Arbitrator's Power To Determine Whether A Contract Is Void Ab Initio

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In an article which appeared in the *Australia Law News* in October 1992, His Honour Mr Justice Rogers and Rachel Launders championed the view that arbitrators had the jurisdiction to determine whether a contract, pursuant to a provision of which they were appointed, was void ab initio.

In so doing, the learned authors suggested that the views to the contrary expressed in *Heyman v Darwins Limited* [1942] AC 356 @367, 383 and 395, *Codelfa Constructions Pty Limited v State Rail Authority of New South Wales* (1982) 149 CLR 337 @364 and in *IBM Australia Limited v National Distribution Services Limited* (1991) 22 NSWLR 466 @485-486 and 487, should not be followed. They based their arguments on the concept of separability or severability of an arbitration clause from the principal contract.

At the time of their article, the decision of Foster J in *QH Tours Limited v Ship Design & Management (Australia) Pty Limited* (1991) 105 ALR 371 was the sole Australian decision which declined to adopt the views expressed in the above decisions. The learned authors stated:

> '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.'

Nearly 2 years later the Court of Appeal in *Ferris and anor v Plaister and anor, Stapp and anor v Grey and anor* (Court of Appeal, 17 August 1994) held that an arbitrator was entitled to determine whether the contract containing the arbitration agreement under which he was appointed, was void ab initio by reason of fraud.

The facts of *Ferris v Plaister* were straightforward. The appellants had entered into building contracts with Venture Industries Pty Limited under the BC3 form of building contract. The contracts were for work of a domestic nature. Disputes and differences arose. Arbitrators were appointed. Conferences between the parties and the arbitrators were held. After the arbitration had commenced, the appellants discovered facts which led them to say that Venture had obtained its building licence by fraud. There had been a forged testamur of a degree of Bachelor of Building which the controller of Venture had claimed had been awarded to him. There was no dispute that the degree was a forgery.

On this discovery, Mr and Mrs Ferris rescinded their contract with Venture ab initio by reason of fraud. They then instituted proceedings in the Supreme Court of New South Wales seeking to restrain the arbitrator from proceeding with the arbitration. Mr and Mrs Stapp were in a similar factual position and took similar steps.

Young J ultimately declined to restrain the arbitrator from proceeding and ordered the arbitration to proceed pursuant to the *Commercial Arbitration Act 1984*. In reaching this conclusion Young J found that the arbitration clause was severable from the rest of the contract and that the clause itself was in fact drafted in wide enough terms to cover the disputes between the parties. Mr and Mrs Ferris appealed.

The appeal against Young J's decision was dismissed by the Court of Appeal.

The concept of severability was accepted by the Court.

Kirby P grounded his judgment on the concept of severability which he described in a comprehensive fashion. Mahoney JA accepted 'the device of severability as a useful device for achieving the accommodation of legal logic'. He construed the words used in the arbitration agreement as being wide enough and as being drafted in a way which indicated an intent that the particular disputes were to be decided by arbitration. Clarke JA referred to the orthodox view stated in *Heyman v Darwins Ltd* (and accepted as correct by himself and Handley JA in the *IBM* case). He went on to say that since Heyman, it has come to be recognised that an arbitration agreement is regarded as a separate or collateral contract. In the *IBM* case, the orthodox view referred to in *Heyman* was not argued, but was referred to by the court to illustrate a point. However, on the point being placed in issue and fully argued, Clarke JA stated that once it was recognised that an arbitration agreement was separate or collateral, the logic underpinning the arguments in *Heyman* disappeared. Clarke JA based his judgment on the width and proper construction of the arbitration clause under review.

It is clear that there has been a retreat from the long accepted position that an arbitrator has no jurisdiction to consider whether or not a contract was void ab initio, as expressed in *Heyman, Codelfa* and *IBM*. What is also clear is that the concept of severability has obtained a recognition in Australia in the judgments of Foster J in *QH Tours Limited v Ship Design and Management (Australia) Pty Limited* (1991) 105 ALR 371, Einfeld J in *Morton v Baker* (Federal Court, unreported, 25 March 1993) and Young J (at first instance) and Kirby P, Mahoney and Clarke JJA (in the Court

of Appeal) in *Ferris v Plaister*.

In the context of the acceptance of the doctrine of separability or severability, it is relevant to keep in mind that the doctrine applies to the situation where a party is contending that the contract which contains the arbitration clause is void ab initio. In those circumstances, the arbitration agreement contained in the relevant clause will be seen as separate or collateral, or separable or severable, whatever terminology is used. The arbitration agreement survives to do the work for which it was created, to refer disputes to arbitration. It is at this point that a separate exercise has to be carried out. That is the construction of the arbitration agreement to determine whether or not the words employed confer upon the arbitrator the jurisdiction to determine disputes about, as in *Ferris v Plaister,* whether one party had the right to rescind the contract as void ab initio for fraud.

