2025 INSC 1380

REPORTABLE

IN THE SUPREME COURT OF INDIA

CIVIL APPELLATE JURISDICTION

CIVIL APPEAL NO. 14565 - 14566 OF 2025

(@ SLP(C) 32849-32850 of 2025 @ Diary No.56596 of 2024)

BPL LIMITED **....Appellant(s)**

VERSUS

MORGAN SECURITIES AND CREDITS PRIVATE LIMITED **....Respondent(s)**

J U D G M E N T

J.B. PARDIWALA, J.

For the convenience of exposition, this judgment is divided in the following parts:-

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1. Leave granted.

2. Since the issues involved in both the captioned appeals are the same, the parties are also the same and the subject matter of challenge in one of the connected appeals is to the order of review passed by the High Court in the main matter those were taken up for hearing analogously and are being disposed of by this common judgment and order.

3. These appeals arise from the judgment and order passed by the High Court of Delhi dated 18.11.2024 in FAO(OS) (COM) No. 46 of 2019 by which the appeal filed by the appellant herein under Section 37(1)(b) of the Arbitration and Conciliation Act, 1996 (for short, the "Act, 1996") read with Section 13 of the Commercial Courts Act, 2015 (for short, the "Act, 2015") seeking to assail the order dated 18.12.2018 passed by a learned Single Judge of the High Court in OMP (COMM) No. 176/2017 upholding the arbitral award came to be dismissed.

4. The appellant also seeks to challenge the order passed by the High Court, rejecting the review application preferred against the judgment and order dismissing the Section 34 appeal.

A. <u>FACTUAL MATRIX</u>

5. One M/s BPL Display Device Ltd./BDDL had sold certain goods to the appellant herein/BPL over a period of time. As there arose some issues of timely payments, the buyer and seller companies *viz.*, BPL and BDDL, together approached the respondent for extending a Bill Discounting facility to BDDL, to which the respondent agreed. Accordingly, the Bill Discounting facility was sanctioned by the respondent vide letters dated 27.12.2002 (to the extent of Rs. 6 crores) and 11.06.2003 (to the extent of Rs. 6.5 crores).

6. It would be apposite to bring to the fore, some relevant terms of the Sanction Letters, as mutually agreed between the parties:

- The said Sanction Letters referred to BDDL as the 'Drawer' and the appellant/BPL as the 'Drawee'.
- It was provided that the "Bill of Exchange /Hundi shall be with recourse to Drawer."
- The repayment of the amount was mutually agreed to be both the responsibility of the Drawer/BDDL and drawee/appellant jointly and severally.
- The facility was approved at a concessional rate of interest i.e., 22.5% per annum payable upfront as against the normal agreed rate of interest, i.e., 36% per annum but in case of default in making payment on its due dates, the concessional rates would stand withdrawn and the normal rate of interest i.e., @ 36% per annum would become payable.
- The bill discounting period was up to 150 days. §

- As per the Sanction Letter dated 11.06.2003, one M/s Electronic Research Pvt. Ltd./ERPL stood surety for the repayment of Rs. 6,43,32,301/- in the event the Drawer and Drawee failed to repay the amount due in term of sanction letter dated 11.06.2003. In pursuance of the same, ERPL furnished a 'Comfort letter' along with PDCs guaranteeing repayment of the amounts due and payable to the respondent/claimant.

7. However, dispute between the parties arose when a sum of Rs.25,79,91,096/- against particular Bills of Exchange became due and payable to the respondent/claimant by BPL and BDDL in 2004, which amount they defaulted in repaying despite several reminders on behalf of the respondent/claimant. It is stated that during the subsistence of the contract, BDDL along with ERPL had issued postdated cheques (PDCs) to discharge their respective partial contractual liabilities towards the respondent/claimant. However, BPL allegedly requested the claimant to not encash the said cheques and assured the respondent/claimant that given some more time, they would make arrangements for the payments. The respondent/claimant, in good faith, considered the requests and upon assurances of BDDL, did not present the cheques for encashment.

8. After an extension of time to make the payments was sought, admittedly, the appellant/BPL made two payments to the respondent herein *vide* Demand Drafts dated 08.08.2005 and 29.08.2005 both drawn on Bank of India for a sum of Rs. 50,00,000/- each, and it is stated that such amounts were adjusted by the respondent/claimant towards seven Bills of Exchange drawn pursuant to the Sanction Letter dated 11.06.2003, the details of which are reproduced hereinbelow:

S.NO.	**BILL OF EXCHANGE NO.**	**AMOUNT ON BILL OF EXCHANGE (IN RS.)**
1.	OMR 13	1753920
2.	OMR 14	1160000
3.	OMR 11	1893120
4.	OMR 15	1624000
5.	OMR 16	1624000
6.	OMR 17	1519693
7.	NO. 112	1658800

9. However, despite the assurances extended by the appellant/BPL and BDDL as well as the indulgence accorded by the respondent, the appellant/BPL and BDDL failed to repay the amounts due with interest and relying upon the letter of acknowledgement of debt dated 02.02.2007 issued by the appellant/BPL, the respondent invoked arbitration by way of issuance of a Notice dated 28.06.2007, against the appellant/BPL as well as BDDL. Accordingly, a sole Arbitrator was appointed to preside over the matter.

B. ARBITRAL PROCEEDINGS:

10. In a nutshell, the respondent/claimant raised a total of four claims; three claims under the sanction letter dated 11.06.2003, and one claim under the sanction letter dated 27.12.2002, amounting to an aggregate of Rs.25,79,91,096/- which had become due and payable by the appellant/BPL and BDDL to the respondent herein. It is pertinent to note that during the course of the arbitration proceedings, ERPL was impleaded as respondent No.3 and the claim against BDDL was dropped by the respondent/claimant, since BDDL was undergoing liquidation proceedings.

11. On the basis of the pleadings, the following issues were framed by the learned sole Arbitrator:

> *"1. Whether the claimant is entitled to a sum of Rs.7,27,05,579/- as on 10.08.2007 against Bill Discounting Facility Agreement/ sanction vide letters dated 27.12.2002 and Rs,20,62,28,681/- as on 10.08.2007 on account of the Bill Discounting Facility Agreement/ Sanction letter dated 11.06.2003?*
>
> *2. Whether the claimant is entitled to any damages. If so, to what amount?*
>
> *3. Whether the claimant is entitled to interest. If so, at what rate and from which date?*
>
> *4. Whether the claimant is entitled to cost?*
>
> *5. Whether the claims have been validly instituted? OPR2*

6. Whether, assuming the Respondent No.2 is liable for payment under the Bill Discounting Facility Agreement dated 27.12.2002 and 11.06.2003, the claim is barred by time? OPR2

7. Whether the Claimant can claim any amount from Respondent No.2 under the Bill Discounting Facility Agreement dated 27.12.2002 and 11.06.2002 in view of the Respondent No.2 having tendered post-dated cheques towards payment of liability on the hundies discounted by the Claimant? OPR2

8. Whether the Respondent N.o.2 made any verbal representation to the Claimant not to present the post-dated cheques issued by the Respondent No.2 as alleged by the Claimant? OPR2

9. If not, did the Claimant waive its right to the payment of the amounts of each cheque issued by Respondent No.2 and under the Bill Discounting Agreement? OPR2

10. Reliefs."

12. As regards Issue No.1, the learned Arbitrator outright rejected the contention of the appellant that the transaction between the parties is governed by the Usurious Loans Act, 1918, as amended by the Punjab Relief of Indebtedness Act, 1934, by observing that the transaction between the parties was neither a loan nor a debt, rather it was simply in the nature of a commercial transaction wherein BPL and BDDL being 'traders', had transacted a deal in the course of their business. Since BPL was not in a financial position to pay BDDL, and therefore, they together approached the respondent/claimant to pay to the seller the amounts of the transactions, with a stipulation that the same would be repaid to the respondent/claimant along with interest as per the terms agreed upon. Secondly, the learned Arbitrator held that it cannot be said that the sanction letters are distinct from the Bills of Exchange/hundis or that the Bill Discounting Agreements/sanction letters are not binding upon BPL and BDDL; nor can it be said that the claim of the non-payment of the bills of exchange is not governed by the terms of the said Bill Discounting Agreements/sanction letters. Accordingly, the learned Arbitrator decided Issue No.1 in favour of the claimant/respondent herein.

13. As regards Issue No. 2, it was held by the learned Arbitrator that the claimant has failed to prove that damages had been suffered, and thus, the said issue was decided against the claimant/respondent herein.

14. As regards Issue No.3, relying upon ***Class Motors Ltd v. Maruti Udyog Ltd***. reported in 1996 SCC OnLine Del 872, ***Modi Rubber Ltd v. Morgan Security and Credits*** reported in 2002 SCC OnLine Del 546 and ***West Bengal Cement Ltd v. Syndicate Bank*** reported in 2009 SCC OnLine Del 3318, the learned Arbitrator held that the terms of payment of interest as mutually agreed upon by the parties *vide* sanction letters dated 27.12.2002 and 11.06.2003 respectively cannot be held to be unconscionable, arbitrary, or excessive in case of non-payment after the stipulated due date. It was held that BPL and BDDL were under no obligation to enter into a contract with the respondent/claimant in the first place, and thus, having taken the advantage of the contract, the appellant herein, could not be allowed to turn around and raise a plea that the rate of interest was excessive or unconscionable. Moreover, the learned Arbitrator by relying upon ***Central Bank of India v. Ravindra and Others*** reported in 2001 SCC OnLine SC 1266, rejected the contention of the appellant that the interest cannot be added to the principal amount and held that since the compounding of interest on monthly rest was provided in the mutually agreed upon terms of the contract entered into between the parties, therefore, the respondent/claimant was entitled to claim interest as per the terms of the contract i.e., @ 36% per annum with monthly rests. Accordingly, Issue No. 3 was decided in favour of the claimant/respondent herein.

15. Issue No. 5 was decided by the learned Arbitrator in favour of the claimant/respondent herein by observing that Section 64 of Negotiable Instruments Act, 1881 is not applicable to the facts of the present case and the surety ERPL (Respondent No.3 therein) having admitted the existence of the arbitration agreement/sanction letter dated 11.06.2003, has rightly been impleaded to the arbitration proceedings. It was further held that BPL has also been rightly impleaded in view of the joint liability clause contained in the sanction letters dated 27.12.2002 and 11.06.2003.

16. As regards Issue No.6 qua the issue of limitation, the learned Arbitrator while observing that the part payments amounted to acknowledgement and would extend the period of limitation, held that since, admittedly, there was a part payment made by BPL within the period of limitation i.e., in August 2005, and the debt was acknowledged *vide* letter dated 02.02.2007, by no stretch of imagination can the claims of the claimant/respondent herein be said to be barred by time in view of the fact that the claimant invoked arbitration within six months from 02.02.2007. Thus, Issue No. 6 was decided in favour of the claimant/respondent herein.

17. In respect of Issues No. 7, 8 and 9, relying upon the decision in ***Harish Chander v. Ganga Singh and Sons*** reported in 1973 SCC OnLine P&H 40, it was held that despite the fact that the claimant/respondent herein did not present the postdated cheques issued by BDDL, it would not absolve the appellant herein from its liability. However, with regard to ERPL, it was held that its liability stood discharged on account of the failure of the claimant/respondent herein to present the post-dated cheques issued by ERPL for payment coupled with the fact that ERPL never issued any letter of acknowledgement of debt either, and thus, the claim of the respondent herein against ERPL was dismissed as barred by limitation.

18. Resultantly, the learned Arbitrator, by way of the impugned award dated 14.12.2016, directed the appellant to pay a sum of Rs. 7,27,05,579/- as well as Rs. 20,62,28,681/- with interest as applicable in the terms of the sanction letters i.e., @ 36% per annum from the date these amounts were due till the date of the Award, and @10% per annum from the date of the Award till realization.

C. FIRST APPEAL UNDER SECTION 34 OF THE ACT, 1996

19. Aggrieved by the Award dated 14.12.2016, each of the rival parties instituted an application under Section 34 of the Act, 1996 before the Delhi High Court. On one hand, the appellant herein challenged the directions of the learned sole Arbitrator to make the payment of the claim to the respondent herein, while on the other hand, the respondent herein challenged the dismissal of its claims against ERPL.

D. ORDER PASSED BY A LEARNED SINGLE JUDGE IN SECTION 34 PETITION DATED 18.12.2018

20. The gist of the findings recorded by the learned Single judge while dismissing Section 34 petition filed by the appellants herein, is as under:

> *"(i)The claim of the respondent/claimant was not on the basis of the Bills of Exchange but on the basis of two Sanction Letters to which the appellant herein was admittedly a party. Section 80 of the NI Act, which prescribes a fixed rate of interest to be charged, has no application to the present case.*

(ii) As per Section 31(7) of the NI Act, the transaction in question does not fall within the ambit of the Usurious Loans Act, 1918 as amended by the Punjab Relief of Indebtedness Act, 1934 since the transaction in question was not in the nature of a loan or a debt, rather it pertained to discounting of Bills of Exchange which was simply a commercial transaction.

(iii) The interest awarded by the learned sole Arbitrator, having been granted in accordance with the terms of the contract between the parties, cannot be set aside by invoking the general principles of fairness or equity.

(iv) Since the respondent/claimant had stated on affidavit that it had adjusted the part payments made by the appellant against seven particular Bills of Exchange, the respondent cannot claim the benefit of extension of limitation for those Bills of Exchange for which it did not receive any payment. Therefore, the claim of the respondent for Bill of Exchange bearing OMR No.35 has to be held as being barred by limitation.

(v) As per Section 37 of NI Act as well as the terms of the Sanction Letters, the Drawer/BDDL and the Drawee/BPL of the Bills of Exchange are jointly and severally liable for repayment of the amounts discounted. Merely because the terms of the Sanction Letters state for reference to the Drawer/BDDL, it cannot absolve the Drawee/BPL of such liability.

(vi) Non-application of Section 64, NI Act to the facts and circumstances of the present case is a finding on fact made by the learned Sole Arbitrator, hence it cannot be interfered into in Section 34, Arbitration Act proceedings.

(vii) There was no acknowledgment of liability by ERPL that could have extended the period of limitation against it. Further, no reason for non-presentation of the Post-Dated Cheques issued by ERPL was presented by the respondent/claimant before the Arbitrator or before this Court. Thus, the ERPL has been rightly discharged from the liability by the ld. Sole arbitrator.

(viii) Post-award interest awarded by the learned Sole arbitrator is a matter of discretion of the arbitrator, hence the same cannot be faulted merely because the Court could have exercised its discretion in another manner."

21. Thus, the learned Single Judge *vide* common order dated 18.12.2018 partly allowed the petition filed under Section 34 of the Act, 1996 preferred by the appellant herein and dismissed the petition filed by the respondent herein.

22. The final directions issued by the learned Single Judge read thus:

> *"63. In view of the above, the Award on the principal sum of Bill of Exchange bearing No.OMR-35 of an amount of Rs.75,39,304/- is set aside. The Award inasmuch as it directs the petitioner to make payments to the respondent except for the above Bill of Exchange and proportionate interest thereon, is upheld."*

23. The appellant herein being dissatisfied with the judgment and order passed by the learned Single Judge referred to above, preferred an appeal under Section 37(1)(b) of the Act, 1996.

24. The Division Bench of the High Court dismissed the appeal filed by the appellant herein holding as under:

> *"42. We find that there is not an iota of patent illegality in the aforesaid reasoning spelled out by learned Single Judge except for a typographical error that the learned judge was referring to Section 31(7) of the A& C Act. The Usurious Loan Act, 1918 as followed by the Punjab Relief of Indebtedness Act, 1934, were promulgated in a different era and the power of the Court to adjudicate if the interest on a loan amount is excessive has to give way in view of the plenary powers of the Courts provided under the later enactment i.e., the Arbitration & Conciliation Act. Unhesitatingly, the transactions between the parties whereby payments were made for supply of goods to the appellant by the respondent/claimant were not in the nature of a loan or an*

advance. In essence, the respondent/claimant had been making payment to the appellant for the supply of goods to BDDL and such payments were purely in the nature of commercial transactions as amongst the parties. Both parties, the appellant herein/BPL and the respondent No.2/BDDL evidently approached the respondent/ claimant for providing bill discounting facilities and agreed to their joint and several liabilities towards the discounting of the Bills of Exchanges."

25. The final order passed by the Division Bench dismissing the Section 37 appeal reads as under:

"43. In view of the foregoing discussion, this Court finds that neither the learned Arbitrator nor the learned Single Judge, while adjudicating the issues raised by the rival parties, has committed any patent illegality or perversity that go to the root of the matter. The arbitral award, although has granted interest at a rate which is on the higher side, cannot be held to be so unfair and unreasonable so as to shock the conscience of this Court. There is nothing to suggest that the Award is opposed to public policy, and therefore, inexecutable.

42. In view of the above, the instant appeal is dismissed, thereby holding that there is no illegality, infirmity or incorrect approach adopted by the learned Single Judge in passing the impugned order dated 18.12.2018, thereby awarding a sum of Rs. 7,27,05,579/- and Rs. 20,62,28,681/- with interest as applicable in accordance with the terms of the agreements/Sanction Letters from the date these amounts became due till the date of the award as well as interest @ 10% per annum from the date of the award till realization.

43. The parties are left to bear their own costs."

26. It appears that after the dismissal of Section 37 appeal by the High Court, a Review Petition No. 309 of 2024 was filed. The Review Petition also came to be rejected *vide* the order dated 18.11.2024.

27. The High Court while rejecting the review application made the following observations:

"18. Adverting to the issues raised in the instant review, the plea that as per the tabular chart submitted by the respondent before the Arbitral Tribunal, most of the bills of exchange/hundis stood paid within a period of nine months, is belied from the record of the Arbitral Tribunal inasmuch as while deciding Issue No.1 as to what amount is payable against the bill discounting facility/sanction letters dated 27.12.2002 up to 10.08.2007, it was categorically found that not a single bill of exchange/hundi was paid by the applicant/appellant on the respective due dates. The said statements which were marked Ex.CW-1/294 with respect to sanction letter dated 27.12.2002 and Ex.CW-1/295 with respect to sanction letter dated 11.06.2003 were not assailed in any manner before the learned Arbitral Tribunal.

19. In fact, a bare perusal of the tabular details of the bills of exchange/hundis in the instant application so as to invoke the review jurisdiction, is rather in the nature of almost placing a whole new interpretation with regard to the chart that was filed by the applicant/appellant vide annexure "B" as well annexure "A" relied upon by the respondent/claimant, referred to in our judgment vide paragraph (29). By all means, it amount to espousing a new assertion to the whole story that most of the bills of exchanges/hundis were discharged within nine months. It is borne out from the record that no plea was advanced to the effect that substantial payments had been made within a period of nine months. It is also a matter of record that neither the witness for the respondent/claimant was prodded about the payments done within nine months nor the Managing Director of the applicant/appellant stepped into the witness box to prove such aspect. The evidence led by the claimant proven in accordance with statement of claim forming Annexure "A" was not shaken or controverted in any manner.

20. Likewise, the plea that only seven payments were attributable to the applicant/appellant under the sanction letter dated 11.06.2003 and none under the first sanction letter dated 27.12.2002 is also misconceived since the liability of both the drawer and the drawee i.e., BDDL as *drawer, and the applicant/appellant as the drawee, was joint and several, and the desperate attempt by the applicant/appellant to wriggle out of its liability towards the bills of exchange/hundis deserves to be nipped in the bud, in the face of acknowledgment of its liability vide letter dated 02.02.2007 issued by the applicant/appellant, the contents of which letter are referred by us in paragraph (30) of the impugned judgment dated 19.07.2024.*

21. In the same vein, the plea that each bill of exchange was an independent negotiable instrument and could not have been clubbed or lumped together for the purposes of Section 19 of the Limitation Act, 1963, was also decided by taking a substantive view of the matter inter alia upholding the observations of the Arbitral Tribunal as well as the learned Single Judge who passed the order dated 18.12.2018 under Section 34 of the A&C Act.

22. As regards the plea raking up the issue of the unreasonableness of the rate of interest claimed on the bills discounted in terms of the two sanction letters, the same was ardently urged before the Arbitral Tribunal, and later before the learned Single Judge in the application under section 34 of the A& C Act, and lastly before us in proceedings under section 37 of the A & C Act, only to be met with rejection from all the three forums. Further, the plea advanced to the effect that the stipulation of high interest @ 36% is contrary to the usage, practices or ordinary disposition in the financial world cannot be re-agitated in review proceedings once it is found that a substantive view has been taken on that aspect.

