ARBITRATION IN ILLEGAL CONTRACTS

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The basic question of law is that whether the specified arbitrator or the Court shall decide the questions/disputes arising out of an illegal/unenforceable contract[1]. A class action was brought against interest rates higher than Florida usuary law[2] allows. Contention was that the arbitration clause was part of an illegal contract and therefore *void ab initio*. The question presented in the Supreme Court of the United States was whether the Florida Supreme Court erred by holding consistent with the Alabama Supreme Court, but, in direct conflict with the "Federal Arbitration Act" which allows a party to avoid arbitration by claiming that the underlying contract containing an arbitration clause is void for illegality, therefore, by inference, unenforceable in toto.

The question presented in the Supreme Court of the U.S.A. was to reflect it's view on whether the "severability doctrine" applied to claims which are void for illegality. If the severability doctrine applies, the rate of interest may be reduced by the court and the remaining agreement may be deemed enforceable as the illegality i.e. the excess rate of interest is removed by the court and excess rate is reduced. Another dimension of the matter is that the moneylender itself reduces the rate of interest to avoid court litigation and insists on arbitration proceedings. It is submitted that in this case, the usuary agreement would become legal and enforceable in any case. Another legal aspect is that, if the court affirms and holds that the claims should be decided by the courts, the policies behind the Federal Arbitration Act, which allows a party to avoid arbitration by claiming that the underlying contract containing arbitration clause is void for illegality, **may suffer.** If the Court, decides otherwise, the consumers, consumer protection regulation, and the integrity of the judicial system as a whole may negatively affect. The definition of arbitrability given by Craig, Park and Paulson is as follow:-

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Author's Note: [1] This lecture was delivered in the training course of Second Batch of Additional District & Sessions Judges on Nov 14, 2009 & Nov 16, 2009 at Punjab Judicial Academy, Lahore.

[1] This question arose in the case titled "Buckeye Check Cashing V. Cardenga (04-1264), Appealed from: Florida Supreme Court (Jan, 20, 2005) Oral arguments (Nov. 29, 2005) to the Supreme Court of USA.

[2] A law which prohibits money lenders from charging illegally high interest rates.

> "the concept of arbitrability is limited to the inquiry whether the claims raised are prohibited by law from being resolved by arbitration, irrespective of the otherwise undoubted jurisdiction of the arbitral tribunal"[3].

The fundamental principle of any arbitration is the free will and consent of the parties to arbitrate their dispute. However, there is a "**subjective arbitrability**" and an "**objective arbitrability**". Objective arbitrability is the restriction or limitation on matters referred to arbitration by national laws. As Lew, Mistellis and Kroll indicate, certain disputes may involve such intensive public policy issues that it is felt that they should only be dealt with by the judicial authority of State Courts.[4] An obvious example is criminal law which is generally the domain of the national courts. These disputes are not capable of settlement by arbitration. This restriction on party autonomy or discretion of the contracting parties is justified to the extent that arbitrability is a manifestation of national or international public policy. Consequently, arbitration agreement covering those matters will, in general, not be considered valid, will not establish the jurisdiction of the arbitrators and the subsequent award may not be enforced.

There are a number of matters in which the arbitrability has been argued, contested or opposed in particular in the fields of contracts *contra bonos mores*, (contracts against good morals), claims in tort, competition anti-monoply/anti-trust law, patents and trademarks, bankruptcy, securities law, trade boycott, employment agreements, consumer transactions and matters of personal status[5].

Criterias For Arbitrability

The jurists have selected/proposed/determined eight different methods/criterias to determine as to whether an issue is arbitrable.

i. The local/national law of the parties needs to be looked into.
ii. The law to which a contract has been subjected to.
iii. Assuming arbitration clause is non-existent in the contract, the law of the country whose courts will be competent to adjudicate the matter.

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[3] Lawrence Craig, William Park and Jan Paulson, "International Chamber of commerce Arbitration", 3rd Edition (1998) p.60.

[4] Julian Lew, Loukar Mistelis and Stefan Kroll, "Comparative International Commercial Arbitration", (2003) p.188.

[5] Lawrence Craig, William Park and Jan Paulsson, *op-cit*, p.69

iv. The law(s) of the country or countries where the execution/enforcement of the award is to take place.

v. The law governing the arbitration agreement.

vi. A combination of laws attracted to the facts and circumstances of the case.

vii. Common and general, internationally recognized, principles of law.

viii. The venue of the arbitration tribunal selected by the parties in the contract or otherwise.

Additionally, in the majority of cases courts have determined the question of arbitrability at the pre-award stage **according to their national law** taking as a basis art. V(2)(a) of New York Convention and art. VI(2) of the European Convention[6]. The tribunals have also determined the arbitrability of a dispute on the basis of **provisions of the place of arbitration**[7].

Basis of Illegality

Not all allegations of illegality make the dispute not arbitrable. What clauses render a contract wholly illegal and what clauses will be simply deemed as non-existent being illegal, keeping the remaining contract intact/enforceable as far as possible will depend on the (i) statute and (ii) public policy.

