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PATENT ILLEGALITY AND ARBITRAL AWARDS: BALANCING LEGAL OVERSIGHT AND ARBITRATION EFFICIENCY

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ABSTRACT

Arbitration has evolved as an important alternative to traditional litigation, providing greater flexibility, cost savings, and efficiency in conflict resolution. It enables parties to resolve disputes outside of the traditional legal procedure by appointing an arbitrator whose decision is binding as a court ruling. However, the idea of finality in arbitration is called into question by the concept of "patent illegality," which refers to legal mistakes that are obvious on the face of an arbitral ruling. Section 34 of the Arbitration and Conciliation Act of 1996 allows courts the jurisdiction to set aside such judgments if they contradict public policy, basic legal principles, or contract conditions.

The idea of patent illegality was originally established by the Supreme Court of India in *ONGC Ltd. v. Saw Pipes Ltd.* (2003), when the court broadened the ambit of public policy to encompass awards that are clearly unfair or unjustified. This paved the way for further court intervention in arbitration judgments, particularly where they are proven to be in direct disagreement with established law, conventional legal principles, or contractual obligations. *Renusagar Power* further elucidated that arbitral awards might be reversed if they were in conflict with fundamental legal principles of India, with the interests of India, or with fundamental notions of fairness and morality.

In subsequent decisions such as *Ssangyong Engineering and Associated Builders*, the Supreme Court established that patent illegality must be a blatant, obvious fault apparent in the face of the judgment. It should not include reappreciation of evidence or misreading of a contract unless the inaccuracy is so severe that it undermines the very nature of justice. The court highlighted that arbitration aims to offer a quick and cost-effective settlement of disputes and that excessive judicial interference would undermine this goal.

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This paper highlights the delicate balance between judicial oversight and arbitration's intended finality, arguing that while arbitration offers a faster path to conflict resolution, safeguarding fairness and justice is equally essential. The discussion underscores the need for procedural safeguards and transparency in arbitration to ensure its integrity while allowing courts to intervene only when an arbitral award is manifestly illegal or unjust. While arbitration aims to provide a final and binding resolution to disputes, the doctrine of patent illegality ensures that justice is upheld by allowing limited judicial intervention in cases of clear legal error. Striking the right balance between finality and fairness is essential to preserving the integrity and legitimacy of arbitration as a dispute resolution mechanism.

INTRODUCTION

Arbitration has become a vital requirement in today's world, with ongoing court cases stacking up to an alarming level and causing undue delays in justice. Arbitration is an out-of-court alternative for resolving disputes. In today's time-constrained world, arbitration is one of the most popular techniques of settling conflict outside of the courts, saving the parties involved substantial time and resources. It is a conflict settlement procedure in which the disputing parties resolve their differences through a third party known as an arbitrator, whose decision is enforceable as a court judgment. It is a quasi-judicial method that eliminates the formality, delay, and cost of a traditional trial. Arbitration is typically favoured over traditional litigation because of its flexibility, secrecy, and capacity to deliver a faster result. Furthermore, the decision rendered by the arbitrator is final and binding, providing a feeling of closure to all parties concerned.

An arbitral award is a decision made by an Arbitral Tribunal to resolve a legal dispute. Once the contesting parties have been heard, the Arbitral Tribunal can render a decision called as an award, which is comparable to a judgment in a Court of Law, and that award must be enforced under the Code of Civil Procedure, 1908 in the same way that a court decree would be. An award is binding on both parties. Once an arbitral award is issued, it is considered final, much like a court judgment. However, if an arbitral judgment appears unfair or erroneous, the claimant can seek the court to set aside or correct the award rendered.

Arbitral Award arising out of 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. Patently Illegal refers to a legal error that strikes at the heart of the subject. This legal mistake might refer to

conflict with common law, the country's constitution, or a legislative requirement. The Court may also overturn an arbitral judgment if it determines that it violates the country's public policy. This includes cases in which the award violates basic concepts of justice and morality.

