APPLYING THE DOCTRINE OF BLUE-PENCIL TO ARBITRATION AGREEMENTS

- *Tariq Khan & Ausaf Ayyub*

Introduction

It is not uncommon for the parties to dispute the validity of an arbitration agreement; they often try to avoid arbitral proceedings by putting a question on the validity of the arbitration agreement. The court in such a situation faces the dilemma of invalidating the arbitration agreement or compelling the parties to arbitration. That is when the doctrine of Blue-Pencil comes into play. The Doctrine of Blue-Pencil is relatively a new advance in the field of contract law. It is a judicial tool used to nullify the offending part of an agreement without tampering with the valid part of it. It is based on the principle of Doctrine of Severability. This doctrine was evolved in the case of *Attwood v. Lamont,*[1] wherein the contract had a negative covenant that restricted the defendant to engage in a similar business; the court found the clause to be wider than necessary to protect the interest of the petitioner. Consequently, the court applied the doctrine of severability to strike off the offending portion of the clause while saving the rest of it. Black's Law Dictionary defines Blue Pencil as a *"judicial standard for deciding whether to invalidate the whole contract or only the offending words"*.

Originally the doctrine was evolved in the context of restrictive trade clauses,[2] but its application has been extended to all forms of contract,[3] including arbitration agreements.[4] The courts usually sever the invalid part of an agreement if it does not permeate the entire arbitration agreement, the true test of determining the extent of severability of any agreement would be to see if the parties would have entered the same agreement without the severed clause.[5] It is also not necessary to have a severance clause for severing an illegal portion of an agreement.[6]

The reason behind the wide acceptability of this doctrine lies in the pro-arbitration approach of the judicial institutions. Recent judicial trends show that courts are heading towards minimal interference in the arbitral procedure. Indian courts have also avoided going into technicalities while interpreting an arbitration clause; more importance is given to the intention of the parties and other circumstances while referring the parties to the arbitration. In *Visa International Limited*

[1] *Attwood v. Lamont* [1920] 2 KB 146.
[2] *Mallan v. May* [1843] 11 Meeson and Welsby 653.
[3] *Babasaheb Rahimsaheb v. Rajaram Raghunath Alpe* AIR 1931 Bom 264.
[4] *Rambilas Mahto v. Babu Durga Bijai Prasad Singh* AIR 1965 Patna 239.
[5] *Beltran v. AuPair Care, Inc.* [2018] 907 F.3d 1240, 1263 (10th Cir. 2018).
[6] *Shipman Agency, Inc. v. The Blaze Inc.* [2018] S.D. Tex. 315 F.Supp.3d 967.

v. Continental Resources (USA) Limited,[7] the Supreme Court of India observed, *"No party can be allowed to take advantage of inartistic drafting of arbitration clause in any agreement as long as clear intention of parties to go for arbitration in case of any future disputes is evident from the agreement and material on record including surrounding circumstances."* The apex court in *Enercon (India) Ltd. v. Enercon GMBH,*[8] observed that *"It is a well-recognised principle of arbitration jurisprudence in almost all the jurisdictions, especially those following the UNCITRAL Model Law, that the courts play a supportive role in encouraging the arbitration to proceed rather than letting it come to a grinding halt. Another equally important principle recognised in almost all jurisdictions is the least intervention by the courts".*

Applicability of Blue-Pencil Doctrine to Arbitration Agreements in India

> *"when faced with a seemingly unworkable arbitration clause, it would be the duty of the court to make the same workable within the permissible limits of the law, without stretching it beyond the boundaries of recognition."*[9]

The Severability of the arbitration agreement is relatively a new development in India. Initially, the courts did put too much emphasis on the wording of an arbitration clause, but gradually the courts have gravitated towards giving primacy to the intention of the parties over minor technicalities which renders a part of the clause void.

The issue of severability of an invalid portion of arbitration agreement came up for the first time in the case of *Union Construction Co. (P) Ltd. v. Chief Engineer, Eastern Command,*[10] wherein the arbitration agreement provided that the decision of the arbitrator shall be binding and conclusive and not amenable to any challenge, the petitioner contended that such clause is void and the parties cannot be referred to the arbitration. The court rejected the contention of the petitioner and severed the offending portion of the agreement that restricted appeal against the award.