23. To sum up, we are not persuaded to take a different view on the instant review application. In upholding the findings of both the Arbitral Tribunal and the learned Single Judge, we have taken a substantive view of the matter by reaching to the conclusion that the payment of interest on the basis of the terms of the two sanction letters cannot be called unconscionable or excessive. At first blush, the interest rate and quantum worked out so far seem to be quite humungous, however, objections in the *nature of arbitrariness, unconscionability and violation of public policy, cannot be invoked in cases where a business entity has entered into a commercial contract, and has acquiesced and acted upon the terms and conditions of the said contract, without ever having raised any objections of such nature, either before or immediately after entering into the contract.*

24. Evidently, the applicant /appellant never took any steps to avoid the contract within the stipulated time and having reaped the benefits arising out the contract, now, at this belated stage, it does not lie in its mouth to avoid the said stipulation in the contract by alleging unfairness and unconscionability. It is on record that the applicant/appellant directly benefited from the two sanction letters. As noted in paragraph (34) of the judgment under review, the applicant/appellant acknowledged its liability via letter dated 02.02.2007, specifically referencing outstanding dues pertaining to the BDDL account and seeking additional time for payment.

25. Notably, the author of this letter did not testify before the Arbitrator, and consequently, no objection was raised regarding the interest clause in the sanction letters. It is axiomatic that the sanctity of a contract is a fundamental principle underlying the stability and predictability of legal and commercial relationships. This legal position is precisely what we have upheld.

26. There is no gainsaying that the question as to whether the charging of a high rate of interest in the case of a purely commercial transaction is morally wrong entails a complex web of issues that would be contingent upon a variety of factors and perspectives. Although at first glance, the charging of interest @36% could be considered as exploitative, unfair and morally blameworthy, high interest rates reflect the lenders risk of default due to highly competitive and uncertain market conditions, besides the fact that high interest rates might discourage borrowers from taking unnecessary risks. In the commercial world, justifiability or reasonability of high interest rates would depend on the transparency of the terms and conditions of *the contract entered into between the lender and the borrower, as well as the informed consent of the borrower. Ultimately, morality is inherently dependent on context, shaped by a complex interplay of cultural norms, as well as individual values. The moral implications of high interest rates are not absolute, rather they must be assessed through a nuanced lens that considers the inter-relationship between economic, social, and regulatory factors.*

27. Further, the plea that interest has been granted in contravention of the Section 80 of the Negotiable Instruments Act, 1881 and the award is liable to be set aside for being against the public policy of India, since the claim is not entirely based on the bills of exchange but the two sanction letters, cannot be countenanced again in the review sought since such pleas already stand rejected in view of the categorical finding that the bills of exchange were an integral part of the two sanction letters. It is a matter of record that the claim of the respondent was not based merely on the basis of bills of exchange, rather on the basis of the two sanction letters to which the applicant/ appellant was admittedly a party.

28. Likewise, the plea in the same vein that the interest claimed is hit by the Usurious Loans Act, 1918, as amended by Punjab Relief Indebtedness Act, 1934, was too rejected by us for the substantive finding that the aforesaid Act was not applicable in view of Section 31(7)(a)10 (b)11 as it stood prior to the amendment. The said view was supported with case law by the learned Single Judge as also by us in the impugned judgment under review."

28. On the issue whether interest rate is against public policy, the High Court observed thus:

"32. In the light of the aforesaid discussion, reverting back to the instant matter, on a plain and grammatical construction of clauses (ii) and (iii) of Explanation 1 to Section 34(2) of the A&C Act, it is doubtful if the imposition

of an exorbitant interest in the background of contemporary commercial practices, would be against the fundamental policy of Indian Law, or against the basic notions of morality or justice. It is noteworthy that the applicant/appellant has consistently and brazenly denied its liability to honour the hundis, despite being confronted with overwhelming evidence. Furthermore, it has shown no willingness to settle accounts with the respondent/claimant. Consequently, the applicant/appellant cannot now dispute its substantial financial liability. Notably, the applicant/ appellant is a sophisticated entity, unaffected by illiteracy, ignorance, or economic disadvantage.

33. While exorbitant interest rates may be deemed unjust or immoral in certain circumstances, particularly where beneficiaries lack equal bargaining power or suffer from illiteracy, poverty, or ignorance, the present case does not warrant such consideration.

34. Considering the foregoing discussions, we are unconvinced that any error apparent on the face of the record warrants a review of our judgment dated 19.07.2024. The review sought essentially constitutes an appeal to recall our judgment, which is inherently not maintainable. To reiterate, the pleas raised in this application have already been addressed through a substantive examination of the matter, in accordance with the law."

29. Being dissatisfied with the judgment and order passed by the High Court dismissing the Section 37 appeal, and also the order rejecting the review application, the appellant is here before this Court with the present appeals.

E. SUBMISSIONS ON BEHALF OF THE APPELLANT

30. Mr. Gopal Subramanium, the learned Senior counsel appearing for the appellant strenuously submitted that clause 4 of the sanction letters which prescribes the rate of interest carries in it an unambiguous element in so far as the applicable rate of 36% is concerned. It was submitted that read as a whole, the clause is capable of a construction that parties intended that if there was any default, they would revert to the normal rate being 36% which would be through an active notification.

31. As a second proposition, the learned Senior counsel submitted that the rate of interest at 36% with monthly rest as provided in clause 4 is in the nature of penal interest and could not have been awarded having regard to illustration 'D' read with Section 74 of the Indian Contract Act, 1872. Section 74 of the Indian Contract Act, prescribed that even if there is a penal stipulation, only damages as occurred or suffered can be adjudicated.

32. As a third proposition, the learned Senior counsel submitted that the words "unless otherwise agreed as occurring in Section 31(7)(a)" are susceptible of three interpretations. The first is that the words unless otherwise agreed between the parties referred to an agreement containing a prohibition against the arbitral tribunal to award interest.

33. The learned Senior counsel argued that the second interpretation is that if there is no bar which precludes the arbitrator from granting interest then, the Arbitrator acts under Section 31(7)(a) having regard to the factors outlined therein to make a judicious and judicial determination of reasonable amount of interest which would be payable. In such a case too, the Arbitrator can consider the terms of the contract including any term which may prescribe interest as a relevant factor in consideration under Section 31(7)(a).

34. The third interpretation according to the learned Senior counsel is that "unless otherwise agreed between the parties" can control whole aspect of the matter covered under Section 31(7)(a).

35. In the last, the learned Senior counsel submitted that the observations contained in the ***DMRC v. Delhi Airport Metro Express Private Limited*** reported in (2024) 6 SCC 357 to the aforesaid extent were not apposite for the issue which fell for consideration. It was submitted that having regard to the nature of the arbitral functions to award interest both under Sections 31(7)(a) and 31(7)(b) being of an adjudicatory character which is a performative function of the arbitral tribunal, there can only be an exclusion of that function but not the ancillary execution of that function through an Agreement.

36. The gist of the broad submissions canvassed by Mr. Gopal Subramanium is as under:

"a. Grant of interest under the Award and Impugned Orders is opposed to public policy in terms of Section 34(2)(b)(ii) of the Arbitration Act read with Section 80 of the Negotiable Instruments Act, 1881;

b. Award and Impugned Orders are passed in contravention of Section 31(7)(a) of the Arbitration Act which concerns itself with 'reasonable pendente-lite interest' and not contractual rate of interest;

c. In the absence of either a statement of account or a demand for payment by the Respondent, clause 4 of the Sanction Letter dated 27.12.002 was not effectively exercised;

d. Interpretation of clauses 4 and 5 respectively of the Sanction Letter dated 27.12.2002 in light of the admitted adjustment of payments against the principal amount of the Bills of Exchange (34 Bills of Exchange in toto);

*e. Clause 4 of the sanction letter 27.12.2002 is subject to the principle of '**verba chartarum fortius accipiuntur contra proferentem**' and the effect of a unilateral and one-sided arbitration clauses under the sanction letters;*

f. Interest awarded at 36% per annum is 'penal interest on penal interest' and as such, is opposed to public policy;

g. The Award and Impugned Orders fail to consider the fact that the Respondent's claims were ex-facie barred by Limitation.

37. To fortify the submissions noted above, the learned Senior counsel placed strong reliance on the following decisions:

(1) ***Central Bank of India v. Ravindra and Others*** reported in (2002) 1 SCC 367. Paras 36, 37, 38, 39, 40, 44 and 55 respectively.

(2) ***Unitech Limited and Others v. Telangana State Industrial Infrastructure Corporation (TSHC) and***

Others reported in (2021) 16 SCC 35. Paras 47, 48 and 49 respectively.

(3) ***Morgan Securities and Credits Private Limited v. Videocon Industries Limited*** reported in (2023) 1 SCC 602. Para 24.

(4) ***Jaiprakash Associates Limited (JAL) v. Tehari Hydro Development Corporation (THDC)*** reported in (2019) 17 SCC 786. Paras 15, 16 & 17 respectively.

(5) ***Delhi Airport Metro Express Private Limited v. Delhi Metro Railway Corporation*** reported in (2022) 9 SCC 286.

38. In such circumstances referred to above, the learned Senior counsel prayed that there being merit in his appeal, the same may be allowed and the impugned judgment and order passed by the High Court be set aside.

39. In the last, the learned Senior counsel prayed that in so far as the rate of interest is concerned this Court may modify the same accordingly with a view to balance the equities between the parties.

F. <u>SUBMISSIONS ON BEHALF OF THE RESPONDENT</u>

40. Mr. Shyam Divan the learned Senior Counsel appearing for the respondent broadly submitted the following:

a. No error not to speak of any error of law could be said to have been committed by the High Court in passing the impugned judgment and order.

b. The four sets of concurrent findings encompass various issues such as the enforceability of the contractual rate of interest, limitation, inapplicability of Section 80 of the Negotiable Instruments Act, 1881(“**NI Act**”), Joint and Several Liability of Drawer and Drawee, inapplicability of Section 64 of the NI Act to the facts of the present case, inapplicability of the Usurious Loans Act, 1918 etc.

c. It is a settled law that when an arbitral award has been affirmed by the Court under Section 34, and thereafter, by the Court in an appeal under Section 37 then this Court in exercise of its jurisdiction under Article 136 of the Constitution should be slow and loath in disturbing such concurrent findings. In this regard reliance has been placed on the decision of this Court in the case of ***MMTC Limited v. Vedanta Limited*** reported in (2019) 4 SCC 163 para 14.

d. It is for the first time that the appellant canvassed an entirely new plea i.e., that no specific notice was issued to it by the respondent for withdrawal of the concessional rate of 22.50% p.a.

e. No such plea had been taken either before the arbitrator or in the proceedings or arguments before the Court under Section 34 and Section 37 of the Act, 1996 respectively.

f. The aforesaid did not find mention in any response to the notice of arbitration dated 28.06.2007 issued by the respondent or in the statement of defence before the arbitrator or in the pleadings under Section 34 and Section 37 of the Act, 1996 respectively wherein, the rate of interest 36% p.a. with monthly rests stood firmly embedded in the claim amount/award amount. At no point of time the appellant redressed the grievance that the same had caused prejudiced citing alleged lack of such notice.

h. Withdrawal of a concessional rate of interest or for that matter any other concession for failure to apply with the terms thereof cannot be said to be a penalty.

i. The appellant made no attempt to pay any part of the claimed amount at any stage of the arbitral proceedings or even after the award. No attempt to pay any part of the claimed sum was made even after the orders under Section 34 and Section 37 of the Act, 1996 respectively. It is only for the first time before this Court that some amount came to be deposited under the orders passed by this Court.

l. The *pendente lite* period was utilized by the appellant in diverting various assets and monies to third parties with the intention to take the said assets beyond the pale of a potential enforcement process and because of such conduct the appellant company and its contractors were held guilty of contempt of court on account of wilful violation of the interim restraint order dated 23.08.2013 passed by the Delhi High Court.

m. In terms of Section 31(7)(a) of the Act, 1996, the contractual rate of interest held the field for the pre-award period and in a commercial contract between two large corporates no cavil could have been raised with the agreed rate of interest.

n. The arbitrator's jurisdiction to grant *pendente lite*/pre award interest is governed strictly by the contract between the parties. In this regard, reliance was placed on the decisions of this Court in the case of ***State of Haryana v. S.L. Arora*** reported in (2010) 3 SC 690 and in the case of ***Delhi Airport Metro Express*** (supra) para 20 respectively.

o. The principle of unconscionability is inapplicable to voluntary commercial agreements between the parties of equal bargaining strength.

p. Clauses providing for compounding of interest in commercial contracts voluntarily entered into between the parties are not violative of Public policy. In this regard, reliance was placed on the decision of this Court in the case of ***Renusagar Power Company Limited v. General Electric Company*** reported in 1994 Supp (1) SCC 644 at 693 para 93.

41. In such circumstances referred to above, it was prayed by the learned Senior counsel appearing for the respondent that there being no merit in this appeal, the same may be dismissed.

G. <u>ANALYSIS</u>

42. Before adverting to the rival submissions canvassed on either side, we must look into few pieces of documentary evidence on record.

43. The letter dated 27.12.2022 addressed by the respondent herein to the appellant as regards the Bill Discounting facility to the extent of Rs. 6, 00, 00, 000/- reads thus:

"MORGAN SECURTIES AND CREDITS PRIVATE LIMITED
CORPORATE OFFICE: 53, Friends Colony (East), New Delhi-110065.

Dated: 27.12.2022

BPL Display Devices Limited
A-41, 42 & 42/1 Site IV
Industrial Area Sahibabad
Ghaziabad-201010
Uttar Pradesh.

Dear Sir,

Re: Bill Discounting Facility to the extent of Rs. 6,00,00,000/-

Please refer your request and the discussions your representatives had with us in connection with extension of the Bills Discounting facility to you. We have considered your proposal and on the basis of the documents, explanations, representations (hereinafter collectively called as the proposal). Furnished and made by you, we are agreeable to sanction you a facility of Bills Discounting limit to the extent of Rs. 6,00,00,000/- (Rupees Six Crores Only), on the following terms and conditions (hereinafter call as "the Facility").

1. We hereby confirm the allocation of funds on the following terms and conditions:

i) Amount	*Upto Rs. 6,00,00,000/-*
ii) Period	*Upto 150 days*
iii) Drawer	*BPL Display Devices Ltd*
iv) Drawee	*BPL Limited*

2. The above facility be utilized in a way that the total amount outstanding at any point of time should not exceed the maximum limit of Rs. 6,00,000/- granted herein.

3. Bill of Exchange/Hundi shall be with recourse to Drawer. Therefore, the liability to repay amount to Morgan Securities & Credits Private Limited (hereinafter referred to as "the Discounting Company") on the due date shall be of Drawer and Drawee jointly and severally. In case the Drawee does not make payment on due date of any bill of exchange /hundi, the Drawer shall make the payment of all the amount due thereon to without any notice or demand or presentment from the payee or the holder in this behalf.

4. <u>The Drawee/Drawer agrees that normal agreed rate for providing Bill Discounting facility is 36% p.a., however as a special case the Discounting Company is providing the Bill Discounting Facility at concessional rate of 22.5% p.a. payable upfront. In case of delay or default in making payment of amount of the Bill of Exchange or overdue bill discounting charges/interest or any part thereof on its due date, the concessional rate will be withdrawn and the normal rate of bill discounting charges of 36% p.a. monthly rests, shall be payable by the Drawee/Drawer from its due date. Margin @3% p.m. for 3 days shall be deducted at the time of discounting, to be adjusted against delays in repayment, if any</u>.

5. The repayment on the due date will be made to us by way of crossed cheque/Demand Draft payable at New Delhi of high value, clearing. Any amount paid under any Bill of Exchange by the Drawer and/ or Drawee shall be first adjusted towards overdue charges/interest, costs and expenses and other facilities, if any, and then towards the amount of Bill of Exchange.

6. In the event of any amount remaining overdue or any hundi/bill of exchange under this facility, neither of the Drawer and Drawee shall without the prior written permission of the Discounting Company pass any resolution for its winding up for its amalgamation/merger or otherwise or for amalgamation/merger of any other Company into the Drawer or Drawee: enter directly or indirectly into any new area/field of business/operation or dispose off or sell or encumber any of its undertaking or business or any of its investments in shares etc.; register/recognize any transfer of its shares by any of its present promoters' group; change its paid up share capital or redeem any security; appoint or reappoint, or modify any term and condition of appointment of, any whole time or managing; director; pay any remuneration to any of its managing directors, whole time directors or the Chairman; or pay any dividend on any shares.

7. This sanction is made at New Delhi and the disbursement shall be made from New Delhi. The Courts at New Delhi only shall have the exclusive jurisdiction to entertain any dispute relating to this facility. However, in case of dishonour of any cheque relating to this facility. However, in case of dishonour of any cheque issued by the Drawer/Drawee under this facility, the Courts having the territorial jurisdiction over the area where the collecting banker of the dishonoured cheque is situated, shall have the exclusive jurisdiction to try the offence under the Negotiable Instruments Act, 1881.

8. The amount shall be disbursed to you on the submitting by you the following:

i) Post dated cheque for the payment of Amount of Bills of Exchange from the Drawer and Drawee.

ii) Signature Attestation of the signatories from the bank of signatories of Hundi as well as resolution (of Drawer as well as drawee).

iii) Bill of Exchange (as per our format) duty stamped and accepted for payment on due date by Drawer & Drawee company (with recourse to Drawer)

iv) Original copies of Invoices/Bills duly accepted by Drawee stating that the goods received are in perfect order and condition and certified/original copies of relevant Challans L/R and G/R

v) Certified true copy of the Board Resolution authorising to draw documents/acceptance of Bill Discounting facility and authorization of persons to sign for and on behalf of Drawer & Drawee Company.

vi) Mode of Operation of Bank Account of Drawer & Drawee Company (wherein cheque signing authorities are given)

vii) Names and Residential addresses of Directors of Drawer & Drawee Company.

Any dispute or difference whatsoever between the parties arising out of or in connection with the present facility and for any other transaction/s between the parties shall be settled by Arbitration of a Sole Arbitrator appointed by Chairman of Morgan Securities and Credits Private Limited, who would also have right to appoint alternate Arbitrator in place of the aforesaid Arbitrator, in case of his death or being incapable or refusal to act or in the event of termination of his mandate for any reason. The arbitration proceedings shall be held at New Delhi. The power of the Chairman to appoint a sole Arbitrator shall not be challenged by any party. Further, the parties agree that the Arbitrator be appointed may be an employee and/or professional retainer and/or a person who has a relation or interest in the company. The parties agree not to ask for any adjournment except under extra-ordinary reasons.

We reserve the right to modify, add or delete any of the terms and conditions mentioned in this letter at any time for which due notice will be given to you.

Kindly furnish the above documents/papers at an early date with a letter of acceptance to the terms and conditions of this sanction letter by you and the drawee.

We look forward to a continuous business relationship and assure you of our prompt services at all times.

Thanking you,

Yours faithfully,
For Morgan Securities and Credits Private Limited

Sd/
Authorised Signatory."

(Emphasis supplied)

44. The letter dated 11.06.2023 addressed by the respondent to the appellant as regards the Bill Discounting facility to the extent of Rs. 6,50,00,000/- reads thus:

"MORGAN SECURITIES AND CREDITS PRIVATE LIMITED
CORPORATE OFFICE: 53, Friends Colony (East), New Delhi-110065.

Dated: 11.06.2023

BPL Display Devices Limited
A-41, 42 & 42/1 Site IV
Industrial Area Sahibabad
Ghaziabad-201010
Uttar Pradesh.

Dear Sir,

Re: Bill Discounting Facility to the extent of Rs. 6,50,00,000/-

With reference to our discussions, we are pleased to sanction Bill Discounting Limit to your Company to the extent of Rs. 6,50,00,000/- (Rupees Six Crores Fifty Lakhs only), for your Sales to BPL Limited. We hereby confirm the allocation of funds on the following terms and conditions:

i) Amount	*Upto Rs. 6,50,00,000/-*
ii) Period	*Upto 150 days*
iii) Drawee	*BPL Limited*
iv) Drawer	*BPL Display Devices Ltd*
v) Guarantor	*Electronic Research Private Limited.*

2. Bill of Exchange/Hundi shall be with recourse to Drawer. Therefore, the liability to repay amount to lender on the due date *shall be of Drawer & Drawee jointly and severally, which hereafter shall be collectively referred to as the "Borrower". Kindly arrange to furnish the following documents/papers of the Company:-*

i) Memorandum & Articles of Association of the Drawer & Drawee Companies.

ii)Copies of the Audited Annual Reports for the last two years of the Drawer & Drawee Companies.

iii)Post Dated Cheque for the payment of Principal Amount from the Drawer and Drawee. Drawer's cheque to be used in case Drawee is unable to pay on due date.

iv)Signature Attestation of the signatories from the bank of signatories of Hundi as well as resolution (of Drawer as well as Drawee).

v) Bill of Exchange (as per format) duly accepted for payment on due date by Drawer and Drawee Company (with recourse to Drawer).

vi) Original Copies of Invoices/Bills duly accepted by Drawee stating that the goods received are in perfect order and condition and copies of Challans L/R and G/R.

vii) Certified true copy of the Board Resolution authorizing to draw documents/acceptance of Bill Discounting facility and authorization of persons to sign for and on behalf of Drawer & Drawee Company.

viii)Certified true copy of the Resolution passed u/S. 293(1)(d) of the Companies Act, 1956 of the drawee company and an undertaking that the total borrowing has not exceeded.

ix) Mode of Operation of Bank Account of Drawer & Drawee Company.

x) Names and Residential addresses of Director of Drawer & Drawee Company.

xi) Comfort letter along with PDC of Electronic Research Limited guaranteeing repayment of amount due.

