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FOREIGN ARBITRAL AWARDS AND INDIAN PUBLIC POLICY: THROUGH THE LENS OF PENAL INTEREST

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Introduction

A foreign element in arbitration brings into play three different sets of laws: "*the proper law of the contract; the proper law of the arbitration agreement/lex arbitri; and the proper law governing the conduct of arbitration/lex fori/curial law.*"[1] Under Indian law, two Indian parties are allowed to opt for a foreign law as the governing law for either the substantive contract or the arbitration agreement subject to certain conditions.[2] But such flexibility raises concern when such choices are made to bypass the law. For example, the Reserve Bank of India ["**RBI**"] recently prohibited Regulated Entities ["**REs**"], which include banks, from charging penal interest[3] and left them with the choice of approaching courts for such a relief.[4] However, international arbitration might be misused to circumvent this prohibition and thus expose weaknesses in the current protections.

In terms of arbitration principles, party autonomy is a precept that guarantees a party's rights to freely make choices on which country's law and jurisdiction should be applied, along with the law and rules to govern the process of arbitration proceedings.[5] This liberty is meant to protect arbitration as the fast and efficient form of dispute settlement, especially regarding cross-border contracts.

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[1] *Reliance Industries Ltd. v Union of India* (2014) 7 SCC 603.

[2] *Dholi Spintex (P) Ltd. v Louis Dreyfus Co (India) (P) Ltd* 2020 SCC OnLine Del 1476.

[3] Reserve Bank of India, Fair Lending Practice - Penal Charges in Loan Accounts 2023, RBI/2023-24/53 (Issued on 18 August 2023).

[4] *ICICI Bank Ltd v Pradeep Singh* 2021 CS (Comm) 5208.

[5] Simeona Kostova, 'Party Autonomy in a Modern Context: A Critical Analysis of its Scope under the Rome I Choice of Law Rules and Some Contemporary Considerations' (2023) Centre for Private International Law Working Paper Series 1/2023, <https://www.abdn.ac.uk/media/site/law/documents/Aberdeen_Centre_for_Private_International_Law_WP_12023.pdf> accessed 20 January 2025.

It is also important that the arbitration proceedings cannot be misused by parties to an agreement as such misuse would not only deprave the purpose of arbitration as an efficient alternative dispute resolution system but also would burden the courts and risk, creating greater injustice. Arbitration has been intended as a swift, effective alternative to traditional litigation. Consequently, it should promote fairness and reduce judicial intervention. However, when parties use arbitration to circumvent mandatory legal provisions or regulatory safeguards, it defeats the very purpose of the process. Such misuse can erode trust in arbitration as a credible mechanism for dispute resolution and lead to outcomes that contravene public policy or the natural justice principles. Thus, maintaining the integrity of arbitration requires vigilance from both arbitral tribunals and courts to prevent its abuse.

This article explores the guidelines introduced by the recent RBI notification and their impact. It then explores the framework behind the possibilities of setting aside a foreign arbitral award. Following this, the intersection of these discussions is analysed, with penal interest used as an example to illustrate how the framework operates in the context of international arbitration. Finally, the article delves into the various safeguards currently in place and highlights the need for further enhancements to ensure their effectiveness.

Understanding Penal Interest

Penal interest means the extra interest charged to borrowers beyond the existing rate of interest in the event of default or non-compliance with terms. Such practice is conventionally utilised to impart credit discipline to stakeholders. For example, on April 1, 2022, the RBI directed banks to levy penal interest for delays or discrepancies in reporting currency chest transactions by chest-holding banks.[6] With time, the imposition of penal interest became common, with some banks charging up to two per cent per month as penal interest on overdue amounts. In February 2023, the RBI Governor pointed out how REs were utilising penal interest rates unabashedly, apparently as a revenue generation tool instead of simply imposing credit discipline.[7] Hence, on August 18, 2023, the RBI issued new guidelines prohibiting REs from charging penal interest. Although these guidelines prevented such activities domestically, they permitted REs to charge penalties or compound interest for defaults, and importantly, certain financial instruments like credit cards,

[6] Reserve Bank of India, Master Direction on Penal Provisions in deficiencies in reporting of transactions/ balances at Currency Chests 2022, RBI/2022-23/91 (Issued on 1 April 2022).

