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Pre-deposit Clauses in an Arbitration Agreement: Are Arbitration Agreements Justiciable?

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The Indian Supreme Court recently in *M/s Icomm Tele Ltd. vs. Punjab State Water Supply & Sewerage Board,* ("**Icomm**"), struck down a clause in an arbitration agreement as unconstitutional. The clause mandated a pre-deposit of 10% of the amount claimed in the arbitration proceeding. The Court found this clause to be arbitrary and resulting in a discouragement to arbitrate. While giving the judgment, the Court relied on the importance of alternative dispute mechanisms and the need to de-clog the court machinery. However, the judgment seems to raise more issues than it answers by extending the power of judicial review of courts to private agreements. It also brings to light the dichotomy of the Court to put a higher standard whenever the State is impleaded as a party. While, this may be necessary for social justice, it is interesting when similar principles are not extended to private parties.

The judgment in Icomm

The decision in *Icomm* was the result of an appeal to a writ petition filed in the Punjab and Haryana (P&H) High Court. The petitioner company had been awarded a tender for various civil/electrical works in the country by the respondent. Clause 25 of the notice inviting tender contained an arbitration clause which required a 10% of the amount claimed as pre-deposit to avoid "frivolous" claims. The clause also stated that in the event of a favourable award, the deposit will be refunded to him in an amount proportionate to the amount awarded, and the balance, if any, will be forfeited and paid to the other party. The petitioner claimed that this was arbitrary and opposed to public policy. However, the High Court refused to go into the merits of this contention and dismissed the writ. It stated that this was in nature of a private contract which was an open agreement and freely consented to by both the parties.

The Supreme Court on appeal overruled this judgement and accepted the contention of the petitioner. It stated that contracts of tender are justiciable since there is an element of public policy involved. What is interesting to note is that the precedents cited by the Court to support this power of judicial review all tested the procedure of awarding. The scope of judicial review is limited to the check of any bias inherent in the performance of administrative functions as understood in *Tata Cellular vs. UOI* , ("**Tata**"), which is cited by both the courts. The Supreme Court relied on this case but unlike the High Court, did not divulge into the application of the principles of *Tata* in later cases.

The High Court discussed this case in detail and distinguished the application of the principle given from the facts of the case at hand. For instance, in *Raunaq International vs. IVR Construction Ltd.*, ("**Raunaq**"), the presence of any direct or indirect harm to the public (in the form of say undue delay in the construction of public utilities) was recognized as the core concern. The Wednesbury principle of unreasonableness was also considered to test arbitrariness wherever such harm was present. *Jagdish Mandal vs. State of Orissa*, applied and further explained the principles given in *Raunaq*. The Court here stated that the scope of judicial review in commercial transactions is very limited and the principles of equity and natural justice stay at arm's length. But even these cases only questioned the fairness of procedure of grant of tenders and not any arbitration clause in their agreement.

The Supreme Court did accept that the review of private contracts is limited when it denied the petitioner's contention that the notice was a contract of adhesion. In saying this, it held that imbalance of power cannot be claimed in commercial transactions. But, the specific nature of this clause, especially the part which allowed forfeiture of deposit by the party against whom an award had been passed, compelled the Court to hold clause 25 to be violative of Article 14 of the constitution. The Supreme Court distinguished the present case from *S.K. Jain vs. State of Haryana (P&H HC)*, ("**SK Jain**"), in which a similar pre-deposit clause was challenged but was held to be valid.

The clause in *SK Jain* was valid and distinguishable on two grounds – the amount deposit in terms of percentage chargeable increased with the increase in the quantum involved and there was no forfeiture. The pre-deposit was thus considered logical in light of being the balancing factor to prevent frivolous and inflated claims. In the present case the Court did not find any such nexus with frivolousness. This was because the clause required a 10% pre-deposit of the amount claimed in every instance of arbitration, no matter if the claim was genuine. The Court also opined that the courts, and by implication the arbitrator, can always dismiss frivolous claims with exemplary costs. There was no need for a party to have such pre-deposit clauses in their contract.

According to the Court, "Deterring a party to an arbitration from invoking this alternative dispute resolution process by a pre-deposit of 10% would **discourage arbitration, contrary to the object of de-clogging the Court system** and would render the arbitral process **ineffective and expensive**".

The doctrine of freedom of contract vis-à-vis government contracts

This is not the first time that the Court has made special concessions to impose a higher degree of public interest in arbitration proceedings where the State is involved. In *Datar Switchgears Ltd. vs. Tata Finance Ltd.* (2000), ("**Datar**"), the Supreme Court held a clause which allowed one party to single-handedly choose the arbitrator is the event of a dispute to be valid. This was because of the doctrine of freedom of contract which gave complete discretion to the parties to choose their own terms. This has been upheld in several other cases involving two private parties.

The situation is slightly different when the State is involved. In *Voestalpine Schienen GmbH vs. DMRC Ltd.*, the Court questioned a clause which allowed DMRC to choose a pool of arbitrators from which the other party could proceed to appoint one. It opined on the necessity of independent and impartial arbitrators in an arbitration process and discussed the importance of neutrality of

arbitrators as set out in Section 12(3) of the Arbitration and Conciliation Act, 1996 (A&C Act). It also discussed the application of the provision in relation to contracts with State entities and how the balance between procedural fairness and the binding nature of contracts has been titled in favour of the former.

But the court did not invalidate the clause, nor did it extend the interpretation of section 12. It merely stated that there was a need to have a healthier and fairer environment for arbitration and send positive signals to the international business community. It categorically stated that the duty to do so is higher when one of the parties is the government. The case also stated that the theory of forfeiture in *Datar* is still binding precedent but failed to discuss the implications of freedom of contract where an instrumentality of the State is involved.

Conclusion

It is difficult to state that the judgment lays down a clear ratio with respect to the justiciability of arbitration agreements. It is simply restricted to the special facts of the case. Since *SK Jain* was distinguished and not overruled, thus, pre-deposit clauses are by themselves not banned. What the judgement reflects is the anxiety of the Judiciary to encourage ADR mechanisms in the country and try to keep up in pace with the international pressure to make the country more arbitration-friendly. However, it is not uncommon to see such arbitrary clauses as seen in *Icomm*, in private contracts. Unlike what the Court might want to believe, there is often a power imbalance which is exploited by the party making the contract. What will be interesting to see is how such an approach could help pierce the domain of arbitrary clauses between two private entities. Perhaps, the Court could test such an agreement via section 23 of the Indian Contract Act which declares contracts against public policy as void. But even this section is attracted when the object of the agreement is against public policy. If it can be used when only one clause in the agreement is questioned only time will tell.

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