BINDING NON-SIGNATORY GUARANTORS TO AN ARBITRATION AGREEMENT: A JUDICIAL SCRUTINY

K Sunethra Reddy
Year II, Symbiosis Law School, Pune

Introduction

Section 7(4) of the Arbitration and Conciliation Act, 1996 provides that arbitral proceedings must take place in furtherance of an arbitration agreement, which must be in writing and duly consented to, and signed by both parties. In the absence of such agreements, following Section 89 of the Civil Procedure Code, a joint memo has to be filed with the consent of both parties, showing joint intention to resolve the dispute through arbitration.[1] However, in reality, most commercial transactions are multi-layered with several parties and interconnected agreements. In such cases, when an arbitration agreement exists between two parties, the question that arises is whether a non-signatory, who is also a stakeholder in the transaction between the contractual counterparts, can be joined to the arbitration proceedings.

In this paper, the author will be addressing the more specific question of binding arbitration agreements between guarantors who are not signatories to an arbitration agreement that exists between the Principal borrower and the Creditor. The research objective is to critically examine and trace the legal developments and judgements delivered both in favour of and against binding non-signatory guarantors to an arbitration agreement. The author will draw conclusions from pronouncements by the Indian Judiciary, with help from an International perspective, while concurrently providing a critical analysis to the research question.

Tracing the developments on Non-Signatories and Arbitration Agreements

Global Scenario:

On an international level, *Dow Chemical v. Isover-Saint-Goblain* ["**Dow Chemicals**"] was instrumental in laying down the position on whether a non-signatory is bound by an arbitration agreement, where the non-signatory was a parent company of one of the parties involved in the Arbitration.[2] Here, a preliminary objection was taken by the parent-company on the grounds that only the subsidiary company was a party to the arbitration agreement under which the Arbitration was initiated. The tribunal laid down the Doctrine of "*Group of Companies*", which stipulates that mere

[1] *Afcons Infrastructure Ltd v Cherian Varkey Construction Co (P) Ltd* (2010) 8 SCC 24.
[2] *Dow Chemical v Isover St Gobain*, ICC Award No 4131.

corporate tie between a group of companies cannot lead to a conclusion of binding non-signatories to an arbitration agreement. Instead, the non-signatory company must have played an essential role in the *"conclusion, performance or the termination of the contracts*". This ruling set a strong precedent for all disputes that involved a non-signatory being forced to join an arbitration.

Another concept recognized by Dow Chemicals is that of "*une realité économique unique",*[3] which leads to the suggestion that the Group of Companies doctrine may be invoked where there is a tight organizational structure or financial links, thereby forming a single economic unit or reality. Example, where the funds of the parent company is used to financially restructure the subsidiaries. However, this doctrine has not received much traction and has been critically reviewed and rejected by most tribunals and countries.[4]

Indian Scenario:

In India, the first landmark case pertaining to the binding nature of arbitration agreement on non-signatories was in 2003, in *Sukanya Holdings Ltd. v. Jayesh. H. Pandya.* ["**Sukanya Holdings**"] Here a dispute arose over one transaction involving multiple parties, some of who were not signatories to the arbitration agreement. The Supreme Court upheld party autonomy, stating that "*causes of action against different parties cannot be bifurcated in a single arbitration*".[5] In pursuance of Section 8 of the Arbitration and Conciliation Act, 1996, the Court held that an arbitration agreement will bind only signatory parties and the court refused to join the other entities as a party to the arbitration.[6]

A decade later, the Apex Court in *Chloro Controls India Pvt. Ltd. v. Severn Trent Water Purification* ["**Chloro Controls**"] ruled in favour of joining the non-signatory to an arbitration agreement.[7] The Court laid down the concept of a "*composite transaction*", where the "*performance of the principal agreement would not be feasible without the aid and execution of an ancillary agreement"* both of which are entered into, in furtherance of a common objective.[8] In such cases, where agreements are interlinked, an entity can be bound by an Arbitration agreement it is not a party to. The Court further filled the loopholes by stating that if the mutual intention of the parties was to bind a non-signatory as well, then the same can be proceeded with. The *composite transaction* concept has been