This article addresses the concept of patent illegality in arbitral verdicts, concentrating on its breadth, legal interpretation, and the delicate balance between judicial oversight and the principle of finality in arbitration.

PATENT ILLEGALITY

The Supreme Court of India first clarified the term "patent illegality" in the case of *ONGC Ltd. v. Saw Pipes Ltd. (2003)*,² where the Supreme Court ruled that an arbitral judgment might be overturned if it contradicted the public policy of Indian law or was clearly unconstitutional. In this case, "public policy" was given a larger meaning. The public policy infringement must be so unjust and outrageous that it shocks the court's conscience. However, if the arbitrator has gone beyond the scope of established law of the contract or given relief in a non-disputed subject, Section 34 of the Act will be in effect.

The Supreme Court's significant ruling in *Renusagar Power*³ established the definition of 'public policy' for setting aside an arbitral award, holding that an award violated public policy if it contradicted the fundamental principles of Indian law, India's interests, or justice and morality. This considerably increased the scope of judicial participation in arbitral award.

"Section 34(2A)" cites patent illegality as one of the grounds for annulling an arbitral ruling; however, the word "patent illegality" is not defined anywhere in the 1996 Arbitration and Conciliation Act. In arbitration, "illegality" refers to the illegality of the underlying contract, its subject matter, and the circumstances surrounding the contract's or the arbitration agreement's execution.

In the *Saw Pipe* case⁴, the Apex Court defined "error of law," which gave the term "illegality" a whole new meaning in the context of arbitration. The term "patent" implies that the illegality

² (2003] 3 SCC 705

³ 1994 AIR 860

⁴ 2003 AIR SCW 3041

must be clear or manifest on the face of the award itself. Determining the illegality shouldn't involve a thorough review or inquiry. If the arbitrator interprets a contract incorrectly or makes legal mistakes, it could not be considered patent unlawful unless the errors are so grave that they contradict basic legal principles.

In the case of *Ssangyong Engineering*⁵, the Apex Court ruled that the additional basis for nullifying a domestic arbitral award under Sub-section (2A) of Section 34 of the Amendment Act, 2015 refers to fundamental illegality rather than merely an incorrect interpretation of the law. To be clear, the Court has decided that when it comes to using the backdoor to set aside an award due to patent illegality, it is not permissible to do so for the violation of a statute that is unrelated to public policy or interest and is not covered by the fundamental policy of Indian law.

Previously, the Apex Court in the case of *Associated Builders*⁶ had held that "Patent Illegality" would encompass the following: a) fraud or corruption; b) a contravention of substantive law, which goes to the root of the matter; c) error of law by the arbitrator; d) a violation of the Act itself; e) where the arbitrator fails to take into consideration the terms of the contract and usages of the trade as required under Section 28(3) of the said Act; and f) if the arbitrator does not give reasons for his decision.

The Supreme Court ruled in *Ssangyong Engineering* that if an arbitrator does not provide reasons for an award and violates Section 31(3) of the Act, the judgment is patently illegal on its face. Furthermore, depending on the aforementioned judgment, the Court ruled that a conclusion based on no evidence at all or an award that ignores critical facts in reaching its result would be perverse and likely to be overturned on the grounds of patent illegality. Furthermore, a determination based on documents obtained behind the parties' back by the arbitrator would qualify as a judgment based on no evidence in the sense that it is not based on the evidence presented by the parties and so must be characterized as perverse.

According to the Act⁷, a "purely domestic arbitral award" may be set aside on the grounds of "patent illegality" in two different situations: first, if the arbitrator's ruling is determined to be

⁵ AIR 2019 SUPREME COURT 5041

⁶ 2015 (3) SCC 49

⁷ Arbitration and Conciliation Act, 1996

perverse, or so irrational, that no reasonable person could have reached the same conclusion; and second, if the arbitrator's interpretation of the contract is such that no fair or reasonable person would reach a similar conclusion.

