

Dispute Resolution Hotline

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WHAT IS 'ACCEPTABLE ERROR' AND 'UNACCEPTABLE ERROR' IN AN ARBITRAL AWARD? SUPREME COURT CLARIFIES THE SCOPE OF JUDICIAL INTERVENTION

- An erroneous contractual interpretation by an arbitrator should not lead to setting aside of an arbitral award if the interpretation is a plausible one.
- A contractual interpretation which results in rewriting the terms of the underlying agreement should result in setting aside of such an award.
- Courts and tribunals should avoid going beyond the scope of the underlying agreement while determining disputes arising thereunder.

The Supreme Court in a recent judgment of *Indian Oil Corporation Ltd Through its Senior Manager v. M/s Shree Ganesh Petroleum Rajgurunar Through its Proprietor Mr. Laxman Dagdu Thite*,¹ expounded upon the scope and limitations of an arbitrator's power to interpret the terms of the underlying agreement.

FACTUAL BACKGROUND

M/s Shree Ganesh Petroleum Rajgurunar ("**Dealer/Lessor**") had leased a plot of land ("**Premises**") to Indian Oil Corporation Ltd. ("**Appellant/IOC/Lessee**") for a period of 29 years pursuant to a lease deed dated September 20, 2005 ("**Lease Deed**"). The Lease Deed contained a dispute resolution clause which prescribed arbitration as the dispute resolution mechanism for disputes arising out of the Lease Deed.

Subsequently, IOC had set up a retail outlet on the Premises and the Dealer was appointed as the dealer under a separate dealership agreement dated November 15, 2006 ("**Dealership Agreement**"). The Dealership Agreement prescribed that it shall remain in force for a period of 15 years and could be extended by one year until determined by either party. The Dealership Agreement also contained a dispute resolution clause which prescribed arbitration as the dispute resolution mechanism for disputes arising out of the Dealership Agreement. Therefore, IOC and the Dealer had entered into two separate agreements with independent dispute resolution mechanisms.

PROCEDURAL HISTORY

IOC noticed certain irregularities in the running of the retail outlet. Consequently, IOC directed the Dealer to halt further sales and supplies to the retail outlet. Pursuant to these irregularities, IOC terminated the Dealership Agreement and called upon the Dealer to vacate the Premises ("**Termination**"). Considering that the Dealer challenged the Termination, the dispute was referred to arbitration under the Dealership Agreement.

Although the arbitration was invoked under the Dealership Agreement, the Dealer also prayed for amendment of the Lease Deed to increase the lease rent. The Arbitrator partly allowed the Dealer's prayer under the Lease Deed by (a) increasing the lease rent, and (b) reducing the lease period ("**Award**").

Aggrieved by the Award, IOC approached the Court of the District Judge, Pune ("**Dist. Judge**") under Section 34 of the Arbitration and Conciliation Act, 1996 ("**Arbitration Act**") to set aside the Award. The Dist. Judge partially set aside the Award to the extent of the decrease in the lease period. Both IOC and the Dealer preferred an appeal before a Division Bench of the Bombay High Court ("**High Court**") under Section 37 of the Arbitration Act.² While the Dealer's appeal pertained to the Dist. Judge's order which partially set aside the Award ("**Dealer's Appeal**"), IOC's appeal pertained to Dist. Judge's order upholding the rest of the Award ("**IOC's Appeal**").

The High Court upon consideration of both the appeals upheld the Award in its entirety. The judgment of the High Court was challenged before the Supreme Court.

JUDGMENT OF THE SUPREME COURT

At the outset, relying on its judgment in *Associate Builders v. Delhi Development Authority* ("**Associate Builders**"),³ the Supreme Court noted that a Court considering a setting-aside application under Section 34 of the Arbitration Act cannot look into the merits of the award except when the award is in conflict with the public policy of India as provided in Section 34(2)(b)(ii) of the Arbitration Act.