Kindly furnish the above documents/papers at an early date with a letter of your acceptance. The Drawee/Drawer agrees with the lender that normal rate for providing Bill Discounting facility is 36% p.a. however, as a special case the lender is providing this Bill Discounting facility at concessional rate of 22.5% p.a. payable upfront. In case of delay or default in making payment of principal or overdue bill discounting charges/interest or any party thereof on its due date, the concessional rate will be withdrawn and the normal rate of bill discounting charges/interest of 36% p.a. monthly rests, shall be payable by the Drawee/Drawer from its due date.

As per our understanding, the repayment on the due date will be made to us by way of crossed cheque/Demand Draft payable at New Delhi of high value clearing failing which interest on the delayed period would be payable to us as per above.

Any dispute of difference whatsoever arising between the parties out of or in relation to the construction, meaning, scope, operation or effect of any transaction/s or the validity or the breach thereof arising out of or in connection with the present agreement and for any other transaction/s between the parties shall be settled by Arbitration of a Sole Arbitrator appointed by Chairman of Morgan Securities & Credits Private Limited, who would also have right to appoint alternate Arbitrator in place of the aforesaid Arbitrator, in case of his death or being incapable or refusal to act or in the event of termination of his mandate for any reason. The arbitration proceedings shall be held at New Delhi. The power of the Chairman to appoint a Sole Arbitrator shall not be challenged by either party. Further, the parties agree that the Arbitrator so appointed may be an employee and/or professional retainer and/or a person who has a relation or interest in the company. Both parties are not to ask for any adjournment except under extraordinary reasons. The award given by the arbitrator shall be final and binding upon the parties.

We look forward to a continuous business relationship and assure you of our prompt services at all times.

Thanking you,

Yours faithfully,

For Morgan Securities & Credits Private Limited.

Sd/-

Authorized Signatory"

(Emphasis supplied)

45. Thus, what is important for us to look into and try to understand is clause 4 of the sanction letters dated 27.12.2022 and 11.06.2023 respectively referred to above. We reproduce the same as under:

> "*4. The Drawee/Drawer agrees that normal agreed rate for providing Bill Discounting facility is 36% p.a., however as a special case the Discounting Company is providing the Bill Discounting Facility at concessional rate of 22.5% p.a. payable upfront. In case of delay or default in making payment of amount of the Bill of Exchange or overdue bill discounting charges/interest or any part thereof on its due date, the concessional rate will be withdrawn and the normal rate of bill discounting charges of 36% p.a. monthly rests, shall be payable by the Drawee/Drawer from its due date. Margin @3% p.m. for 3 days shall be deducted at the time of discounting, to be adjusted against delays in repayment, if any.*"
>
> (Emphasis supplied)

46. Clause 4 can be divided into three parts. First, the Drawer and Drawee agreed that the normal rate for providing Bill Discounting facility would be 36% p.a. The second part provides that as a special case the discounting company, i.e., the respondent herein would provide the Bill Discounting facility at the concessional rate of 22.5% p.a. payable upfront and the third part provides that in the event of delay or default, in making payment of amount of the Bill of Exchange or overdue bill discounting charges/interest or any part thereof on its due date, the concessional rate would be withdrawn and the normal rate of bill discounting charges of 36%

p.a., monthly rest would be payable by the Drawer/Drawee from its due date. The margin at the rate of 3% per month for three days would be deducted at the time of discounting to be adjusted against delays in the repayment if any.

H. NATURE OF THE COMMERCIAL CONTRACT BETWEEN THE PARTIES

47. As the entire debate revolves around clause 4 of the agreement providing for bill discounting facility, and more particularly, the rate of interest specified therein, we should try to understand the basic difference between a business loan and bill discounting. It is necessary to understand this difference to meet with the case put up by the appellant that interest at the rate of 36% with monthly rest is opposed to public policy and could be said to be unconscionable.

48. The crucial difference is that a bill discounting facility is a short-term financing option where a business sells its unpaid invoices to a financial institution for immediate cash, while a business loan is a traditional debt obligation where the business receives a lump sum and is responsible for repaying it with interest. High interest rates are prescribed in a contract, relating to a bill discounting facility primarily due to the higher risk profile of the financing, its nature as a short-term unsecured funding source and the need for the financial institution to compensate for the associated costs and potential for non-payment.

49. The higher rate is a trade-off for the business, which gains immediate liquidity and operational flexibility by paying a premium to offload the waiting period and associated payment risks to a financial institution. In other words, contracts relating to a bill discounting facility typically contain high rates of interest primarily due to the higher risk profile for the lender, the unsecured and short-term nature of the financing, and the quick and hassle-free access to cash it provides.

50. Keeping the fine distinction between a loan and a bill discounting facility in mind, the High Court did well to take the view that the provisions of the Usurious Loans Act, 1918 would not be applicable in the present case. The High Court said so because in the present litigation the commercial transaction was one relating to the bill discounting facility and not a loan. The Usurious Loans Act, 1918 would apply to a loan and not to transaction relating to bill discounting facility.

I. <u>SECTION 31(7)(a) AND (b) RESPECTIVELY OF THE ACT, 1996</u>

51. The scope of Section 31(7)(a) and (b) and the interplay between the sub clauses (a) and (b) respectively have been very succinctly explained by this Court in a very recent pronouncement in the case of ***HLV Limited v. PBSAMP Projects Pvt. Limited*** : 2025 INSC 1148**.** We may clarify that in ***HLV Limited*** (supra) the court was concerned with pre-amended Section 31(7)(b) of the Act, 1996. However, in the case on hand, we are not concerned with Section 31(7)(b) but rather with sub clause (a) of the Act, 1996.

52. We must look into Section 31(7) of the Act, 1996 which reads thus:

> *"31. Form and contents of arbitral award. **(7)(a) Unless otherwise agreed by the parties, where and insofar as an arbitral award is for the payment of money, the Arbitral Tribunal may include in the sum for which the award is made interest, at such rate as it deems reasonable, on the whole or any part of the money, for the whole or any part of the period between the date on which the cause of action arose and the date on which the award is made.*
>
> *(b) A sum directed to be paid by an arbitral award shall, unless the award otherwise directs, carry interest at the rate of two per cent. higher than the current rate of interest prevalent on the date of award, from the date of award to the date of payment."*

53. A bare perusal of the aforesaid provision would indicate that Section 31(7) has got two clauses: clause (a) and clause (b) respectively. Clause (a) starts with the expression 'unless otherwise agreed by the parties'. Thereafter, it says that where an award is for payment of money, the arbitral tribunal may include in the sum for which the award is made interest at such rate as it deems reasonable on the whole or any part of the money and for the whole or any part of the period from the date when the cause of action arose to the date when the award is made. In other words, clause (a) empowers the tribunal to include interest in the 'sum' for which the award is made. The arbitral tribunal is further conferred the discretion to award interest on the principal sum awarded at such rate as it deems reasonable. However, this discretion of the arbitral tribunal is subject to any decision which is agreed upon by the parties.

54. Clause (a) of Section 31(7) of the Act, 1996 was examined by this Court in ***North Delhi Municipal Corporation v. S.A. Builders Limited*** reported in (2025) 7 SCC 132 whereafter it was held as under:

> *"36.1. From a minute reading of sub-section (7), it is seen that it has got two parts: the first part i.e. clause (a) deals with passing of award which would include interest up to the date on which the award is made. The second part i.e. clause (b) deals with grant of interest on the "sum" awarded by the Arbitral Tribunal.*
>
> *36.2. Let us now discuss in detail the contours of the two clauses. As per clause (a), when an award is made by the Arbitral Tribunal for payment of money, the "sum" which is awarded may include interest at such rate as the Arbitral Tribunal deems appropriate, on the whole or any part of the money and for the whole or any part of*

the period. The period for which the interest may be granted would be between the date on which the cause of action arose and the date on which the award is made. The expression which needs to be noticed in this part is the following: the Arbitral Tribunal may include in the sum for which the award is made interest at such rate as it deems reasonable.

36.3. The word "may" appearing in the above expression is quite significant. It implies that the Arbitral Tribunal has the discretion to grant interest at a reasonable rate. In other words, it may grant interest or it may not grant interest; but if it grants interest, it would be included in the "sum" which is awarded by the Arbitral Tribunal."

55. Insofar clause (b), as it stood at the relevant time is concerned, i.e., pre-amended it provides for award of interest by the arbitral tribunal on the 'sum' adjudged under clause (a). It says that 'unless the award otherwise directs', a sum directed to be paid by an award shall carry interest at the rate of 18% per annum from the date of the award to the date of payment. In other words, clause (b) is subject to the interest that may be awarded by the arbitral tribunal. This provision was explained in ***S.A. Builders*** (supra) in the following manner:

"36.4. This brings us to the second part i.e. clause (b) which deals with post-award interest. The "sum" directed to be paid by the Arbitral Tribunal shall, unless the award otherwise directs, carry interest @ 18% p.a. from the date of the award to the date of payment. Thus, what clause (b) provides for is that the Arbitral Tribunal may award interest on the "sum" adjudged under clause (a). But if no such interest is awarded, then there shall be interest @ 18% on the "sum" awarded by the Arbitral Tribunal from the date of the award to the date of

payment. The two crucial words in this part are sum and shall. As seen from clause (a), the "sum" awarded by the Arbitral Tribunal would include interest if it is granted by the Arbitral Tribunal. Therefore, the "sum" as awarded by the Arbitral Tribunal may or may not include interest. Whether the "sum" so awarded includes or does not include interest, it would carry further interest @ 18% from the date of the award to the date of payment unless another rate of interest is granted by the Arbitral Tribunal. While granting of interest under clauses (a) and (b) by the Arbitral Tribunal is discretionary, the interest contemplated under clause (b) in the event of failure of the Arbitral Tribunal to award interest is mandatory. Therefore, the legislature has consciously used the word shall."

56. Thus, from a conjoint analysis of Section 31(7)(a) and Section 31(7)(b) of the Act, 1996 respectively what is discernible is that insofar award of interest from the date on which the cause of action arose till the date of the award is concerned, the legislative intent is that the parties possess the autonomy to determine the interest and the rate of interest for the aforesaid period. Clause (a) i.e. discretion of the arbitral tribunal to award interest is subject to agreement by and between the parties. Therefore, party autonomy takes precedence over the discretion of the arbitral tribunal. However, clause (b) is subject to award of interest by the arbitral tribunal. In other words, as per clause (b), the 'sum' directed to be paid under an arbitral award shall carry interest at the rate of 18% p.a. from the date of the award to the date of payment 'unless the award otherwise directs'. Therefore, this provision is subject to award of interest by the arbitral tribunal. If it awards interest, then the same shall be applicable from the date of the award till the date of payment; if not, then the 'sum' as adjudged under clause (a) shall carry interest at the rate of 18%. After the amendment in 2015 interest at the rate of 2% higher than the current rate of interest prevalent on the date of award, from the date of award to the date of payment.

57. A two-Judge Bench of this Court in ***S.L. Arora*** (supra) considered the question as to whether Section 31(7) of the Act, 1996 authorises and enables arbitral tribunals to award interest on interest from the date of the award? In the facts of that case, the consequential question formulated was as to whether the arbitral award granted future interest from the date of award, only on the principal amount found due to the respondent or on the aggregate of the principal and interest up to the date of the award? After an analysis of the aforesaid provision, the Bench observed that Section 31(7) makes no reference to payment of compound interest or payment of interest upon interest. It was held that in the absence of any provision for interest upon interest in the contract, arbitral tribunals do not have the power to award interest upon interest or compound interest either for the pre-award period or for the post-award period. It was held thus:

"18. Section 31(7) makes no reference to payment of compound interest or payment of interest upon interest. Nor does it require the interest which accrues till the date of the award, to be treated as part of the principal from the date of award for calculating the post-award interest. The use of the words "where and insofar as an arbitral award is for the payment of money" and use of the words "the Arbitral Tribunal may include in the sum for which the award is made, interest … on the whole or any part of the money" in clause (a) and use of the words "a sum directed to be paid by an arbitral award shall … carry interest" in clause (b) of sub-section (7) of Section 31 clearly indicate that the section contemplates award of only simple interest and not compound interest or interest upon interest. "A sum directed to be paid by an arbitral award" refers to the award of sums on the substantive claims and does not refer to interest awarded on the "sum directed to be paid by the award". In the absence of any provision for interest upon interest in the contract, the Arbitral Tribunals do not have the power to award interest upon interest, or compound interest, either for the pre-award period or for the post-award period."

58. Thereafter the Bench upon a threadbare analysis concluded that Section 31(7) merely authorizes the arbitral tribunal to award interest in accordance with the contract and in the absence of any prohibition in the contract and in the absence of specific provision relating to interest in the contract, to award simple interest at such rates as it deems fit from the date on which the cause of action arose till the date of payment. The Bench further clarified that if the award is silent about interest from the date of award till the date of payment, the person in whose favour the award is made will be entitled to interest at 18% per annum on the principal amount awarded from the date of award till the date of payment. In the facts of that case, the Bench declared that the calculation that was made in the execution petition as originally filed was correct and that the modification sought for by the respondent increasing the amount due under the award was contrary to the award. It was concluded as under:

> *"34. Thus it is clear that Section 31(7) merely authorises the Arbitral Tribunal to award interest in accordance with the contract and in the absence of any prohibition in the contract and in the absence of specific provision relating to interest in the contract, to award simple interest at such rates as it deems fit from the date on which the cause of action arose till the date of payment. It also provides that if the award is silent about interest from the date of award till the date of payment, the person in whose favour the award is made will be entitled to interest at 18% per annum on the principal amount awarded, from the date of award till the date of payment. The calculation that was made in the execution petition as originally filed was correct and the modification by the respondent increasing the amount due under the award was contrary to the award."*

59. The correctness of the view taken in ***S.L. Arora*** (supra) came up for consideration before a three-Judge Bench of this Court in ***Hyder Consulting (UK) Limited v. Governor, State of Orrisa*** reported in (2015) 2 SCC 189. The majority held that the conclusion reached in ***S.L. Arora*** (supra) was not in consonance with the clear language of Section 31(7) of the Act, 1996. After extracting Section 31(7) of the Act, 1996 the Bench explained clause (a) of sub-section (7) of Section 31 in the following manner:

> *"4. Clause (a) of sub-section (7) provides that where an award is made for the payment of money, the Arbitral Tribunal may include interest in the sum for which the award is made. In plain terms, this provision confers a power upon the Arbitral Tribunal while making an award for payment of money, to include interest in the sum for which the award is made on either the whole or any part of the money and for the whole or any part of the period for the entire pre-award period between the date on which the cause of action arose and the date on which the award is made. To put it differently, subsection (7)(a) contemplates that an award, inclusive of interest for the pre-award period on the entire amount directed to be paid or part thereof, may be passed. The "sum" awarded may be the principal amount and such interest as the Arbitral Tribunal deems fit. If no interest is awarded, the "sum" comprises only the principal. The significant words occurring in clause (a) of sub-section (7) of Section 31 of the Act are "the sum for which the award is made". On a plain reading, this expression refers to the total amount or sum for the payment for which the award is made. Parliament has not added a qualification like "principal" to the word "sum", and therefore, the word "sum" here simply means "a particular amount of money". In Section 31(7), this particular amount of money may include interest from the date of cause of action to the date of the award."*

60. On the above analysis, the Bench explained clause (b) of sub-section (7) of Section 31 of the Act, 1996 to mean that the 'sum' which is directed to be paid by the award, whether inclusive or exclusive of interest, shall carry interest at the rate of 18% per annum for the post-award period unless otherwise ordered. The above provision was explained as under:

> *"7. Thus, when used as a noun, as it seems to have been used in this provision, the word "sum" simply means "an amount of money"; whatever it may include — "principal" and "interest" or one of the two. Once the meaning of the word "sum" is clear, the same meaning must be ascribed to the word in clause (b) of sub-section (7) of Section 31 of the Act, where it provides that a sum directed to be paid by an arbitral award "shall … carry interest …" from the date of the award to the date of the payment i.e. post-award. In other words, what clause (b) of sub-section (7) of Section 31 of the Act directs is that the "sum", which is directed to be paid by the award, whether inclusive or exclusive of interest, shall carry interest at the rate of eighteen per cent per annum for the post-award period, unless otherwise ordered."*

61. Finally, ***Hyder Consulting*** (supra) arrived at the following conclusion:

> *"13. Thus, it is apparent that vide clause (a) of subsection (7) of Section 31 of the Act, Parliament intended that an award for payment of money may be inclusive of interest, and the "sum" of the principal amount plus interest may be directed to be paid by the Arbitral Tribunal for the pre-award period. Thereupon, the Arbitral Tribunal may direct interest to be paid on such "sum" for the post-award period vide clause (b) of subsection (7) of Section 31 of the Act, at which stage the amount would be the sum arrived at after the merging of interest with the principal; the two components having lost their separate identities."*

62. The question as to whether the 'sum' awarded under clause (a) of sub-section (7) of Section 31 of the Act, 1996 would include interest pendente lite or not again came up for consideration before a two-Judge Bench of this Court in ***Delhi Airport Metro Express Private***

Limited (supra). The Bench analysed ***Hyder Consulting*** (supra) in the following manner:

> *"15. It could thus be seen that the majority view of this Court in Hyder Consulting (UK) is that the sum awarded may include the principal amount and such interest as the Arbitral Tribunal deems fit. It is further held that, if no interest is awarded, the "sum" comprises only the principal amount. The majority judgment held that clause (a) of sub-section (7) of Section 31 of the 1996 Act refers to the total amount or sum for the payment for which the award is made. As such, the amount awarded under clause (a) of sub-section (7) of Section 31 of the 1996 Act would include the principal amount plus the interest amount pendente lite. It was held that the interest to be calculated as per clause (b) of sub-section (7) of Section 31 of the 1996 Act would be on the total sum arrived as aforesaid under clause (a) of sub-section (7) of Section 31 of the 1996 Act. S.A. Bobde, J. in his judgment, has referred to various authorities of this Court as well as Maxwell on the Interpretation of Statutes. He emphasised that the Court must give effect to the plain, clear and unambiguous words of the legislature and it is not for the courts to add or subtract the words, even though the construction may lead to strange or surprising, unreasonable or unjust or oppressive results."*

63. Thereafter, the Bench made an analysis of clause (a) of sub-section (7) of Section 31 of the Act, 1996 and noted that it begins with the expression '*unless otherwise agreed by the parties*'. This expression was explained by the Bench by holding as under:

> *"17. <u>It could thus be seen that the part which deals with the power of the Arbitral Tribunal to award interest, would operate if it is not otherwise agreed by the parties. If there is an agreement between the parties to the contrary, the Arbitral Tribunal would lose its discretion to award interest and will have to be guided by the agreement between the parties. The provision is clear</u>*

that the Arbitral Tribunal is not bound to award interest. It has a discretion to award the interest or not to award. It further has a discretion to award interest at such rate as it deems reasonable. It further has a discretion to award interest on the whole or any part of the money. It is also not necessary for the Arbitral Tribunal to award interest for the entire period between the date on which the cause of action arose and the date on which the award is made. It can grant interest for the entire period or any part thereof or no interest at all."

(Emphasis supplied)

64. Thus, this Court was of the view that power of the tribunal to award interest would operate if it is not otherwise agreed by the parties. If there is an agreement between the parties to the contrary, the arbitral tribunal would lose its discretion to award interest and will have to be guided by the agreement between the parties. Thus, the expression 'unless otherwise agreed by the parties' assumes significance and concluded as under:

"20. If clause (a) of sub-section (7) of Section 31 of the 1996 Act is given a plain and literal meaning, the legislative intent would be clear that the discretion with regard to grant of interest would be available to the Arbitral Tribunal only when there is no agreement to the contrary between the parties. The phrase "unless otherwise agreed by the parties" clearly emphasises that when the parties have agreed with regard to any of the aspects covered under clause (a) of sub-section (7) of Section 31 of the 1996 Act, the Arbitral Tribunal would cease to have any discretion with regard to the aspects mentioned in the said provision. Only in the absence of such an agreement, the Arbitral Tribunal would have a discretion to exercise its powers under clause (a) of subsection (7) of Section 31 of the 1996 Act. The discretion is wide enough. It may grant or may not grant interest. It may grant interest for the entire period or any

part thereof. It may also grant interest on the whole or any part of the money."

