THE IMPACT OF INCLUSION OF ARBITRATION CLAUSE BY REFERENCE IN MAIN CONTRACT AND SUB CONTRACT DOCUMENTS IN THE CONSTRUCTION INDUSTRY AND ITS NEGATIVE CONNOTATIONS

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ABSTRACT

In construction contracts an arbitration clause comes into being, as an exclusive clause in the main contract or by reference to another contract. In the dispute resolution process the Arbitrator derive his power from the arbitration agreement and from the applicable law which invariably makes it mandatory for the arbitration clause to be in writing. Such clause prevents Court jurisdiction since party autonomy will prevail. Therefore, it is important to identify, which form of arbitration clause would serve the purpose, since the usage of such clause in the dispute resolution process may become void if it is incorporated by general reference. The Court will not allow proceedings unless the arbitration clause is properly constituted. The Arbitration Clause by reference in itself could lead to disputes! An arbitration clause in a contract comes into being through a separate agreement, as an exclusive clause in the main contract or by reference to another contract. Therefore, it is important to have a properly constituted clause, and if it is by specific reference or general reference, or both, it would pave the way for disputes. The arbitration clause is a self-contained co-lateral contract preventing Court jurisdiction and would survive even if the main contract is void. When the arbitration clause is incorporated with lacuna, the opposing party could successfully challenge its validity in Courts. Disputes can be compounded when a main contractor sub-contracts to another who in turn sub-contracts to others making reference to the terms of the main contract. In this context, this paper is presented with a literature review and English case law to show the importance of properly constituting an arbitration clause to reduce disputes in the construction industry.

Keywords: *Arbitration by Reference, Construction Industry, Dispute Resolution, Negative Connotations.*

1. INTRODUCTION

Historically Arbitration has been used to resolve commercial disputes. Generally contracting parties enter into a commercial Contract wherein they would also agree to resolve any disputes in an expeditious manner by referring such disputes through a quasi judicial process known as Arbitration. Generally all disputes which can be decided by a civil court involving private rights can be referred to Arbitration. In order to resolve a dispute by arbitration, a neutral third party would be appointed by the parties or by the process contained in the agreement which both parties had undertaken to abide by the decision of the so called third party who is known as an Arbitrator. Due to the development of commerce, in order to avoid the disputes that may arise by reference to litigation, internationally most governments have entered into treaties which are identified as the New York Convention. Arbitration can be classified into domestic arbitration, international arbitration, ad hock arbitration and institutional arbitration. The crux of the matter is the arbitration agreement through which the Arbitrator derives his power. The literature review indicates that arbitration has evolved in different forms in different nations.

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2. BACKGROUND

"The modern origin of international arbitration can be traced to the Jay treaty (1784) between the USA and the UK, which provided for the determination of legal disputes between the states by mixed commissions. The Hague Conventions of 1899 and 1907 contained rules of arbitration that have now become part of customary international law. The 1899 Convention created the Permanent Court of Arbitration which was not, strictly speaking, a Court but a means of providing a body of arbitrators on which the parties to a dispute can draw. Consent to arbitration by states is given in three ways: by inclusion of a special arbitration clause in the treaty; by a general treaty of arbitration which arranges arbitration procedures for future disputes; and by a special arbitration treaty designed for a current dispute (Oxford Dictionary of Law, 2009).

Arbitration in India can be traced back to ancient times. Lal and Singhe (1983) proposed that: "In ancient India a decision by Panchayats has been accepted as binding. In ancient India there were various grades of arbitrators or Panchayats namely Puga, Sreni, Kula."

Similarly in Sri Lanka ancient civilisation also adopted arbitration procedures in different forms to resolve disputes. More recent studies (Kanag-Isvaran, 2006) show that "Sri Lanka has a rich tradition of dispute resolution going back to over two thousand five hundred years".

During colonial times there were instances when British Government Agents used arbitration as a way of resolving disputes (Woolf, 1960). In Pryles (2002) in his famous study Dispute Resolution in Asia, claims similar evolution of the process in the People's Republic of China, Hong Kong, Indonesia, Japan, Malaysia, Vietnam and Thailand.

In every civilisation or every legal history dispute resolution has evolved and it has being embraced into the common law as well as civil law systems. Arbitration is an Alternate Dispute Resolution (ADR). Arbitration in particular has been advocated rigorously by civil law countries than that of countries with common law traditions. Even England, the originator of common law, now advocates ADR. The change in the civil litigation landscape in England by Woolf Reform stands for this rating.