[7] 'Monetary Policy' (2023) (18)(11) MCIR <https://rbi.org.in/scripts/PublicationsView.aspx?Id=21750#mainsection> accessed 20 December 2024.

external commercial borrowings ["**ECBs**"], and trade credits ["**TCs**"] were exempted from such guidelines because of their specific regulatory treatment.[8]

ECBs, which involve commercial borrowings from non-resident lenders using instruments such as floating rate notes and fixed rate bonds, and TCs, short-term credit arrangements for imports, tend to have a cross-border component. This cross-border aspect situates them outside the domestic fair lending practice purview. Thus, in order to analyse penal interest in context of international arbitration, it becomes imperative to consider those foreign awards which were to be granted in regards to loan agreements entered between the REs and other persons/entities. Notably, Section 44 of the Arbitration and Conciliation Act, 1996 ["**Arbitration Act**"], which defines a foreign award, is party-neutral in nature. Therefore, awards made between Indian parties should also be considered foreign awards, provided they meet the criteria outlined in the section.[9]

To Set Aside Foreign Arbitral Awards in India

Foreign arbitral awards are acknowledged and enforced in India through the New York Convention[10] (Chapter I, Part II) and the Geneva Convention[11] (Chapter II, Part II) of the Arbitration Act. The conventions provide the basis for the foreign awards' enforcement with conditions stipulated in Section 48 of the said Arbitration Act. The section identifies the grounds on which the Indian courts may decline enforcement, including contraventions of public policy, justice, or fairness.

The jurisdiction to set aside an arbitral award in India is available under Section 34 of the Arbitration Act, but it can be exercised only against domestic awards. The Indian courts do not have the jurisdiction to challenge a foreign award on its merits. The room for setting aside a foreign award is thus limited to the reasons laid down under Section 48. These are treated as defenses available to the respondent against enforcement and are founded mostly on violation of public policy. Notably, the court cannot examine the case's merits, which drastically restricts interference with foreign arbitral awards.

[8] Fair (n 3).

[9] *PASL Wind Solutions Pvt Ltd v GE Power Conversion India Pvt Ltd* AIR 2021 SC 2517.

[10] United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, June 10, 1958, 4 ILM 532.

[11] Geneva Convention on the Execution of Foreign Arbitral Awards, July 26, 1929, 92 LNTS 301.

One of the landmark cases here is *Renusagar Power Co. Ltd. v General Electric Co.*,[12] where the court declared that an award could be refused if it violates India's fundamental policy, interests, justice, or morality. Yet, the "fundamental policy" is narrowly interpreted in the case of foreign awards, and a high threshold is maintained for denial of the same. Violations of public policy which might cause refusal of enforcement include: violation of judicial approach; disobedience of natural justice; and perversity in decision-making.[13] In *Vijay Karia and Ors. v Prysmian Cavi E Sistemi Srl and Ors.*,[14] the court added further that the fundamental policy of India means the basic values of Indian law, which cannot be sacrificed.

Enforceability of Foreign Arbitral Awards Involving Penal Interest: A Hypothetical Analysis

Under the existing legal framework on foreign arbitral awards, a question arises as to whether an international arbitral award granting penal interest as relief would be enforceable in India, particularly in light of the RBI's restrictions on REs.

The RBI has issued guidelines barring REs (such as banks) from levying penal interest. According to these guidelines, REs are prohibited from imposing penal interest and must seek court intervention to obtain such relief. However, the RBI's policy does not impose a blanket ban on penal interest. It specifically targets loan transactions involving REs, while penal interest remains legal and enforceable in other contexts. Therefore, the question arises whether an international arbitral award that permits penal interest would be enforceable in India, particularly when the lender is an RE.

Since the RBI policy is applicable only to REs, and penal interest continues to be allowed in other contexts, an international arbitral award allowing penal interest would not be violative of Indian statutes or judicial precedents in such cases. The enforcement of such an award in India would generally be permissible, in the absence of other significant illegality. Courts would not interfere with the award unless it is contrary to public policy or offends a fundamental principle of Indian law, for example, by penal interest in respect of REs.

Moreover, as mentioned above, foreign arbitral awards cannot be set aside on account of violation of any particular rule or regulation. Therefore, with respect to any interest awarded as penal interest

[12] *Renusagar Power Co. Ltd. v General Electric Co.* AIR 1994 SC 860.

