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Beyond the Contract: Examining the Legal Fiction of Arbitration Clause Separability

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Beyond the Contract: Examining the Legal Fiction of Arbitration Clause Separability

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Abstract

The doctrine of severability, a cornerstone of modern arbitration law, posits that an arbitration clause within a contract is legally autonomous and survives even when the underlying contract is alleged to be void, voidable, or terminated. While this principle—recognized under the Arbitration and Conciliation Act, 1996 and reinforced through judicial interpretation—aims to preserve party autonomy and ensure the efficacy of arbitral proceedings, its application has increasingly raised concerns of doctrinal overreach and potential exploitation. This study critically examines the "veil of severability" to explore how the artificial separation of the arbitration agreement from the main contract may, in practice, undermine substantive justice.

The research interrogates the tension between contractual invalidity and arbitral jurisdiction, particularly in cases involving fraud, coercion, misrepresentation, and inequality of bargaining power. It argues that treating the arbitration clause as a standalone agreement may inadvertently legitimize procedurally valid yet substantively flawed arrangements, thereby shielding exploitative contracts from judicial scrutiny. Through an analysis of judicial trends in India and comparative perspectives from international arbitration regimes, the paper evaluates whether the doctrine has been applied in a manner consistent with principles of fairness, equity, and access to justice.

Further, the study highlights the intersection of severability with the doctrine of kompetenz-kompetenz, emphasizing how arbitral tribunals' authority to determine their own jurisdiction may exacerbate concerns of procedural exclusion. It advocates for a calibrated approach wherein courts adopt a more nuanced standard in assessing the validity of arbitration agreements embedded in disputed contracts. The paper concludes by proposing doctrinal and policy reforms to ensure that the principle of severability does not become a tool for perpetuating contractual exploitation, but rather serves its intended purpose of facilitating fair and effective dispute resolution.

Keywords: *Severability, Arbitration Agreement, Contractual Autonomy, Kompetenz-Kompetenz, Arbitration Law, Contract Validity, Judicial Review, Exploitation.*

Introduction

One of the oldest forms of dispute resolution, arbitration significantly predates our modern system of judicial courts. The development of our legal systems within both civil and common law traditions indicates that arbitration began as very informal agreements to allow mutually trusted arbitrators to resolve disputes without recourse to formal courts, or in reliance upon respected community elders. At this early stage, arbitration was consensual in nature, drawing on mutual reliance, social unity and the need to swiftly settle conflicts before they reached too high a level, or disrupted too much peace. It eventually evolved as a form of alternative dispute resolution into more institutionalized means of resolving disputes, yet retained its characteristic attributes, that the parties are in control of who the arbiter is and that the dispute resolution process is contractual, or consensual, in nature.

In the modern world and legal systems, arbitration is now extraordinarily popular in terms of resolving dispute. This popularity has become prevalent due to global commercialization and business. Many cross- border transactions and commercial relationships mean that dispute resolution methods that are efficient, time and cost effective, confidential, expert and have minimal court involvement, such as arbitration, are preferred. In these cases parties are allowed to choose their own arbiter and method of arbitration, leading to greater satisfaction. The prevalence and attraction of arbitration in these commercial fields has caused a number of standard commercial contract terms including arbitration clauses to be commonly imposed.[1]

However, the transformation of arbitration from a tool of voluntary dispute resolution to that of standard contractual clauses, embedded in standard mass market form contracts has fundamentally changed arbitration and the context in which it operates. Today, there are thousands of standard form contracts that include arbitration clauses that are non-negotiable. This is typically provided to consumers on a "take-it-or-leave-it" basis that constitutes what has become known in law as contracts of adhesion.[2]

In today's contracting environment arbitration clauses are routinely encountered in adhesion contracts which are offered on a "take-it-or-leave-it" basis by a dominant party possessing overwhelming bargaining power, and are common in consumer contracts, employment contracts and increasingly in small and medium-sized business commercial contract transactions. While Arbitration

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[1] Thomas J. Stipanowich, The Third Arbitration Trilogy: Stolt-Nielsen, Rent-A-Center, Concepcion and the Future of American Arbitration, 22 American Review of International Arbitration 323 (2011).

