Oil And Natural Gas Corporation Ltd. v. Saw Pipes Ltd.

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ABSTRACT

This case note examines the Supreme Court's decision in *Oil and Natural Gas Corporation Ltd. v. Saw Pipes Ltd.* This landmark ruling reshaped the scope of judicial interference with arbitral awards under Section 34 of the Arbitration and Conciliation Act, 1996. The dispute arose from a liquidated damages clause in a supply contract, which the arbitral tribunal set aside on the ground that ONGC had failed to prove actual loss. On appeal, the Supreme Court widened the meaning of "public policy of India" to include "patent illegality" as an independent ground for setting aside a domestic award. This note sets out the factual background, the issues framed, the rival contentions, and the Court's reasoning, and evaluates the judgment's lasting influence on Indian arbitration jurisprudence, including the legislative correction brought about by the Arbitration and Conciliation (Amendment) Act, 2015.

KEYWORDS

Arbitration, Patent Illegality, Public Policy, and Arbitral Tribunal.

INTRODUCTION

Arbitration in India is intended to function as a speedy and largely final alternative to litigation, with courts playing only a supervisory role once an award has been rendered. Section 34 of the Arbitration and Conciliation Act, 1996[2] lists the limited grounds on which a domestic award can be challenged, one of which is that the award is in conflict with the "public policy of India". Because the Act does not define this phrase, its meaning has been left to judicial interpretation, and the approach taken by courts has a direct bearing on how much finality an arbitral award actually enjoys. *Oil and Natural Gas Corporation Ltd. v. Saw Pipes Ltd.*[3] is one of the most significant and most debated pronouncements on this question. Arising out of a routine commercial dispute over liquidated damages for delayed supply, the case became the occasion for the Supreme Court to lay down an expansive test for setting aside awards, a test that would

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[2] The Arbitration and Conciliation Act, No. 26 of 1996.
[3] Oil and Natural Gas Corporation Ltd. v. Saw Pipes Ltd. AIR 2003 SC 2629.

go on to influence, and eventually provoke a legislative response to, the law of arbitration in India.

OBJECTIVES

1. To examine the factual background of the dispute between ONGC and Saw Pipes Ltd.
2. To analyse the scope of judicial power under Section 34 of the Arbitration and Conciliation Act, 1996 as interpreted by the Supreme Court.
3. To study the Court's expansion of the "public policy of India" ground to include "patent illegality".
4. To examine the interplay between Sections 73 and 74 of the Indian Contract Act, 1872 in relation to liquidated damages clauses.
5. To assess the legal significance of the judgment and the subsequent legislative and judicial response to it.

RESEARCH METHODOLOGY

This case note follows a doctrinal method of legal research. It relies primarily on the reported judgment of the Supreme Court in *Oil and Natural Gas Corporation Ltd. v. Saw Pipes Ltd.,* along with the relevant statutory provisions of the Arbitration and Conciliation Act, 1996 and the Indian Contract Act, 1872. Secondary sources, including subsequent case law that applied or refined the "patent illegality" test and the Law Commission's 246th Report, have been used to trace the doctrinal evolution and eventual legislative response to the ruling.[4]

FACTS OF THE CASE

The respondent was a supplier of offshore oil exploration equipment and agreed to supply casing pipes of 26-inch and 30-inch diameter to the appellant, ONGC, on agreed terms and conditions. ONGC accepted the offer, and under the terms of the contract, the goods were required to be supplied on the decided date.

The contract contained a liquidated damages clause stating ONGC to be entitled, in the case of delay, to recover 1% of the contract price of the whole unit per week of delay (up to a ceiling

[4] Law Commission of India, Report No. 246: Amendments to the Arbitration and Conciliation Act 1996 (Aug. 2014).

of 10%), expressly described as genuine and pre-estimated damages and not a penalty, which would be recovered by deduction from the contractor's bill.

A general strike of steel mill workers occurred across Europe, which prevented the respondent's Italian raw material suppliers from delivering material on time. The respondent sought a 45-day extension, which was granted by ONGC, but specifically stated that the amount equivalent to liquidated damages for the delay would still be recovered from the respondent. ONGC made payment after deducting US $3,04,970.20 and Rs. 15,75,559 towards liquidated damages for the delay, upon supply of the goods.