[3] ibid [131], [136]
[4] *Manuchar Steel Hong Kong Ltd v Star Pacific Line Pvt Ltd* [2014] SGHC 181, [100]-[102], [134].
[5] *Sukanya Holdings (P) Ltd v Jayesh H Pandya* (2003) 5 SCC 531.
[6] Arbitration and Conciliation Act 1996, s 8.
[7] *Chloro Controls India (P) Ltd v Severn Trent Water Purification Inc* (2013) 1 SCC 641.
[8] ibid [73].

applied in multiple arbitral proceedings and has become a way of exercising jurisdiction over a non-signatory party.[9]

What is important to note in Chloro Controls is that it was a foreign arbitral proceedings, where the parties were referred to arbitration under Section 45 of the Arbitration and Conciliation Act, 1996. Unlike Section 8 of this Act (which deals with domestic arbitration), Section 45 has wider mandate and provides that even "*persons claiming under"* the signatory party can be added to arbitral proceedings.[10] However, Section 8 was amended in October, 2020 and the 246th Law Commission Report elaborated the scope of Section 8 to match that of Section 45.[11] Therefore, it is evident that Chloro Controls can be relied upon, even in cases of domestic arbitrations. Although Sukanya Holdings was never formally overruled, the findings in Chloro Controls have taken precedence over it.

Following Chloro Controls, the Courts have permitted for the non-signatory to be added to a domestic Arbitration proceeding.[12] These positions of law laid down by various courts were consolidated in *Cheran Properties Limited v. Kasturi and Sons Limited.*[13] The Apex Court reiterated the principle of composite nature of a transaction having common subject matter, and the Group of Companies doctrine was applied along with the condition of mutual intention to bind. It was held that it is imperative to find the essence of a business transaction and to unravel the multi-layered arrangement, in order to asses if the role played by certain entities was sufficient to add them as a party to an arbitral proceedings, they initially did not agree upon. In addition, the court also stated that even an arbitral award under Section 35 of the Arbitration and Conciliation Act, 1996, can be binding upon a non-signatory, provided that he is a person claiming under the signatory.

Finally, cases decided in 2019 include the *Mahanagar Telephone Nigam Ltd. v. Canara Bank and Ors.*[14] ["**Mahanagar Telephone**"] and the *Reckitt Benckiser (India) Private Limited vs. Reynders Label Printing India Private Limited and Ors.*[15] The bench in both instances did not depart from the previously laid down principles. It ruled against joining the non-signatory, noting that the non-signatory was not involved in any way, in the negotiations or execution of the principal agreement and once again pressed on mutual intention and necessity of a "*direct relationship"* between the parties. A similar position was taken in *Magic Eye Developers v. Green Edge Infra Pvt. Ltd.*, a 2020 case of the Delhi High

[9] David St John Sutton, Judith Gill, Matthew Gearing, *Russell on Arbitration* (23rd edn Sweet and Maxwell 2009)
[10] Arbitration and Conciliation Act 1996, s 45.
[11] Law Commission of India, 246th Report, 2014.
[12] *Ameet Lalchand Shah v Rishabh Enterprises* (2018) 15 SCC 678.
[13] *Cheran Properties Ltd v Kasturi & Sons Ltd* (2018) 16 SCC 413.
[14] *Mahanagar Telephone Nigam Ltd v Canara Bank* 2014 SCC OnLine SC 1762.
[15] *Reckitt Benckiser (India) (P) Ltd v Reynders Label Printing (India) (P) Ltd* (2019) 7 SCC 62.

Court, which held that the non-signatories were group companies with common intention to arbitrate[16].