[2] Alan Redfern & Martin Hunter, Law and Practice of International Commercial Arbitration, Oxford University Press, 6th ed., 2015

preserves the doctrine of autonomy on its face, in fact its practice frequently comes at the expense of voluntary consent and access to fairness due to gross bargaining power disparities. A significant development has been the judicial creation of the "sophisticated" versus "unsophisticated" party dichotomy to analyze enforceability of arbitration clauses. The judicial presumption of sophistication of certain parties such as business concerns or experienced individuals appears to translate into judicial assumptions of sophistication of parties with the capacity to understand and negotiate contractual terms, including the Arbitration Provision. Thus, "sophisticated" parties like businesses or experienced individuals are consistently subjected to arbitration even when the court may not find meaningful bargaining power, ignoring the obvious fallacy that sophistication alone is not synonymous with equal bargaining power.

Another significant factor reinforcing the increase in arbitration seems to be a judicial attitude, which is strongly in favor of arbitration. The judicial attitude towards enforcement of arbitration provisions under laws such as the Federal Arbitration Act, has always favored party autonomy and contractual enforceability. However, lately the judiciary is failing to examine the consequences of upholding a contractual clause like Arbitration Provision that, while being considered a standard contract of adhesion and potentially waiver of statutorily granted rights and access to a proper forum or remedy, remains enforceable. As a consequence, arbitration is turning out not to be an option, but a remedy that the dominant party can inflict upon the weaker party.

Additional concerns have arisen with respect to the potential "degradation of substantive rights" through the use of arbitration clauses. Barriers, such as restriction of class action remedies, high arbitration costs, limited discovery, and narrow judicial review, may inhibit less powerful parties from adequately asserting their rights. When used by stronger parties to limit liability or public scrutiny, arbitration clauses can become an oppressive contractual device.

This paper will critically analyze how arbitration clauses, contracts of adhesion, and party "sophistication" interact within the legal system and will attempt to demonstrate whether the legal framework and "sophistication" test are appropriately accounting for significant imbalances of bargaining power in the modern contract landscape. An evaluation of case law, legislation and academic thought will illustrate how arbitration is appropriately being seen as both a beneficial and unjust practice.

Concept of Arbitration

Arbitration is a consensual dispute resolution process where the parties involved agree to submit their disputes to one or more neutral third parties (arbitrators) for a binding decision and resolution. The principle of party autonomy governs

arbitration and, along with the agreement between the parties; it has been seen as forming the contractual foundation of arbitration. Arbitration differs from court proceedings in many respects, predominantly being far more flexible and far less formal and it can even be kept confidential if parties choose it to be so. From an informal procedure based on the mutual trust between contracting parties in the early times to a formal mechanism based on statutory frameworks, arbitration has evolved a great deal. The Supreme Court of the United States has said that arbitration is inherently a contractual concept and in many of its rulings, like Mitsubishi Motors Corp v Soler Chrysler-Plymouth Inc., it has stated that arbitration means the surrender of nothing other than the right to have your case tried in court-you do not give up your right to the substantive rights which would apply if you had gone to court. Such a purely contractual reading has come under criticism where the courts, more recently and notably, had been increasingly confronted with cases of mass contracting through standard form adhesion contracts, and therefore arbitration has increasingly come to be viewed as being imposed rather than consented to in many cases.