Respondent disputed this deduction, and the dispute was referred to arbitration. The tribunal held that it was for ONGC to establish that it had actually incurred loss on account of the delay. Since ONGC had failed to do so, the deduction was wrong. The arbitral tribunal directed refund of the deducted amount with interest. ONGC's challenge to this award under Section 34 was dismissed both by the Single Judge and the Division Bench of Bombay High Court (HC), leading to an appeal in Supreme Court (SC).

LEGAL ISSUES INVOLVED

1. What is the ambit and scope of the power of a court to set aside an arbitral award under Section 34 of the Arbitration and Conciliation Act, 1996?
2. What meaning should be assigned to the term "arbitral procedure" occurring in Section 34(2)(a)(v)[5] of the Act?
3. What meaning could be assigned to the phrase "public policy of India"?
4. According to the facts of this case, whether, under Section 73 and 74[6] of the Indian Contract Act, 1872, a party claiming liquidated damages that are stated in the contract to be a genuine pre-estimate of loss is required to independently prove that it has actually suffered a loss before it can recover the stipulated amount?
5. Whether the claim of refund of the amount deducted by the appellant from the bills is disputed or an undisputed claim?

[5] The Arbitration and Conciliation Act, No. 26 of 1996, § 34(2)(a)(v) (India).
[6] The Indian Contract Act, No. 9 of 1872, §§ 73-74.

ARGUMENTS BY APPELLANT (ONGC)

Senior Counsel, Mr. Ashok Desai, appearing on behalf of the appellant, advanced the following submission:

1. When there is clear violation of Sections 28 to 31[7] of the Arbitration and Conciliation Act, 1996, or the terms of the contract, the award can be and is required to be set aside by the court while exercising jurisdiction under Section 34[8].
2. Under the terms of the contract, ONGC was entitled to recover agreed liquidated damages for delay in supply. The Arbitral award directing refund was contrary to Section 28(3)[9] of the Act, which requires the Tribunal to decide disputes according to the terms of the contract.
3. The award was illegal and erroneous, on the face of it, as the Tribunal wrongly held that ONGC had to prove its actual loss, even though the contract treated the agreed amount as a genuine pre-estimate of damages and not a penalty.
4. The Tribunal wrongly awarded interest on the deducted liquidated damages as the terms of the contract clearly stated no interest was payable on a disputed claim. Since the refund claim was disputed, no interest should have been awarded.
5. When interpreting a contract, the party's intention must be determined from the words used in the agreement, not from outside assumptions, especially when a contract is drafted by experts.
6. The narrow interpretation of "public policy of India" in *Renusagar Power Co. Ltd. v. General Electric Co.*[10] was rendered in the context of enforcement of a foreign award under the Foreign Awards Act, 1961[11] and not concerned with a challenge to the validity of a domestic award under Section 34, and therefore should not be automatically applied to restrict the scope of Section 34.

ARGUMENTS BY RESPONDENT (SAW PIPES LTD.)

Senior Counsel, Mr. Dushyant Dave, appearing on behalf of the respondent, advanced the following submission:

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[7] *Supra* Note 2.
[8] *Id.*
[9] *Id.*
[10] Renusagar Power Co. Ltd. v. General Electric Co., AIR 1994 SC 860.
[11] The Foreign Awards (Recognition and Enforcement) Act, No. 45 of 1961, India Code (1993).