(Emphasis supplied)

65. From the above, the view of the court is clearly discernible in that the discretion to grant interest would be available to the arbitral tribunal under clause (a) of sub- section (7) of Section 31 only when there is no agreement to the contrary between the parties. When the parties agree with regard to any of the aspects covered under clause (a) of subsection (7) of Section 31, the arbitral tribunal would cease to have any discretion with regard to the aspects mentioned in the said provision. Only in the absence of such an agreement, the arbitral tribunal would have the discretion to exercise its powers under clause (a) of sub-section (7) of Section 31 of the Act, 1996.

66. In the facts of that case, it was held that in view of the specific agreement between the parties, the interest quotient prior to the date of the award so also after the date of the award will be governed by article 29.8 of the concession agreement which was also directed by the arbitral tribunal. This view was accordingly affirmed by this Court.

67. In ***Morgan Securities and Credits Private Limited*** (supra), a two-Judge Bench of this Court again examined the decision in ***Hyder Consulting*** (supra). After an extensive analysis, the Bench was of the view that the decision in ***Hyder Consulting*** (supra) was on the limited issue of whether post-award interest could be granted on the aggregate of the principal and the pre-award interest. The opinion authored by Bobde, J. was limited to this aspect of post-award interest. Thereafter, the Bench noted that the issue before it was whether the phrase 'unless the award otherwise directs' in Section 31(7)(b) of the Act, 1996 only provides the arbitrator the discretion to determine the rate of interest or both the rate of interest and the 'sum' it must be paid against. Thereafter it was noted that both clauses (a) and (b) of sub-section (7) of Section 31 are qualified. While clause (a) is qualified by the arbitration agreement between the parties, clause (b) is qualified by the arbitration award. The words 'unless otherwise agreed by the parties' occurring at the beginning of clause (a) qualifies the entire provision. However, the words 'unless the award otherwise directs' occurring in clause (b) only qualifies the rate of post-award interest.

68. In line with the ***Delhi Airport Metro Express Private Limited*** (supra) we have to our advantage one recent pronouncement of this Court in the case of ***PAM Developments Private Limited v. State of West Bengal and Another*** reported in (2024) 10 SCC 715 wherein this Court observed thus:

> *"**23.3.** Under the 1996 Act, the power of the arbitrator to grant interest is governed by the statutory provision in Section 31(7). This provision has two parts. Under clause*

> *(a), the arbitrator can award interest for the period between the date of cause of action to the date of the award, unless otherwise agreed by the parties. Clause (b) provides that unless the award directs otherwise, the sum directed to be paid by an arbitral award shall carry interest @ 2% higher than the current rate of interest, from the date of the award to the date of payment.*
>
> ***23.4.*** *The wording of Section 31(7)(a) marks a departure from the Arbitration Act, 1940 in two ways : first, it does not make an explicit distinction between pre-reference and pendente lite interest as both of them are provided for under this sub-section; second, it sanctifies party autonomy and restricts the power to grant pre-reference and pendente lite interest the moment the agreement bars payment of interest, even if it is not a specific bar against the arbitrator. [Sayeed Ahmed & Co. v. State of U.P., (2009) 12 SCC 26, paras 14, 23, 24 : (2009) 4 SCC (Civ) 629; Union of India v. Saraswat Trading Agency, (2009) 16 SCC 504 : (2011) 3 SCC (Civ) 499; Sree Kamatchi Amman Constructions v. Railways, (2010) 8 SCC 767, para 19 : (2010) 3 SCC (Civ) 575; Union of India v. Bright Power Projects (India) (P) Ltd., (2015) 9 SCC 695, para 13 : (2015) 4 SCC (Civ) 702; Reliance Cellulose Products Ltd. v. ONGC Ltd., (2018) 9 SCC 266, para 24 : (2018) 4 SCC (Civ) 351; Jaiprakash Associates Ltd. v. Tehri Hydro Development Corpn. (India) Ltd., (2019) 17 SCC 786, paras 13-15 : (2020) 3 SCC (Civ) 605; Delhi Airport Metro Express (P) Ltd. v. DMRC, (2022) 9 SCC 286, paras 16-20, 24 : (2022) 4 SCC (Civ) 623]"*
>
> (Emphasis supplied)

J. IS PENAL INTEREST ON PENAL INTEREST OPPOSED TO PUBLIC POLICY?

69. The leaned Senior counsel appearing for the appellant made a gallant effort to convince us to take the view that although there may be an agreement between the parties prescribing a particular rate of interest yet the words "unless otherwise agreed between the parties" would control the whole aspect of the matter covered under Section 31(7)(a) of the Act, 1996. In other words, the argument is that once the parties enter Section 31(7)(a) of the Act, 1996 it would be within the discretion of the arbitral tribunal to include in the sum for which the award is made, interest at such rate as it deems reasonable.

70. We are afraid it is not legally permissible for us to subscribe to such a view as sought to be canvassed by the learned Senior counsel referred to above. The language of Section 31(7)(a) of the Act, 1996 is plain and simple. We place emphasis on the words "*unless otherwise agreed by the parties*". The words "*unless otherwise agreed by the parties*" at the beginning of clause (a) qualify the entire provision. Once the parties by mutual consent agreed to a particular rate of interest to be charged and the same is included in the terms of the contract there is no escape thereafter. The party concerned would be bound by the rate of interest as prescribed in the agreement. The rate of interest once agreed and forms part of a written contract between the parties the borrower after availing the finance cannot turn around and question the rate on the ground of being unconscionable or opposed to Public policy.

71. The words of Justice Burrough aptly justify the unpredictability of the interpretation of the term 'public policy'. He says, "Public Policy is an unruly horse where once you stride on it you do not know where it's going to take you."

72. When Justice Burrough said in ***Richardson v. Mellish***, a famous 1824 English case: "Public is an unruly horse," he gave us a definition both original and witty, but one which does not help us much to clearly understand the meaning of the term. "Public policy is in its nature so uncertain and fluctuating, varying with the habits and fashions of the day, with the growth of commerce and the usages of trade, that it is difficult to determine its limits with any degree of exactness. It has never been defined by the courts, but has been let loose and free from definition in the same manner as fraud.

73. Public policy is dictated by the law-making power the legislature, and is found in the general tenor of statutes, and in direct enactments. When the legislature, within the powers conferred by the constitution, has declared the public policy, and fixed the rights of the people by statute, the courts cannot declare a different policy or fix different rights.

74. In the aforesaid context, we must look into the decision rendered by the United Kingdom Supreme Court in the case of ***Cavendish Square Holding BV v. Talal El Makdessi*** decided on 01.12.2015.

75. The facts of the said case were that by an agreement, Mr Makdessi agreed to sell to Cavendish a controlling stake in the holding company of the largest advertising and marketing communications group in the Middle East. The contract provided that if he was in breach of certain restrictive covenants against competing activities, Mr Makdessi would not be entitled to receive the final two instalments of the price paid by Cavendish (clause 5.1) and could be required to sell his remaining shares to Cavendish, at a price excluding the value of the goodwill of the business (clause 5.6). Mr Makdessi subsequently breached these covenants. Mr Makdessi argued that clauses 5.1 and 5.6 were unenforceable penalty clauses. The Court of Appeal, overturning Burton, J., at first instance, held that the clauses were unenforceable penalties under the penalty rule as traditionally understood.

76. The Supreme Court allowed the appeal in ***Cavendish v. El Makdessi*** (supra), upholding the validity of the disputed clauses.

77. In the joint leading judgment by Lords Neuberger and Sumption (with which Lord Clarke and Lord Carnwath agreed), both the learned judges held that the true test of whether a clause is penal, and therefore unenforceable, is whether the offending clause is a secondary obligation which imposes a detriment on the party in breach, out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation.

78. They went on to explain that the validity of a clause providing for the consequences of a breach of contract depends on whether the innocent party could be said to have a legitimate interest in the enforcement of the clause. There is a legitimate interest in the recovery of a sum constituting a reasonable pre-estimate of damages, but the innocent party may have a legitimate interest in performance which extends beyond the recovery of pecuniary compensation. The law will not generally uphold a contractual remedy where the adverse impact of that remedy significantly exceeds the innocent party's legitimate interest.

79. Lords Neuberger and Sumption also described the penalty rule as "an ancient, haphazardly constructed edifice which has not weathered well" but maintained that the penalty rule should not be abolished in light of its endorsement by and application across all major systems of law in the western world.

80. The court went on to conclude that neither clause 5.1 nor clause 5.6 respectively were unenforceable penalty clauses.

81. The court construed clause 5.1 as a price adjustment clause. It went on to explain that the relevant clause was not a secondary provision but a primary obligation. The sellers earn consideration for their shares by (amongst other things) observing the restrictive covenants. Whilst clause 5.1 had no relationship with the measure of loss attributable to the breach, Cavendish also had a legitimate interest in the observance of the restrictive covenants, in order to protect the goodwill of the Group generally. The goodwill of the business was critical to Cavendish and the loyalty of Mr Makdessi was critical to the goodwill. The Supreme Court observed that the Court should not assess the precise value of that obligation or determine how much less Cavendish would have paid for the business without the benefit of the restrictive covenants. The parties were the best judges of how it should be reflected in their agreement. To that end, in finding that neither of the disputed provisions was avoided by the penalty rule, the court also considered that the agreement had been extensively negotiated between informed and legally advised parties dealing on equal terms, and a large proportion of the price for the shares represented goodwill.

82. A very similar analysis was applied to clause 5.6. The clause was also justified by the same legitimate interest as the first provision, being an interest in matching the price of the retained shares to the value that the seller was contributing to the target's business. In this regard, the court considered that the price formula in the disputed clause had a legitimate function, i.e. it reflected the reduced consideration which Cavendish would have been prepared to pay for the acquisition of the business on the hypothesis that they could not count on the loyalty of Mr Makdessi.

83. We may refer to few observations made in the judgment:

"***The law in relation to penalties***

3. The penalty rule in England is an ancient, haphazardly constructed edifice which has not weathered well, and which in the opinion of some should simply be demolished, and in the opinion of others should be reconstructed and extended. For many years, the courts have struggled to apply standard tests formulated more than a century ago for relatively simple transactions to altogether more complex situations. The application of the rule is often adventitious. The test for distinguishing penal from other principles is unclear. As early as 1801, in Astley v Weldon (1801) 2 Bos & Pul 346, 350 Lord Eldon confessed himself, not for the first time, "much embarrassed in ascertaining the principle on which [the rule was] founded". Eighty years later, in Wallis v Smith (1882) 21 Ch D 243, 256, Sir George Jessel MR, not a judge noted for confessing ignorance, observed that "The ground of that doctrine I do not know". In 1966 Diplock LJ, not a judge given to recognising defeat, declared that he could "make no attempt, where so many others have failed, to rationalise this common law rule": Robophone Facilities Ltd v Blank [1966] 1 WLR 1428, 1446. The task is no easier today. But unless the rule is to be abolished or substantially extended, its application to any but the clearest cases requires some underlying principle to be identified.

Equitable origins

4. The penalty rule originated in the equitable jurisdiction to relieve from defeasible bonds. These were promises under seal to pay a specified sum of money, subject to a proviso that they should cease to have effect on the satisfaction of a condition, usually performance of some other ("primary") obligation. By the beginning of the 16th century, the practice had grown up of taking defeasible bonds to secure the performance obligations sounding in damages. This enabled the holder of the bond to bring his action in debt, which made it unnecessary for him to prove his loss and made it possible to stipulate for substantially more than his loss. The common law enforced the bonds according to their letter. But equity regarded the real intention of the parties as being that the bond should stand as security only, and restrained its enforcement at common law on terms that the debtor paid damages, interest and costs. The classic statement of this *approach is that of Lord Thurlow LC in Sloman v Walter (1783) 1 Bro CC 418, 419:*

> *"… where a penalty is inserted merely to secure the enjoyment of a collateral object, the enjoyment of the object is considered as the principal intent of the deed, and the penalty only as accessional, and, therefore, only to secure the damage really incurred ..."*

5. The essential conditions for the exercise of the jurisdiction were (i) that the penal provision was intended as a security for the recovery of the true amount of a debt or damages, and (ii) that that objective could be achieved by restraining proceedings on the bond in the courts of common law, on terms that the defendant paid damages. As Lord Macclesfield observed in Peachy v Duke of Somerset (1720) 1 Strange 447, 453:

> *"The true ground of relief against penalties is from the original intent of the case, where the penalty is designed only to secure money, and the court gives him all that he expected or desired: but it is quite otherwise in the present case. These penalties or forfeitures were never intended by way of compensation, for there can be none."*

> *This last reservation remained an important feature of the equitable jurisdiction to relieve. As Baggallay LJ put it in Protector Endowment Loan and Annuity Company v Grice (1880) 5 QBD 592, 595, "where the intent is not simply to secure a sum of money, or the enjoyment of a collateral object, equity does not relieve".*

<u>The common law rule</u>

6. The process by which the equitable rule was adopted by the common law is traced by Professor Simpson in his article The penal bond with conditional defeasance (1966) 82 LQR 392, 418-419. Towards the end of the 17th century, the courts of common law tentatively began to stay proceedings on a penal bond to secure a debt, unless the plaintiff was willing to accept a tender of the money, together with interest and costs. The rule was regularised and extended by two statutes of 1696 and 1705. Section 8 of the Administration of Justice Act 1696 (8 & 9 Will 3 c 11) is a prolix provision whose effect was that the plaintiff suing in the common law courts on a defeasible bond to secure the performance of covenants (not just debts) was permitted to plead the breaches and have his actual damages assessed. Judgment was entered *on the bond, but execution was stayed upon payment of the assessed damages. The Administration of Justice Act 1705 (4 & 5 Anne c 16) allowed the defendant in an action on the bond to pay the amount of the actual loss, together with interest and costs, into court, and rely on the payment as a defence. These statutes were originally framed as facilities for plaintiffs suing on bonds. But by the end of the 18th century the common law courts had begun to treat the statutory procedures as mandatory, requiring damages to be pleaded and proved and staying all further proceedings on the bond: see Roles v Rosewell (1794) 5 TR 538, Hardy v Bern (1794) 5 TR 636. The effect of this legislation was thus to make it unnecessary to proceed separately in chancery for relief from the penalty and in the courts of common law for the true loss. As a result, the equitable jurisdiction was rarely invoked, and the further development of the penalty rule was entirely the work of the courts of common law.*

7. It developed, however, on wholly different lines. The equitable jurisdiction to relieve from penalties had been closely associated with the jurisdiction to relieve from forfeitures which developed at the same time. Both were directed to contractual provisions which on their face created primary obligations, but which during the 17th and 18th centuries the courts of equity treated as secondary obligations on the ground that the real intention was that they should stand as a mere security for performance. The court then intervened to grant relief from the rigours of the secondary obligation in order to secure performance in another, less penal or (in modern language) more proportionate, way. In contrast, the penalty rule as it was developed by the common law courts in the course of the 19th and 20th centuries proceeded on the basis that although penalties were secondary obligations, the parties meant what they said. They intended the provision to be applied according to the letter with a view to penalising breach. The law relieved the contract-breaker of the consequences not because the objective could be secured in another way but because the objective was contrary to public policy and should not therefore be given effect at all. The difference in approach to penalties of the courts of equity and the common law courts is in many ways a classic example of the contrast between the flexible if sometimes unpredictable approach of equity and the clear if relatively strict approach of the common law.

8. With the gradual decline of the use of penal defeasible bonds, the common law on penalties was developed almost entirely in the context of damages clauses – ie clauses which provided for payment of a specified sum in place of common law damages. Because they were a contractual substitute for common law damages, they could not in any meaningful sense be regarded as a mere security for their payment. If the agreed sum was a penalty, it was treated as unenforceable. Starting with the decisions in Astley in 1801 and Kemble v Farren (1829) 6 Bing 141, the common law courts introduced the now familiar distinction between a provision for the payment of a sum representing a genuine pre-estimate of damages and a penalty clause in which the sum was out of all proportion to any damages liable to be suffered. By the middle of the 19th century, this rule was well established. In Betts v Burch (1859) 4 H & N 506, 509, Martin B regretted that he was "bound by the cases" and prevented from holding that "parties are at liberty to enter into any bargain they please" so that "if they have made an improvident bargain they must take the consequences". But Bramwell B (at p 511) appeared to have no such reservations.

9. <u>The distinction between a clause providing for a genuine pre-estimate of damages and a penalty clause has remained fundamental to the modern law, as it is currently understood. The question whether a damages clause is a penalty falls to be decided as a matter of construction, therefore as at the time that it is agreed: Public Works Comr v Hills [1906] AC 368, 376; Webster v Bosanquet [1912] AC 394; Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd [1915] AC 79, at pp 86-87 (Lord Dunedin); and Cooden Engineering Co Ltd v Stanford [1953] 1 QB 86, 94 (Somervell LJ). This is because it depends on the character of the provision, not on the circumstances in which it falls to be enforced. It is a species of agreement which the common law considers to be by its nature contrary to the policy of the law. One consequence of this is that relief from the effects of a penalty is, as Hoffmann LJ put it in Else (1982) Ltd v Parkland Holdings Ltd [1994] 1 BCLC 130, 144, "mechanical in effect and involves no exercise of discretion at all." Another is that the penalty clause is wholly unenforceable: Clydebank Engineering & Shipbuilding Co Ltd v Don Jose Ramos Yzquierdo y Castaneda [1905] AC 6, 9, 10 (Lord Halsbury LC); Gilbert-Ash (Northern) Ltd v Modern</u>

<u>Engineering (Bristol) Ltd [1974] AC 689, 698 (Lord Reid), 703 (Lord Morris of Borth-y-Gest) and 723- 724 (Lord Salmon); Scandinavian Trading Tanker Co AB v Flota Petrolera Ecuatoriana (The "Scaptrade") [1983] 2 AC 694, 702 (Lord Diplock); AMEV-UDC Finance Ltd v Austin (1986) 162 CLR 170, 191-193 (Mason and Wilson JJ). Deprived of the benefit of the provision, the innocent party is left to his remedy in damages under the general law</u>. As Lord Diplock put it in The "Scaptrade" at p 702:

> *"The classic form of penalty clause is one which provides that upon breach of a primary obligation under the contract a secondary obligation shall arise on the part of the party in breach to pay to the other party a sum of money which does not represent a genuine pre-estimate of any loss likely to be sustained by him as the result of the breach of primary obligation but is substantially in excess of that sum. The classic form of relief against such a penalty clause has been to refuse to give effect to it, but to award the common law measure of damages for the breach of primary obligation instead."*

10. Equity, on the other hand, relieves against forfeitures "where the primary object of the bargain is to secure a stated result which can effectively be attained when the matter comes before the court, and where the forfeiture provision is added by way of security for the production of that result": Shiloh Spinners Ltd v Harding [1973] AC 691, 723 (Lord Wilberforce). As Lord Wilberforce said at p 722, the paradigm cases are the jurisdiction to relieve from a right of re-entry in a lease of land and the mortgagor's equity of redemption (and the associated equitable right to redeem) in relation to mortgages. Save in relation to non-payment of rent, the power to grant relief from forfeiture to lessees is now contained in section 146 of the Law of Property Act 1925, and probably exclusively so (see Official Custodian for Charities v Parway Estates Departments Ltd [1985] Ch 151). Relief for mortgagors through the equitable right to redeem is (save in relation to most residential properties) largely still based on judge-made law. However, neither by statute nor on general principles of equity is a lessor's right of re-entry or a mortgagee's right of sale or foreclosure treated as being by its nature contrary to the policy of the law. What equity (and, where it applies, statute) typically considers to be contrary to the policy of the law is the enforcement of such rights in circumstances where their purpose, namely the performance *of the obligations in the lease or the mortgage, can be achieved in other ways – normally by late substantive compliance and payment of appropriate compensation. The forfeiture or foreclosure/power of sale is therefore enforceable, equity intervening only to impose terms. These will generally require the lessee or mortgagor to rectify the breach and make good any loss suffered by the lessor or mortgagee. If the lessee or mortgagee cannot or will not do so, the forfeiture will be unconditionally enforced – although perhaps not invariably (see per Lord Templeman in Associated British Ports v CH Bailey plc [1990] 2 AC 703, 707-708 in the context of section 146, and, more generally, the judgments in Cukurova Finance International Ltd v Alfa Telecom Turkey Ltd (No 3) [2013] UKPC 20, [2015] 2 WLR 875).*

11. <u>The penalty rule as it has been developed by the judges gives rise to two questions, both of which have a considerable bearing on the questions which arise on these appeals. In what circumstances is the rule engaged at all? And what makes a contractual provision penal</u>?

<u>In what circumstances is the penalty rule engaged</u>?

