ARBITRATION CLAUSE IN THE ARTICLES OF ASSOCIATION OF A COMPANY: SCOPE AND AMBIT

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I. INTRODUCTION

Whether arbitration as a branch of our procedural laws has failed to serve as an effective alternative to litigation is a concern that seems to be gaining voice recently. Even after the legislative efforts to minimize the role played by courts in the matter of arbitration, witnessing invariably time-consuming arguments by parties who devise legal defenses in support of their unwillingness to submit themselves to arbitration procedure, despite the existence of express arbitration agreements, is a routine affair in our court rooms these days.

II. STATUTORY PROVISIONS AND SEEMINGLY EASY INFERENCES

The relevant question is whether the Articles of Association of a Company ("Articles") constitute a contract for the purpose of section 7(2) of the Arbitration & Conciliation Act, 1996 ("Arbitration Act") so that an arbitration clause contained therein could validly be treated as an "arbitration agreement" under the said provision. A bare reading of section 36(1) of the Companies Act, 1956("Companies Act") leads to the impression that the Articles necessarily constitute a valid contract to which the company and its members are parties.

However, such an easy and seemingly effortless inference is indeed not fully shielded from some valid and compelling legal concerns as sought to be voiced in this paper.

III. THE INVOCATION OF ARBITRATION CLAUSE IN THE ARTICLES INTER-SE ITS MEMBERS

There is one manner in which an arbitration clause found in a usual commercial contract could differ from an arbitration clause found in the Articles of a company. It is usually a matter of customary practice and norm to specify in a commercial contract that the arbitration clause therein can be invoked in relation to disputes arising out of or in relation to any breaches of the terms of such commercial contract. However, considering that Articles of a company are a set of general guidelines in the matter of administration of a company, it is possible that such a limitation may be absent in the express language of an arbitration clause contained in its Articles. Under such circumstances, a natural doubt that

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arises is whether a broad construction bringing all the disputes between the members including their private disputes which unrelated to the company within arbitration is desirable or not. The Bombay High Court in *Mohanlal Chhaganlal v. Bissessarial Chirawalla*[1] favoured the broad construction whereas the Kolkata High Court in *Khusiram v. Honutmal*[2] favoured a restrictive interpretation stating that the arbitration clause could be invoked only in the matter of disputes between the members within their company relationship. The Bombay High Court in the later decision of *Shiv Omkar v. Bansidhar Jagannath,*[3] favoured the broad interpretation by holding that the main object of including an arbitration agreement in the Articles may be frustrated if the said agreement is not held to apply to the commercial dealings between the members *inter se*, but qualified it by further stating that such enforcement of arbitration clause would be unjustifiable when such private transactions are "*in respect of commodities not within the purview of the association but outside it*." In such a qualified context, the Hon'ble Court held that the enforcement of the arbitration agreement in respect of private commercial dealings between members *inter se* could be seen as a matter in which the company is interested.

It is therefore clear that the matter is capable of raising confusion which would demand enormous time of our judiciary for reaching a determination. Yet another distinct dilemma would be when a member of a company acts in dual capacities. Such a question would not be easy to be resolved and is left open for determination from time to time.

Even in cases where the aforementioned predicaments are absent, the issue of applicability of arbitration clause may still not be fully out of controversy. The question whether members *inter se* can subject themselves to arbitration without impleading the company and giving an opportunity for it to be heard is an issue that has significant bearing on both our procedural laws as well as our substantive laws.

Therefore, it will not be erroneous to point out that the enforceability of arbitration clauses found in the articles even *inter se* members of a company is a matter seeped in controversies, confusions and debates thereby capable of demanding large number of hours in each before reaching a resolution.

IV. INVOCATION OF AN ARBITRATION CLAUSE BY/AGAINST AN OUTSIDER

A bare reading of the relevant provisions of the Companies Act, most particularly section 36 mentioned above, leads to the logically sound conclusion

[1] A.I.R. 1947 Bom. 268 (India)
[2] 53 CWN 505 (H)
[3] A.I.R. 1956 Bom. 459 (India)

that an outsider cannot be bound by the Articles of a company and therefore cannot be subjected to or take the benefit of an arbitration clause that may be found in the Articles. Therefore, even if the Articles of a company stipulate that disputes that may arise with outsiders, say for example with contractors that the company may engage, will be subject to arbitration, it may be an uncomplicated conclusion that such third parties cannot be bound by or take the benefit of the arbitration clause since they are not parties to the Articles.

One of the main grounds in this regard could also be that the third party will be entitled to legitimately claim ignorance to the provisions of the Articles, including the one dealing with arbitration. It is true that the "doctrine of constructive notice" regarding the internal affairs of a company has faded away much in the history of common laws and the Indian laws.