1. Court's jurisdiction under Section 34 of the Act is limited, and an arbitral award could be set aside mainly if it conflicts with "public policy of India". This phrase cannot be interpreted so widely to mean that any violation of law would justify the court setting aside the award.
2. Unlike Article 34 of the United Nations Commission on International Trade Law (UNCITRAL) Model Law[12], Section 34[13] of the Act does not allow an arbitral award to be challenged for an "error of law". If Parliament had intended to give courts wider powers like an appeal, it would have included provisions similar to the English Arbitration Act, 1996.
3. The 1996 Act gives courts only limited powers to ensure finality of arbitral awards and speedy resolution of disputes through arbitration. A broad interpretation of "public policy" would defeat this purpose.
4. Under Section 74 of the Indian Contract Act[14], compensation can be awarded only if actual loss from breach is proved, and therefore, the tribunal was right in requiring ONGC to prove its actual loss before recovering.
5. Even if the Tribunal made an error of fact or law, the court cannot interfere under Section 34[15] of the Act as long as the error was within the Tribunal's jurisdiction.
6. If there are two reasonable interpretations of the law or facts, the court should not replace the Tribunal's view with its own and should not interfere with the award.

JUDGMENT OF THE COURT

The court observed that to determine the question of jurisdiction, it shall first consider the meaning which should be assigned to the term "arbitral procedure", and its scope. The court held that Sections 2-43[16] of the Act prescribe both power/jurisdiction and the procedure of the Arbitral Tribunal. Jurisdiction and procedure are closely connected. If the Tribunal acts beyond the powers given by the Act or follows procedure contrary to them, the award becomes illegal on the face of it (patently illegal). If the Tribunal fails to follow the mandatory provisions of

[12] U.N. Comm'n on Int'l Trade Law, UNCITRAL Model Law on International Commercial Arbitration, art. 34, U.N. Doc. A/40/17, Annex I (June 21, 1985).
[13] *Supra* Note 2.
[14] *Id.* at 5.
[15] *Supra* Note 2.
[16] *Id.*

the Act, particularly Sections 24, 28, and 31(3)[17], it acts beyond its jurisdiction, and such an award is patently illegal and liable to be set aside under Section 34[18].

The court held that Parliament could not have intended that an award violating the provisions of the Act should remain valid and immune from challenge, and allowing an award passed in contravention of the Act to stand would be contrary to the basic concept of justice. “There can be no wrong without a remedy”, and therefore, if the Tribunal violates mandatory procedural provisions, the court has the power to set aside the award under Section 34(2)(a)(v)[19].

“Public policy of India” is not defined in the Act. The court adopted a purposive and liberal approach, rather than the narrower meaning in *Renusagar Power Co. Ltd. v. General Electric Co.,*[20] which dealt with enforcement of a foreign award. The court held that an award can be set aside under the head of “public policy of India” if it is patently illegal. An award could be set aside if it is contrary to fundamental policy of India, or Interest of India, or Justice or morality, or in addition, if it is patently illegal. Patent illegality means illegality that goes to the root of the matter, and a minor or trivial illegality is not sufficient to set aside the award. It can be only set aside if it is so unfair or unreasonable that it shocks the conscience of the court. The court held that such an award is against public policy and therefore void and liable to be set aside under Section 34[21].

The scope of “public policy of India” was expanded to include “patent illegality”, making it an additional ground for setting aside a domestic arbitral award under Section 34. Sections 73 and 74 of the Indian Contract Act,1872 must be read together. Under Section 73[22], compensation is given for breach caused by natural or unforeseeable factors. Under Section 74[23], the aggrieved party need not prove actual loss to claim compensation. Reasonable compensation can be awarded if the amount is not a penalty and is reasonable. When there is a genuine pre-estimate of loss, the burden is on the other party to lead evidence to prove no loss is likely to occur by such breach.

[17] *Id.*
[18] *Id.*
[19] *Supra* Note 2.
[20] *Supra* Note 6.
[21] *Supra* Note 2.
[22] *Supra* Note 3.
[23] *Supra* Note 3.

In this case, the contract clearly stated the liquidated damages were a genuine pre-estimate of damages and not a penalty, and since the contract was clear and well drafted, its terms had to be given effect. Therefore, the tribunal wrongly required ONGC to prove actual losses and observed that in complex commercial contracts, it is often impossible to calculate the exact loss caused by delay. The Tribunal ignored the terms of the contract, and thus this was a clear violation of Section 28(3) of the Arbitration and Conciliation Act.