Controversy in case of Non-Signatory "Guarantors"

In the international arena, in a landmark Swiss International Arbitration decision in 2008, the parent Italian company gave a guarantee to its subsidiary company, which did not have an arbitration clause.[17] The Federal tribunal stated that the arbitration agreement only binds the signatory parties, unless the non-signatory involves itself into the contractual relationship.[18] Given the factual context, the guarantee was governed by Italian laws and the tribunal held that the guarantor would be bound if he assumes a *"joint and several liability"* with the subsidiary debtor company. However, if the guarantee was governed by Swiss laws which have a stricter mandate, the guarantee must include an explicit reference to the arbitration clause, otherwise the guarantor will have no obligation to submit to the jurisdiction of the arbitral tribunal.

In the Indian context, the Delhi High Court before this Swiss decision, back in 2004 itself held in *Canbank Financial Services Ltd. vs. M/s. SFL Industries Ltd.*, that the guarantor could be joined in the Arbitral proceedings as the lease agreements (which contained the arbitration clause) were specifically referred to; in the guarantee deed. In the deed, the guarantor had agreed that his liability would be joint and several. Therefore, the court allowed the non-signatory guarantor to be joined as a party of the arbitral proceedings.[19]

However, this position been impliedly overruled by the 2009 judgement in *M. R. Engineers and Contractors v. Som Datt Builders Ltd.*[20] The Supreme Court took a different view and held that Section 7(5) of the Arbitration and Conciliation Act, 1996 indicates that merely referring to a text does not imply incorporation of the arbitration clause, and that the reference should be made in such a way that it demonstrates the desire to incorporate the arbitration clause. If the Guarantee deed does not make special reference, indicating mutual intention to incorporate the arbitration clause, the non-signatory guarantor cannot be joined to the proceedings.

Following this, the Supreme Court in the landmark ruling in *N. Prasad v. Monnet Finance Ltd.* ["**N. Prasad**"] reiterated its position, if not, made it more rigid.[21] It categorically stated that in the

[16] *Magic Eye Developers Pvt Ltd v Green Edge Infra Pvt Ltd* 2020 SCC OnLine Del 597.
[17] *X v Y and Z*, 4A_128/2008 (Swiss International Arbitration Decision).
[18] ibid [3.2].
[19] *Canbank Financial Services Ltd v M/s SFL Industries Ltd* (2004) ILR 1 Delhi 430.
[20] *M R Engineers & Contractors (P) Ltd v Som Datt Builders Ltd* (2009) 7 SCC 696.
[21] *S N Prasad v Monnet Finance Ltd* (2011) 1 SCC 320.

absence of a valid arbitration agreement, either in writing or through subsequent statements of claim, no one can be made a party to arbitral proceedings. The court went as far as rejecting the contention that the guarantor should be joined even if his liability is joint and several with that of the principal borrower.

The position again became unpredictable with *Sahyadri Earthmovers v. L&T Finance* which took a different view and held that the guarantor, even though not a party to the arbitration agreement, can be joined, as all transactions between the principal debtor and guarantor are interlinked and inexorably interconnected.[22] The judge distinguished the N. Prasad case on vague grounds that the borrower nowhere denied the arbitration clause and consequently even the guarantor cannot take shelter of non-mentioning of specific Arbitration clause in the guarantee deed. However, the position of law changed in the following years.

The Delhi high Court in 2014 and 2016 in *Sunil Nanda v. L&T Finance*[23] and *STCI Finance Ltd. v. Sukhmani Technologies Pvt Ltd.*[24] respectively, returned to the original ruling and stated that the arbitrator had erred in binding guarantor in the arbitral proceedings and subsequently the award. This was affirmed in 2018 in *MSTC Ltd. v. Omega Petro Products*, where the loan agreement and the guarantee deed were held as completely independent contracts and that the arbitration clause needs to be specifically incorporated in the latter.[25] The position in MSTC Ltd. was reiterated in 2020 in *STCI Finance Ltd. v. Shreyas Kirti Lal Doshi*, where the Delhi High Court stated that an application to join the non-signatory to arbitration would be totally misconceived if the intention was not to include the guarantee deeds within the arbitration clause.[26]