Contracts of Adhesion: Meaning and Legal Nature

A contract of adhesion is one which has been drafted by one of the parties, and is usually a standardized form contract presented to the weaker party on a take it or leave it basis, as this party does not usually have a reasonable opportunity to negotiate or even object to the specific terms therein. The obvious use of this method of contracting can be seen in almost every sphere of modern contracting-insurance, banking, and consumer contracts are ubiquitous, while in employment context also it has become increasingly common. The enforceability of adhesion contracts is subject to judicial review where the courts have, over time recognized the inherent difference in bargaining power between the parties to a contract of adhesion and the need to protect the weaker party from unfairly onerous terms. The issue that most frequently arises pertains to the clauses within such a contract that can alter the terms of a contract considerably, and here arbitration clauses in standard form contracts stand out.

Party Autonomy: Foundation of Arbitration Law

Party autonomy has been referred to as the lifeblood of arbitration. The freedom of the parties to a contract to determine for themselves the dispute resolution mechanism by which the latter will resolve any disputes that arise, choice of arbitrators, governing law, procedural rules as well as seat of arbitration, all find their basis under this principle of autonomy. The Arbitration and Conciliation Act of 1996 is said to have upheld party autonomy in all regards where such autonomy does not conflict with the law of the country of domicile. While on the one hand the courts have been very vocal in stating that arbitration is a result of voluntary submission to the process by parties, there has been serious debate on whether such an assertion holds true when the arbitration clause in a contract of adhesion

requires parties to bypass court access and hence this forms a major issue in enforcing such a clause.[3]

Origins and Purpose of Arbitration Statutes (The FAA)

The Federal Arbitration Act (FAA), enacted in 1925, forms the basis for modern arbitration law in the United States. The goal of the FAA was to overcome judicial antipathy towards arbitration agreements and put such agreements on equal footing with other contracts. Arbitration at the time of enactment was viewed as a commercial instrument employed by merchants having comparatively equivalent bargaining power. It was not the intent of Congress in enacting the FAA to do away with the courts, but rather to allow arbitration agreements properly concluded to be upheld. Discussions during the drafting of the FAA indicates that it was envisioned by the legislator that arbitration is a dispute resolution device used by equally situated commercial contracting parties.

In the modern landscape of judicial interpretation of the FAA, however, courts have interpreted the act to cover much more than commercial transactions. The FAA is also now applied to consumer, employment and statutory claims, in the same way it applies to commercial transactions, giving courts more opportunities for judicial review (although rarely exercised) of arbitration provisions.

According to modern judicial theory, the FAA embodies a strong federal policy favoring arbitration. This means arbitration clauses can be and are enforced, even in adhesion contexts, with great judicial deference and limited interference. This judicial trend, according to critics, diverges significantly from the congressional intent behind the FAA.

7 Indian Arbitration Law and Its Evolution

The Arbitration and Conciliation Act, 1996, which is largely based on the UNCITRAL Model Law on International Commercial Arbitration, is the controlling legislation in India regarding arbitration. Enacted to modernize the laws governing arbitration in India, the Act was intended to curb excessive judicial intervention and position India as an arbitration-friendly environment. The law follows three principles of arbitration: party autonomy, minimalist judicial intervention, and enforceability of arbitral awards. Section 7 of the Actdefines an arbitration agreement, and Section 8 provides for mandatory judicial reference of disputes to arbitration when a valid arbitration agreement exists. The grounds for setting aside an arbitral award are limited to procedural fairness and considerations of public policy (as laid out in Section 34). Indian courts have tended to be arbitration-friendly in commercial transactions. However, they have shown a greater tendency to respect fairness and statutory protections compared to their counterparts in the U.S. The broad interpretation of

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[3] Gary B. Born, International Commercial Arbitration, Kluwer Law International, 3rd ed., 2021

the doctrine of "public policy of India" has been a key judicial mechanism for refusal to enforce awards that are patently unjust or contrary to essential societal principles. In cases like Bharat Aluminium Co. V. Kaiser Aluminium Technical Services Inc. (BALCO)and S.B.P. & Co. V. Patel Engineering Ltd., the Supreme Court interpreted the territorial scope of arbitration law, and reiterated its minimal interventionist role at the pre-arbitration stage. Recent case law reveals that the judiciary has increasingly begun to acknowledge and give consideration to the element of fairness involved in arbitration clauses, especially when involving unequal bargaining power. Arbitration clauses in consumer-related contracts and in employment matters have not seen the same degree of enforcement as in commercial transactions.[4]