The Court ruled that once ONGC deducted liquidated damages and the contractor sought a refund, the refund became a disputed claim, and the tribunal had to decide this deduction. The tribunal wrongly held the claim as undisputed merely because the goods had been delivered and the bills were otherwise accepted. This finding was unreasonable, unsustainable, and patently illegal. The terms of the contract clearly prohibited interest on disputed claims. By awarding this interest, the Tribunal violated Section 28(3) of the Arbitration Act[24]. The court reiterated that the primary duty of the Arbitral Tribunal is to enforce the contract and uphold its sanctity.

RATIO DECIDENDI

The core legal principles that emerged from the judgment are:

1. <u>Expansion of "public policy":</u> An arbitral award can be set aside if it is contrary to fundamental policy of Indian law, interest of India, justice or morality, award is patently illegal (provided illegality goes to the root of the matter).
2. <u>Definition of patent illegality:</u> An award is patently illegal if it violates substantive Indian law, terms of contract, or is completely contrary to the basic notion of justice.
3. <u>Stance on liquidated damages:</u> If a contract explicitly names a reasonable sum as liquidated damages for a breach, the party claiming it need not have to prove actual loss or damage, provided the loss is difficult to estimate, and the amount is genuine.

LEGAL SIGNIFICANCE AND IMPACT OF THE CASE

The judgment was criticised for weakening the objectives of the 1996 Act as it aims at minimal judicial intervention and finality of the arbitral award. "Patent" is supposed to mean something obvious just by looking at it, but not something you find by digging through the whole record. The court should clearly define how far courts can go when reviewing the award. "Patent

[24] *Supra* note 2.

Illegality" should be limited to objective, checkable things and not re-appreciating the whole evidence. The grounds should not be vague or subjective; rather should either drop or be defined much more precisely; otherwise, it will give judges room to substitute their own opinion for the arbitrator's.

The principle of patent illegality was expanded in cases like *McDermott International v. Burn Standard*[25], *ONGC v. Western Geco*[26], and *Associate Builders v. DDA*[27], where such decisions broadened the "fundamental policy of Indian law" test and increased judicial intervention. This created concern that Section 34 had become a quasi-appellate remedy, discouraging arbitration and foreign investment.

The Arbitration and Conciliation (Amendment) Act, 2015 was introduced, which was based heavily on the 246th Report of the Law Commission of India which clarified that courts cannot review the merit of the dispute under the "fundamental policy" ground, insertion of Section 34(2A), limiting patent illegality to domestic (non-international commercial) arbitration, provided that an award cannot be set aside merely for an erroneous application of law or reappreciation of evidence.

This amendment was a legislative correction to the broad interpretation adopted in the case. The case remains an important precedent because it explains evolution of the "public policy of India", relationship between Sections in the Arbitration Act and the Contract Act, balance between finality of arbitral awards and judicial review, principle where liquidated damages are genuine pre-estimate and not a penalty.

CONCLUSION

Oil and Natural Gas Corporation Ltd. v. Saw Pipes Ltd. remains a pivotal judgment in Indian arbitration law. By reading "patent illegality" into the "public policy of India" ground under Section 34, the Supreme Court gave courts a wide avenue to review the merits of domestic arbitral awards, a position that sat uneasily with the 1996 Act's underlying objective of minimal judicial intervention. On the contractual question, the Court's holding that a genuine pre-estimate of liquidated damages need not be independently proved as actual loss remains good

[25] McDermott International Inc. v. Burn Standard Co. Ltd., (2006) 11 SCC 181.
[26] ONGC v. Western Geco International Ltd., (2014) 9 SCC 263.
[27] Associate Builders v. Delhi Development Authority, (2015) 3 SCC 49.

law and continues to guide the interpretation of Sections 73 and 74 of the Indian Contract Act, 1872.

However, the broader test laid down for setting aside awards was progressively expanded in later decisions, prompting the Arbitration and Conciliation (Amendment) Act, 2015 to confine "patent illegality" to domestic, non-international commercial arbitration and to bar courts from reviewing an award merely for an erroneous application of law or reappreciation of evidence. Read together with these later developments, Saw Pipes illustrates the ongoing tension in Indian arbitration law between ensuring the finality of awards and preserving a meaningful check against fundamentally unjust awards.