arbitrator may determine whether the contract ever bound or continues to bind the parties (pp. 391-392).

For a long time, the restrictive view of the majority held sway (e.g. *Ashville Investments Ltd v Elmer Contractors Ltd* [1988] 2 All ER 577 per Balcombe LJ at p. 589 and May LJ at p. 586).

However in 1990 Steyn J in *Paul Smith Ltd* (supra) reviewed the English doctrine of separability. He noted that (p. 130):

> Rescission, termination on the ground of fundamental breach, breach of condition, frustration and subsequent invalidity of the contract, have all been held to fall within arbitration clauses. Even what was once perceived to be the 'rule' that a rectification issue always falls outside the scope of an arbitration clause has given way to the realism of the separability doctrine.

He accepted that there was no English decision finding that an arbitrator had jursidiction to decide whether a contract was void *ab initio*. However, given that an arbitration clause is independent of the main contract, Steyn J saw no reason why an arbitrator should not have this power. It is a natural step in the law governing arbitration. He concluded (p. 131):

> it is possible to say with confidence that the evolution of the separability doctrine in English law is virtually complete.

In *Harbour Assurance Company (UK) Ltd v Kansa General International Company Ltd* [1992] 1 Lloyds Rep 81 Steyn J made a much more extensive examination of the authorities and of principle. He pointed out that because the invalidity, discharge, termination or rescission of the contract did not cause the arbitration agreement to fall with the principal contract, the principle of separability was already part of English law. The question was where the line should be drawn.

He concluded that the statements by the majority in *Heyman* on whether an arbitrator had jurisdiction to declare a contract void *ab initio* were not part of the *ratio decidendi* of the case. Other decisions were also not binding. Older cases on separability needed to be treated with caution as the policy behind arbitration had changed, to favour party autonomy (p. 88).

After finding an absence of binding precedent, Steyn J pointed out that invalidity of an agreement could be arbitrated if the arbitration agreement was entered into after the dispute arose, between the execution of the contract and the time the dispute arose, or at the same time as the principal contract (p. 86). In logic, the arbitration clause, as a separate clause, should be in the same position (p. 92):

> Once it became accepted that the arbitration clause is a separate agreement, ancillary to the contract, the logical impediment to referring an issue of the invalidity of the contract to arbitration disappears. Provided that the arbitration clause itself is not directly impeached . . . the arbitration agreement is as a matter of principled legal theory capable of surviving the invalidity of the contract. After all, such an arbitration clause is, by reason of its categorization as a separate agreement, in the same position as an arbitration agreement contained in a separate document but executed at the same time as the contract. Logically, there is no obstacle in either case to the arbitration agreement surviving the invalidity of the contract.

Commercial expectations (p. 92) and the public interest (p. 93) also supported this result. It allowed the arbitral process to be effective by recognising party autonomy.

However, Steyn J was not able to reach the same conclusion with respect to initial illegality, being bound by the decision of the Court of Appeal in *Smith, Coney & Barrett v Becker, Grey & Co* [1916] 2 Ch 86. The judge was of the opinion that this was an undesirable distinction between initial invalidity and illegality which should not prevail (p. 95).

(iii) Europe

In *Sonatrach v KCA* 116 BGE Ia 56, JT 1990 I 563 (referred to in (1991) 2 World

Arbitration & Mediation Report 297) the Swiss Supreme Court held that, because of its procedural nature, an arbitration clause was an independent clause. It continued to have force after the parties had terminated the principal contract. As the parties had not provided otherwise in their termination agreement, they were presumed to have intended to arbitrate a dispute concerning the termination.

The Netherlands, Belgium, Sweden and France accept both separability and the arbitrator's power to determine whether a contract is void *ab initio*. (Cf Schwebel, pp. 58-59 and AL Marriott, "*Jurisdiction, Power and Authority of Arbitrators*", The School of International Arbitration, University of London, pp. 24-28).

The only Australian authority referred to in *IBM* was *Codelfa* (supra). The relevant issue there was the arbitrability of a claim of frustration. With respect, Mason J (with whom Stephen, Aickin and Wilson JJ agreed) went much further than the resolution of the question for decision required. It would have been sufficient simply to take from *Heyman* the conclusion that frustration of the main contract left the arbitration clause intact. However, his Honour followed the *obiter* statements in *Heyman* when he said, (p. 365):

> *In its application to an arbitration clause the distinction between a contract which is void ab initio and a contract which is valid but subsequently repudiated is well taken.*

Codelfa does not create an insurmountable barrier to the acceptance of separability. The part of the judgment quoted is *obiter*. In addition, *Codelfa* was decided seven years before the Commonwealth Act was passed.

It is submitted that the view expressed in *Codelfa* is ripe for reconsideration. It is preferable to adopt a domestic law which accords with the Commonwealth Act. That Act shows that the legislature accepts in full the principle of separability, in an international context. It should be part of the domestic law unless there are considerations which make the principle unsuitable for domestic arbitrations. There are none.

In *QH Tours*, Foster J accepted the existence of the principle of separability in Australian domestic arbitration without explaining, in great depth, his reasons for doing so.

In its setting, *QH Tours* was much like *IBM* except that the applicant expressly sought an order under section 87 of the Act that the contract be declared void either *ab initio* or from some later time or, alternatively, that it not be enforced.

Foster J was of the opinion that the statements in *IBM* were merely *obiter*, as the relief claimed in *IBM* did not include a declaration that the contract was void *ab initio* (p. 379).

Foster J's approach reflects that of Steyn J in *Harbour Assurance*, although Foster J does not refer to that decision. His Honour held that the statements of the majority of the House of Lords in *Heyman* were not binding authority on this point. He felt able to take this approach notwithstanding that in *Ashville* and other cases, the speeches of the majority in *Heyman* were accepted as correctly stating the law (pp. 380-384). His Honour referred to the quoted statement by Lord Wright in *Heyman* (p. 378) with approval. Foster J said (p. 384):

> I am not satisfied that there is any rule of law which prohibits the empowering of an arbitrator to decide the initial validity of the contract containing the arbitration clause. With respect to those who hold a different view, I do not consider that there is any "received doctrine" to this effect. Moreover, having regard to the specific nature of an arbitration clause, as discussed by Lord Wright in *Heyman*, I consider that, generally speaking, it can be regarded as severable from the main contract with the result that, logically, an arbitrator, if otherwise empowered to do so, can declare the main contract void ab initio without at the same time destroying the basis of his power to do so."

If this issue arises again in a State court, the decision of Foster J in the Federal Court, the American cases and the two decisions of Steyn J should be followed. The obiter views expressed in *Heyman, Codelfa* and *IBM* do not promote party autonomy or the use of arbitration as a dispute resolution method.

INSTITUTE COURSES/ CONFERENCES 1993

Institute Conference

2-4 May 1993	Hyatt Hotel, Sanctuary Cove, Gold Coast, Queensland

John Keays Memorial Lecture

3 May 1993	Hyatt Hotel, Sanctuary Gove, Gold Coast, Queenland

General Residential Arbitration Courses

4-7 May 1993	Bond University, Gold Coast, Queensland
July/August 1993	Sydney, New South Wales

Advanced Residential Arbitration Courses

October/November 1993	Sydney, New South Wales.

The dates should be reserved now. Details of venues, programme, etc, will be mailed to members later on.