Analytical Speaking

VINOD KOTHARI & COMPANY

The limits on arbitrability: SC ruling limits arbitrators' rights on mortgages, potentially even hypothecations

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The recent Supreme Court ruling in *Booz Allen and Hamilton inc vs SBI Home Finance Ltd and others* [2011 (5) SCALE 147] sets severe limitations on rights of arbitrators. Housing finance companies are immediately affected, as it was common practice among housing finance companies to use the arbitration route for getting mortgage foreclosures. However, it would be myopic to believe that the implications of the Supreme Court ruling are limited to mortgage foreclosures only. In fact, as the ruling gets into the very issue of what is an arbitrable matter, the practice, very commonly used in the finance industry, to use arbitration awards as the device to order repossession of assets, may also come for serious question.

What was the case all about:

The history of the case involves several facts that may be not be relevant to our analysis here. Hence, we focus only on the relevant facts. Booz Allen (BA) was using flats which were acquired on leave and license basis from the owners of the flats. The owners of the flats, in turn, had taken a loan from SBI Home Finance (SHF). The owners defaulted on payment of the loan. Hence, SHF sought to foreclose the mortgage and evict BA. BA's contention was that BA had paid a huge security deposit while entering into the leave and license agreement. One of the owners who has given the property on leave and license basis had already become a sick company and was before BIFR.
Several issues were taken to courts at various levels, of which the key issue is – whether the arbitrator could pass an award for foreclosure of the mortgage? It is a different issue that any foreclosure would be highly inequitable for BA, as BA has paid a huge amount, may be almost the market value of the property, as security deposit against the leave and license agreement. However, that is the risk that anyone acquiring a property on leave and license basis anyway takes.

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What is an arbitrable matter:

Where a judicial proceeding is commenced in a matter which is subject matter of an arbitration agreement, the judicial forum is bound, by sec 8 (1), to refer the matter for arbitration by the arbitral tribunal. This provision implies that if the matter is an arbitrable matter, and is covered by the arbitration agreement, the matter must be decided by arbitration rather than by adjudication. The underlying crucial issue for this provision is – what exactly is an arbitrable matter, or what are the limits to arbitrability?

The limit to arbitrability is a very significant topic in law relating to arbitration, and has been discussed world-over, including at the UNCITRAL itself. Courts in several jurisdictions have rendered rulings on arbitrability. Over a period of time, several exceptions to arbitrability have emerged. For instance, matters pertaining to public policy are non-arbitrable. Recently, a Singapore Supreme Court ruling went at length to define the limits of arbitrability where one of the parties is insolvent company[1]. The Supreme court ruling in Booz Allen itself says: "The well recognized examples of non-arbitrable disputes are : (i) disputes relating to rights and liabilities which give rise to or arise out of criminal offences; (ii) matrimonial disputes relating to divorce, judicial separation, restitution of conjugal rights, child custody; (iii) guardianship matters; (iv) insolvency and winding up matters; (v) testamentary matters (grant of probate, letters of administration and succession certificate); and (vi) eviction or tenancy matters governed by special statutes where the tenant enjoys statutory protection against eviction and only the specified courts are conferred jurisdiction to grant eviction or decide the disputes."

Clearly, if the matter is non-arbitrable, an arbitrator cannot rule in the matter. The moot question in the present case was, whether the right to foreclose a mortgage, was an arbitrable matter, and whether the arbitrator could pass an award for mortgage foreclosure.

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Personal rights and real rights

Citing from Russell on Arbitration, and the ruling of Supreme Court in *Chiranjilal Shrilal Goenka vs. Jasjit Singh and Ors*. 1993 (2) SCC 507, the court in the present case drew an important exception to arbitrability – real rights are not arbitrable, personal rights are. This brings us to an important point – what are real rights, as opposed to personal rights? Salmond in his class treatise *Jurisprudence*, in chapter XI, has discussed at length real and personal rights. "A real right corresponds to a duty imposed upon persons in general whereas a personal right corresponds to a duty imposed upon determinate individuals. A real right is available against the world at large; a personal right is available only against particular persons. The distinction is one of great prominence in the law". For example, a right to the peaceable occupation of one's farm is a real right, for all the world is under a duty towards him not to interfere with it. But if he grants a lease of the farm to a tenant, then his right to receive the rent from such tenant is personal; for it avails exclusively against the tenant himself. For the same reason a right to the possession and use of the money in one's purse is real; but my right to receive money from some one who owes it to him is personal.
Why is the distinction between real and personal rights relevant for matters of arbitration? Since real rights affect the world at large, an arbitrator giving a ruling on real rights is likely to affect the interests of third parties too, which an arbitrator is incompetent to do.

[1] See, for a detailed discussion of the position in various countries on the limits of arbitrability, Comparative Law of International Arbitration, by Jean Fracois Poudret, section 3.7

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Is repossession of an asset a personal right or real right:

In the NBFC sector in the country, repossession of assets is very commonly based on an award of arbitrator. The question would be – is repossession of an asset pursuant to a default on a loan an arbitrable matter? The Supreme Court's ruling in *Booz Allen* is not on the issue of mortgage foreclosure alone. It is not merely because a special procedure is laid down in Civil Procedure Code for foreclosure of mortgages that the SC was persuaded to hold a mortgage foreclosure to be beyond the scope of an arbitration award. Most commentators commenting on the ruling have assumed that the impact of the ruling is limited to mortgage foreclosures. However, that would be myopic. The underlying rationale in the ruling of the Apex court clearly lay enforceability of real rights through arbitration agreements.
A right to recover money under a loan is a personal right, but the question is, is the right to seize an asset on default of a loan a personal right? An asset is a real right, not a personal right. A right of repossession is taking away the real right of the person owning the asset. Taking the SC ruling forward, it may be possible to contend that even repossession of assets would fall under the same category as enforcement of a mortgage. One of the reasons why the enforcement of a mortgage is not an arbitrable matter is that a court passing a decree on a mortgage deals not only with the rights of the mortgagor and mortgagee, but also of several third parties such as puisne/mesne mortgagees, persons entitled to equity of redemption, persons having an interest in the mortgaged property, auction purchasers, persons in possession. An arbitral tribunal will not be able to do so. The same argument may apply to other physical asset such as a commercial vehicle, an earth moving equipment, etc.

Conclusion

The Apex court ruling in *Booz Allen* is a milestone in the law of arbitration and the limits on arbitrability. At the same time, it exposes the weak links that abound pertaining to enforcement of security interests on variety of assets. The SARFAESI Act made a change in respect of banks, but that Act itself, and more particularly the relation of that Act to several other competing laws such as Sick Industrial Companies Act, is mired in controversy. A system that expects for a law to be created by judges is an unfortunate system. Laws are to be created by the lawmakers. Where lawmakers leave gaping holes that is where courts come and lay the law. But surely enough, courts are not the best

institutions to lay the law, because till the time it is settled by judiciary, the subjects would have passed through a great period of uncertainty.