In a study by Redfern and Hunter (2001), argued that: "It is private, it is effective and, in most parts of the world, it is now the generally accepted method of resolving international business disputes. International commercial arbitrations take place daily in different countries and against different legal and cultural backgrounds; because they take place by agreement between the parties and are conducted in private, there is an informality about them which is striking". The entire nation in the global village trade internationally and work towards ADR in order to resolve their commercial disputes expediently.

3. ALTERNATE DISPUTE RESOLUTION PROCESS

Gearey *et al*. (2009) conclude that: "The arbitration is one method of ADR amongst many others. ADR is the broad name for those methods of dispute resolution that do not involve recourse to the court system. These include Mediation, Arbitration, Conciliation and Early Neutral Evaluation. Mediation can be both formal and informal and it usually involves an experienced person (mediator) who acts as a facilitator to encourage discussion of the parties' concerns and tries to encourage the parties to reach a solution that they are all happy with. Conciliation is slightly different in that the conciliator is authorised to propose a solution for the parties to consider before they reach a conclusion. Neutral evaluation involves an expert considering all of the evidence and reaching a view which, although not binding, is used in an attempt for all parties to see what the effect could be if the case goes to courts. It is hoped that both parties will resolve their disputes if they are confronted by this neutral position. However, Arbitration tends to be used in commercial cases since it is legally binding and a professional arbitrator will determine how the case will be resolved. This is a much more formal process than the previous forms of ADR and it is often seen as an expensive but useful alternative".

4. ARBITRATION AGREEMENT AND INCORPORATION OF THE ARBITRATION CLAUSE

The distinguishing feature in arbitration is the agreement to arbitrate. Though it is referred to as an agreement it is a co-lateral contract. In Lord Diplock in Bremer Vulkan *vs.* South India Shipping (1981) AC 909, states that: "The status of a so-called 'arbitration clause' included in a contract of any nature is different from other types of clauses because it constitutes a 'self-contained contract co-lateral or ancillary to the substantive contract". In the case of the arbitration clause over the doctrine of severability, the arbitration clause would survive even if the main contract is void.

The arbitration agreement, or rather the agreement to arbitrate, can come into existence as a separate agreement, as a clause in the agreement itself between the parties or incorporation by reference. The Oxford Dictionary of Law (2009) concludes that incorporation by reference is reference to named contract terms. This is often being sufficient to incorporate the term by reference to the contract, although the other party may not have taken the opportunity to read the terms. It is further enumerated that: "there are risks in incorporation if the terms are merely incorporated by reference".

It is these aspects of the risk that is necessary to encapsulate with particular reference to construction contracts. It is the common law position that the arbitration agreement may prevent the parties from bringing a dispute into the court. Further, more often than not, it has been laid down by statute that the agreement to arbitrate has to be a "written agreement". The object of the legislators is to ensure that one is not deprived of the right to have disputes resolved by court unless and until he has consciously and deliberately agreed to do so. Lastly, the nature of an arbitration clause in the contract is different to other type of clauses because it constitutes a self-contained contract co-lateral to or ancillary to substantive contract.

This agreement serves several features, namely parties have consented to resolve their disputes by arbitration and expression of the will of the parties on the basis of party autonomy. Once the consent is given it cannot be withdrawn unilaterally.

An arbitration agreement does not merely serve to evidence the consent of the parties and to establish the obligation to arbitrate in the event of a dispute being referred. The cardinal principle is, it is a basis of source of power to arbitrate although it is supplanted by statutes. In this sense it deprives one's right to determine a dispute by reference to court since in the case of determination of Scott *vs*. Avery by the English Court in favour of arbitration over litigation. Therefore the English Courts do not advocate such deprivations now unless by specific references since determination by Aughton Ltd. (formerly Aughton Group Ltd.) *vs.* MF Kent Services Ltd. (1991) 57 B.L.R. 1 at 30. The intention of this paper is to articulate instances where statutes have made it mandatory for the arbitration clause to be in writing. Courts are reluctant to construe an arbitration clause as properly incorporated unless there are specific references.