In *Shin Satellite Public Co. Ltd. v. Jain Studios,*[11] the Supreme Court of India, while dealing with an application under Section 11(6), has applied the blue pencil test to invalidate an offending part of an arbitration agreement. In that case, the arbitration agreement provided that no appeal shall lie against the award, and parties have waived off their right of appeal or objection. The court invalidated the offending portion, which precluded the parties from taking recourse against the

[7] *Visa International Ltd. v. Continental Resources (USA) Ltd.* [2009] 2 SCC 55.
[8] *Enercon (India) Ltd. v. Enercon Gmbh* [2014] 5 SCC 1.
[9] *Enercon (India) Ltd. v. Enercon Gmbh* [2014] 5 SCC 1.
[10] *Union Construction Company Private Limited v. Chief Engineer, Eastern Command, Lucknow and Another* AIR 1960 All 72.
[11] *Shin Satellite Public Co. Ltd. v. Jain Studios Ltd.* [2006] 2 SCC 628.

award without invalidating the rest of the clause; it referred the parties to arbitration as provided under the clause.

In *Value Advisory Services v. ZTE Corporation,*[12] an invalid or seemingly unworkable arbitration agreement which provided that any dispute would be submitted to SIAC and the arbitrator(s) shall be appointed under the rules of ICC. SIAC declined to hold arbitral proceedings for the reason that ICC rules do not apply to SIAC arbitrations. Similarly, ICC also communicated that only the ICC court would have the jurisdiction if ICC rules were to apply. The arbitration happened according to the ICC rules, and the ICC court provided institutional administrative assistance. The award holder objected to the enforcement in terms of Section 48(1)(d). The court rejected the objection and held that the part of the arbitration agreement which provided the dispute to be submitted to SIAC could be severed by running a Blue-Pencil across it to give meaning to the intention of the parties to refer their dispute to arbitration.[13]

The Delhi High Court applied the blue pencil rule to an arbitration agreement which provided that the decision of the *Decision Review Board* would be final and conclusive on both parties; the court found such a clause to be violative of Section 28 of The Indian Contract Act, 1872 and severed the legal part from the offending portion of it.[14]

In *Vinod Kumar v. Sunil Kumar,*[15] the petitioner contended that since the arbitration agreement left a blank on the name of the arbitrator, the same is void for uncertainty, the court rejected the contention of the petitioner to hold that an arbitration agreement does not become void even if the parties do not agree on the name of the arbitrator; moreover, such an error can always be corrected by the court by applying the doctrine of Blue-Pencil.

In *Rapti Contractors v. Reliance Energy Ltd.,*[16] the respondent challenged the validity of the arbitration agreement, which provided that the arbitral proceedings shall be governed by the Arbitration Act & Conciliation Act, 1940 ["**1940 Act**"]; however, by that time, the Arbitration & Conciliation Act, 1996 ["**1996 Act**"] had already come into force. The respondent contended that the arbitral agreement has become void and there is no valid agreement therefore, the parties cannot be referred to the arbitration. The court held that an incorrect reference to the 1940 Act would not

[12] *Value Advisory Services v. ZTE Corporation* [2017] SCC OnLine Del 8933.
[13] *Ankur Narang v. State* [2019] SCC OnLine Del 8933.
[14] *Karam Chand Thapar v. Tehri Hydro Corporation India Ltd.* [2012] SCC OnLine Del 5705.
[15] *Surendra Singh Baba (Dr.) v. State of U.P.* [2003] SCC OnLine All 919.
[16] *Gurcharan Singh Sahney & Ors. v. Harpreet Singh Chhabra & Anr* [2009] Arb LR 2 (Del).

render the entire agreement void, and the courts shall apply the blue pencil doctrine to severe the valid portion of the agreement.[17]

