Among the various grounds to set aside or refuse enforcement of an arbitral award, the ground of ‘patent illegality’ has been the subject of a deeply contested discussion amongst practitioners in India and abroad. Recently, a three-judge bench of the Supreme Court of India, in a landmark decision in Patel Engineering Ltd. v. North Eastern Electric Power Corporation Ltd. (May 22, 2020), clarified the scope of using the ground of ‘patent illegality’ to set aside an arbitral award in domestic arbitrations governed under Part-I of the Arbitration and Conciliation Act, 1996, as amended by the 2015 amendments. While doing so, the Court reaffirmed the decisions by the division benches of the Court in Associated Buildersand Ssangyong Engineering (which were delivered after the 2015 amendments were enacted).

This post seeks to critically examine the Patel Engineering decision and explain the scope of the ‘patent illegality’ ground for setting aside an arbitral award, under the 2015 amendments. However, before delving into the case, it is pertinent to trace the development of this ground through judicial precedents prior to the 2015 amendments.

Judicial Origins of ‘Patent Illegality’

Under the unamended Act, there was no exception of ‘patent illegality’, for setting aside a domestic award or refusing enforcement of a foreign-seated award. Under Part-I, in section 34(2)(b)(ii) of the Act, an award could be set aside if it were in contravention with ‘public policy of India’ (for Indian-seated arbitrations). Similarly, under section 48(2)(b)(ii) in Part-II(A) of the Act (for foreign-seated arbitrations under the New York Convention) and section 57(1)(e) in Part-II(B) (for foreign seated-arbitrations under the Geneva Convention), the enforcement of the award could be refused by a judicial authority on the ground that it conflicted with the public policy of India.

The landmark decision of the Supreme Court in Renusagar Power (which predates the Act) had clarified the scope of ‘public policy’ for setting aside an arbitral award, by stating that an award contravened public policy if it went against first, the fundamental policy of Indian law, second, interests of India, or third, justice and morality. However, in the ONGC v. Saw Pipes decision (under the unamended Act), the Supreme Court undertook a purposive approach to further read ‘patent illegality’ as a part of the ‘public policy’ exception, for the enforcement of an award under section 34(2) of the Act.

In Saw Pipes, the Court explained that an award suffered from ‘patent illegality’ when it was first, patently against the substantive provisions of laws in force in India, second, in conflict with provisions of the Act, or finally, against terms of the contract. Eventually, a three-judge bench in ONGC v. Western Geco, while upholding Saw Pipes, noted that ‘illegality’ of the award must go to root of the matter. Illegality of a trivial nature could not be held to violate the public policy.

As a result of the expansion of the scope of the ‘patent illegality’ ground (under the ‘public policy’ exception), judicial authorities began to excessively set aside awards in domestic arbitrations, and also refused enforce foreign-seated arbitral awards in Part-II of the Act. The latter was especially curious, since the Saw Pipes decision was limited to domestic awards.
Background of Patel Engineering

Patel Engineering Ltd. (PEL) and North Eastern Electric Power Corporation Ltd. (NEEPCO) had a supply agreement with an arbitration clause. PEL and NEEPCO had contractually agreed that additional payment will be provided to PEL in case the materials transported (sand) to the quarries were from a ‘lead’ longer than that envisaged in the contract.

Subsequently, a payment dispute arose and a sole arbitrator was appointed. Within the context of the dispute, both PEL and NEEPCO agreed that PEL was entitled to extra payment for the extra lead. The only issue before the arbitrator was which clause, between clause 33(ii)(a) or clause 33(iii) of the contract, would be applicable for calculating the payment for transportation. The arbitrator held in favour of PEL, noting that clause 33(ii)(a) was applicable for the computation of the additional payment, and issued three awards. NEEPCO challenged these awards under section 34 of the Act before the Additional Deputy Commissioner (Judicial) [‘ADC’] in Shillong. The ADC rejected the application, and upheld all the arbitral awards.

On appeal under section 37 of the Act, the High Court of Meghalaya set aside the ADC’s judgment and found that the award suffered from patent illegality, and held it to be against the fundamental policy of Indian law. Further, NEEPCO’s review petition was dismissed by High Court, observing that there was no ground for review (also noting the delay in filing). The dismissal of the review petition was challenged before the Supreme Court.

Narrowing the Scope of ‘Patent Illegality’ in the 2015 Amendments

Noting that the petition to challenge the award under section 34 was made after October 23, 2015 (the day on which the 2015 amendments came into force), the Supreme Court observed that the 2015 amendments would be applicable to the case, as per the BCCL v. Kochi Cricket decision. While the Court acknowledged that the patent illegality ground was first expounded upon in Saw Pipes, it traced the developments on the application of the ground after the 2015 amendments.