[13] *Ssangyong Engineering & Construction Co Ltd v National Highways Authority of India* AIR 2019 SC 5041.

[14] *Vijay Karia and Ors. v Prysmian Cavi E Sistemi Srl and Ors.* AIR 2020 SC 1807.

by a foreign arbitral tribunal, it cannot be said that it would violate Indian law, so long as the award is not violative of any fundamental public policy and natural justice principles. But this raises significant concerns pertaining to bypassing the law of the land. The issue is, thus, whether parties can use a foreign seat of arbitration and the governing law to be foreign law in the hope of avoiding Indian law. Courts appear to recognise a party's right to select applicable law for the interpretation of contractual obligations, but with the limitation that such party selection does not offend Indian public policy.

In this respect, in the case of *PASL Wind Solutions Pvt. Ltd. v GE Power Conversion India Pvt. Ltd.*,[15] it has been held that two Indian parties can, after all, opt for a seat of arbitration that is foreign although the arbitration may be conducted outside India. If the choice of a foreign law is intended merely to bypass some mandatory provisions of Indian law, then the courts are likely to step in.[16] Furthermore, albeit vague, certain safeguards can be traced in the judicial precedents pertaining to such awards. In *Aapico Hitech Public Company Limited v Sakthi Auto Component Limited*,[17] the court underscored that a choice of foreign law must be justified by a substantial foreign element linking the contract to the jurisdiction whose laws are chosen. If two Indian nationals enter into an agreement governed by foreign law without a substantial foreign element, Indian courts may apply Indian law, nullifying any relief such as penal interest if the lender is an RE.

This ensures that the foreign law choice is not arbitrary but reflects a real connection with either the transaction or the parties concerned. The court will carefully review such choices in order not to allow parties to use foreign arbitration as a method of circumvention of Indian law.

Analysis and Conclusion

The major problem in the present framework for foreign arbitral awards' enforcement in India is that the parameters for a foreign element are not well-defined to ensure that parties' choices of foreign governing laws or arbitration seats involve a substantial foreign element. While being absolutely respectful of the party autonomy in choosing a seat or law abroad, there should be some safeguards so that the parties are deterred from abusing their discretion to further their own cause in avoiding consequences of mandatory laws of India. This would become all more important where the law or seat of arbitration is chosen precisely to avoid Indian regulatory regimes, for example penal interest or other provisions of financial restriction.

[15] PASL (n 9).
[16] Dholi (n 2).
[17] *Aapico Hitech Public Company Limited v Sakthi Auto Component Limited* 2023 SCC OnLine Mad 514.

The need of the hour is to have a well-defined test or a set of guidelines that would assess the *substantiality* of the foreign element in the arbitration agreement. Such a test could include factors like the location of the parties, the place where the contract is executed, the jurisdiction of the dispute, the area where a major part of the transaction is to be executed, and the connection of the dispute to the foreign laws or arbitral seat. It would be possible to have clear parameters in place, giving courts a structured approach on whether the choice of foreign law or seat is legitimate or is used to evade Indian legal obligations.

Such a test or guidelines would introduce predictability and consistency in the judicial decisions and ensure that such foreign arbitration agreements are not made improperly without giving heed to the presence of a valid foreign element to them and that they are not just devised to sidestep Indian laws. This would keep India's public policy interests while respecting the global nature of arbitration as well as autonomy of contracting parties.

Conclusively, though India has a robust legal framework related to the implementation of foreign arbitration awards, very much compliant by and large, yet there is still scope to further develop them so that they eradicate all sorts of loopholes and ambiguities. That would significantly increase the fairness, transparency, and consistency of the determination made regarding enforcement decisions by introducing a clear test or a comprehensive set of guidelines related to the existence and sufficiency of an element of foreignness in arbitration agreements. This would serve the dual purpose of preventing arbitration from being misused as a means to violate mandatory Indian law and further strengthen the principles of party autonomy by requiring substantive justification for the choice of foreign law or jurisdiction.

These measures would, thus, balance the imperative to uphold contractual freedoms with the imperative to protect India's legal and regulatory framework and bolster the credibility and effectiveness of the arbitration system. They would also provide clearer benchmarks for courts and arbitral tribunals, fostering a more predictable and just environment for resolving disputes. Ultimately, it would strengthen the country's stature as an arbitration-friendly jurisdiction while safeguarding the broader interests of justice and public policy.