Analysing the Inconsistency

Based on the developments that have been chronologically traced above, it appears that this issue lacks judicial clarity. As far as the general question of a non-signatory's position in an arbitral proceeding is concerned, the position has been standardised through the application of the Group of Companies doctrine to ascertain whether the dispute arises from a composite transaction with the presence of a mutual intention to resolve through arbitration. However, there is an ambiguity with regards to the specific question pertaining to a non-signatory, who is the guarantor to a loan agreement. Until the N. Prasad judgement, the test was to check whether the guarantor had joint

[22] *Sahyadri Earthmovers v L&T Finance* 2011 (6) BomCR 393.
[23] *Sunil Nanda v L&T Finance* 2014 SCC Online Del 1057.
[24] *STCI Finance Ltd v Sukhmani Technologies Pvt Ltd* 235 (2016) DLT 150.
[25] *MSTC Ltd v Omega Petro Products* 2018 SCC OnLine Bom 487.
[26] *STCI Finance Ltd v Shreyas Kirti Lal Doshi and Ors* 2020 SCC OnLine Del 100.

and several liability with that of the signatory principal debtor. However, this too was rejected. This mixed position of law leads to the question of why non-signatory guarantors are treated differently when compared to non-signatory persons.

Although there is a fundamental difference in the nature of the relationship between corporate transactions and loan agreements with a guarantee deed, it is important to note that in the absence of a guarantee deed, certain loan agreements may not even be executed or concluded. Further, it has been stated that the liability of the guarantor is always co-extensive with that of the principal debtor.[27] A guarantee deed is collateral to a loan agreement with the common objective of facilitating credit or loan and has a collective bearing on the dispute and hence may be referred to as being part of a composite transaction. Nevertheless, the intention of the parties must also be considered to look more closely at the rationale behind the structure of the transaction. The difficulty lies in proper understanding of the specific and dynamic characteristics of a contractual relationship and therefore, more attention should be paid to the examination of facts that allow for the extension of an arbitration agreement to third parties.[28]

In the author's views, even though the guarantee deed is an independent contract, if the guarantor assumes joint liability with the principal borrower and the deed is part a composite transaction, it is intelligible to bind the non-signatory guarantor to the arbitration agreement. The author believes that the Sahyadri case, where the guarantor was allowed to be bound to an arbitration agreement because all transactions between the principal debtor and guarantor are interlinked and inexorably interconnected, follows correct reasoning. The N Prasad judgement, by refusing to hold the non-signatory guarantor as a party to the arbitration, even though the guarantor had joint liability, may have made the position rigid, which could also be used by the non-signatory as a way to avoid settlement through arbitration.

Conclusion

In multi-layered commercial disputes which have multiple parties overlapping over each other, it is important to make a detailed analysis before taking an overzealous approach to join a non-signatory party to the arbitration. It is appropriate to draw a line between the legal consequences of a mere guarantee undertaking and the assumption of a debt. However, this should not lead to an over-cautious approach like the view taken in N Prasad. If the standardised position of law applied in case of non-signatory persons were applied to non-signatory "guarantors", the latter

[27] Pollock & Mulla on *Indian Contract and Specific Relief Act*, (10th Edn LexisNexis) [728]; *State Bank of India v. M/s. Indexport Registered* (1992) SCC (3) 159.
[28] Marc Blessing, *The Law Applicable to the Arbitration clause*, ICCA Congress Series No 9 Paris (1999).

could be joined to arbitration proceedings as they satisfy all the conditions laid down by Indian cases and align with the international perspective. However, subject to the facts and circumstances of each case, if there is evidence that the non-signatory intended to be bound by the arbitration agreement, there is implied consent and the guarantor assumes joint liability, then the non-signatory guarantors should be joined to the arbitration agreement.