Illegal contracts are illegal by statute or are illegal at common law on the grounds of being contrary to public policy. This is the basic criteria. Where a provision is regarded as being void or illegal it may be possible to severe it to allow the remaining part of the contract to be enforced. It has also been seen that severance may also be possible where a contractual provision is regarded as being "**uncertain**[8]**.**"

In England, doubt has been cast upon whether severance applies in the case of an illegal contract[9]. However, in Australia any

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[6] *See also*, Bernard Hanotiau "what Law governs the issue of arbitrability", 12 *Arbitration International*, (1996) pp.391, 398

[7] Julian Lew, Loukas Mistelis and Stephan Kroll, *op-cit*, 2003, p.197

[8] *See* e.g. Whitelock V. Brew (1968)

[9] *See* e.g. Bennet V. Bennet (1952) 2 K B 249.

such doubt was dispelled by the High Court in Thomas Brown & Sons. Ltd. V. Fazal Deen[10], which held that in an appropriate case a court may severe an illegal promise. It may be, however, that, that court will take into account the nature of the illegality as a factor when deciding whether severance is appropriate in a particular case. In the case of statutory invalidity, the courts do not seem to have much discretion with regard to **"severability"**. However, in the case of "**public policy"**, the courts may use their discretion on a case to case basis.

Unlawful Agreements/Contracts by Statute:

For example:

i) agreement without consideration;

ii) agreement in restraint of marriage;

iii) agreement in restraint of trade;

iv) agreement in restraint of legal proceedings.

In such like illegal agreements/contracts, the courts do not seem to have any discretion with regard to severability. However, in the cases of public policy, court may look into the matter and use discretion judiciously on a case to case basis.

Agreements/Contracts Illegal Due To Public Policy.

Among the agreements, which are illegal as tending to injure the public interest, some are as follows:

i) Agreements by public officers for greater pay than is fixed by law for performance of official duty, or for less pay where the services are yet to be performed;

ii) Assignment of future salary, and, under some circumstances his pension, by a public officer;

iii) Lobbying contracts, to influence legislation by personal solicitation of the legislators, or other objectionable means[11].

From reading the above, one can understand that a very heavy **burden of discretion** is cast upon the courts.

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[10] *See* e.g. Thomas Brown & Sons Ltd. V. Fazal Deen (1962) 108 CCR 391. (See also Carney V. Herbert (1985) AC 301)

[11] *See*, Lawrence P. Simpson, "Contracts" (Los Angeles 1965).

<u>Serverance Criteria</u>.

The question of severance depends upon determining of the intention of the parties, and the seriousness of the illegality. In the cases where severance may be refused[12], two other substantive rules are important[13].

- Severance must be achieved by taking out the objectionable parts, but must not require the court to rewrite the contract[14] just like amendment in pleadings cannot make out a new case.

- Severance may correct the intent only but not the basic kind or the nature of the contract[15].

Severance may take one of a number of forms; severance of dealing within a larger enterprise or transaction severance of an offending provision from the remainder of the contract and severance of an offending part of a provision.

<u>Presumption In Favour Of Arbitrability</u>.

Not every allegation of illegality makes the disputes not arbitrable. **<u>There is a heavy presumption in favour of arbitrability</u>**. Some court decisions have confirmed that any doubts concerning the scope of arbitration should be resolved in favour of arbitration[16]. If the provisions of the contract which raise the question of illegality are of such kind that they require the dispute to be decided by the courts, there will be no question of arbitrability[17].

<u>As a general rule, "court may refuse to enforce contracts that violate law or public policy"</u>[18]. Generally three criterias are used for determination as to whether a certain dispute is arbitrable:

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[12] Severance may be refused where the illegality is deemed to be "calculated" or "oppressive". *See e.g.* "Horwood v. Miller's Timber & Trading Co. Ltd. (1917) 1KB 305"

[13] *See also* N.Thompson, "The Rights of Parties to Illegal Transactions, (Federation press) (Sydney 1991)" p.130.

[14] *See, e.g.* Esso Petroleum Co. Ltd. V. Harper's Garage Ltd. (1968) AC 269 at 295. **<u>This is known as the blue pencil test.</u>**

[15] M.C.Farlen v. Daniell (1938) 38 SR (NSW) 337 at page 345.

[16] First option of Chigaco, Inc. V. Kaplan, 514 U.S. 938, 1995.

[17] Julian Lew, *Loc cit*, 2003, p.210.

[18] United Paperworks International Union, AFL-eio V. Misco, Inc., 484 U.S 29, 41 1987. W.R. Grace & Co. V. Rubber Workers 461 U.S 757, 766, 1983.

(i) Withdrawing some matters considered to be of public policy.

(ii) Withdraw matters in which the public has been ignored by the parties.

(iii) To allow arbitrators to decide on disputes pertaining to public policy matters but making the Award appealable in the court[19]and it shall not be final.

Pursuant to the principle of the autonomy or severability **the arbitration agreement has an autonomous existence distinct from the contract that it may be contained in main**. The essential function of this doctrine of the arbitration agreement being separate from the main contract, is to prevent the jurisdiction of arbitration tribunal from being frustrated by a mere allegation that the underlying contract is null and void and to permit the arbitral tribunal to decide whether this is the case that they should decide, and if so, to decide also upon the consequences. This principle is recognized by most of the arbitration legal regulations, like the UNITRAL Rules of the UNITRAL Law, the ICC Rules (6, 4), etc.[20]

In short, illegal contracts cannot be arbitrated because they are not arbitrable. There are certain exceptions to this rule which have been enumerated above.

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[19] Philippe Fouchard, Emmanial Gaillard and Berhold Goldman, "Trait`e de l Arbitrage Commercial International 1996, p.349.

[20] Yves Derains and Eric Schwartz, "A Cnide to the ICC Rules of Arbitration, 2005, p.111.