GOVERNMENT OF INDIA

LAW COMMISSION
OF
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Supplementary to Report No.246 on Amendments to Arbitration and Conciliation Act, 1996

"Public Policy"

Developments post-Report No.246

February 2015

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D.O. No.6(3)/238/2014-LC(LS)

6 February, 2015

Dear Mr. Sadananda Gowda ji,

The Law Commission of India, through its Report No. 246, suggested certain amendments to the Arbitration and Conciliation Act, 1996. The Report was submitted to the Government on 5 August 2014. However, through two judgments in *ONGC Ltd., v. Western Geco International Ltd.*; and *Associate Builders v. Delhi Development Authority,* the Supreme Court has interpreted the term 'public policy' in Section 34 of the Act expansively. This has necessitated the Law Commission of India to have a relook into that Section and suggest changes to it. Accordingly, the Commission has reworked Section 34 of the Act and the same is sent herewith as a supplementary to its Report No. 246, with the title **"Public Policy" – Developments post Report No. 246**. This may be kept in view while considering the proposed amendments to the Act. I may add here that a copy of this report was sent to Mr. P K Malhotra, Law Secretary, through e-mail, as he is out of the country at present, and his concurrence was obtained.

With warm regards,

Yours sincerely,

[Ajit Prakash Shah]

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"Public Policy"

Developments post Report No.246

The Law Commission of India was entrusted with the task of reviewing the provisions of the Arbitration and Conciliation Act, 1996 ("**the Act**") in view of the several inadequacies observed in the Act's functioning. After extensive consultations, the Commission made certain recommendations and proposed various amendments to the Act. This was reflected in the 246th Report of the Commission, titled the '***Amendments to the Arbitration and Conciliation Act 1996***', which was submitted to the Government of India on 05 August 2014.

2. The Act has been enacted with an aim of, *inter alia*, consolidating and amending the law relating to domestic arbitration, international commercial arbitration and enforcement of foreign arbitral awards. The object of the Act, drafted to replace the existing 1940 Act, is to ensure speedy disposal with minimum court intervention. This can be ascertained from the Statement of Objects and Reasons in the Arbitration and Conciliation Bill, 1995, which are as follows:

a. To comprehensively cover international commercial arbitration and conciliation and also domestic arbitration and conciliation;

b. To minimise the supervisory role of courts in the arbitral process;

c. To provide that every final arbitral award is enforced in the same manner as if it were a decree of court.

3. It is thus evident that the Act aims to promote international commercial arbitration in India, and thereby, promote foreign investments. To this end, the Act is based on the UNCITRAL Model Law on International Commercial Arbitration, 1985 and the UNCITRAL Conciliation Rules, 1980. Given that foreign investors often prefer arbitration to litigation in local courts, many legal systems seek to provide a pro-arbitration, and therefore pro-investment environment. For instance, the UK government has announced that the legal services sector contributed 20.9 billion GBP to the economy in 2011, a majority of which would have come from arbitration given that London is the leading preferred centre for arbitration.[1]

[1] UK Ministry of Justice, *UK Legal Services on the International Stage: Underpinning Growth and Stability* (2013), *available at* <http://www.justice.gov.uk/downloads/publications/corporate-reports/MoJ/legal-services-action-plan-0313.pdf>.

At today's prices this is equivalent to Rupees 2.9 lakh crores in a year.

4. The chief reason for the present supplementary report is that a month after the Law Commission submitted its 246th Report on amendments necessary to make arbitration more relevant in India, a three judge bench of the Supreme Court in *ONGC Ltd. v. Western Geco International Ltd*[2] ("**Western Geco**") interpreted the term "public policy" in Section 34 of the Act widely to include the Wednesbury principle of reasonableness within the phrase "fundamental policy of Indian law".