5. EMERGENCE OF UNCITRAL MODEL LAW

In a study by Kwatra (1997, p.85) argued that: "Over the years nations after nations ventured into international trade resulting in the birth of The United Nations Commission on International Trade Law (UNCITRAL). UNCITRAL was established by the General Assembly in 1966. In establishing the Commission, the General Assembly recognised that disparities in national laws governing international trade created obstacles to the flow of the trade; it regarded the Commission as the vehicle by which the United Nations could play a more active role in reducing and removing these obstacles. It thus gave the Commission a general mandate to further the progressive harmonisation and unification of the law of international trade. The Commission has since come to be the core legal body of the United Nations system in the field of international trade law". Work carried out by UNCITRAL includes, but is not limited to, the "UNCITRAL" model law.

UNCITRAL Model Law is designed to assist states in reforming and modernising their laws and arbitral procedures so as to take into account the particular features and needs of international commercial arbitrations. It was adopted by UNCITRAL in 1985 and has already been enacted into law by a considerable number of jurisdictions from both developing and developed countries (Kwatra, 1997).

The Model Law provides a template for drafting national laws so that harmonisation may take place. The

Model Law Article (vii) covers the definition and the form of arbitration agreement. Article (vii) of The Model Law in its current form in 2006, provides that:

- Arbitration agreement' is an agreement by the parties to submit to arbitration all or certain disputes which have arisen or which may arise between them in respect of a defined legal relationship, whether contractual or not. An arbitration agreement may be in the form of an arbitration clause in the contract or in the form of a separate agreement.
- The arbitration agreement shall be in writing.
- The reference in a contract to any document containing an arbitration clause constitutes an arbitration agreement in writing, provided that the reference is such as to make that clause part of the contract."

6. CASE LAWS INCORPORATING ARBITRATION BY REFERENCE

In the Scott *vs.* Avery decision, common law had developed arbitration into greater echelons with many exceptions, and one such being the incorporation of the arbitration clause by reference and acceptance by the judiciary ranging from construction, shipping to insurance etc. Mustill and Boyd (2001) stated that: "Although in general the law takes a benevolent view of the use of general words to incorporate by reference terms to be found elsewhere, a stricter rule has developed in the case of bills of lading and charter parties. One reason is that the bill of lading, as a transferable document of the title, may come into the hands of person with no knowledge and no remedial means or knowledge of the charter party. (Federal Bulk Carriers Inc *vs.* C Itoh & Co. Ltd., The Federal Bulker (1989) I Lloyd's rep. 103)."

Stephen and Ramsey (2006) proposed incorporation by reference, where it is contended that an arbitration agreement is incorporated by references into another contract, distinct and specific written words were needed prior to the 1996 Act to effect the incorporation and to satisfy the requirement for writing. This still appears to be the position despite the provision in the 1996 Act that: "Reference in an agreement to a written form of the arbitration clause or to a document containing an arbitration clause constitutes an arbitration agreement if the reference is such as to make that clause part of the agreement."

It should be noted that the writers of the above are referring to the Arbitration Act of 1996 of England and Wales. The writer reproduces the long title: "An Act to restate and improve the law relating to arbitration pursuant to an arbitration agreement"

6.1. ENGLISH CONTRACT LAW PRINCIPLES WIDELY USED

Mckendrick (2011) discussed the subject that the 'Europeanisation' of contract law (in the sense of general principles) has been fairly limited because it has largely been aimed at consumer transactions (although the Directive on Self Employed (Commercial Agents) 1986/653/EC), has a more general impact on agency law in the commercial context This paper does not attempt to examine the extent of application of English contract law doctrines to other legal systems but proceeds on the basis of general application and persuasive effect.

6.2. BOUND BY SIGNATURE

Mckendrick (2011) argued that in general, the accepted common law position is that parties are bound by the parol evidence rule and sanctity of written documents. This applies in the case of the written arbitration clause as well. Once the contracting parties have elected to enshrine their contract in a written document, the courts have held that, as a general rule the parties cannot adduce extrinsic evidence to add to, vary or contradict the written document; the document is the sole repository of the terms of the contract. This rule has been called the 'parol evidence rule'. English law does attach importance to the sanctity of written documents and this can be seen in the general rule that a person is bound by the document which he signs, whether he reads it or not. This proposition is seen to be derived from the case of L' Estrange *vs.* F Graucob Ltd. (1934) 2 KB 394.