The 'patent illegality' argument included in Section 34 (2A)⁸ has been stressed once again by the *Patel Engineering Ltd. v. North Eastern Power Corporation Ltd.*⁹ case. The most significant aspect of this ruling is its acknowledgment and support of the patent illegality criteria established in the Associate Builders case. Under Section 34 (2) (b) (ii) of the Arbitration Act, the Supreme Court of India has determined that "unjust enrichment" is grounds for appealing an award, using the public policy principle. However, there is a distinction between misinterpreting the terms of a contract and not acting in accordance with them. An Arbitral Tribunal has the authority to interpret a contract's terms and conditions in order to resolve a dispute. When a contract is read improperly in a circumstance where arbitral disputes are properly and lawfully brought, it is known as a jurisdictional mistake.

In the State of *U.P. v. Nath Construction*¹⁰ decision, the Court held that awards cannot be invalidated unless they are found to be patently illegal due to incorrect application of the law or reappraisal of the evidence.

The Apex Court ruled in *Indian Oil Corporation v. M/s Shree Ganesh Petroleum Rajguru Nagar*¹¹ that an arbitral tribunal must operate in accordance with the provisions of the contract that established it. The tribunal is a product of contract. When the Arbitral Tribunal violates the provisions of the contract or fails to act in accordance with the terms of the contract, the award might be considered illegitimate. But it's important to distinguish between failing to act under a contract and misinterpreting its provisions. When resolving a dispute, an arbitral tribunal has the authority to interpret a contract's terms and conditions. An mistake in contract interpretation in the context of a legal and authorized submission of arbitral disputes to an Arbitral Tribunal constitutes an error within jurisdiction. The award rendered by an Arbitral Tribunal is not appealable to the Court. Unless the Arbitral Tribunal's interpretation of a contractual clause is blatantly irrational or perverse, the Court typically does not intervene with its finding. A court cannot under any circumstances intervene with an arbitral award on the

⁸ Arbitration and Conciliation Act, 1996

⁹ (2020) SCC OnLine SC 466

¹⁰ 2024 SCC OnLine All 1525

¹¹ 2022 SCC OnLine SC 131

grounds that it believes justice has not been served. That would be a consideration of the merits of the case, which is against the spirit of Section 34 of the 1996 Act, as we have already observed in this ruling. The arbitrator's job was to settle disputes in accordance with the conditions of the agreement. Other than what the parties granted him in the contract, he has no more authority. If he has gone beyond what was agreed upon, he is operating outside of his jurisdiction. A tribunal for arbitrators is not a court of law. It is incapable of using its authority *ex debito justitiae*. The Arbitrator's authority is limited to the scope of the contract and any decisions made outside of that scope would be considered as acting beyond jurisdiction. Therefore, it is crucial for an Arbitral Tribunal to adhere strictly to the terms agreed upon by the parties in order to maintain its legitimacy and effectiveness.

BALANCING EFFICIENCY AND FAIRNESS: THE FINALITY OF ARBITRATION DECISIONS

When an arbitral award is based on a transaction or contract that is unlawful or against public policy, it is referred to as patent illegality. This idea presents a challenging situation: On the one hand, maintaining the finality of arbitration awards is essential to guaranteeing consistency and dependability in the settlement of disputes. However, the pursuit of justice and equity requires that agreements that are unlawful or unethical cannot be safeguarded through arbitration.

Even while the concept of finality is essential to the implementation of arbitral rulings, the patent illegality assumption is also important since human mistake is inevitable and requires some sort of corrective action. Several reasons exist for deeming patent illegality permissible, including as respecting the rule of law, safeguarding the public interest, ensuring equity and justice, preserving the integrity of contracts, and acting as a deterrent to arbitral wrongdoing. Proponents of arbitration's finality argue that permitting courts to overturn verdicts based on patent illegality undermines arbitration's fundamental character. According to them, the main appeal of arbitration is its capacity to quickly and amicably settle conflicts, saving the parties concerned from the drawn-out and expensive process of traditional litigation. Furthermore, the arbitration procedure needs to be final in order to preserve confidence from businesses and the general public.