However, even such a seemingly uncomplicated and secure conclusion may be found to be on an unsteady foundation on a deeper analysis. Following the mandate of section 7(5) of the Arbitration Act, if a contract that the company enters into with an outsider has a seemingly inconsequential clause that states that it would also be subject to the rights and liabilities of the company embedded in its Articles and memorandum of association, a question can arise whether an arbitration clause provided in the Articles of the company could be invoked to govern a dispute arising under such contract. It could always be a possible argument that the arbitration clause stood incorporated by reference and this is capable of invariably leading to a time consuming exercise of judicial determination.

V. THE CONCERNS WHEN THE SUBSEQUENT CONTRACTUAL DOCUMENTS DON'T CONTAIN AN ARBITRATION CLAUSE

It is a possible scenario that disputes concerning the members may arise out of documents other than the Articles. In today's world innumerable disputes cloud the court rooms and arbitration chambers as arising out of agreements between the shareholders. This is most typical when the company invites an investor whose introduction into the membership of the company in most cases would lead to the execution of shareholders' agreements setting out the terms and conditions concerning the administration of the company. Such agreements, by its sheer volume, nature and contents in most cases would act as a second set of Articles.

It is a very common scenario these days that various *lis* arising out of such shareholders agreements are submitted to litigation by taking such agreements as a complete code and without much recourse to the Articles of the company. Under such circumstances it becomes a matter of doubt whether an arbitration clause that may find place in the Articles and may be absent in such subsequent

agreements, would still govern the members. This is therefore yet another dilemma that invocation of an arbitration clause in the Articles of a company is vexed with.

VI. IMPLEADING AND HEARING ON MEMBERS WHILE ADJUDICATING A DISPUTE

It would be relevant to mention herein about another practical problem that could arise while trying to invoke the arbitration clause found in the Articles of a company.

The party who is unwilling to participate in the arbitration may contend that the dispute involves even third parties who are outsiders as far as the Articles are concerned and therefore the invocation of the arbitration clause cannot be valid. For example if a member seeks to institute an arbitration action against the company or against the majority shareholder of a company stating that the company ought not have entered into a certain loss-making and financially unviable commercial contract with a third party, a counter argument could be raised that such third party will have to be heard to determine the issues under dispute and that such third party not being a party to the Articles, no invocation of the arbitration clause is possible.

A large body of judicial precedents has dealt with the issue of impleadment of third parties to circumvent an arbitration clause. The Andhra Pradesh High court in the case of *M/s. Srivenkateswara Constructions and others v. The Union of India,*[4] observed as under:

"*It often happens that in order to circumvent an arbitration clause a plaintiff adds some unnecessary parties to the suit and in such cases it has been held that the Court can grant stay of proceedings.* In *Cekop v. Asian Refractories Ltd.*[5]*, it was laid down that a party to an arbitration agreement cannot defeat the agreement between the parties merely by joining a third party in the suit against whom no relief is claimed. Following the said decision, a Bench of this Court, of which one of us (Krishnarao, J.) was a member in C.M.A. No. 467 of 1966, D/-18-12-1969 (Andh.Pra.) held that though the plaintiff added a prayer as against an unnecessary defendant who was not a party to the agreement it was nevertheless a case for granting stay….The addition of the 3rd plaintiff in the present suit does not introduce a different cause of action or a different subject matter at all. This is, therefore a clear case where the plaintiffs adopted the ingenious devise of bringing in unnecessary parties into the arena of dispute, obviously for the purpose of preventing the 1st defendant from invoking the arbitration clause."*

[4] A.I.R. 1974 A.P. 278 (India)
[5] (1969) 73 Cal WN 192 (India)

The Hon'ble Supreme Court on the other hand held in *Sukanya Holdings v. Jaiyesh Pandya*[6], that when the where the gamut of the dispute is such that some partly fall within the domain of the arbitration and some others can be tried in civil court and also in which the parties are not the same as in the arbitration agreement, the court should continue with the entire suit instead of splitting the causes of action.

Therefore, it is clear that the possibility of invoking an arbitration clause in the Articles even to cover disputes between members of a company and concerning the affairs of a company would vary on a case to case basis.

VII. CONCLUSION

The above analysis is only a brief synopsis of many possible difficulties and concerns that exist even while trying to invoke an arbitration clause that is clearly stipulated in the Articles of a company. As mentioned in the beginning of this paper, the time and effort which are invariably spent on resolving even the fundamental doubt as to whether or not certain disputes are necessarily governed by arbitration procedure itself could be significant. This reality is therefore capable of snuffing out the intended charm of a quicker relief from our arbitration laws. There seems to be no easy remedy to save the charm of the intended savior.

[6] (2003) 5 S.C.C. 531 (India)