On the facts, Young J and the Court of Appeal held that the arbitration clause in the BC3 form of contract was wide enough to give the arbitrator that jurisdiction. As stated by Mahoney JA, it all depends on the wording of the arbitration agreement. It is not inconceivable that parties may agree that only certain types of disputes will be referred to arbitration, ie matters of certification. In such a case, an arbitration agreement along those lines, although severable, would be of little assistance to parties in a dispute about whether or not a contract was void ab initio for fraud.

The concept of severability must be distinguished from the situation where there is a dispute about whether or not the contract or the arbitration agreement came into existence at all. In *Harbour Assurance Co (UK) Ltd v Kansa General International Insurance Co Ltd* [1992] 1 Lloyd's Rep 81 Mr Justice Steyn (as he then was) stated at p86.

> "The foundation of an arbitrator's authority is the arbitration agreement. If the arbitration agreement does not in truth exist, the arbitrator has no authority to decide anything. Similarly, if there is an issue as to whether the arbitration agreement exists, that issue can only be resolved by the court. For example, if the issue is whether a party ever assented to a contract containing an arbitration clause, the issue of lack of consensus impeaches the arbitration agreement itself. Similarly, the arbitration agreement itself can be directly impeached on the ground that the arbitration agreement itself is void for vagueness, void for mistake, avoided on the ground of misrepresentation, duress and so forth. All such disputes fall outside the scope of the arbitration agreement, no matter how widely drawn, and are obviously outside the arbitrator's jurisdiction. The scope of the principle of the separability of the arbitration agreement only arises for consideration where the challenge is directed at the contract, which contains an arbitration clause. This fundamental distinction requires the court to pay close attention to the precise nature of each dispute."

The decision of the Court of Appeal of Bermuda in *Sojuznefteexport (SNE) v JOC Oil Limited* Yearbook of Commercial Arbitration XV (1990), 384 referred to in the judgment of Kirby P supports this position. There the court, referring to two qualifications to the doctrine of severability, stated:

> "There are two qualifications on the doctrine of severability which are generally accepted. The first is succinctly stated by Pieter Sanders, Emeritus Professor of Law at Erasmus University, Rotterdam as follows:
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> > 'Where the existence of the contract itself is contested. If the question arises whether the parties have indeed concluded a contract containing an arbitration clause, the jurisdiction of the arbitrator is put in question. If there is no contract at all, the legal basis of the arbitrator's powers which reside in the arbitration clause found in the contract "is also missing".'
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> This exception recognises that there is a distinction between the nullity of a contract and its never having existed at all. However, where prima facie evidence is presented showing that the parties have entered into a contract, the burden of demonstrating that there never was a contract will be a heavy one, particularly if at any stage the parties acted as if there were a contract between them.
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> The second qualification arises where the attack is not upon the principal agreement but upon the validity of the arbitration clause itself - whether for instance it conformed to the requirements for the conclusion of a valid arbitration agreement under the proper law of the agreement or whether it is, for example, itself vitiated by fraud. Here, while the arbitral tribunal is competent to pass upon that question, it is, as a rule, not competent to pass upon it with definitive effect."

Conclusion

The position might be summarised as follows.

1. Where there is no dispute that the parties entered into the contract containing an arbitration agreement, but disputes and differences arise concerning whether one or other of the parties is discharged from the future performance of the contract - accompanied by the often competing claims for damages or restitution, an appropriately drawn arbitration agreement would confer jurisdiction on an arbitrator to determine the matters in dispute; *Heyman v Darwins Ltd* [1942] AC 356.
2. Where there is no dispute that the parties entered into the contract containing an arbitration agreement, and there is an allegation that the contract is void ab initio, the arbitration agreement is severable and depending upon the proper construction of the arbitration agreement, the arbitrator will have jurisdiction to deal with the question of whether the contract is void ab initio, and if so, the financial consequences; *Ferris v Plaister & anor* (unreported, Court of Appeal, 17 August 1994), *Harbour Assurance Co (UK) Ltd v Kansa General International Insurance Co Ltd* [1993] Lloyd s *Rep* 455.
3. Where there is a dispute about whether or not the

parties entered into a contract containing an arbitration agreement, or an arbitration agreement itself, that dispute may not be determined by an arbitrator, notwithstanding the width of the terms of the arbitration agreement. Disputes of this nature are to be determined by the court; per Steyn J *Harbour Assurance Co (UK) Ltd v Kansa General International Insurance Co Ltd* [1992] 1 Lloyd's Rep 81 at 86.

4. Where there is a dispute about whether an arbitration agreement itself is void for any reason, that dispute may not be determined by an arbitrator, notwithstanding the width of the arbitration agreement. These disputes are to be determined by the Court; *Harbour Assurance Co (UK) Ltd v Kansa General International Insurance Co Ltd,* supra.
5. In international arbitrations the positions set out in 3 and 4 may not apply. Arbitration rules such as the UNCITRAL Model Law on International Commercial Arbitration and the International Chamber of Commerce Rules for Arbitration provide that:
   (a) the arbitral tribunal may rule on its own jurisdiction - Article16 Model Law; and
   (b) any decision as to the arbitrator's jurisdiction shall be taken by the arbitrator himself Article 8(3)(4) ICC Rules for Arbitration. ❑