A part of an arbitration agreement that excluded the applicability of the 1996 Act is illegal and can be severed from the rest of the valid portion by applying the rule of blue pencil.[18] The division bench of the Delhi High Court had set aside a judgment of the single bench, which had dismissed the execution petition filed by the award holder on the ground that parties by an agreement had excluded the applicability of the 1996 Act. The court applied the blue pencil rule and severed the illegal element of the arbitration agreement; it also opined that parties cannot exclude the mandate of parliamentary legislation by an agreement.[19] An illegal part of an arbitration agreement that stipulates that the Director of the Respondent Company would act as the sole arbitrator can be severed by the court while exercising its power under Section 11(6) and appoint an independent arbitrator.[20] An arbitrator can also run the blue pencil across any offending portion of the agreement.[21]

In *Afcons Infrastructure Limited v. Rail Vikas Nigam Limited,*[22] the arbitration agreement contemplated that the retired employees of the respondent were to act as the arbitrators. The court found such a clause to be ultra vires of Section 12(5), therefore, severed with the aid of the blue pencil rule and referred the parties to arbitration after appointing a neutral arbitrator.

International Perspective

International courts have taken a more liberal approach while interpreting an arbitration agreement; courts have generally referred the parties to arbitration by striking off the illegal or void part of the agreement and retaining the rest of the agreement.

The Supreme Court of the United States, in *Rent-A-Ctr, W., Inc. v. Jackson,* has observed that *"the invalidity of one provision within an arbitration agreement does not necessarily invalidate its other provisions … [There is no] magic bond between arbitration provisions that prevents them from being severed from each other."*[23]

An arbitration that required both the parties to bear the cost of arbitration, attorney's fee, and the cost of administration of arbitration regardless of the outcome of the result of arbitration was

[17] *Purshottam v. Anil* [2018] 8 SCC 95.
[18] *Hyderabad Precision Mfg. Pvt. Ltd. v. Government of India* [2013] SCC OnLine AP 528.
[19] *Ircon International Ltd. v. National Building Construction Corpn. Ltd.* [2008] 155 DLT 226 (DB).
[20] *Karishma MEP Services Pvt. Ltd. v. KSG Milestones Construction Ltd.* [2015] 7 Mad LJ 15.
[21] *Forbes Gokak Ltd. v. Central Warehousing Corporation* [2010] SCC OnLine Del 369.
[22] *Afcons Infrastructure Ltd. v. Rail Vikas Nigam Limited* [2017] SCC OnLine Del 8675.
[23] *Rent-A-Ctr, W., Inc. v. Jackson* [2010] 561 U.S. 63, 69 (U.S. S.Ct. 2010).

found to be violative of the rights of the parties[24] and therefore, the court severed the attorney's fee and cost part from the arbitration agreement.[25] An arbitration agreement that precluded a party from enforcing their statutory right was held to be illegal and severable from the rest of the arbitration agreement.[26]

In *Galalway Cook Allan v. Ewan Robert Carr,*[27] the arbitration agreement provided that the arbitral award could be challenged both on the questions of law and facts; on the other hand, the arbitration act only postulated appeal only on a question of law. The New Zealand Court of Appeal severed the part of the arbitration agreement which provided appeal on a question of fact and enforced the agreement to arbitrate. The court further held that such severance only alters an incidental or ancillary provision of the agreement and not the true nature of the agreement which provided for arbitration. It held as under:

> "*That subject matter and the parties' primary obligations would remain essentially unchanged by excision of the words "and fact". Such a deletion alters only the extent of an ancillary right of appeal but not the nature and character of the agreement to arbitrate. The offending words are not so interconnected with the remaining provisions as to form an indivisible whole.*"

In *Gannon v. Circuit City Stores, Inc.,*[28] the district court held an arbitration agreement that provided a limited punitive damages clause to be unenforceable. The United States Court of Appeal overturned the decision of the district court on the ground that the punitive damages clause is only one part of the agreement which could be easily severed without disturbing the main intent of the parties to refer their dispute to arbitration. It is further observed as under:

> *"In an evolving climate such as this, if we were to hold entire arbitration agreements unenforceable every time a particular term is held invalid, it would discourage parties from forming contracts under the FAA and severely chill parties from structuring their contracts in the most efficient manner for fear that minor terms eventually could be used to undermine the validity of the entire contract. Such an outcome would represent the antithesis of the "liberal federal policy favouring arbitration agreements."*

In *Garcia v. Kasish,*[29] the arbitration agreement limited the right of the plaintiff to choose an arbitrator; the court found such a clause in the agreement to be unconscionable. It further held that such a clause is the result of unequal bargaining power.