5. The Commission's recommendations in its 246th Report were meant to introduce fairness, speed and economy in the resolution of disputes through arbitration; bring arbitration practice in India in conformity with international principles; and reduce extensive judicial intervention in arbitration matters. This was considered imperative to stem the gradual, though steady, shift away from India as a preferred seat for international commercial arbitrations in

[2] 2014 (9) SCC 263

favour of more investor-friendly jurisdictions such as Singapore, Hong Kong and London. In fact, the shortcomings of the current Act have resulted in even Indian parties now preferring to institute arbitration proceedings abroad. The government has also taken cognizance of the problem of excessive judicial intervention in arbitration proceedings and has emphasised the need to establish and popularise institutional arbitration in India, to make it on par with international standards. In this context, it has committed to developing India into a global hub for arbitration and legal process outsourcing. [3] The Commission's recommendations in its 246th Report and in this supplementary report serve to further this objective.

6. However, the Supreme Court's judgment in *Western Geco* undermines the Commission's attempts to bring the Act in line with international practices and will discourage the possibility of international arbitration coming to, and domestic arbitration staying in, India. Consequently, the proposed Section

[3] Minister, Law and Justice & Communications and IT, Government of India, Letter to the Chairman of the Law Commission, D.O. No. 304MLJ/VIP/2014 dated 18th June 2014.

34 of the Act (as recommended in the 246th Report) needs to be further amended.

7. Understanding "Public Policy" in Section 34 of the Act:

7.1 One of the defences available to the *losing* party in an arbitration award is to challenge it under Section 34 of the Act, which deals with applications for setting aside an arbitral award. The grounds enumerated for such a challenge relate to the *process* of arriving at the decision and do not provide for an examination of any part of the *merits of the* award. They are also expressly exhaustive. One such ground for setting aside the award is provided in Section 34(2)(b)(ii) of the Act if the court is satisfied that the award conflicts with the "public policy" of India.

7.2 The term "public policy" is not defined, either in the 1996 Act or in any other statute.[4] In fact, in numerous cases, the Supreme Court has itself

[4] A contract against public policy is void under s. 23 of the Indian Contract Act, 1872. It was interpreted by the Supreme Court in *Gherulal Parakh v Mahadeo Das* (1959) Supp (2) SCR 206, stating that the 'public policy' is an untrustworthy guide. It is also noteworthy that the UK protested against the inclusion of the term by writing a Note pointing out the differences between Civil Law and the Common Law Countries. However, the UNCITRAL agreed to retaining public policy as a ground of challenge.

accepted that the term public policy is like an "untrustworthy guide" or an "unruly horse",[5] the latter being a description coined for the phrase "public policy" in England as far back as 1824.[6]

7.3 The power of the Courts to set aside an arbitral award (under the UNCITRAL Model Law and the Act) was never meant to be a license to overturn an arbitral award on merits.[7] The Courts were supposed to merely act as Courts of Review rather than as Courts of Appeal, even while examining whether the arbitral award was "in conflict with the *public policy* of India" under Section 34.[8]

7.4 Accordingly, the Supreme Court, in *Renusagar Power Co. Ltd. v. General Electric Co.*[9] (**"Renusagar"**), a 1994 case under the Arbitration Act, 1940, provided

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[5] *P. Rathinam v. Union of India*, (1994) 3 SCC 394; *Union of India v. Shri Gopal Chandra Mishra*, AIR 1978 SC 694; *Gherulal Parakh v. Mahadeo Das* (1959) Supp (2) SCR 206

[6] *Richardson v. Mellish*, [1824-34] All ER Rep 258, per Burrough J.

[7] Jean-Paul Beraudo, *Egregious Error of Law as Grounds for Setting Aside an Arbitral Award*, 23(4) J. OF INTL. ARB. 351 (2006); Patricia Nacimiento, *Article V(1)(a)* in Herbert Kronke, Patricia Nacimiento, *et al.* (eds), RECOGNITION AND ENFORCEMENT OF FOREIGN ARBITRAL AWARDS: A GLOBAL COMMENTARY ON THE NEW YORK CONVENTION 205-230 (Kluwer Law International 2010).

[8] *Ibid.*

[9] (1994) SCC Supp. (1) 644.

a narrow interpretation to the term "public policy" stating:

Applying the said criteria it must be held that the enforcement of a foreign award would be refused on the ground that it is contrary to public policy if such enforcement would be contrary to (i) fundamental policy of Indian law; or (ii) the interests of India; or (iii) justice or morality.