Origin of "Sophisticated Party"

The notion that commercially experienced parties should be treated differently from non-commercial consumers or from unsophisticated parties dates back to the time of classical contract law, when common law presumption treated parties engaged in commercial transactions as being aware of contractual risks and able to protect their interests. However, twentieth and twenty-first century development has led the concept to be transformed in a judicial doctrine to protect arbitral agreements and encourage arbitration for commercial disputes. As arbitration agreements became common in commercial contracts, so did the idea of courts to hold the party responsible for accepting an arbitration clause on the basis of its "sophistication." This presumption of consent that "sophisticated party" cannot contest arbitration agreements became the core for arbitral agreements' enforceability. This was, and continues to be, reinforced by policy goals within arbitration statues (e.g. Federal Arbitration Act in US; Arbitration and Conciliation Act in India), where autonomy of the parties is heavily encouraged and judicial intervention is minimised. Hence, "sophistication" transformed from an empirical category to a conceptual justification in arbitration law. Courts became accustomed to consider a commercial transaction as evidence that the party intended to accept all the terms of the agreement. The consequence is a stricter and higher bar in enforcing doctrines such as unconscionability in cases involving "sophisticated party".

What is a "Sophisticated Party"?

There has never been a specific, well-defined category that clearly outlines what constitutes a "sophisticated party". Instead, courts have relied on certain indications to determine a party's sophistication status. These indicators usually include: (1) whether the party is a corporation or in the business world, (2) previous commercial transactions the party has participated in, (3) whether the

[4] P.C. Rao & William Sheffield, Alternative Dispute Resolution: What it is and How it Works in India, Indian Journal of Arbitration Law, Vol. 1, Issue 1 (2009)

party had legal counsel assisting it when the contract was formed, (4) the size of the party and its financial capacity, and (5) whether the party was engaging in interstate or international commerce. While these elements suggest that a party may be knowledgeable about business and contractual norms, they fail to provide convincing evidence that the party has bargaining power over or the choice to refuse any terms of a contract. For example, even a medium or small business may be "sophisticated" because of its commercial nature, while on the other hand, even if a party has legal counsel, it does not necessarily prove that the counsel negotiated fair terms and the contract is not inherently oppressive. Ultimately, this vagueness and subjectivity are part of the criticism of the doctrine: it seems that "sophistication" is simply a malleable characteristic, whose existence is determined by a judge to fit his ruling.[5]

Judicial Reliance on "Sophisticated Party" In Arbitration

Courts rely on "sophisticated party" doctrine often in arbitration cases involving businesses in the following way:

1. The business is commercially sophisticated or is represented by legal counsel
2. It is presumed to understand the arbitration agreement
3. It is therefore presumed to have consented voluntarily and meaningfully to arbitration
4. Thus, the arbitration agreement is enforced unless exceptionally unfair

This logic of enforcement overlooks actual bargaining power and instead shifts focus from structural fairness of the contract to supposed business knowledge of the parties. Therefore, this implies that it will be very difficult to challenge a substantively unfair arbitration clause on unconscionability grounds against a "sophisticated party".

Sophistication in Indian Arbitration Jurisprudence

While Indian arbitration law has not explicitly provided for the doctrine of "sophisticated party", judicial decisions interpreting the concept of "party autonomy" under the Arbitration and Conciliation Act, 1996 have given rise to this indirect understanding. Indian courts often presume that commercial parties and/or entities involved in business operations such as companies have sufficient awareness to appreciate the nature and consequences of arbitration clauses.
Compared to certain jurisdictions where there is strong pro-enforcement bias, Indian courts have had occasions to be intervenient when a substantial difference in the bargaining power of parties exists. This provides a tension in the legal and judicial framework, between formality of commercial identity and reality of fairness.