Poole (2010) discussed the subject as: "This is an important buttress of contractual certainty and a reflection of objective approach to the contract formation, since if the parties sign a document they are objectively to be taken to be agreeing to its terms. However, its unbending application has sometimes appeared to cause hardship".

6.3. INCORPORATION BY REFERENCE AS IN ENGLISH CASE LAW

There is a generally accepted common law position where parties can incorporate an arbitration agreement into a contract 'by reference'. There has been a mixed authority in England whether it is sufficient to refer to a contract containing an arbitration clause or alternatively if the arbitration clause itself must be referred in order to validly incorporate the arbitration agreement as held in Sir John Megaw in Aughton Ltd. *Vs.* MF Kent Services Ltd. (1991) 57 B.L.R. 1;31. Con. L.R.60 CA.

The mere reference to a contract containing an arbitration clause would not in itself be sufficient. Sir John Megaw in Lexair Ltd. *vs.* Edgar W. Taylor Ltd. (1993) 65 B.L.R. 87 QBD (Fox –Andrews J.) states that: "An arbitration clause cannot be incorporated by a mere reference to the terms and conditions of another contract containing an arbitration clause (known as "the rule in *Aughton*") has been applied reasonably consistently in subsequent English cases concerning the incorporation of an arbitration clause by reference".

To express it differently, even where the assent of the parties to an agreement is signified in some manner other than by signature on a document containing or referring to its terms, it is still possible for the terms contained in a document or documents to become part of the agreement between those parties, for instance in the industry or trade association terms the document or documents may even be the terms of another contract between the parties, or of a draft agreement between them, or of a contract between one of them and a third party. All that is required is a clear intention on the part of all parties to the agreement that the terms contained in that one or more documents be incorporated into their agreement.

The authority of English law for the principle as enumerated in the above paragraph is found in Modern Buildings Wales Ltd. *vs.* Limmer & Trinidad Co. Ltd., Court of Appeal, Civil division, Buckley and Ormrod LJJ, 7, 10 February 1975.

In *Arbitration Act* 1950, s 4(1) "Arbitration – Stay of proceedings – a Dispute as to existence of arbitration agreement arose – Determination of dispute on interlocutory motion for stay – Question was whether arbitration clause incorporated in contract – whether Duty of court had the power to determine before defendant took further steps in proceedings.

The plaintiffs were head contractors for the construction of a building. The defendants were nominated sub-contractors for the purpose of putting in ceilings in that building. The defendants' quotation for the work was accepted by the plaintiffs' order which contained the words 'in full accordance with the appropriate form for nominated sub-contractors (R.I.B.A., 1965)'. The plaintiffs sued the defendants for damages for breach of contract and applied for summary judgment under RSC Ord. 14. The defendants contended that the plaintiffs' order had incorporated a contract ('the green form') normally used by contractors and nominated sub-contractors when contracting inter se, which contained an arbitration clause. The defendants applied under s 4(1) of the Arbitration Act 1950 for stay of the proceedings in the action pending reference of the dispute to arbitration. The plaintiffs contended that the words in their order did not refer to the green form, that where there was doubt about the existence of an arbitration agreement the court should exercise its discretion to allow the action to proceed rather than deciding the question on an interlocutory basis, and that they knew of no defence to their claim. Section 4(1) is set out at p 551 a and b, post.

It was held – A stay would be granted for the following reasons -

(i) Where a party claimed that proceedings should be stayed because there was an arbitration agreement in force, the court was under a duty to construe the terms of the contract in order to decide whether there was a valid arbitration clause [1975] 2. All ER 549 at 550. That question had to be determined at an interlocutory stage because it had to be done before the defendant took any steps in the action (p 554 b and c and p 556 g to j, post).

(ii) The defendants' evidence showed clearly that the contract incorporated the green form, including the arbitration clause, and that there was a bona fide dispute between the parties. There was therefore no sufficient reason under s 4 of the 1950 Act for the Court to refuse a stay (see p 556 c to f and p 557 e g and h, post).

In adjudication of this case English judges distinguished in London Sack & Bag Co Ltd *vs.* Dixon & Lugton Ltd. where the plaintiff company bought from the defendant company 5,000 used cotton flour bags, and on delivery complained that the goods were not up to description and claimed repayment, with interest and damages. There was no arbitration clause in the written contract, but the point was taken that both the parties were members of a company called United Kingdom Jute Goods Association [1975] 2 All ER 549 at 553.