Although the term "fundamental policy of the law of India" was not defined, the context of the case showed that the court declined to accept the contention that an international award that *merely* violates Indian law (by awarding compound interest) would be violative of public policy. The judgment was followed in other cases.

7.5 Subsequently, in its 2003 decision *ONGC Ltd v. Saw Pipes Ltd.*[10] ("***Saw Pipes***"), the Supreme Court opened the floodgates so far as judicial interference in arbitrations was concerned. It expanded the definition of "public policy" to include cases of "patent illegality". In doing so it stated:

[10] (2003) 5 SCC 705.

Therefore, in our view, the phrase 'Public Policy of India' used in Section 34 in context is required to be given a wider meaning.... However, the award, which is, on the face of it, patently in violation of statutory provisions cannot be said to be in public interest. Such award/judgment/decision is likely to adversely affect the administration of justice...(the) award could be set aside if it (sic) contrary to:--

(a) fundamental policy of Indian law;

(b) the interest of India; or

(c) justice or morality,

(d) in addition, if it is patently illegal.

Illegality must go to the root of the matter and if the illegality is of trivial nature it cannot be held that award is against the public policy.

8. Criticism of the interpretation of "public policy"

8.1 The decision in *Saw Pipes* provoked considerable adverse comments from practicing lawyers and academics. Eminent jurist and Senior

Advocate Fali Nariman reportedly said that the judgment:

> *... virtually set at naught the entire Arbitration and Conciliation Act of 1996 . . If Courts continue to hold that they have the last word on facts and on law — notwithstanding consensual agreements to refer matters necessarily involving facts and law to adjudication by arbitration — the 1996 Act might as well be scrapped.*
>
> *... The Division Bench decision of the two Judges of the Court has altered the entire road-map of Arbitration Law and put the clock back to where we started under the old 1940 Act.*[11]

8.2 Others have also criticised the *Saw Pipes* judgment for upsetting the delicate balance in Section 34 between the finality of arbitral awards and permissible judicial review, and for reverting to a pre-1996 state of being able to challenge arbitral awards for error of law apparent on the face of the record.[12]

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[11] Mr Fali S. Nariman, *Legal Reforms in Infrastructure*, Speech delivered in New Delhi on 2nd May 2003 and cited from Sumeet Kachwaha, *The Arbitration Law in India: A Critical Analysis*", 1 INT. ARB. L.R. 13, 15 (2007).

[12] D.R. Dhanuka, *A Critical Analysis of the Judgment ONGC v Saw Pipes Ltd. – Plea for Consideration by Larger Bench*, 51(3) ARB. L.R. 1 (2003); S. Gupta, *Challenge to Arbitral Awards on Public Policy: A Comment on ONGC v Saw Pipes*, 52(3) ARB. L.R. 1 (2003); Sumeet Kachwaha, *Enforcement of Arbitration Awards in India*, 4 ASIAN INT'L ARB. J. 64, 70 (2008); Alok Ray and Dipen Sabharwal, *Indian Arbitration at Cross Roads*,1(6) GLOBAL ARB. REV. (2006).

8.3 The Supreme Court in *McDermott International Inc v. Burn Standard Coal Company*[13] in 2006 noted that *Saw Pipes* has come in for criticism from various circles, but left the issue of overruling the judgment to a larger Bench. Justice Sinha, observed:

> *We are not unmindful that the decision of this court in ONGC had invited considerable adverse comments but the correctness or otherwise of the said decision is not in question before us. It is only for a larger bench to consider the correctness or otherwise of the said decision. The said decision is binding on us.*

8.4 Similarly, in *Centrotrade Minerals & Metals Inc v. Hindustan Copper Ltd,* [14] the Court noted that regardless of whether it agreed or disagreed with the "rationale expressed in *Saw Pipes*", it had no choice but to abide by the decision.