---

[24] *Martin v. TeleTech Holdings Inc.* [2006] 9th Cir. 213 F.App'x 581, 583-84.
[25] *Spinetti v. Service Corp. Intern.* [2003] 3rd. Cir. 324 F.3d 212.
[26] *Bonded Builders Home Warranty Ass'n of Texas v. Rockoff* [2016] Tex. App. 509 S.W.3d 523, 537.
[27] *Gallaway Cook Allan v Carr* [2013] NZCA 11 (Wellington Ct. App.).
[28] *Gannon v. Circuit City Stores, Inc.* [2001] 8th Cir. 262 F.3d 677, 682-83.
[29] *Garcia v. Kakish* [2017] WL 2773667 (E.D. Cal.).

When an arbitration agreement cannot be severed?

> *"…the contract, shorn of the offending parts, must retain the characteristics of a valid contract, so that if severance will remove the whole or main consideration given by one party the contract becomes unenforceable"*[30]

An arbitration agreement would not be severable only when the entire agreement is permeated with unconscionability or illegality,[31] where the illegal portion was integral to the arbitration agreement,[32] and the arbitration agreement contains so many unconscionable provisions that it becomes impossible to clear the wheat from the chaff.[33]

The Supreme Court of India expounded that the courts should not re-write the contract in the garb of severing the illegal portion of it, the true test of determining the validity of an arbitration clause would be *'Substantive Severability'* and not *'Textual Severability'*.[34]

In *Subcontracting Concepts (CT), LLC v. De Melo*,[35] the Court of Appeal at California, declined to compel the parties to arbitration on the ground that the arbitration agreement was permeated with both procedural and substantive unconscionability, it suffered from a multitude of illegalities; therefore, the severance was not possible. It held that the arbitration agreement suffered from procedural unconscionability on these grounds: (a) the petitioner was forced to sign the contract on-spot without the time to think about the same, (b) the petitioner was not fluent in English and was not made aware of the terms of the agreement, (c) the petitioner was not given the time to get his contract reviewed from a legal professional and (d) the arbitration agreement was made a pre-condition to his employment. Moreover, the clause suffered from substantive unconscionability in the form that; (a) irrespective of the result of arbitration, the cost was to be shared by both the parties, (b) the limitation on the right to recover the cost of attorney's fee and, (c) the limitation on the right to recover punitive damages.

Conclusion

The Doctrine of Blue-Pencil is a big push for arbitration, it fosters the pro-arbitration approach propounded by the Model Law. It encourages the court to make work an unworkable arbitration clause by severing the illegal part of it. The pro-arbitration approach adopted by the Indian courts

[30] *Halsbury's Laws of England* (4th edn.) Vol. 9 p. 297, para 430.
[31] *Faber v. Menard*, Inc., [2004] 8th Cir. 367 F.3d 1048, 1054.
[32] *MacDonald v. CashCall, Inc.* [2018] 3rd. Cir. 883 F.3d 220, 232.
[33] *Nino v. Jewelry Exch., Inc.* [2010] 609 F.3d 191, 206 (3rd Cir. 2010).
[34] *Shin Satellite Public Co. Ltd. v. Jain Studios* [2006] 2 SCC 628.
[35] *Subcontracting Concepts (CT) LLC v. De Melo* [2019] Cal. App. 5th 201.

gives an impetus to this doctrine. However, the growth of this doctrine has been very limited. Moreover, there is a growing need for uniform policy vis-à-vis the power of the court to modify an arbitration clause. Therefore, a more proactive approach is to be taken by the courts.