Nonetheless, the demand for justice and fairness must be addressed. Allowing awards based

on patent illegality to stay uncontested would contravene public policy and undermine the judicial system's legitimacy. It would establish a hazardous precedent that illegality and unfairness may be hidden beneath the cloak of arbitration, eroding equity and legal morality.

The topic of patent illegality poses a difficult and subtle challenge in arbitration. While the necessity for finality in arbitration is critical, it must be carefully balanced with the concepts of justice and equity. By implementing a case-specific approach and encouraging proactive due diligence, the arbitration process may attempt to balance finality with justice, ensuring that arbitration's legitimacy is not jeopardized.

Furthermore, parties engaged in arbitration must be careful in ensuring that the process is transparent and unbiased in order to avoid any abuse of power or manipulation. Finally, striking a careful balance between finality and fairness is critical to sustaining arbitration's credibility and validity as a conflict settlement tool. Arbitration may efficiently resolve issues while adhering to ethical norms by establishing strong procedural protections and fostering open communication between parties. Arbitrators must stay objective and unbiased throughout the process to provide a fair decision for all parties concerned.

CONCLUSION

Arbitration has established itself as a vital conflict settlement tool, providing significant advantages over traditional litigation, such as reduced time, expense, and procedural complexity. However, the idea of "patent illegality" adds a crucial degree of court supervision to ensure that the arbitral procedure remains impartial and free from egregious legal mistakes. This careful balance between securing the finality of arbitration and enabling limited court intervention to correct severe errors is important to arbitration's credibility and efficiency.

The notion of patent illegality, articulated in significant cases such as *ONGC Ltd. v. Saw Pipes Ltd.* and *Ssangyong Engineering*, gives courts the jurisdiction to overturn arbitral verdicts that violate basic legal principles or public policy. However, this judicial power is not without limitations. The courts have stressed that patent illegality must be clear on the face of the award, without requiring a thorough examination of the evidence or a reassessment of the case's merits. This guarantees that the fundamental goal of arbitration—providing a final and binding resolution—is not endangered by frequent court scrutiny.

Fundamentally, patent illegality acts as a safeguard to prevent arbitration from being used as a cover for unethical or criminal behaviour. It upholds justice by ensuring that rewards based on fraud, corruption, or illogical legal interpretations are not upheld. However, the court has always made it clear that it plays a limited role in arbitration. Courts have been cautious to distinguish between a contract's wrong interpretation and a clear disobedience of the law or public policy, only becoming involved when an arbitral result deviates significantly from the bounds of basic legal mistakes. This strategy is essential for maintaining the arbitration process' independence while making sure it complies with broader fairness and public interest. Arbitration's legitimacy as a valid and efficient means of resolving disputes is preserved when courts have the ability to reject judgments in situations involving patent illegality without jeopardizing the process's finality. Additionally, by limiting the window of opportunity for court involvement, the arbitration procedure avoids spiraling into yet another level of litigation, maintaining its appeal as a quicker, less expensive resolution.

In the long run, maintaining the integrity of arbitration is the shared duty of the parties and the arbitrators. To reduce conflicts over jurisdiction, parties must carefully and precisely design their arbitration agreements, outlining the extent and boundaries of the arbitrator's power. For their part, arbitrators have to make sure that their decisions are grounded in rational legal interpretations rather than extrajudicial or subjective considerations. They also have to stick closely to the terms of the contracts and legal principles.

In the end, the theory of patent illegality makes sure that, even if arbitration is intended to provide closure to disputes, justice is not sacrificed in the process. When awards are blatantly illegitimate, courts have a crucial, if limited, role to play in protecting the integrity of the arbitration process. This framework guarantees that arbitration will always be a just and moral means of settling conflicts while preserving its fundamental benefits. Maintaining arbitration's popularity and legitimacy in the legal system depends critically on finding this delicate balance between finality and fairness.