The Supreme Court further noted that an arbitral tribunal is a creature of contract and is therefore, bound to act in terms of the contract under which it is constituted. The Supreme Court further stated that an award can be said to be patently illegal where the arbitral tribunal failed to act in terms of the contract or has ignored the specific terms of a contract.

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The Supreme Court drew a distinction between (a) failure to act in terms of a contract and (b) an erroneous interpretation of the terms of a contract. While adjudicating a contractual dispute, an arbitral tribunal is entitled to interpret the terms and conditions of a contract. Such an interpretation would not generally be interfered by a court in a setting aside proceeding unless such interpretation is patently unreasonable or perverse. The Supreme Court observed that an erroneous contractual interpretation by an arbitral tribunal which falls within the contours of the underlying agreement cannot be set aside.

The Supreme Court further explained that a setting aside court cannot substitute its interpretation of the underlying agreement with that of a plausible interpretation provided by an arbitral tribunal. The Supreme Court further remarked that a setting aside court cannot sit in appeal over the award passed by an arbitral tribunal.

The Supreme Court observed the following in regard to the factual background of the dispute:

- The Dealership Agreement and the Lease Deed were two distinct and separate agreements.
- Although the invocation of arbitration by the parties was under the Dealership Agreement only, the Award dealt with disputes under both the Dealership Agreement and the Lease Deed.

Considering that the Award dealt with matters outside the scope of the underlying agreement (i.e., Dealership Agreement), it was deemed to be against public interest and therefore, liable to be set aside on the ground of public policy.

In addition to the above, the Supreme Court briefly expounded the scope and limitations of an arbitrator's powers with respect to interpretation of the terms of a contract:

- Neither an arbitral tribunal nor the court can alter the terms and conditions of a valid contract.⁴
- Re-writing a contract for the parties would be breach of fundamental principles of justice.⁵
- If an arbitrator travelled beyond the contract, he would be acting without jurisdiction.⁶

CONCLUSION

In the past decade, courts have drastically reduced the extent of judicial intervention while reviewing arbitral awards. The approach has been to avoid any re-appreciation of pleadings, evidence and arguments submitted before the arbitral tribunal. This principle has been espoused in multiple judgments of the Supreme Court.

Within this narrow scope of review, courts have stated that if an erroneous contractual interpretation is a plausible one then the same would be considered as an 'acceptable error'. However, the Supreme Court, in the present judgment has clarified that any contractual interpretation having the effect of re-writing the agreement would be considered as an 'unacceptable error' and would render the arbitral award patently illegal.

Therefore, while the scope of intervention by courts is very narrow, it is nevertheless the court's mandate and judicial function to ensure that an arbitral award does not suffer from any 'unacceptable error'. The present judgment of the Supreme Court lends clarity with respect to such distinction between an 'acceptable error' and an 'unacceptable error'.

The aforesaid distinction imposes clear, identifiable constraints on the manner in which an arbitrator can perform its adjudicatory functions. However, courts should be wary of conducting an extensive and mechanical reappraisal of the merits of an arbitral award while determining whether such an award contains an 'acceptable error' or an 'unacceptable error'.

— Adimesh Lochan, Arjun Gupta & Vyapak Desai

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You can direct your queries or comments to the authors

¹ Civil Appeal Nos. 837-838 Of 2022

² Arbitration Appeal No. 19 of 2013 filed by the Respondent; Arbitration Appeal No. 39 of 2013 by IOC

³ (2015) 3 SCC 49.

⁴ Paragraph 49 of the Judgment dated February 01, 2022.

⁵ *PSA SICAL Terminals Pvt. Ltd. v. Board of Trustees of V.O. Chidambaram Port Trust Tuticorin & Ors.*, (2021) SCC Online SC 508; *SSangyong Engineering and Construction Company Limited v. NHAI*, (2019) 15 SCC 131; *Satyanarayana Construction Company v. Union of India & Ors.*, (2011) 15 SCC 101.

⁶ *PSA SICAL Terminals Pvt. Ltd. v. Board of Trustees of V.O. Chidambaram Port Trust Tuticorin & Ors.*, (2021) SCC Online SC 508

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