It is noted that the English court declined to infer that there was an arbitration clause thus reproduced the obit dictum by Scott LJ: 'The arbitration clause must be in the written submission. It cannot be said that there is a written agreement to arbitrate unless there is a clear reference in the written contract between the parties to the alleged arbitration clause and that reference must amount to an incorporation of it.'

6.4. INSTANCES WHERE THE ARBITRATION CLAUSE DOES NOT APPLY IN COMMON LAW

If the contract is in itself assignable, the arbitration clause being part of that contract, is also assignable; but if a contractor assigns the right to receive all the money due or to become due under a contract, the contract otherwise remaining in force between himself and the employer and the contractor contains an arbitration clause, the arbitrator has no power to make an award of such money in favour of the contractor.

Where the arbitration clause provided that the reference should not be opened until after the completion of the works and the contractor determined the contract before completion (as he had power to do under a clause in the contract), it was held that the arbitrator had no jurisdiction. Limitations on the opening of the reference are strictly construed.

Where a sub-contractor agrees to be bound by the terms of a principal contract, which contains a clause referring disputes between the employer and the contractor to arbitration, this does not necessarily operate as a submission to arbitration of disputes between the contractor and the sub-contractor, unless the language used by the parties to the sub-contract points plainly to an intention to incorporate the arbitration clause in the main contract.

In many building disputes the employer will wish to bring a claim against the contractor, with whom he may have an arbitration agreement, and against the architect or engineer with whom he may not have an arbitration agreement or an agreement requiring the disputes to be referred to the same arbitrator. In these circumstances, the Court is nonetheless obliged to grant a stay of proceedings unless the applicant has taken a step in proceedings to answer the substantive claim or the Court is satisfied that the arbitration agreement is null and void, inoperative or incapable of being performed. Once arbitration proceedings are started, the Court will not readily revoke the authority of the arbitrator.

Unless otherwise agreed by the parties, an arbitration agreement which forms or was intended to form part of another agreement (whether or not in writing) is not to be regarded as invalid, non-existent or ineffective because that other agreement is invalid, or did not come into existence or has become ineffective, and for that purpose it is to be treated as a distinct agreement. This principle of severability means that the invalidity or rescission of the main contract does not necessarily entail the invalidity or rescission of the arbitration agreement.

It is a practical perception when a construction contract is about to be signed after long drawn out negotiations, at times flexing the bargaining power and relative strengths of each other, the importance of the arbitration clause is overlooked. In any event the construction activity is a series of decisions and executions thereof and there is bound to be disagreements which may mature into disputes. Therefore, in the event of a dispute, in general it is the arbitration clause in particular that would come to one's recue as a last resort. If a simple question is asked whether: "Is it worth as a Builder, Contractor, Developer,

Engineer, Architect or Quantity Surveyor to test the knowledge and temperament of the Arbitrator, Judge, Counsel or other Tribunal in the execution of one's profession, or instead, incorporate the arbitration clause properly at the inception in the main contract or as a separate agreement to arbitrate?". There is no doubt that everyone would agree to the latter.

7. CONCLUDING REMARKS

The awareness of the impact of incorporating Arbitration by reference in the contact agreements is very important since if a dispute arises between the parties to a contract and if it is not properly incorporated one party can challenge the validity or existence of an arbitration clause in the contract. This is seen in the number of case laws cited in the above literature review. It is also identified that an arbitration agreement must be properly incorporated by reference to another contract, in which the arbitration clause is spelled out provided specific reference has been made and the other party has notice of it. This way both parties have equal opportunity to resolve their disputes without a challenge. However industry research also shows that there are instances where incorporating the arbitration by reference has been challenged successfully and could be challenged in the future as well. However it is important for the construction industry stakeholders such as Builders, Engineers, Contractors or any other building professional not to venture into testing the common law, particularly English common law, and end up in difficulties. Also under varying degrees of uncertainties and mix of legal authorities, it may be not prudent to incorporate the arbitration clause by general reference but at the inception of the contract. One could reproduce the same clause, or alternatively include a well-tested arbitration clause, or enter into a separate contract to arbitrate or make a specific reference with notice to the other party so that parties do not fall into pitfalls with lack of awareness or understanding. It is believed that understanding of the ADR process very specifically the Arbitration process and its inclusion in the contract condition and in sub contract agreements will help build a less litigious construction industry.

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