It relied on the 246th Law Commission Report [‘Commission’] which had recommended the insertion of the ‘patent illegality appearing on the face of the award’ as a ground to set it aside. This ground, as noted above, is limited to domestic awards and excludes any awards arising out of international commercial arbitrations under Part-I. Further, to limit excessive judicial intervention, the Commission added a clarificatory proviso, stating that an award shall not be set aside merely on the ground of an erroneous application of the law or, by reappreciating of evidence. The accepted recommendation was inserted as sub-section (2A) in section 34 of the Act, via the 2015 amendments. Thus, the unintended consequences of the judicial interpretation in Saw Pipes were curtailed.

The Court in Patel Engineering noted that the amended section 34(2A) provided an additional, albeit carefully limited ground of patent illegality, to set aside an award arising out of a domestic arbitration, while excluding the applicability of this ground to awards arising out of international commercial arbitrations under Part-I of the 1996 Act. Moreover, it noted that in foreign awards under the New York Convention (governed by Part-II of the Act), ‘patent illegality’ could not be invoked to resist enforcement, since it is not an available ground under section 48 therein. Further, the Court relied on Ssangyong Engineering to hold that the expansive interpretation given to ‘public policy of India’ in Saw Pipes and Western Geco had been neutralised after the 2015 amendments (which is be applicable to all cases involving section 34 applications, filed after October 23, 2015).

Moreover, it relied on Associated Builders, noting that the construction of the terms of a contract primarily falls under the arbitrator’s jurisdiction. Such a construction only suffers from patent illegality when the arbitrator construes the contract in a manner which no fair-minded or reasonable person would (i.e., the view taken by the arbitrator is not even a possible view to take). This was due to the effect of amended section 28(3) (modified by the 2015 amendments). Finally, the Court also affirmed the observations of the Associated Builders decision, that first, post the 2015 amendments, a mere contravention of the substantive law of India is not a ground to set aside an arbitral award; however,
if the arbitrator wanders outside the contract and deals with matters not referred to him, he commits an error of jurisdiction. The latter is covered under the ground of ‘patent illegality’ in amended section 34(2A).

In summary, the court held that ‘patent illegality’ is a ground available under the Act for setting aside a ‘purely domestic arbitral award’ in two instances, first, the arbitrator’s decision is found to be perverse, or so irrational that no reasonable person would have arrived at the same decision; and second, the arbitrator’s construction of the contract is such that no fair or reasonable person would arrive at a similar conclusion.

**Outcome in Patel Engineering**

The Supreme Court upheld the High Court’s findings, that first, no reasonable person could have arrived at a similar conclusion while interpreting the contract, as the sole arbitrator did; and second, that the arbitrator took into account various irrelevant factors in his decision, and ignored vital clauses of the tender documents. Thus, the award suffered from the vices of irrationality and perversity, and suffered patent illegality.

Finally, it also upheld the High Court’s finding that the award was contrary to the fundamental policy of Indian law, as the effect of arbitrator’s misconstruction of the relevant contractual clauses would lead to a loss of approx. INR 1000 crores to NEEPCO, imposing a heavy burden on the public exchequer, while unjustly enriching of PEL.

**Comments**

The judgment in *Patel Engineering* continues the emerging judicial trend of establishing a pro-enforcement Indian arbitration regime (in the context of domestic awards under Part-I), which commenced with the decisions in *Associated Builders* and *Ssangyong Engineering*. It strongly reaffirms the fact that enforcement of arbitral awards made under international commercial arbitrations (under Part-I) and foreign-seated arbitral tribunals can no longer be challenged on the ground of ‘patent illegality’. While the Court only discussed non-applicability of ‘patent illegality’ as a ground to refuse enforcement to New York Convention awards in Part II(A), we believe that this position would apply *mutatis mutandis* to Geneva Convention awards in Part II(B). The Court also affirmed that post the 2015 amendments, the position of law upheld in *Saw Pipes* and *Western Geco* is not applicable to cases where an award (under domestic arbitrations) is challenged under section 34, after October 23, 2015.

Interestingly, while section 34 of the Act has been recently amended by the 2019 amendment, the legislature has made no modification to sub-section (2A). This indicates the legislative intent to continue with the position established by the 2015 amendments, along with the judicial precedents of *Associated Builders* and *Ssangyong Engineering*, to limit judicial intervention on the ground of ‘patent illegality’, in cases of awards rendered in purely domestic arbitrations. However simultaneously, the retention of the limited ground of ‘patent illegality’ itself implies the legislative intent to allow judicial authorities to retain this additional ground to interfere with domestic awards.

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