12. In England, it has always been considered that a provision could not be a penalty unless it provided an exorbitant alternative to common law damages. This meant that it had to be a provision operating upon a breach of contract. In Moss Empires Ltd v Olympia (Liverpool) Ltd [1939] AC 544, this was taken for granted by Lord Atkin (p 551) and Lord Porter (p 558). As a matter of authority the question is settled in England by the decision of the House of Lords in Export Credits Guarantee Department v Universal Oil Products Co [1983] 1 WLR 399 ("ECGD"). Lord Roskill, with whom the rest of the committee agreed, said at p 403:

> *"Perhaps the main purpose, of the law relating to penalty clauses is to prevent a plaintiff recovering a sum of money in respect of a breach of contract committed by a defendant which bears little or no relationship to the loss actually suffered by the plaintiff as a result of the breach by the defendant. But it is not and never has been for the courts to relieve a party from the consequences of what may in the event prove to be an*

onerous or possibly even a commercially imprudent bargain."

As Lord Hodge points out in his judgment, the Scottish authorities are to the same effect.

13. This principle is worth restating at the outset of any analysis of the penalty rule, because it explains much about the way in which it has developed. There is a fundamental difference between a jurisdiction to review the fairness of a contractual obligation and a jurisdiction to regulate the remedy for its breach. Leaving aside challenges going to the reality of consent, such as those based on fraud, duress or undue influence, the courts do not review the fairness of men's bargains either at law or in equity. The penalty rule regulates only the remedies available for breach of a party's primary obligations, not the primary obligations themselves. This was not a new concept in 1983, when ECGD was decided. It had been the foundation of the equitable jurisdiction, which depended on the treatment of penal defeasible bonds as secondary obligations or, as Lord Thurlow LC put it in 1783 in Sloman as "collateral" or "accessional" to the primary obligation. And it provided the whole basis of the classic distinction made at law between a penalty and a genuine pre-estimate of loss, the former being essentially a way of punishing the contract-breaker rather than compensating the innocent party for his breach. We shall return to that distinction below.

14. <u>This means that in some cases the application of the penalty rule may depend on how the relevant obligation is framed in the instrument, i.e., whether as a conditional primary obligation or a secondary obligation providing a contractual alternative to damages at law. Thus, where a contract contains an obligation on one party to perform an act, and also provides that, if he does not perform it, he will pay the other party a specified sum of money, the obligation to pay the specified sum is a secondary obligation which is capable of being a penalty; but if the contract does not impose (expressly or impliedly) an obligation to perform the act, but simply provides that, if one party does not perform, he will pay the other party a specified sum, the obligation to pay the specified sum is a conditional primary obligation and cannot be a penalty.</u>

15. However, the capricious consequences of this state of affairs are mitigated by the fact that, as the equitable *jurisdiction shows, the classification of terms for the purpose of the penalty rule depends on the substance of the term and not on its form or on the label which the parties have chosen to attach to it. As Lord Radcliffe said in Campbell Discount Co Ltd v Bridge [1962] AC 600, 622, "the intention of the parties themselves", by which he clearly meant the intention as expressed in the agreement, "is never conclusive and may be overruled or ignored if the court considers that even its clear expression does not represent 'the real nature of the transaction' or what 'in truth' it is taken to be" (and as per Lord Templeman in Street v Mountford [1985] AC 809, 819). This aspect of the equitable jurisdiction was inherited by the courts of common law, and has been firmly established since the earliest common law cases.*

16. Payment of a sum of money is the classic obligation under a penalty clause and, in almost every reported case involving a damages clause, the provision stipulates for the payment of money. However, it seems to us that there is no reason why an obligation to transfer assets (either for nothing or at an undervalue) should not be capable of constituting a penalty. While the penalty rule may be somewhat artificial, it would heighten its artificiality to no evident purpose if it were otherwise. Similarly, the fact that a sum is paid over by one party to the other party as a deposit, in the sense of some sort of surety for the first party's contractual performance, does not prevent the sum being a penalty, if the second party in due course forfeits the deposit in accordance with the contractual terms, following the first party's breach of contract – see the Privy Council decisions in Public Works Comr v Hills [1906] AC 368, 375-376, and Workers Trust & Merchant Bank Ltd v Dojap Investments Ltd [1993] AC 573. By contrast, in Else (1982) at p 146, Hoffmann LJ, citing Stockloser v Johnson [1954] 1 QB 476 in support, said that, unlike a case where "money has been deposited as security for due performance of [a] party's obligation", "retention of instalments which have been paid under contract so as to become the absolute property of the vendor does not fall within the penalty rule", although, he added that it was "subject … to the jurisdiction for relief against forfeiture".

17. The relationship between penalty clauses and forfeiture clauses is not entirely easy. Given that they had the same origin in equity, but that the law on penalties was then developed through common law while the law on forfeitures was not, this is unsurprising. Some things appear to be clear.

Where a proprietary interest or a "proprietary or possessory right" (such as a patent or a lease) is granted or transferred subject to revocation or determination on breach, the clause providing for determination or revocation is a forfeiture and cannot be a penalty, and, while it is enforceable, relief from forfeiture may be granted: see BICC plc v Burndy Corpn [1985] Ch 232, 246-247 and 252 (Dillon LJ) and The "Scaptrade", pp 701-703, (Lord Diplock). But this does not mean that relief from forfeiture is unavailable in cases not involving land – see Cukurova Finance International Ltd v Alfa Telecom Turkey Ltd (No 2) [2013] UKPC 2, [2015] 2 WLR 875, especially at paras 92-97, and the cases cited there.

18. What is less clear is whether a provision is capable of being both a penalty clause and a forfeiture clause. It is inappropriate to consider that issue in any detail in this judgment, as we have heard very little argument on forfeitures – unsurprisingly because in neither appeal has it been alleged that any provision in issue is a forfeiture from which relief could be granted. But it is right to mention the possibility that, in some circumstances, a provision could, at least potentially, be a penalty clause as well as a forfeiture clause. We see the force of the arguments to that effect advanced by Lord Mance and Lord Hodge in their judgments.

<u>What makes a contractual provision penal</u>?

19. As we have already observed, until relatively recently this question was answered almost entirely by reference to straightforward liquidated damages clauses. It was in that context that the House of Lords sought to restate the law in two seminal decisions at the beginning of the 20th century, Clydebank in 1904 and Dunlop in 1915.

20. Clydebank was a Scottish appeal about a shipbuilding contract with a provision (described as a "penalty") for the payment of £500 per week for delayed delivery. The provision was held to be a valid liquidated damages clause, not a penalty. Lord Halsbury (p 10) said that the distinction between the two depended on

> *"whether it is, what I think gave the jurisdiction to the courts in both countries to interfere at all in an agreement between the parties, unconscionable and extravagant, and one which no court ought to allow to be enforced."*

Lord Halsbury declined to lay down any "abstract rule" for determining what was unconscionable or extravagant, saying only that it must depend on "the nature of the transaction – the thing to be done, the loss likely to accrue to the person who is endeavouring to enforce the performance of the contract, and so forth". Lord Halsbury's formulation has proved influential, and the two other members of the Appellate Committee both delivered concurring judgments agreeing with it. It is, however, worth drawing attention to an observation of Lord Robertson (pp 19-20) which points to the principle underlying the contrasting expressions "liquidated damages" and "penalty":

> *"Now, all such agreements, whether the thing be called penalty or be called liquidate damage, are in intention and effect what Professor Bell calls 'instruments of restraint', and in that sense penal. But the clear presence of this does not in the least degree invalidate the stipulation. The question remains, had the respondents no interest to protect by that clause, or was that interest palpably incommensurate with the sums agreed on? It seems to me that to put this question, in the present instance, is to answer it."*

21. Dunlop arose out of a contract for the supply of tyres, covers and tubes by a manufacturer to a garage. The contract contained a number of terms designed to protect the manufacturer's brand, including prohibitions on tampering with the marks, restrictions on the unauthorised export or exhibition of the goods, and on resales to unapproved persons. There was also a resale price maintenance clause, which would now be unlawful but was a legitimate restriction of competition according to the notions prevailing in 1914. It was this clause which the purchaser had broken. The contract provided for the payment of £5 for every tyre, cover or tube sold in breach of any provision of the agreement. Once again, the provision was held to be a valid liquidated damages clause. In his speech, Lord Dunedin formulated four tests "which, if applicable to the case under consideration, may prove helpful, or even conclusive" (p 87). They were (a) that the provision would be penal if "the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach"; (b) that the provision would be penal if the breach consisted only in the non-payment of money and it provided for the payment of a *larger sum; (c) that there was "a presumption (but no more)" that it would be penal if it was payable in a number of events of varying gravity; and (d) that it would not be treated as penal by reason only of the impossibility of precisely pre-estimating the true loss.*

22. Lord Dunedin's speech in Dunlop achieved the status of a quasi-statutory code in the subsequent case-law. Some of the many decisions on the validity of damages clauses are little more than a detailed exegesis or application of his four tests with a view to discovering whether the clause in issue can be brought within one or more of them. In our view, this is unfortunate. In the first place, Lord Dunedin proposed his four tests not as rules but only as considerations which might prove helpful or even conclusive "if applicable to the case under consideration". He did not suggest that they were applicable to every case in which the law of penalties was engaged. Second, as Lord Dunedin himself acknowledged, the essential question was whether the clause impugned was "unconscionable" or "extravagant". The four tests are a useful tool for deciding whether these expressions can properly be applied to simple damages clauses in standard contracts. But they are not easily applied to more complex cases. To deal with those, it is necessary to consider the rationale of the penalty rule at a more fundamental level. What is it that makes a provision for the consequences of breach "unconscionable"? And by comparison with what is a penalty clause said to be "extravagant"? Third, none of the other three Law Lords expressly agreed with Lord Dunedin's reasoning, and the four tests do not all feature in any of their speeches. Indeed, it appears that, in his analysis at pp 101-102, Lord Parmoor may have taken a more restrictive view of what constituted a penalty than did Lord Dunedin. More generally, the other members of the Appellate Committee gave their own reasons for concurring in the result, and they also repay consideration. For present purposes, the most instructive is that of Lord Atkinson, who approached the matter on an altogether broader basis.

23. Lord Atkinson pointed (pp 90-91) to the critical importance to Dunlop of the protection of their brand, reputation and goodwill, and their authorised distribution network. Against this background, he observed (pp 91-92):

> *"It has been urged that as the sum of £5 becomes payable on the sale of even one tube at a shilling less*

than the listed price, and as it was impossible that the appellant company should lose that sum on such a transaction, the sum fixed must be a penalty. In the sense of direct and immediate loss the appellants lose nothing by such a sale. It is the agent or dealer who loses by selling at a price less than that at which he buys, but the appellants have to look at their trade in globo, and to prevent the setting up, in reference to all their goods anywhere and everywhere, a system of injurious undercutting. The object of the appellants in making this agreement, if the substance and reality of the thing and the real nature of the transaction be looked at, would appear to be a single one, namely, to prevent the disorganization of their trading system and the consequent injury to their trade in many directions. The means of effecting this is by keeping up their price to the public to the level of their price list, this last being secured by contracting that a sum of £5 shall be paid for every one of the three classes of articles named sold or offered for sale at prices below those named on the list. The very fact that this sum is to be paid if a tyre cover or tube be merely offered for sale, though not sold, shows that it was the consequential injury to their trade due to undercutting that they had in view. They had an obvious interest to prevent this undercutting, and on the evidence it would appear to me impossible to say that that interest was incommensurate with the sum agreed to be paid."

Lord Atkinson went on to draw an analogy, which has particular resonance in the Cavendish appeal, with a clause dealing with damages for breach of a restrictive covenant on the canvassing of business by a former employee. In this context, he said (pp 92-93):

"It is, I think, quite misleading to concentrate one's attention upon the particular act or acts by which, in such cases as this, the rivalry in trade is set up, and the repute acquired by the former employee that he works cheaper and charges less than his old master, and to lose sight of the risk to the latter that old customers, once tempted to leave him, may never return to deal with him, or that business that might otherwise have come to him may be captured by his rival. The consequential injuries to the trader's business arising from each breach by the employee of his covenant cannot be measured by the

direct loss in a monetary point of view on the particular transaction constituting the breach."

Lord Atkinson was making substantially the same point as Lord Robertson had made in Clydebank. The question was: what was the nature and extent of the innocent party's interest in the performance of the relevant obligation. That interest was not necessarily limited to the mere recovery of compensation for the breach. Lord Atkinson considered that the underlying purpose of the resale price maintenance clause gave Dunlop a wider interest in enforcing the damages clause than pecuniary compensation. £5 per item was not incommensurate with that interest even if it was incommensurate with the loss occasioned by the wrongful sale of a single item.

24. Although the other members of the Appellate Committee did not express themselves in the same terms as Lord Atkinson, their approach was entirely consistent with his. Lord Parker at p 97 said that "whether the sum agreed to be paid on the breach is really a penalty must depend on the circumstances of each particular case", and at p 99, echoing Lord Atkinson's fuller treatment of the point, as just set out, he described the damage which would result from any breach as "consisting in the disturbance or derangement of the system of distribution by means of which [Dunlop's] goods reach the ultimate consumer". In their speeches, Lord Dunedin (p 87), Lord Parker (p 98) and Lord Parmoor (p 103) ultimately were content to rest their decision that the £5 was not a penalty on the ground that an exact pre-estimate of loss was impossible, whereas, in the passages quoted above, Lord Atkinson analysed why that was so. It seems clear that the actual result of the case was strongly influenced by Lord Atkinson's reasoning. The clause was upheld although, on the face of it, it failed all but the last of Lord Dunedin's tests. The £5 per item applied to breaches of very variable significance and it was impossible to relate the loss attributable to the sale of that item. It was justifiable only by reference to the wider interests identified by Lord Atkinson.

25. The great majority of cases decided in England since Dunlop have concerned more or less standard damages clauses in consumer contracts, and Lord Dunedin's four tests have proved perfectly adequate for dealing with those. More recently, however, the courts have returned to the possibility of a broader test in less straightforward cases, in the context *of the supposed "commercial justification" for clauses which might otherwise be regarded as penal. An early example is the decision of the House of Lords in The "Scaptrade", where at p 702, Lord Diplock, with whom the rest of the Appellate Committee agreed, observed that a right to withdraw a time-chartered vessel for non-payment of advance hire was not a penalty because its commercial purpose was to create a fund from which the cost of providing the chartered service could be funded.*

26. In Lordsvale Finance plc v Bank of Zambia [1996] QB 752, Colman J was concerned with a common form provision in a syndicated loan agreement for interest to be payable at a higher rate during any period when the borrower was in default. There was authority that such provisions were penal: Lady Holles v Wyse (1693) 2 Vern 289; Strode v Parker (1694) 2 Vern 316, Wallingford v Mutual Society (1880) 5 App Cas 685, 702 (Lord Hatherley). But Colman J held that the clause was valid because its predominant purpose was not to deter default but to reflect the greater credit risk associated with a borrower in default. At pp 763-764, he observed that a provision for the payment of money upon breach could not be categorised as a penalty simply because it was not a genuine pre-estimate of damages, saying that there would seem to be:

> *"no reason in principle why a contractual provision the effect of which was to increase the consideration payable under an executory contract upon the happening of a default should be struck down as a penalty if the increase could in the circumstances be explained as commercially justifiable, provided always that its dominant purpose was not to deter the other party from breach."*

27. Colman J's approach was approved by Mance LJ, delivering the leading judgment in the Court of Appeal in Cine Bes Filmcilik ve Yapimcilik v United International Pictures [2004] 1 CLC 401, para 13. A similar view was taken by Arden LJ in Murray v Leisureplay plc [2005] IRLR 946, para 54, where she posed the question

> *"Has the party who seeks to establish that the clause is a penalty shown that the amount payable under the clause was imposed in terrorem, or that it does not constitute a genuine pre-estimate of loss for the purposes of the Dunlop case, and, if he has shown the*

latter, is there some other reason which justifies the Page 14 discrepancy between [the amount payable under the clause and the amount payable by way of damages in common law]?" (emphasis added).

She considered that the clause in question had advantages for both sides, and pointed out that no evidence had been adduced to show that the clause lacked commercial justification: see paras 70-76. But Buxton LJ put the matter on a wider basis for which Clarke LJ (para 105) expressed a preference. He referred to the speech of Lord Atkinson in Dunlop and suggested that the ratio of the actual decision in that case had been that "an explanation of the clause in commercial rather than deterrent terms was available". All three members of the court endorsed the approach of Colman J in Lordsvale and Mance LJ in Cine Bes.

28. Colman J in Lordsvale and Arden LJ in Murray were inclined to rationalise the introduction of commercial justification as part of the test, by treating it as evidence that the impugned clause was not intended to deter. Later decisions in which a commercial rationale has been held inconsistent with the application of the penalty rule, have tended to follow that approach: see, for example, Euro London Appointments Ltd v Claessens International Ltd [2006] 2 Lloyd's Rep 436, General Trading Company (Holdings) Ltd v Richmond Corpn Ltd [2008] 2 Lloyd's Rep 475. It had the advantage of enabling them to reconcile the concept of commercial justification with Lord Dunedin's four tests. But we have some misgivings about it. The assumption that a provision cannot have a deterrent purpose if there is a commercial justification, seems to us to be questionable. By the same token, we agree with Lord Radcliffe's observations in Campbell Discount at p 622, where he said:

"… I do not myself think that it helps to identify a penalty, to describe it as in the nature of a threat 'to be enforced in terrorem' (to use Lord Halsbury's phrase in Elphinstone v Monkland Iron & Coal Co Ltd (1886) 11 App Cas 332, 348). I do not find that that description adds anything of substance to the idea conveyed by the word 'penalty' itself, and it obscures the fact that penalties may quite readily be undertaken by parties who are not in the least terrorised by the prospect of having to pay them and yet are, as I understand it,

> *entitled to claim the protection of the court when they are called upon to make good their promises."*

Moreover, the penal character of a clause depends on its purpose, which is ordinarily an inference from its effect. As we have already explained, this is a question of construction, to which evidence of the commercial background is of course relevant in the ordinary way. But, for the same reason, the answer cannot depend on evidence of actual intention: see Chartbrook Ltd v Persimmon Homes Ltd [2009] AC 1101, paras 28-47 (Lord Hoffmann). However, while we have misgivings about some aspects of their reasoning, these aspects are peripheral to the essential point which Colman J and Buxton LJ were making, and we consider that their emphasis on justification provides a valuable insight into the real basis of the penalty rule. It is the same insight as that of Lord Robertson in Clydebank and Lord Atkinson in Dunlop. A damages clause may properly be justified by some other consideration than the desire to recover compensation for a breach. This must depend on whether the innocent party has a legitimate interest in performance extending beyond the prospect of pecuniary compensation flowing directly from the breach in question.

29. The availability of remedies for a breach of duty is not simply a question of providing a financial substitute for performance. It engages broader social and economic considerations, one of which is that the law will not generally make a remedy available to a party, the adverse impact of which on the defaulter significantly exceeds any legitimate interest of the innocent party. In the famous case of White & Carter (Councils) Ltd v McGregor [1962] AC 413, Lord Reid observed, at p 431:

> *"It may well be that, if it can be shown that a person has no legitimate interest, financial or otherwise, in performing the contract rather than claiming damages, he ought not to be allowed to saddle the other party with an additional burden with no benefit to himself. If a party has no interest to enforce a stipulation, he cannot in general enforce it: so it might be said that, if a party has no interest to insist on a particular remedy, he ought not to be allowed to insist on it. And, just as a party is not allowed to enforce a penalty, so he ought not to be allowed to penalise the other party by taking one course when another is equally advantageous to him. … Here*

> *the respondent did not set out to prove that the appellants had no legitimate interest in completing the contract and claiming the contract price rather than claiming damages. … Parliament has on many occasions relieved parties from certain kinds of improvident or oppressive contracts, but the common law can only do that in very limited circumstances."*

In White & Carter the innocent party was entitled to ignore the repudiation of the contract-breaker and proceed to perform, claiming his remuneration in debt rather than limiting himself to damages, notwithstanding that this course might be a great deal more expensive for the contract-breaker. This, according to Lord Reid (p 431), was because the contract-breaker "did not set out to prove that the appellants had no legitimate interest in completing the contract and claiming the contract price rather than claiming damages".

30. More generally, the attitude of the courts, reflecting that of the Court of Chancery, is that specific performance of contractual obligations should ordinarily be refused where damages would be an adequate remedy. This is because the minimum condition for an order of specific performance is that the innocent party should have a legitimate interest extending beyond pecuniary compensation for the breach. The paradigm case is the purchase of land or certain chattels such as ships, which the law recognises as unique. Because of their uniqueness the purchaser's interest extends beyond the mere award of damages as a substitute for performance. As Lord Hoffmann put it in addressing a very similar issue "the purpose of the law of contract is not to punish wrongdoing but to satisfy the expectations of the party entitled to performance": Co-operative Insurance Society Ltd v Argyll Stores (Holdings) Ltd [1998] AC 1, 15.