9. Extending *Saw Pipes* to Challenging Foreign Arbitral Awards

9.1 Section 48(2)(b) of the 1996 Act also provides for the non-enforcement of a foreign arbitral awards if

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[13] 2006 (2) Arb LR 498, 531 (SC).
[14] 2006 (2) Arb LR 547, 575-576 (SC).

"the enforcement of the award would be contrary to the public policy of India."

9.2 The popular international view has been that since the enforcement of foreign awards is regulated by the New York Convention ("**NYC**"), the term "public policy", as contained in Article V(2)(b) of the NYC and incorporated in Section 48(2)(b) of the Act, must be interpreted in consonance with the objectives of the NYC. There are a plethora of international decisions, which state that one of the major objectives of the NYC is to remove impediments to the enforcement of foreign awards.[15] These cases go on to say that when any term of the NYC can be interpreted in two ways, the pro-enforcement interpretation should be adopted. Consequently, the international view is that the term "public policy" must be construed narrowly.[16] This is reflected in the Delhi High Court decision in *Glencore Grain Rotterdam B.V. v. Shivnath Rai*

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[15] *Oltchim, S.A v. Velco Chemicals, Inc*, Yearbook of Commercial Arbitration, Vol. XXXI(2006), US No. 528, p.992; *GreCon Dimter Inc (Germany) v. J.R .Normnand Inc.* (Canada*) and Scierie Thomas Louis Tremblay Inc. (Canada*), Canada No. 22, p.611; . See also *Theresa Ballard v. Illinois Central Railroad Company and R.L.Clark*, Yearbook of Commercial Arbitration, Vol. XXXI(2006), US No. 526, p.978

[16] *Brostrom Tankers AB (Sweden) v. Factorias Vulcano SA (Spain)*, Yearbook of Commercial Arbitration, Vol. XXX(2005), Ireland No. 1, p.591, See also *Seller v. Buyer*, Yearbook of Commercial Arbitration, Vol. XXIX(2004), Germany No. 59, p. 697; *Exclusive Distributor v. Seller*, Yearbook of Commercial Arbitration, Vol. XXIX(2004), Germany No. 61, p.715; *Fotochrome, Inc. v. Copal Company, Limited* (2nd Cir. 1975) 517 F.2d 512

Harnarain (India) Co. [17] ("***Harnarain***"), where the Court relied on *Renusagar*, and not *Saw Pipes*, to construe the term "public policy". However, in another case, the Delhi High Court observed that Saw Pipes would be applicable to interpret Section 48(2)(b).[18]

9.3 The hope was that the view in *Harnarain* would become the law of the land. However, the latter view was accepted by the Supreme Court in 2011 in *Phulchand Exports Ltd. v. OOO Patriot* [19] ("***Phulchand***"), where the Supreme Court held that "patent illegality" under the term "public policy of India" needs to be considered even while examining the enforcement of a foreign award under Section 48 (2)(b) of the Act.

9.4 The judgment in *Phulchand* was overruled by a three judge bench of the Hon'ble Supreme Court in *Shri Lal Mahal Ltd. v. Progetto Grano Spa*[20] and the narrow interpretation in *Renusagar* was held to be applicable in the context of Section 48 of the 1996 Act.

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[17] 2008(4) ARB LR 497(Delhi).
[18] *Toepfer International Asia Pvt. Ltd. v. Priyanka Overseas Pvt. Ltd.* 2007(4)ARB LR 499(Delhi)
[19] 2011(11) SCALE 475
[20] (2014) 2 SCC 433

10. The 246th Report of the Law Commission and the decision in *Western Geco*

10.1 The Law Commission, in the 246th Report, provided for the same narrow standard, namely that a *mere* violation of law of India would not be a violation of 'public policy' in cases of *international commercial arbitrations held in India.* It suggested substantial amendments to Section 34 of the Act, with an endeavor to ensure that the *Renusagar* position applies to all foreign awards and all awards passed in international commercial arbitrations. With respect to domestic arbitrations, the Commission recommended that the "patent illegality" test be retained, although it be construed more narrowly than under the *Saw Pipes* regime. In this regard, the following provisions were added to Section 34(2)(b)(ii) and a new provision, Section 34(2A) was introduced. These provisions are stated as follows:

> *S. 34(2)(b)(ii) the arbitral award is in conflict with the public policy of India.*
> *Explanation. —For the avoidance of any doubt, it is clarified that an award is in conflict with the public policy of India only if:*

(a) the making of the award was induced or affected by fraud or corruption or was in violation of section 75 or section 81;

(b) it is in contravention with the fundamental policy of Indian law; or

(c) it is in conflict with the most basic notions of morality or justice.