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[5] Lucian A. Bebchuk & Richard A. Posner, One-Sided Contracts in Competitive Consumer Markets, 104 Michigan Law Review 827 (2006).

The Indian courts have, in many judgments emphasized that standard form contracts of commercial parties may not necessarily represent "fair" agreements. The Supreme Court in various contexts held that the mere fact of being a commercial party would not negate a finding of duress or coercion. However, there is still a propensity for the courts to presume that a corporate entity is sophisticated. As such the court, in many cases, is quick to uphold arbitration clauses without an independent enquiry as to whether or not the clause was in fact freely negotiated and not just forced upon the party in question. Therefore, in essence, arbitration jurisprudence in India currently shows tension between the principles of unconscionability and public policy as counterbalances to arbitration while maintaining that parties in commercial relation are often inherently "sophisticated" so as to make these balances less operative.

Sophistication and its Effect on SMEs

The effect of sophisticated party doctrine on SMEs is relatively less discussed. Due to the classification of a business enterprise or commercial organizations as "sophisticated" they may fall victim of the trap, as the large corporations often dominate small and medium enterprise as it relates to the negotiation process. Thus, a smaller player will enter into agreement with:

1. Larger suppliers.
2. Franchise networks;
3. Financial service providers;
4. Technology providers.
5. Public authorities, service providers etc.

The large business organization or service provider would force the small business or medium enterprise into signing the contract with an arbitration clause, as there would rarely be any negotiation on the issue. These entities can still claim a superior bargaining power in such relation. Thus, the "business sophisticated" label becomes a façade to conceal the reality of its actual bargaining power.

Conclusion

The research has critiqued arbitration clauses inserted into standard form contracts. It discusses how arbitration affects the access to justice, equality of contract, and the increasing use of arbitration clauses in the courts from different countries. Arbitration, as opposed to a procedure devised by the parties as a quick, efficient substitute to court, has become one of the prevailing methods for resolving disputes within both the commercial and consumer spheres. The increasing popularity of arbitration stems from theories of freedom of contract, party autonomy and procedural efficiency, however this research found that they do not accurately correspond to the realities of contemporary standard form contracting.[6]

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[6] Edward Brunet, Questioning the Quality of Alternative Dispute Resolution, 62 Tulane Law Review 1 (1987).

This study has determined that, unlike its theoretical conception of volitional agreement, the agreement for arbitration does not often occur in standard form contracts. The terms of the contract are often laid out by one party,[7] i.e. The corporation and powerful economical institution; while the weaker party is simply presented with the contract with no opportunity to bargain. Thus arbitration clauses in contracts[8] of adhesion rarely come about from mutual negotiation as they are generally mandatory for parties to access some needed facility, opportunity, employment, or good.[9] This suggests that there is no such thing as an authenticated agreement to arbitration and calls the doctrinal basis of arbitration into question.[10]

The study has also determined that the courts have established an irrelevant distinction in arbitration law due to reliance on the notion of a "sophisticated party[11]". A "sophisticated party" in a court's eyes is believed to possess enough knowledge of the matter at hand and negotiation power to protect itself; hence the court can simply enforce an arbitration clause within a standard form contract without concern for its validity. The theory of a "sophisticated party" does not apply to all modern commercial situations and thus creates a fallacy; if a stronger party cannot secure terms in its favor, then being a "sophisticated party" does not equate to having a realistic bargaining position in most commercial disputes.