31. In our opinion, the law relating to penalties has become the prisoner of artificial categorisation, itself the result of unsatisfactory distinctions: between a penalty and genuine pre-estimate of loss, and between a genuine pre-estimate of loss and a deterrent. These distinctions originate in an over-literal reading of Lord Dunedin's four tests and a tendency to treat them as almost immutable rules of general application which exhaust the field. In Legione v Hateley (1983) 152 CLR 406, 445, Mason and Deane JJ defined a penalty as follows:

> *"A penalty, as its name suggests, is in the nature of a punishment for non-observance of a contractual stipulation; it consists of the imposition of an additional or different liability upon breach of the contractual stipulation ..."*

All definition is treacherous as applied to such a protean concept. This one can fairly be said to be too wide in the sense that it appears to be apt to cover many provisions which would not be penalties (for example most, if not all, forfeiture clauses). However, in so far as it refers to "punishment" and "an additional or different liability" as opposed to "in terrorem" and "genuine pre-estimate of loss", this definition seems to us to get closer to the concept of a penalty than any other definition we have seen. The real question when a contractual provision is challenged as a penalty is whether it is penal, not whether it is a pre-estimate of loss. These are not natural opposites or mutually exclusive categories. A damages clause may be neither or both. The fact that the clause is not a pre-estimate of loss does not therefore, at any rate without more, mean that it is penal. To describe it as a deterrent (or, to use the Latin equivalent, in terrorem) does not add anything. A deterrent provision in a contract is simply one species of provision designed to influence the conduct of the party potentially affected. It is no different in this respect from a contractual inducement. Neither is it inherently penal or contrary to the policy of the law. The question whether it is enforceable should depend on whether the means by which the contracting party's conduct is to be influenced are "unconscionable" or (which will usually amount to the same thing) "extravagant" by reference to some norm.

32. The true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation. The innocent party can have no proper interest in simply punishing the defaulter. His interest is in performance or in some appropriate alternative to performance. In the case of a straightforward damages clause, that interest will rarely extend beyond compensation for the breach, and we therefore expect that Lord Dunedin's four tests would usually be perfectly adequate to determine its validity. But compensation is not necessarily the only legitimate interest that the innocent party may have in the

<u>performance of the defaulter's primary obligations. This was recognised in the early days of the penalty rule, when it was still the creature of equity, and is reflected in Lord Macclesfield's observation in Peachy (quoted in para 5 above) about the application of the penalty rule to provisions which were "never intended by way of compensation", for which equity would not relieve. It was reflected in the result in Dunlop. And it is recognised in the more recent decisions about commercial justification. And, as Lord Hodge shows, it is the principle underlying the Scottish authorities.</u>

33. The penalty rule is an interference with freedom of contract. It undermines the certainty which parties are entitled to expect of the law. Diplock LJ was neither the first nor the last to observe that "The court should not be astute to descry a 'penalty clause'": Robophone at p 1447. As Lord Woolf said, speaking for the Privy Council in Philips Hong Kong Ltd v Attorney General of Hong Kong (1993) 61 BLR 41, 59, "the court has to be careful not to set too stringent a standard and bear in mind that what the parties have agreed should normally be upheld", not least because "any other approach will lead to undesirable uncertainty especially in commercial contracts".

34. Although the penalty rule originates in the concern of the courts to prevent exploitation in an age when credit was scarce and borrowers were particularly vulnerable, the modern rule is substantive, not procedural. It does not normally depend for its operation on a finding that advantage was taken of one party. As Lord Wright MR observed in Imperial Tobacco Company (of Great Britain) and Ireland v Parslay [1936] 2 All ER 515, 523:

> *"A millionaire may enter into a contract in which he is to pay liquidated damages, or a poor man may enter into a similar contract with a millionaire, but in each case the question is exactly the same, namely, whether the sum stipulated as damages for the breach was exorbitant or extravagant ..."*

35. But for all that, the circumstances in which the contract was made are not entirely irrelevant. In a negotiated contract between properly advised parties of comparable bargaining power, the strong initial presumption must be that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach. In that connection, it is worth noting that in Philips Hong Kong at pp

57-59, Lord Woolf specifically referred to the possibility of taking into account the fact that "one of the parties to the contract is able to dominate the other as to the choice of the terms of a contract" when deciding whether a damages clause was a penalty. In doing so, he reflected the view expressed by Mason and Wilson JJ in AMEV-UDC at p 194 that the courts were thereby able to "strike a balance between the competing interests of freedom of contract and protection of weak contracting parties" (citing Atiyah, The Rise and Fall of Freedom of Contract (1979), Chapter 22). However, Lord Woolf was rightly at pains to point out that this did not mean that the courts could thereby adopt "some broader discretionary approach". The notion that the bargaining position of the parties may be relevant is also supported by Lord Browne-Wilkinson giving the judgment of the Privy Council in Workers Bank. At p 580, he rejected the notion that "the test of reasonableness [could] depend upon the practice of one class of vendor, which exercises considerable financial muscle" as it would allow such people "to evade the law against penalties by adopting practices of their own". In his judgment, he decided that, in contracts for sale of land, a clause providing for a forfeitable deposit of 10% of the purchase price was valid, although it was an anomalous exception to the penalty rule. However, he held that the clause providing for a forfeitable 25% deposit in that case was invalid because "in Jamaica, the customary deposit has been 10%" and "[a] vendor who seeks to obtain a larger amount by way of forfeitable deposit must show special circumstances which justify such a deposit", which the appellant vendor in that case failed to do.

<u>Should the penalty rule be abrogated</u>?

36. The primary case of Miss Smith QC, who appeared for Cavendish in the first appeal, was that the penalty rule should now be regarded as antiquated, anomalous and unnecessary, especially in the light of the growing importance of statutory regulation in this field. It is the creation of the judges, and, she argued, the judges should now take the opportunity to abolish it. There is a case to be made for taking this course. It was expounded with considerable forensic skill by Miss Smith, and has some powerful academic support: see Sarah Worthington, Common Law Values: the Role of Party Autonomy in Private Law, in The Common Law of Obligations: Divergence and Unity (ed A Robertson and M Tilbury (2015)), pp 18-26. We rather doubt *that the courts would have invented the rule today if their predecessors had not done so three centuries ago. But this is not the way in which English law develops, and we do not consider that judicial abolition would be a proper course for this court to take.*

37. The first point to be made is that the penalty rule is not only a long-standing principle of English law, but is common to almost all major systems of law, at any rate in the western world. It has existed in England since the 16th century and can be traced back to the same period in Scotland: McBryde, The Law of Contract in Scotland, 3rd ed (2007), paras 22-148. The researches of counsel have shown that it has been adopted with some variants in all common law jurisdictions, including those of the United States. A corresponding rule was derived from Roman law by Pothier, Traité des Obligations, No 346, which is to be found in the Civil Codes of France (article 1152), Germany (for non-commercial contracts only) (sections 343, 348), Switzerland (article 163.3), Belgium (article 1231) and Italy (article 1384). It is included in influential attempts to codify the law of contracts internationally, including the Unidroit Principles of International Commercial Contracts (2010) (article 7.4.13), and the UNCITRAL Uniform Rules on Contract Clauses for an Agreed Sum Due upon Failure of Performance (article 6). In January 1978 the Committee of Ministers of the Council of Europe recommended a number of common principles relating to penal clauses, including (article 7) that a stipulated sum payable on breach "may be reduced by the court when it is manifestly excessive". 38. It is true that statutory regulation, which hardly existed at the time that the penalty rule was developed, is now a significant feature of the law of contract. In England, the landmark legislation was the Unfair Contract Terms Act 1977. For most purposes, the Act was superseded by the Unfair Terms in Consumer Contracts Regulations 1994 (SI 1994/3159), which was in turn replaced by the 1999 Regulations, both of which give effect to European Directives. The 1999 Regulations contain an "indicative and non-exhaustive list of the terms which may be regarded as unfair", including terms which have the object or effect of "requiring any consumer who fails to fulfil his obligation to pay a disproportionately high sum in compensation". Nonetheless, statutory regulation is very far from covering the whole field. Penalty clauses are controlled by the 1999 Regulations, but the Regulations apply only to *consumer contracts and the control of unfair terms under regulations 3 and 5 is limited to those which have not been individually negotiated. There are major areas, notably non-consumer contracts, which are not regulated by statute. Some of those who enter into such contracts, for example professionals and small businesses, may share many of the characteristics of consumers which are thought to make the latter worthy of legal protection. The English Law Commission considered penalty clauses in 1975 (Working Paper No 61, Penalty Clauses and Forfeiture of Monies Paid, April 1975), at a time when there was no relevant statutory regulation, and the Scottish Law Commission reported on them in May 1999 (Report No 171). Neither of these Reports recommended abolition of the rule. On the contrary, both recommended legislation which would have expanded its scope.*

39. Further, although there are justified criticisms that can be made of the penalty rule, it is consistent with other well-established principles which have been developed by judges (albeit mostly in the Chancery courts) and which involve the court in declining to give full force to contractual provisions, such as relief from forfeiture, the equity of redemption, and refusal to grant specific performance, as discussed in paras 10-11 and 29-30 above. Finally, the case for abolishing the rule depends heavily on anomalies in the operation of the law as it has traditionally been understood. Many, though not all of these are better addressed (i) by a realistic appraisal of the substance of contractual provisions operating upon breach, and (ii) by taking a more principled approach to the interests that may properly be protected by the terms of the parties' agreement.

Should the penalty rule be extended?

40. In the course of his cogent submissions, Mr Bloch QC, who appeared for Mr Makdessi on the first appeal, suggested that, as an alternative to confirming or abrogating the penalty rule, this court could extend it, so that it applied more generally. As he pointed out, this was the course taken by the High Court of Australia, and it would have the advantage of rendering the penalty rule less formalistic in its application, and, which may be putting the point in a different way, less capable of avoidance by ingenious drafting.

41. This step has recently been taken in Australia. Until recently, the law in Australia was the same as it is in England: see IAC Leasing Ltd v Humphrey (1972) 126 CLR 131, 143 (Walsh J); O'Dea v Allstates Leasing System (WA) Pty Ltd (1983) 152 CLR 359, 390 (Brennan J); AMEV-UDC at p 184 (Mason and Wilson JJ, citing ECGD among other authorities), 211 (Dawson J); Ringrow Pty Ltd v BP Australia Pty Ltd (2005) 224 CLR 656, 662. However, a radical departure from the previous understanding of the law occurred with the decision of the High Court of Australia in Andrews v Australia and New Zealand Banking Group Ltd (2012) 247 CLR 205. The background to this case was very similar to that in Office of Fair Trading v Abbey National plc [2010] 1 AC 696. It concerned the application of the penalty rule to contractual bank charges payable when the bank bounced a cheque or allowed the customer to draw in excess of his available funds or agreed overdraft limit. These might in a loose sense be regarded as banking irregularities, but they did not involve any breach of contract on the part of the customer. On that ground Andrew Smith J had held in the Abbey National case that the charges were incapable of being penalties: [2008] 2 All ER (Comm) 625, paras 295-299 (the point was not appealed). In Andrews, the High Court of Australia disagreed. They engaged in a detailed historical examination of the equitable origin of the rule and concluded that there subsisted, independently of the common law rule, an equitable jurisdiction to relieve against any sufficiently onerous provision which was conditional upon a failure to observe some other provision, whether or not that failure was a breach of contract. At para 10, they defined a penalty as follows:

> *"In general terms, a stipulation prima facie imposes a penalty on a party (the first party) if, as a matter of substance, it is collateral (or accessory) to a primary stipulation in favour of a second party and this collateral stipulation, upon the failure of the primary stipulation, imposes upon the first party an additional detriment, the penalty, to the benefit of the second party. In that sense, the collateral or accessory stipulation is described as being in the nature of a security for and in terrorem of the satisfaction of the primary stipulation. If compensation can be made to the second party for the prejudice suffered by failure of the primary stipulation,*

the collateral stipulation and the penalty are enforced only to the extent of that compensation. The first party is relieved to that degree from liability to satisfy the collateral stipulation."

42. Any decision of the High Court of Australia has strong persuasive force in this court. But we cannot accept that English law should take the same path, quite apart from its inconsistency with established and unchallenged House of Lords authority. In the first place, although the reasoning in Andrews was entirely historical, it is not in fact consistent with the equitable rule as it developed historically. The equitable jurisdiction to relieve from penalties arose wholly in the context of bonds defeasible in the event of the performance of a contractual obligation. It necessarily posited a breach of that obligation. Secondly, if there is a distinct and still subsisting equitable jurisdiction to relieve against penalties which is wider than the common law jurisdiction, with three possible exceptions it appears to have left no trace in the authorities since the fusion of law and equity in 1873. The first arguable exception is in In re Dagenham (Thames) Dock Co; Ex p Hulse (1873) LR 8 Ch App 1022 (followed by the Privy Council in Kilmer v British Columbia Orchard Lands Ltd [1913] AC 319), where the Court of Appeal granted a purchaser, who had been in possession for five years and carried out improvements, further time to pay the second and final instalment of a purchase price on the ground that the clause requiring him to vacate and to forfeit the first instalment for not having paid the second instalment on time, was a "penalty". However, James and Mellish LJJ may have been treating the clause as a forfeiture (as they both also used that expression in their brief judgments), and in any event they treated the purchaser in the same way as a mortgagor in possession asking for more time to pay. Further, as Romer LJ pointed out in Stockloser at pp 497-498, the decision could be justified by the fact that time had already been extended twice by agreement, and in any event there was no question of the vendor being required to repay the first instalment. The second arguable exception is no more than an unsupported throw-away line in the judgment of Diplock LJ in Robophone at p 1446, where he said it was "by no means clear" whether penalty clauses "are simply void", but, on analysis, he was dealing with a rather different point (namely that discussed *by Lord Atkin in the passage that follows). The third exception is the unsatisfactory decision in Jobson v Johnson [1989] 1 WLR 1026, to which we shall return in paras 84-87 below. It is relevant to add in this connection that the law of penalties has been held to be the same in England and Scotland: Stair Memorial Encyclopaedia of the Laws of Scotland, vol 15, paras 783-801, and see Clydebank. Yet equity, although influential, has never been a distinct branch of Scots law. In the modern law of both countries, the penalty rule is an aspect of the law of contract. Thirdly, the High Court's redefinition of a penalty is, with respect, difficult to apply to the case to which it is supposedly directed, namely where there is no breach of contract. It treats as a potential penalty any clause which is "in the nature of a security for and in terrorem of the satisfaction of the primary stipulation." By a "security" it means a provision to secure "compensation … for the prejudice suffered by the failure of the primary stipulation". This analysis assumes that the "primary stipulation" is some kind of promise, in which case its failure is necessarily a breach of that promise. If, for example, there is no duty not to draw cheques against insufficient funds, it is difficult to see where compensation comes into it, or how bank charges for bouncing a cheque or allowing the customer to overdraw can be regarded as securing a right of compensation. Finally, the High Court's decision does not address the major legal and commercial implications of transforming a rule for controlling remedies for breach of contract into a jurisdiction to review the content of the substantive obligations which the parties have agreed. Modern contracts contain a very great variety of contingent obligations. Many of them are contingent on the way that the parties choose to perform the contract. There are provisions for termination upon insolvency, contractual payments due on the exercise of an option to terminate, break-fees chargeable on the early repayment of a loan or the closing out of futures contracts in the financial or commodity markets, provisions for variable payments dependent on the standard or speed of performance and "take or pay" provisions in long-term oil and gas purchase contracts, to take only some of the more familiar types of clause. The potential assimilation of all of these to clauses imposing penal remedies for breach of contract would represent the expansion of the courts' supervisory jurisdiction into a new territory of uncertain boundaries, which has hitherto been treated as wholly governed by mutual agreement.*

43. We would accept that the application of the penalty rule can still turn on questions of drafting, even where a realistic approach is taken to the substance of the transaction and not just its form. But we agree with what Hoffmann LJ said in Else (1982) at p 145, namely that, while it is true that the question whether the penalty rule applies may sometimes turn on "somewhat formal distinction[s]", this can be justified by the fact that the rule "being an inroad upon freedom of contract which is inflexible … ought not to be extended", at least by judicial, as opposed to legislative, decision-making."

(Emphasis supplied)

84. Section 74 of the Indian Contract Act explicitly bars any liquidated damages to be paid which is in the nature of penalty. However, the Act does not define "penalty". A clause is considered to be in the nature of penalty if it provides for "a payment of money stipulated as in terrorem of the offending party" (***Dunlop Pneumatic Tyre Co. Ltd. v. New Garage & Motor Co. Ltd.*** (1915) AC 79) or, if the clause's contractual nature is "deterrent rather than compensatory". On the other hand, a clause is said to be one of liquidated damages if it is a genuine endeavour by the parties to stipulate the loss arising out of the breach in advance. The nature of the clause would also depend on its construction and the encompassing circumstances during the time of entering into the contract or at the time of doing the material variation in the contract.

85. In the UK, the principles enunciated by Lord Dunedin in ***Dunlop*** (supra) were the guiding test for deciding whether a clause is in the nature of the penalty or not. It focused on the question of "whether the clause represents the genuine pre-estimate of loss or not". Over a period of time, the contracts have evolved and have become more complex, which questions the relevancy of the test. ***Cavendish Square*** (supra) emphasised that where a clause does not represent the genuine pre-estimate of loss, it cannot be regarded as penalty if there is "commercial justification" for it. The words "commercial justification" are of prime importance.

86. The courts in India are still reluctant to apply the test propounded in ***Cavendish*** (supra), which respects the party's autonomy. In arbitration, the freedom of the parties to define their relationship is the most fundamental principle. Since the relationship between the Arbitral Tribunals and courts oscillate between forced cohabitation and true partnership, we are inclined to adopt ***Cavendish*** (supra), which according to us would be a pro-arbitration approach.

87. The most venerated test for determining penalty clause was propounded by Lord Dunedin in ***Dunlop Pneumatic Tyre Co.*** (supra) where the learned Judge formulated the following four rules for the construction of liquidated damages. “A clause is said to be in nature of a penalty if:

a) The sum pre-estimated is unconscionable and extravagant compared to the greatest loss that could conceivably be proven to arise from the breach.
b) The breach consisting only of not paying a certain amount, and the sum stipulated is a sum greater than the sum which ought to have been paid.
c) A single lump sum is made payable on the occurrence of one or more or all of several events, some of which may occasion serious and other but trifling damage.
d) The sum stipulated is not a genuine pre-estimate of damage in cases where it is impossible to make a precise pre-estimation.”

88. The test as aforesaid may be relevant while looking into clauses of simple damages in standard contracts, however, it is difficult to apply this test when it comes to complex contracts. In complex cases where technical expertise is needed to understand the different aspects of a contract, it is very subjective and difficult to determine what amounts to “genuine pre-estimate of loss”.

89. Later, Lord Woolf in ***Philips Hong Kong Ltd. v. Attorney General of Hong Kong Co.*** reported in (1993) 61 BLR 41 (Privy Council) said, “The Court has to be careful not to set too stringent a standard and bear in mind that what the parties have agreed should normally be upheld because any other approach may lead to undesirable uncertainty, especially in commercial contracts." Lord Colman in ***Lordsvale Finance Plc. v. Bank of Zambia*** reported in (1996) Q.B. 752 was to examine a simple form of provision in a syndicate loan agreement which provided for interest to be paid at a greater rate during any period in which the borrower was in default. The learned Judge observed that simply because the provision for the payment of a sum in case of breach was not a "genuine pre-estimate of damages", it cannot be said to be a penalty clause. He further observed, … no reason in principle why a contractual provision the effect of which was to increase the consideration payable under an executory contract upon the happening of a default should be struck down as a penalty if the increase could in the circumstances be explained as commercially justifiable, provided its dominant purpose was not to deter the other party from breach.

90. The UKSC in ***Cavendish*** (supra) unanimously felt the need for further refinement in the pre-Cavendish position. While rejecting the suggestion of total abolition of the pre-Cavendish position, it provided a reformed test applicable to the clauses which amount to the secondary obligation imposed on the contract breacher. It provided the test in two limbs:

(a) Whether any "legitimate business interest" is protected by the clause (first limb)?

(b) If so, is the provision made in the clause "exorbitant, extravagant or unconscionable" or is there some wider "commercial or socio-economic justification" for the clause (second limb)?

91. Contrary to the strict bar against all covenants of a deterrent nature in ***Dunlop*** (supra) the test in ***Cavendish*** (supra) advocates that deterrence might not compulsorily be considered as penal in the cases in which the party establishes the presence of "legitimate interest" in securing the performance of the contract which goes beyond the mere right of recovering damages. This test in ***Cavendish*** (supra) renders additional protection to the covenants that might otherwise be considered as a penalty under the old Dunlop test but are considered "commercially justifiable" if viewed in the light of the brisk development of present time business and commerce. [Raphael Lok Hin Leung, "In Defence of the Halfway House-The Cavendish Penalty Rule since 2015" (2019) 13 Hong Kong Journal of Legal Studies.]