(2A) An arbitral award arising out of arbitrations other than international commercial arbitrations, may also be set aside by the Court if the Court finds that the award is vitiated by patent illegality appearing on the face of the award.
Provided that an award shall not be set aside merely on the ground of an erroneous application of the law or by re-appreciating evidence.

10.2 The above amendments were suggested on the assumption that other terms such as "fundamental policy of Indian law" or conflict with "most basic notions of morality or justice" would not be widely construed.

10.3 However, a month after the submission of the 246th Report in August 2014, the term "fundamental policy of India" was construed widely by a three-judge bench of Supreme Court in *ONGC Ltd. v. Western Geco*

International Ltd[21] in September to include an award that "no reasonable person would have arrived at". This permitted the review of an arbitral award on merits on the basis of it violating public policy. The Supreme Court's decision was followed by a subsequent two-judge bench in *Associate Builders v. Delhi Development Authority*[22] dated 25.11.2014. In the words of Supreme Court in *Western Geco:*

> *35. What then would constitute the "fundamental policy of Indian law" is the question. The decision in ONGC [ONGC Ltd. v. Saw Pipes Ltd. (2003) 5 SCC 705] does not elaborate that aspect. Even so, the expression must, in our opinion, include all such fundamental principles as providing a basis for administration of justice and enforcement of law in this country. Without meaning to exhaustively enumerate the purport of the expression "fundamental policy of Indian law", we may refer to three distinct and fundamental juristic principles that must necessarily be understood as a part and parcel of the fundamental policy of Indian law. The first and foremost is the principle that in every determination whether by a court or other authority that affects the rights of a citizen or leads to any civil consequences, the court or authority concerned is bound to adopt what is in legal parlance called a "judicial approach" in the*

[21] 2014 (9) SCC 263
[22] 2014 (4) ARBLR 307 (SC)

matter. The duty to adopt a judicial approach arises from the very nature of the power exercised by the court or the authority does not have to be separately or additionally enjoined upon the fora concerned. What must be remembered is that the importance of a judicial approach in judicial and quasi-judicial determination lies in the fact that so long as the court, tribunal or the authority exercising powers that affect the rights or obligations of the parties before them shows fidelity to judicial approach, they cannot act in an arbitrary, capricious or whimsical manner. Judicial approach ensures that the authority acts bona fide and deals with the subject in a fair, reasonable and objective manner and that its decision is not actuated by any extraneous consideration. Judicial approach in that sense acts as a check against flaws and faults that can render the decision of a court, tribunal or authority vulnerable to challenge.

38. Equally important and indeed fundamental to the policy of Indian law is the principle that a court and so also a quasi-judicial authority must, while determining the rights and obligations of parties before it, do so in accordance with the principles of natural justice. Besides the celebrated audi alteram partem rule one of the facets of the principles of natural justice is that the court/authority deciding the matter must apply its mind to the attendant facts and circumstances while taking a view one way or the other. Non-application of mind is a defect that is fatal to any

adjudication. Application of mind is best demonstrated by disclosure of the mind and disclosure of mind is best done by recording reasons in support of the decision which the court or authority is taking. The requirement that an adjudicatory authority must apply its mind is, in that view, so deeply embedded in our jurisprudence that it can be described as a fundamental policy of Indian law.