The research has also found that due to the extensive use of arbitration under an "arbitration-friendly" judicial regime (such as that under the Federal Arbitration Act), there is a gradual removal of the access to public adjudication. An argument exists that the courts' extreme tendency to enforce arbitration agreements under its current form has taken away its power to evaluate and assess arbitration clauses, and this has influenced consumer and employee statutory rights, as well as public policy, and arbitration agreements have come to be more than just alternative means for dispute resolution, they are more like a way for stronger parties to limit their liability, protect themselves from group claims, control how arbitration itself is administered and how fair the process will be.[12]

The arbitration process should also be made more transparent. While some degree of confidentiality may remain appropriate in purely commercial, consensual transactions, a completely confidential arbitration process seems increasingly difficult to justify, especially in cases where substantive rights of consumers or

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[7] Margaret L. Moses, Statutory Misconstruction: How the Supreme Court Created a Federal Arbitration Law Never Enacted by Congress, 34 Fla. St. U. L. Rev. 99, 105–110 (2006).

[8] Jean R. Sternlight, 'Panacea or Corporate Tool?: Debunking the Supreme Court's Preference for Binding Arbitration' (2000) 74 Washington University Law Quarterly 637.

[9] Stephen J. Ware, 'Consumer Arbitration as Exceptional Consumer Law (with a Contractualist Reply to Carrington & Haagen)' (2001) 29 McGeorge Law Review 195.

[10] Thomas E. Carbonneau, The Exercise of Contract Freedom in the Making of Arbitration Agreements, 36 Vanderbilt Journal of Transnational Law 1189 (2003).

[11] Omri Ben-Shahar, 'The Myth of the "Opportunity to Read" in Contract Law' (2009) 5 European Review of Contract Law 1.

[12] Reshma A. Dhanawade, Need for Reform in Indian Arbitration System, 5 Journal of Indian Law and Society 88 (2014).

large numbers of employees may be implicated. One reasonable reform would be the optional publication of arbitral awards. These would have to be anonymized so as not to breach privacy interests, and it is probable that they would most easily function as persuasive precedent in the context of repeat, Institutional arbitration where consistent development of a body of arbitral case law can be encouraged.

Repeat player effect must also be counterbalanced, by adopting rules and standards that govern arbitrator selection. Independent arbitral institutions should have rigorous, transparent arbitrator appointment procedures, including arbitrator rotation and the publication of objective performance criteria for arbiters. Efforts should be made to de-emphasize the economic dependence of arbiters on repeat corporate clients. Accreditation systems for arbitrators can also be considered.

From a legislative perspective, it is possible that jurisdictions like India would also consider explicit provisions related to arbitration clauses in adhesion contracts and apply these regulations to specific industries such as banking, insurance, telecommunications and e-commerce, among others. The legislative approach can, as outlined above, require upfront explanation of the arbitration implications, ban specific types of clauses, or carve out judicial remedies to specific statutory rights. While the FAA strongly supports enforcement of arbitration clauses, the legislature can create clarity regarding their enforceability.

From a judicial perspective, there is the necessity to take a more rights-based and a more fairness-oriented approach to arbitral clauses as opposed to an approach centered entirely on formalism and contract interpretation. The term "sophisticated party" may be used as a per se reason for enforcing an arbitration[13] clause; it should be treated as one factor of several. Courts must focus on the real substantive fairness of arbitral clauses rather than on the formal procedural agreements in issue.[14]

In addition, courts may also reconsider their standard of deference to arbitral awards. While finality has been held to be a hallmark of arbitration, outright dismissal of review based on finality has led to a loss of a safety net for significant legal and constitutional rights that may have been violated. Limited, substantive merits review might be appropriate for a select few categories of disputes or in certain areas with high levels of public interest where a failure to obtain judicial review may result in egregious consequences.[15]

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[13] Ajar Rab, 'Balancing Party Autonomy and Fairness in Arbitration' (2018) 10 Indian Journal of Arbitration Law 45.

[14] Catherine A. Rogers, 'The Vocation of the International Arbitrator' (2013) 20 American University International Law Review 957.

[15] Sumeet Kachwaha, 'Judicial Intervention in Arbitration: Indian Perspective' (2008) 4 Asian International Arbitration Journal 1.

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