92. The test in ***Dunlop*** (supra) is susceptible to three main criticism:

1. That there is the absence of consideration appropriated to commercial realities.

2. After ***Lordsvale*** (supra), this test is inapplicable in complicated matters pertaining to apparently valid commercial justification with impugned clauses. This led to judicial inconsistency and vagueness.
3. That the rigid dichotomy created i.e. “genuine” and “non-genuine” pre-estimate of loss, is misleading, artificial and arbitrary. Lucinda Miller, “Penalty Clauses in England and France: A Comparative Study”, (2008) 53 International and Comparative Law Quarterly 79, 82.

93. This rigid dichotomy has created a dilemma for the judiciary. “Miller” points out that Lord Dunedin's postulation presumes that stipulated damages can either be a penalty or liquidated damages. However, there may be cases where one function may be more dominant than another, and it is not every time the situation that the other function is totally absent. Therefore, both functions are not necessarily mutually exclusive. It is very well possible that a clause may have an element of deterrence, and at the same time it may be a “genuine pre-estimate of loss”. [Lucinda Miller, “Penalty Clauses in England and France: A Comparative Study”, (2008) 53 International and Comparative Law Quarterly 79, 82]. This situation may arise due to the under compensatory character of contract damages. A number of damages remain unpaid, such as loss of productivity, lost opportunity, internal cost and non-monetary losses like emotional distress [Larry A. DiMatteo, Civil-

Common Law Divergence on Penalties: Is it a Thing of the Past? (2022) 43 Liverpool Law Review 426].

94. Critics have contended that the Dunlop test's endurance stems from the court's reluctance to cede its authority to make decisions [Mattei, Ugo, "The Comparative Law and Economic of Penalty Clauses in contract", (1995) 43 American Journal of comparative Law 427]. Having said that, the circumstances surrounding the contract's establishment are not completely meaningless. When parties are fairly informed, well-informed, and possess comparable or nearly equal bargaining power in a contract, a strong initial presumption should be that the parties are the best arbiters of what would be reasonable in the event of a breach of the agreement. The core ideas of contract law, "freedom of contract" and "*pacta sunt servanda*", are essential to the laissez-faire approach taken by the majority of common law jurisdictions worldwide. In order to ensure surety and certainty, this flexibility includes the right of the contracting parties to negotiate and include clauses regarding agreed upon remedies in the event of a breach. It also considers whether the contract may be enforced. Hatzis's argument that parties in business contexts should be deemed to have considered the benefits and drawbacks of the clause before signing the contract, as well as the court's refusal to enforce the terms of the agreement whether they are penal or not further bolsters this line of reasoning [Aristides N. Hatzis, "Having the Cake and Eating it Too: Efficient Penalty Clauses in Common and Civil Contract Law", 22(4) International Review of Law and Economics 381].

95. Decades after ***Dunlop*** (supra), this Court in ***Fateh Chand v. Balkishan Dass*** reported in 1963 SCC Online SC 49, examined a deed of sale which provided that if the purchaser could not register the deed by the stipulated date, the earnest money and the sale price INR 1000 and 24,000 respectively, paid by the purchaser would be forfeited. The Court applied the Dunlop test and observed that the INR 24,000 stipulation was not a "genuine pre-estimate of loss" and was manifestly a stipulation in nature of penalty.

96. Again, in ***Maula Bux v. Union of India*** reported in (1969) 2 SCC 554, it was held by this Court that in cases where the parties are unable to determine the reasonable compensation, if the amount decided by the party is a "genuine pre-estimate of damages" it should be considered a reasonable compensation. Further, in ***Kailash Nath Associates v. DDA*** reported in (2015) 4 SCC 136, this Court held that only those liquidated damages clauses which are "a genuine pre-estimate of damages" can be enforced as "reasonable compensation".

97. Although several Indian decisions have referred to ***Cavendish*** (supra), yet none of them have completely relied on the test propounded therein. In ***Union of India v. Dishnet Ltd.*** reported in 2017 SCC OnLine Tri 90, the High Court of Tripura, referring to Cavendish (supra), said, "though it establishes true principles with respect to such clause, the dominant test in India is still a genuine pre-estimate of damages test" and decided on the basis of that only. Again, in ***Electronics Corpn. of Tamil Nadu Ltd. v. ICMC Corpn. Ltd.*** reported in 2020 OnLine Mad 244, the High Court of Madras was asked to decide upon the invocation of the liquidated damages clause due to the suppliers' failure to follow a delivery schedule. In this case also, the Court again referred to ***Cavendish*** (supra) but ultimately relied on "the genuine pre-estimate of loss test" for deciding the nature of the clause. Lastly, in ***LIC Housing Finance Ltd. v. CST*** reported in 2019 SCC Online CESTAT 8290, the Customs Excise and Service Tax Appellate Tribunal again referred to ***Cavendish*** (supra) however did not discuss its implication on the case. Therefore, though the Indian courts have cited ***Cavendish*** (supra) but abstained from relying on the test.

i. <u>Cavendish embraced in foreign jurisdictions</u>

a. <u>Australia</u>

98. In ***Paciocco v. Australia and New Zealand Banking Group Ltd.*** reported in 2016 HCA 28, the High Court was asked to decide whether a bank's credit card late fees qualified as penalties under the applicable Act. The Court determined that the motive for the imposition of late payment fees was to make up for any potential loss that could arise from the failure to pay. Despite the fact that the fee did not accurately estimate the potential loss resulting from a specific violation due to the relatively small amount of late payment, the court determined that the charge did not qualify as a penalty. The court did not entirely distance itself from the punishment rule, though.

99. The dictum as laid by the High Court of Australia applying the principles as laid down in ***Cavendish*** (supra) could be said to have been followed by this Court in the case of ***Hongkong and Shanghai Banking Corporation Limited v. Awaz and Others*** reported in (2025) 3 SCC 52. In the said case, three questions fell for the consideration of this Court:

> *"(i) Whether Reserve Bank of India (hereinafter referred to as "RBI") is required to issue any circular or guidelines prohibiting the banks/non-banking financial institutions/moneylenders from charging interest above a specific rate?*

(ii) (a) Whether banks can charge the credit card users interest at rates from 36% to 49% p.a. if there is any delay or default in payment within the time specified?

(b) Whether interest at the abovestated rates amounts to charging usurious rates of interest?"

100. While answering the aforesaid three questions this Court observed as under:

*"**67.** The credit card holders in the present case are well informed and educated and had agreed to be bound by the express stipulation by the terms issued by the respective Banks. The Banks in the most important terms and conditions, as provided by the Banks have provided all necessary information with regard to fees, and charges applicable to credit cards, credit and cash withdrawal limits. We are of the considered opinion that once the terms of the credit card operations were known to the complainants and disclosed by the banking institutions before the issuance of the credit cards, the National Commission could not have scrutinised the terms or conditions, including the rate of interest. More so, the respondent has not approached the statutory authority, Reserve Bank of India, for any objection against the rate of interest, or the high Benchmark prime lending rate.*

__68.__ The National Commission, whilst making observations, has made stipulations to the terms of contract agreed between the parties, so much so it has supplanted itself as the custodian of the terms and conditions between the parties. We are of the considered opinion that to re-agitate the terms and conditions of credit card facilities provided by the banks, and rewrite the terms thereof, including the rates of interest charged by the banks, is exorbitant, however reasonable, is an attempt by the National Commission to constitute a new contract, which is impermissible in law. It is a settled canon of law, that a

"contract, being a creature of an agreement between two or more parties, has to be interpreted giving literal meanings unless, there is some ambiguity therein. The contract is to be interpreted giving the actual meaning to

the words contained in the contract and it is not permissible for the Court to make a new contract, however reasonable, if the parties have not made it themselves." [Rajasthan Sidic v. Diamond & Gem Development Corpn. Ltd., (2013) 5 SCC 470 : (2013) 3 SCC (Civ) 153] (Diamond & Gem Development Corpn. case [Rajasthan Sidic v. Diamond & Gem Development Corpn. Ltd., (2013) 5 SCC 470 : (2013) 3 SCC (Civ) 153], SCC p. 483, para 23)

73. *In the present context, the preconditions of "deceptive practice" and "unfair method" are manifestly absent. The Banks have in no manner made any misrepresentation, to deceive the credit card holders. Upon availing the facility of the credit cards, the customers, are made aware of "the most important terms and conditions", including the rate of interest, that shall be charged by the Banks. Even on merits, Reserve Bank of India, has made it clear that there exists no material on record, to establish that any Bank has acted contrary to the policy directives issued by RBI. Even otherwise, there is not even a single averment so as to establish how the charging of rates of interest upon the default by credit card holders, without a standardised rate, is usurious and constitutes an unfair trade practice. The mere inflation in the rates of interest cannot be construed as a practice, intended to cause loss or injury.*

xxx xxx xxx

75. *<u>Thus, we agree with the submissions made by Reserve Bank of India, that the question of directing RBI to act against any bank does not arise, in the facts and circumstances of the present case and that there is no question of RBI being directed to impose any cap on the rate of interest, either on the banking sector as a whole, or in respect of any one particular bank, contrary to the provisions contained in the Banking Regulation Act, and the circulars/directions issued thereunder</u>."*

(Emphasis supplied)

b. <u>New Zealand</u>

101. The structure established by ***Cavendish*** (supra) was adhered to by the Supreme Court of New Zealand in ***127 Hobson Street Ltd. v. Honey Bees Preschool Ltd.*** reported in 2020 NZSC 53. The Court created a new proportionality standard that weighs the stipulated amount against the non-breaching party's "reasonable interest". It acknowledged that damages recoverable under common law might not include broader economic or commercial interest protected. The "legitimate interest" of a non-breaching party is the main focus of this new approach, which rejects the Dunlop test.

c. <u>Malaysia</u>

102. In ***Cubic Electronic Sdn Bhd v. Mars Telecommunication-Sdn Bhd*** reported in (2019) 6 Mad LJ 15 FC, the Federal Court, following ***Cavendish*** (supra), recognised the concept of "legitimate interest" and "proportionality" while judging what should be a reasonable compensation. It held that the court must first determine whether a damages clause serves to protect any "legitimate business or commercial interest" in performance that extends beyond the possibility of monetary compensation which may result from the breach, and if so, whether the provision created to safeguard that interest is in proportion to the identified interest.

d. Germany

103. Liquidated Damages and contractual penalties are distinguished by the German legislation, known as the German Civil Code (**BGB**). In situations where the prescribed amount is "disproportionate and excessively high", Article 343 of the **BGB** requires a judicial reduction; nevertheless, it also states that the evaluation must take "every legitimate interest of the obligee, not merely his financial interest" into account. This evaluation follows the logic presented in ***Cavendish*** (supra).

104. The Cavendish rule gives greater autonomy to parties to define their relationship in comparison to ***Dunlop*** (supra) & party autonomy is one of the cardinal principles behind the evolution of the law of arbitration. In cases where the parties are of equal or comparable bargaining power, the interference by the arbitrator or Judges by declaring any clause of penalty merely on the basis of a reasonable pre-estimate of loss goes against the fundamental principle of party autonomy. The Scottish Law Commission Report has observed, "the Cavendish test is well-received by commercial law firms and professional bodies for being highly flexible and workable in terms of providing clear guidance as to future contract drafting" [Scottish Law Commission, Report on Review of Contract Law Formation, Interpretation, Remedies for Breach, and Penalty clauses (2018) 252]. Various common law jurisdictions have positively responded to ***Cavendish*** (supra) and have relied on them. [Ref: **Embracing The Cavendish Test for Greater Autonomy in Contract Law by Ashish Jha, Gujarat National Law University, Gandhinagar**]

105. Malhotra in his Commentary on the law of arbitration (4th Edition) while explaining the ground of 'public policy' for setting aside the Award is concerned states that:

> "*The concept of 'public policy', of course, is not immutable. By its very nature, 'public policy' is not susceptible to a plain meaning by the courts. Public policy is a dynamic concept that evolves continually to meet the changing needs including political, social, cultural, moral and economic dimensions. The doctrine of public policy is a branch of common law, and just like any other branch of common law, it is governed by precedent; the principles have been crystallised under different heads, and though it is permissible for courts to apply them to different situations, the doctrine should only be invoked in clear and incontestable cases of harm to the public. Public policy connotes some matter which concern public good and public interest. The duty of the court is to expound, and not expand the doctrine of public policy. The courts should use circumspection in holding a contract as void against public policy, and should do so, only when the contract is incontestable, and inimical to public interest. The doctrine should be invoked only in clear cases in which the harm to the public is substantially incontestable and does not*

<u>depend upon the idiosyncratic inferences of a few judicial minds</u>."

(Emphasis supplied)

106. Mr. Shyam Divan is right in his submission that the agreement was entered into between the parties who were well versed with the law and had the advantage of legal assistance before drafting and entering into the aforesaid agreement. Once there is an agreement which provides that the interest shall be at a particular rate the Arbitral Tribunal thereafter is left with no discretion. The Arbitral Tribunal would be bound by the terms of the agreement. Such be the position in law on the principles of interpretation of contract, the clause 4 in the case on hand ought to be interpretated in such a way so as to save the clause rather than to render it invalid on the ground of being opposed to Public policy.

107. It is well settled that a contract is a commercial document between the parties, and it must be interpretated in such a manner so as to give efficacy to the contract rather than to invalidate it in the name of public policy, unconscionability etc. It is equally well settled principle that the terms of the contract executed between two parties, are not open to judicial scrutiny unless the same is arbitrary, discriminatory, mala fide or actuated by bias. The courts should not strike down the terms of a contract because it feels that some other terms would have been fair, wiser or logical.

108. The argument of the learned senior counsel for the appellant that the rate of interest or in other words, the clause providing for penalty on penalty is unconscionable, ex-proprietary and contrary to law also merits rejection because at no stage the appellant had questioned the terms on which the bill discounting facility was extended by the respondent. That apart, having enjoyed those facilities for a long time the appellant cannot turn around and raise an argument that penalty on penalty is opposed to public policy. It must be remembered that the appellant was not in a position of disadvantage *vis-à-vis* the respondent. If the appellant wanted, it could have declined to avail the financial facilities made available by the respondent without asking for any security. However, the fact of the matter is that the appellant had signed the agreement with open eyes and agreed to abide by the terms on which the Bill discounting facility was offered by the respondent. In such circumstances, the doctrine of unconscionable contract cannot be invoked for frustrating the action initiated by the respondent for recovery of its dues.

109. The Privy Council in the case of ***Lala Balla Mal v. Ahad Shah and Anr.*** reported in Calcutta Weekly Notes Volume XXIII Page 233 exposited the legal position that:

> *"A borrower who obtains a loan secured by a promissory note on quite reasonable terms, by neglecting to pay the note at maturity, further neglecting to pay the accruing*

interest for the several years following, and then giving a renewal note for the original debt plus the capitalised interest, could produce a result which might at first sight appear oppressive, and yet there would be nothing harsh or unconscionable in the creditor's demand since the added interest only accumulated while he forbore the payment of the sums from time to time due to him.

On the other hand, it would be quite possible for a money-lender, by making loans for short periods on apparently fair terms, and then insisting on capitalising the interest immediately on its becoming payable, to pile up compound interest on the initial debt at such a rate as would make the result after a few years most oppressive and unconscionable. But there is nothing inherently wrong or oppressive in a lender's securing for himself compound interest after the borrower has for a considerable time neglected to pay the debt he owes or the interest accruing due upon it which he has contracted to pay. The borrower cannot acquire merit simply by breaking his contract."

(Emphasis supplied)

110. The Bombay High Court in the case of ***Sheth Burjorji Shapurji v. Dr. Madhavlal Jesingbhai*** reported in ILR Vol. LVIII Page 95 speaking through Chief Justice Sir John Beamont exposited the legal position in the following words:

"If there is an agreement to pay a sum of money by a particular date with a condition that if the money is not paid on that date a larger sum shall be paid, that condition is in the nature of a penalty against which a Court of equity can grant relief and award to the party seeking payment only such damage as he has suffered by the non-performance of the contract. But if, on the other hand, there is an agreement to pay a particular sum followed by a condition allowing to the debtor a concession, for example, the payment of a lesser sum, or payment by instalments, by a particular date or dates, then the party seeking to take advantage of that concession must carry out strictly the conditions on which it was granted, and there is no power in the Court to relieve him from the obligation of so doing."

(Emphasis supplied)

111. The Calcutta High Court in the case of ***Kulada Prosad Chowdhury v. Ramananda Pattanaik*** reported in AIR 1921 Cal 109 speaking through Justice Mookerjee exposited the legal position in the following words:

> *"As regards the merits of the appeal, the contention is that the agreement for payment of interest is a penalty and should not have been enforced. The mortgage executed on the 11th February, 1916, provides that interest would run at the rate of Rs. 2 per cent, per month and would be paid off every year. It further provides that the amount of interest which will remain unpaid at the end of the year would be treated as principal and interest, that is, compound interest would run at the rate of Rs. 2 per cent, per month. The agreement consequently was that the loan would carry interest at the rate of Rs. 2 per cent, per month with annual rests. There is a further provision to the following effect: Although the rate of interest per cent, per month is fixed at Rs. 2 in the bond and the same is agreed by us, yet at our request and supplication you also agree that in case we pay off in one lump the" entire sum due as interest in proper time, that is just at the end of the year from the date of this document, then we shall pay interest at the rate of Rs. 1 per cent, per month instead of Rs. 2 per cent, per month and you and your heirs shall take interest at the said rate of Rs. 1 per cent, per month without any objection. But if we or our heirs do not pay the whole interest in one lump sum at the rate of Rs. 1 per cent, per month within the year, then we and our heirs shall remain bound to pay interest and compound interest at the rate of Rs. 2 per cent, per month as stated in the bond and this rule will apply all along. We are of opinion that this covenant to accept interest at a reduced rate, if interest is paid punctually, does not make the original rate of interest a penalty within the meaning of section 74 of the Indian Contract Act. It has not been disputed that this principle was applied in the cases of Hardy v. Martin [(1783) 1 Brown C.C. 419 note.] , Union Bank of England v. Ingram [(1880) 16 Ch. D. 53.] , Wallis v. Smith [(1882) 21 Ch. D. 243.] and Willing ford v. Mutual Society [(1880) 5 App. Cas. 685.].*

But it has been contended that the rule is not based on reason and should not be applied to this country. We find, however, that the rule was applied by this Court in the case of Kirti Chunder Chatterjee v. J.J. Atkinson [(1906) 10 C.W.N. 640.] by the Allahabad High Court in the case of Kutubuddin Ahmad v. Bashiruddin [(1910) I.L.R. 32 All. 448.] and by the Madras High Court in the case of Abdul Rahim Mahammad v. Rangiah Gounden [(1913) 1 Mad. L.W. 181.] . We are of opinion that the rule is reasonable; for, as was pointed out by Stanley, C.J., in Kutubuddin v. Bashiruddin [(1910) I.L.R. 32 All. 448.] and by White, C.J., in Abdul v. Rangiah [(1913) 1 Mad. L.W. 181.], the effect of a clause of this description is to encourage punctuality on the part of the debtor and there is no reason why the Courts in such circumstances should be astute to nullify the contract between the parties. We do not overlook that in the case of Shampeary Dassya v. Eastern Mortgage and Agency Co., Ltd. [(1917) 22 C.W.N. 226, 241-245.] the rule, though recognised and approved, was not applied but the decision in that case has, upon this point, been reversed by the Judicial Committee, Mati Lal v. The Eastern Mortgage and Agency Co.[(1920) 25 C.W.N. 265.]. The position then is that the rule as enunciated in Willing ford v. Mutual Society [(1880) 5 App. Cas. 685.] has now been adopted by the Judicial Committee. We hold accordingly that the agreement to accept interest at a reduced rate, on punctual payment, does not make the original rate of interest a penalty. We may add that reference was made to the decision of the Judicial Committee in the case of Sunder Koer v. Rai Sham Krishen [(1906) I.L.R. 34 Calc. 150.], but that was clearly a case where there was no covenant to accept a reduced rate of interest on punctual payment."

(Emphasis supplied)

112. This Court in ***K.P. Subbarama Sastri v. K.S. Raghavan*** reported in (1987) 2 SCC 424 observed thus:

"The question whether a particular stipulation in a contractual agreement is in the nature of a penalty has to be determined by the court against the background of various relevant factors, such as the character of the transaction and its special nature, if any, the relative

situation of the parties, the rights and obligations accruing from such a transaction under the general law and the intention of the parties in incorporating in the contract the particular stipulation which is contended to be penal in nature. If on such a comprehensive consideration, the court finds that the real purpose for which the stipulation was incorporated in the contract was that by reason of its burdensome or oppressive character it may operate in terrorem over the promiser so as to drive him to fulfil the contract,, then the provision will be held to be one by way of penalty."

(Emphasis supplied)

113. We also looked into one judgment of the Delhi High Court in the case of ***Smt. Shakuntla Educational and Welfare Society and Ors. v. S.E. Investments Ltd.***, reported in 2017:DHC:2946 wherein the High Court rightly held as under:

"23. The first and foremost question to be addressed is whether the impugned award is liable to be set aside inasmuch as the arbitral tribunal had rejected the contention of the Society/Guarantors that the contractual rate of interest was expropriatory and unconscionable and thus opposed to public policy. The arbitral tribunal had considered the aforesaid contentions and had held that the parties had agreed to the stipulated rate of interest and had availed the loans exercising their free will and, therefore, it was not open for the Society/Guarantors to resile from its agreement and challenge the loan agreements.