39. No less important is the principle now recognised as a salutary juristic fundamental in administrative law that a decision which is perverse or so irrational that no reasonable person would have arrived at the same will not be sustained in a court of law. Perversity or irrationality of decisions is tested on the touchstone of Wednesbury principle [Associated Provincial Picture Houses Ltd. v. Wednesbury Corporation (1948) 1 KB 223, (1947) 2 All ER 680 (CA)] of reasonableness. Decisions that fall short of the standards of reasonableness are open to challenge in a court of law often in writ jurisdiction of the superior courts but no less in statutory processes wherever the same are available.

40. It is neither necessary nor proper for us to attempt an exhaustive enumeration of what would constitute the fundamental policy of Indian law nor is it possible to place the expression in the straitjacket of a definition. What is important in the context of the case at hand is that if on facts proved before them the arbitrators fail to draw an inference which ought to have been drawn

> *or if they have drawn an inference which is on the face of it, untenable resulting in miscarriage of justice, the adjudication even when made by an Arbitral Tribunal that enjoys considerable latitude and play at the joints in making awards will be open to challenge and may be cast away or modified depending upon whether the offending part is or is not severable from the rest. [Emphasis supplied]*

Therefore, among others, the Wednesbury principle of reasonableness has now been incorporated into the public policy test under Section 34, as it is deemed to be part of "fundamental policy of Indian law."

10.4 Such a power to review an award on merits is contrary to the object of the Act and international practice. As stated in the Statements of Objects and Reasons of the 1996 Act itself, one of the principal objects of that law was "minimization of judicial intervention".[23]

10.5 As the Supreme Court's judgment in *Western Geco* would expand the Court's power rather than

[23] The 1996 Act, Statement of Objects and Reasons, paragraph 4(v).

minimise it, and given that it is also contrary to international practice, a clarification needs to be incorporated to ensure that the term "fundamental policy of Indian law" is narrowly construed. If not, all the amendments suggested by the Law Commission in relation to construction of the term "public policy" will be rendered nugatory, as the applicability of Wednesbury principles to public policy will certainly open the floodgates.

10.6 This will have four major deleterious effect, being (a) a further erosion of faith in arbitration proceedings amongst individuals and businesses in India and abroad; (b) a reduction in popularity of India as a destination for international and domestic commercial arbitration; (c) increased investor concern, amongst domestic and foreign investors, about the efficacy and speed of dispute resolution and potential for judicial interference; and, (d) an incidental increase in judicial backlog. In this regard, the following amendment to the draft is suggested, by inserting Explanation 2 to Section 34(2)(b)(ii) of the Act:

"For the avoidance of doubt the test as to whether there is a contravention with the fundamental policy of Indian law shall not entail a review on the merits of the dispute."

11. Conclusion

Unless the above amendment to the Commission's proposed Section 34(2)(b)(ii) is incorporated, "public policy" will continue to be widely construed and the object of the amendments suggested by Law Commission in this regard would not be met. To this effect, the Commission recommends that the proposed Section 34(2)(b) (ii) and explanations be substituted by the following:

S. 34(2)(b)(ii) the arbitral award is in conflict with the public policy of India.

Explanation 1 —For the avoidance of any doubt, it is clarified that an award is in conflict with the public policy of India only if:

(a) the making of the award was induced or affected by fraud or corruption or was in violation of section 75 or section 81;

(b) it is in contravention with the fundamental policy of Indian law; or

(c) it is in conflict with the most basic notions of morality or justice.

Explanation 2 – For the avoidance of doubt the test as to whether there is a contravention with the fundamental policy of Indian law shall not entail a review on the merits of the dispute

(2A) An arbitral award arising out of arbitrations other than international commercial arbitrations, may also be set aside by the Court if the Court finds that the award is vitiated by patent illegality appearing on the face of the award.

Provided that an award shall not be set aside merely on the ground of an erroneous application of the law or re-appreciation of evidence.

[Justice A.P. Shah]
Chairman

[Justice S.N. Kapoor]
Member

[Prof. (Dr.) Mool Chand Sharma]
Member

[Justice Usha Mehra]
Member

[Dr. S.S. Chahar]
Member-Secretary

[Dr. Sanjay Singh]
Ex-officio Member