*24. The arbitral tribunal had also referred to the decision of the Supreme Court in the case of **Indian Bank v. Blue Jaggers Estates Limited and Others** reported in (2010) 8 SCC 129 and the decision of this Court in **Deepak Bhatia v. Virender Singh** reported in 2015 SCC OnLine Del 12187 and concluded that it was not open for a borrower to challenge the rate of interest after having availed of the loan facilities.*

25. In the case of Blue Jaggers Estates (supra), the Supreme Court had rejected the arguments raised by the respondents therein that the rate of interest was unconscionable, *expropriatory and contrary to law since they had, at no stage, questioned the terms on which the loans/financial facilities were extended by the appellant bank (Indian Bank). The respondents therein had enjoyed the facilities for more than a decade and, therefore, the Court held that it was not open for them to raise such contentions at that stage.*

26. The ratio decidendi of the said decision would, a fortiori, apply to the facts of the present case. In the present case, the arbitral tribunal had noted that the Society/Guarantors/affiliated companies, had entered into 42 loan transactions (other than the subject transactions) over a period of approximately 12 years and had discharged the liability in terms of the loan agreements (SEIL claims that the number is even larger and the Society/Guarantors/affiliated companies had availed of and repaid 47 loans between the year 2000 and 2012). The Society/Guarantors could not be permitted to challenge the terms of the loan agreements after having enjoyed the benefit of the funds lent by SEIL.

27. The above also establishes that the Society/Guarantors were also in no doubt as to the terms of the loan agreements and had entered upon the same voluntarily at the effective rate of the interest payable by them.

28. The arbitral tribunal had referred to the decision of a Coordinate Bench of this Court in Morgan Securities & Credits Pvt. Ltd. v. Morepen Laboratories Ltd & Anr.: 2006 (3) ArbLR 159 Delhi and the decision of the Division Bench in Morepen Laboratories Ltd. & Ors. v. Morgan Securities and Credits Pvt. Ltd.: 2008 (105) DRJ 408 and rejected the contention that the loan transactions fell foul of the Usurious Loans Act, 1918. This Court finds no infirmity with the aforesaid view.

29. <u>It is also necessary to bear in mind that the transactions between the parties was a commercial transaction. Although the rate of interest of 26% p.a. (which would work out to be much higher as it is a flat rate of interest and not based on reducing balance method) is ex facie a very high rate of interest; it cannot be denied that the said transactions were entered into by the parties voluntarily without undue influence, in their commercial interest and it is not safe for courts to pronounce any value based decision on the merits of commercial terms as the same are determined by market forces, given the exigencies of trade and commerce. This is</u>

not a case where the Society/Guarantors are vulnerable parties who were - or could be - subjected to an exploitative unconscionable agreement. It is also relevant to mention that the funds provided by SEIL were unsecured and the loan transactions were plainly perceived as high risks transactions (from a lender's point of view). It is also apparent that the loan or finances sought by the Society was unavailable from the normal banking system and, therefore, the Society/Guarantors had to resort to availing loans from SEIL.

30. It is common knowledge that NBFCs do provide a source of resources to entrepreneurs and persons of commerce in cases where such resources are otherwise unavailable to them. It is also for this reason that it would not be apposite to curtail or restrict such transactions as they may have an effect of completely shutting out the only avenue available to entrepreneurs to avail of such high risk finance.

31. The cost of funds available to NBFCs engaged in lending high risk finance is also significantly higher and would in most cases also include significant component of proprietary funds."

(Emphasis supplied)

114. As discussed above, the appellant was in need of finance and on its own will and volition approached the respondent for the same and knowingly entered into the bill discounting facility agreement. Had the appellant abided by the terms and conditions of repayment it could have availed facility of concessional rate as provided in the agreement, however, the appellant just shut its eyes and declined to make the payment for years together. In such circumstances the conditions stipulated in the agreement of compound interest at the rate of 36% monthly rest cannot be termed as burdensome or oppressive in any manner.

115. The grant of *pendente lite* interest depends upon the phraseology used in the agreement, clauses conferring power relating to arbitration, the nature of claim and dispute referred to the arbitrator, and on what items the power to award interest has been taken away and for which period. Also, the position under Section 31(7) of the 1996 Act, is wholly different, inasmuch as Section 31(7) of the 1996 Act sanctifies agreements between the parties and states that the moment the agreement says otherwise, no interest becomes payable right from the date of the cause of action until the award is delivered. ***(See: Jaiprakash Associates Ltd. v. Tehri Hydro Development Corp. India Ltd.)***

K. APPLICABILITY OF THE MAXIM 'VERBA CHARTARUM FORTIUS ACCIPIUNTUR CONTRA PROFERENTEM' IN THE PRESENT CASE

116. It was sought to be argued by the ld. Senior counsel appearing for the appellant that clause 4 of the Sanction letter dated 27.12.2002 is subject to the principle of '*verba chartarum fortius accipiuntur contra proferentem*'.

117. It is a rule of interpretation that contracts are to be interpreted based on their plain meaning, as a whole and in accordance with the language used. It is also a settled principle that in case of any ambiguity, a contract will have to be interpreted taking into consideration the surrounding facts and circumstances.

118. However, where there are ambiguities, especially in cases of insurance contracts, the principle of *contra proferentem* steps in to aid the interpretation, as reiterated by this Court in its decision in ***Haris Marine Products v. Export Credit Guarantee Corporation Limited*** reported in (2022) 20 SCC 776.

119. The principle of contra proferentem is etymologically traceable to the maxim *verba chartarum fortius accipiuntur contra proferentem*, which means the words of deeds are to be taken most strongly against he who uses them.

120. In ***Sushilaben Indravadan Gandhi v. New India Assurance Co. Ltd*** reported in (2021) 7 SCC 151, paras 37-42, this Court charted the evolution of the rule of *contra proferentem*, and relied inter alia on its explanation as provided under Halsbury's Laws of England : [5th Edn., Vol. 60, para 105.]

> *"Contra proferentem rule.—Where there is ambiguity in the policy the court will apply the contra proferentem rule. Where a policy is produced by the insurers, it is their business to see that precision and clarity are attained and, if they fail to do so, the ambiguity will be resolved by adopting the construction favourable to the insured. Similarly, as regards language which emanates from the insured, such as the language used in answer to questions in the proposal or in a slip, a construction favourable to the insurers will prevail if the insured has created any ambiguity. This rule, however, only becomes operative where the words are truly ambiguous; it is a rule for resolving ambiguity and it cannot be invoked with a view to creating a doubt. Therefore, where the words used are free from ambiguity in the sense that, fairly and reasonably construed, they admit of only one meaning, the rule has no application."*

(Emphasis supplied)

121. The rule of *contra proferentem* thus protects the insured from the vagaries of an unfavourable interpretation of an ambiguous term to which it did not agree. The rule assumes special significance in standard form insurance policies, called *contract d' adhesion* or boilerplate contracts, in which the insured has little to no countervailing bargaining power.

122. As to what amounts to "ambiguity" is clarified in P Ramanatha Aiyar's Advanced Law Lexicon, which defines the term "*ambiguous*" as doubtful or uncertain, particularly in respect of signification; equivocal; indeterminate; indefinite; unsettled; indistinct.

123. ***Haris Marine*** (supra) arose out of an appeal against an order passed by the National Consumer Disputes Redressal Commission (NCDRC) dismissing a complaint filed by the insured against Export Credit Guarantee Corporation Limited (ECGC) for rejecting the insured's claim. The issue was whether the NCDRC was correct in placing reliance on guidelines issued by the Directorate General of Foreign Trade (DGFT) to interpret the date of *'despatch/shipment'* in the Single Buyer Exposure Policy resulting in the consequent denial of the claim. The insured argued for the application of the principle of *contra proferentem*, as the Policy was silent on what amounted to the date of 'despatch' or 'shipment'. While adopting the DGFT Guidelines, the NCDRC rejected the insured's contention that in absence of a clearly specified provision in the Policy, it was entitled to the benefit of the rule of *contra proferentem.*

124. This Court applied the principle of *contra proferentem* and held that the rule assumes special significance in standard form insurance policies, called *contract d' adhesion* or boilerplate contracts, in which the insured has little to no countervailing bargaining power.

125. It further clarified that the *contra proferentem* rule protected the insured from the vagaries of an unfavourable interpretation of an ambiguous term to which it did not agree. This Court was propelled to allow the insured's claim along with interest by reading into the objectives of the ECGC – a government company offering the niche service of export credit insurance – and held that denial of the insured's claim would be contrary to the duties of the ECGC.

126. *Contra proferentem* is not a principle of universal application. Where the terms of the contract are clear, there will be no occasion to apply the *contra proferentem* rule. It is useful to refer to the decision rendered in ***Export Credit Guarantee Corporation of India Ltd. v. Garg Sons International*** reported in 2014 1 SCC 686 wherein it was held that it is not permissible for the court to substitute the terms of the contract itself, under the garb of construing terms incorporated in the agreement of insurance. It was also held that no exceptions can be made on the ground of equity. Further, the principle must certainly not be extended to the extent of substituting words that were never intended to form a part of the agreement.

127. The *contra proferentem* principle does not merit applicability in case of commercial contracts, for the reason that a clause in a commercial contract is bilateral and has mutually been agreed upon as held in a number of judgments, including in ***Rashtriya Ispat Nigam Ltd. v. Dewan Chand Ram Saran*** reported in (2012) 5 SCC 306.

128. The true construction of a commercial contract must depend upon the import of the words used and not upon what the parties choose to say afterwards. Nor does subsequent conduct of the parties in the performance of the contract affect the true effect of the clear and unambiguous words used in the contract. The intention of the parties must be ascertained from the language they have used, considered in the light of the surrounding circumstances and the object of the contract. The nature and purpose of the contract is an important guide in ascertaining the intention of the parties.

129. In ***Ottoman Bank of Nicosia v. Ohanes Chakarian*** reported in AIR 1938 PC 26. Lord Wright made these weighty observations: (AIR p. 29)

> *"… <u>that if the contract is clear and unambiguous, its true effect cannot be changed merely by the course of conduct adopted by the parties in acting under it</u>."*
>
> (Emphasis supplied)

130. In ***Ganga Saran v. Ram Charan Ram Gopal (Firm)*** reported in 1951 SCC 1053 a four-Judge Bench of this Court stated:

> *"12. …Since the true construction of an agreement must depend upon the import of the words used and not upon what the parties choose to say afterwards, it is unnecessary to refer to what the parties have said about it."*

131. It is also a well-recognised principle of construction of a contract that it must be read as a whole in order to ascertain the true meaning of its several clauses and the words of each clause should be interpreted so as to bring them into harmony with the other provisions if that interpretation does no violence to the meaning of which they are naturally susceptible. (***North Eastern Railway Co. v. Lord Hastings*** reported in (1900-03) All ER Rep 199 (HL.)

L. <u>APPLICATION OF SECTION 74 OF THE CONTRACT ACT VIS-A- VIS SECTION 31(7)(a) of the ARBITRATION ACT, 1996</u>

132. Any question as to the unconscionableness of a stipulation contained in an agreement would probably arise for consideration only if it is shown that the relationship between the contracting parties was such that one of them was in a position to dominate the will of the other and that he had made use of such position to obtain an unfair advantage over the other. It is only in cases where both the conditions mentioned above are clearly established by the person who seeks to avoid the transaction and the court further finds that the bargain is in itself unconscionable that the impugned provision will be held to be unenforceable on the ground of unconscionableness. See ***Poosathurai* v. *Kannappa Chettiar***, ILR 43 Mad 546 : (AIR 1920 PC 65), ***Ladli Parshad Jaiswal* v. *The Kernal Distillery Co., Ltd. Karnal***, AIR 1963 SC 1279, and ***Subhas Chandra Das Mushib v. Ganga Presad Das Mushib***, AIR 1967 SC 878. If people with their eyes open choose wilfully and knowingly to enter into a contractual transaction the court will not step in to relieve them of their obligations under such contract on the ground that the terms thereof are unconscionable. [See: ***P.K. Achuthan and another v. State Bank of Travancore, Calicut : AIR 1975 Ker 47 (F.B.)***]

133. In ***John Wallingford v. The Directors and Co. of the Mutual Society, and the Official Liquidator thereof***, reported in (1880) 5 AC 685, which is one of the leading English cases on the subject the House of Lords had to consider the question whether a provision contained in a mortgage bond executed to secure the due payment, by instalments, of a sum due, making the whole amount recoverable in the event of default in payment of any instalment was a stipulation by way of penalty. Rejecting the contention of the appellant that the provision was penal in nature Lord Selborne, L.C. observed thus at page 696:

> "*The real matter seems to stand thus. These mortgage bonds were given to secure the £ 6000, which sum was treated as advanced, although money did not pass, and also the premiums, which would become due by instalments according to the rules of the society; and the payment of which under those rules was liable to be accelerated, if any of the instalments were not punctually paid. I cannot think that such an acceleration of payments has anything in common with a penalty. It was a contract for certain payments which were debits in praesenti although solvenda in future; and, being such, it is consistent both with principle and with authority to hold, that if the party who ought to have paid them, or any of them, at the proper time failed to do so, the default was his own, and the time might lawfully be accelerated for the other payments which were originally deferred. I think, therefore, that it would not be right for your Lordships in your order to give effect to that contention on the part of the Appellant………*"

134. Based on the above dictum laid down by the House of Lords and also subsequent pronouncements by the English courts reiterating the same principle the law on the point has been succinctly summarised in *Halsbury's Laws of England* (third edition), Volume 3, paragraph 655 in the following terms:—

> *"Where a bond is conditioned for the payment of a sum of money by stated instalments and it is provided that in*

> *default of payment of any one instalment the whole sum remaining unpaid shall become payable, the acceleration of the payment of the remaining instalments is not a penalty, and on default in respect of any instalment the entire sum may be claimed."*

135. The same principle has been embodied in illustration (f) to Section 74 of the Indian Contract Act which reads:

> *"A undertakes to repay B a loan of Rs. 1,000 by five equal monthly instalments, with a stipulation that in default of payment of any instalment, the whole shall become due. This stipulation is not by way of penalty and the contract may be enforced according to its terms".*

136. We have no hesitation in going to the extent of saying that where in a contract under which interest is payable it is agreed between the parties that if such interest be not paid punctually the defaulter shall be liable to pay interest at an enhanced rate, whether from the time of default or from the time when interest first became payable under the contract such agreement does not come within Section 74 of the Indian Contract Act, and is to be construed according to the intentions of the parties as expressed therein and not as a stipulation for a penalty. Such agreement is to be enforced according to its terms, unless it be found to have been when made unconscionable or fraudulent.

137. We had the advantage of looking into one very erudite judgment rendered by the Full bench of the Allahabad High Court in the case of ***Banke Behari and Ors v. Sundar Lal and Ors.*** reported in ILR

(1893) 15 All 232 (FB) wherein, seven learned Judges observed as under:

> *"It has been held in India, in cases to which we shall subsequently refer, that a contract to pay a higher rate of interest from the date of the contract, on default being made in payment of a lower rate of interest, is to be regarded as a stipulation for a penalty, to which s. 74 of the Indian Contract Act, 1872, is to be applied. It has also been held in India, and so far as we are aware, has been seldom doubted, that an agreement to pay a higher rate of interest from the date of the default in payment of a lower rate is a contract to be performed, and not a stipulation for a penalty to be relieved against, and that s. 74 of the Indian Contract Act, 1872, does not apply to such an agreement.*
>
> *The two propositions are clearly and concisely put in the judgment in* ***Nanjappa v. Nanjappa*** *reported in [12 M. 161 at pp. 166 and 167.]. Although the cases there put, like many of those in which this question has arisen, were cases in which a borrower had agreed to pay the principal money with certain interest on a given day, with a stipulation that a higher rate of interest should be paid if default were made, there cannot, as it appears to us, be any difference in principle between such cases and that which we are putting by way of illustration. In each case it is the stipulation as to a higher rate of interest, if it could be enforced, which would impose on the borrower the obligation of paying a larger sum than he would have to pay if no default were made. At pp. 166 and 167 of I.L.R., 12 Mad., the two propositions are thus stated:—*
>
> > *"<u>By the cases in this country it is well established that an agreement to pay a sum of money on a given day with interest at a certain rate with a stipulation that in default the debtor shall thenceforward pay a higher rate of interest is strictly enforceable. In such an agreement no question of penalty arises, because it imposes an obligation on the debtor to pay a larger sum than what was originally due. In the words of s. 74 of the Contract Act no sum is named as the amount to be paid in case of such breach. At the moment of the breach no larger sum can be exacted by the creditor, but from that date the terms on which the debtor holds</u>*

the money became less favourable. By the default he accepts the alternative arrangement of paying a higher rate of interest for the future. On the other land, where the stipulation is that on default the higher rate shall be payable from the date of the original obligation, the debtor does on default become immediately liable for a larger sum, viz., the difference between the enhanced and the original rate of interest already due."

We should have thought that in each of those cases the debtor by the default accepted the alternative arrangement of paying a higher rate of interest.

xxx xxx xxx

If a contract, the object of which is to ensure by a provision as to alternative rates of interest, the due and prompt payment of the principal and a lower rate of interest, is to be regarded as a penalty and relieved against, we may ask why do not the Courts in this country apply the same principle to money bonds or mortgages, in which it is agreed that the principle shall be repaid by periodic instalments, and that should default be made in paying an instalment, the balance of the principal shall at once become due and repayable? Is not time as much the essence of the contract in one case as in the other? Is not the provision to ensure prompt payment as much a stipulation in terrorem in one case as in the other? Is the hardship, if it be one, of a borrower being compelled to perform his contract any less a hardship in the one case than in the other? The hardship which may result by the non-payment of principal or interest on the agreed and specified date to a man who lends his capital or part of it, was apparently overlooked by those who were responsible for the evolution of this doctrine of a penalty. The borrower might not have had notice when the contract was made of the loss or damage which might result to the lender by reason of the non-performance of the contract to pay at the due date, and consequently the damages for the breach of contract which could in such a case be legally awarded might prove to be an utterly inadequate compensation. A money-lender cannot now-a-days be regarded in the eye of the law, as formerly he may have been, as hostis humani generis, and as long as his contract is not unconscionable or tainted with fraud, we fail to see *why the other contracting party should not be bound by it."*

(Emphasis supplied)

138. The dictum as laid in ***Banke Behari*** (supra) should be understood and applied, keeping in mind the nature of the transaction of bill discounting facility provided by the respondents to the appellant.

M. CASE LAW RELIED UPON BY THE APPELLANT:

139. We looked into the decision of this Court in the case of ***Central Bank of India*** (supra) on which strong reliance has been placed on behalf of the appellant**.** Having looked into the ratio or rather the dictum as laid in ***Central Bank of India*** (supra) on the issue of penal interest, we are of the view that the same has no application to the facts of the present case. The observations in para 55 placetum a-e of ***Central Bank of India*** (supra) would apply only to non-corporate borrowers as made clear at page 402 of the report placetum b-c. In fact, para 55(3) of ***Central Bank of India*** (supra) militates against the case set up by the appellant as it upholds the capitalization of interest on periodical rest if incorporated in contract voluntarily entered into between the parties. This aspect has been looked into by this Court in ***Punjab Financial***

Corporation v. Surya Auto Industries reported in (2010) 1 SCC 297 at 310 para 26. Over and above, in ***Hyder Consulting*** (supra) this Court had held that the application of ***Central Bank of India*** (supra) should be confined only to those cases under Section 34 of the CPC and the same cannot be treated as an authority for award of interest under Section 31(7) of the Act, 1996.

N. CONCLUSION

140. Our final conclusion may be summarised as under:

i. The arbitral tribunal rightly rejected the contention canvassed on behalf of the appellant as affirmed by the High Court in Section 34 and Section 37 proceedings respectively that the transaction between the parties is governed by the Usurious Loans Act, 1918 as amended by the Punjab Relief of Indebtedness Act, 1934. The Arbitral Tribunal and the High Court rightly returned a finding that the transaction between the parties was neither a loan nor a debt, rather it was simply in the nature of a commercial transaction. In other words, the parties had voluntarily/consciously entered into the bill discounting facility agreement.

ii. The arbitral tribunal including the High Court rightly held that the terms of payment of interest as mutually agreed upon by the parties *vide* sanction letters dated 27.12.2002 and 11.06.2003 respectively cannot be said to be unconscionable, arbitrary or excessive in case of non-payment after the stipulated due date. The arbitral tribunal and the High Court rightly rejected the contention of the appellant that interest could not have been added to the principal amount. It was rightly held that since the compounding of interest on monthly rest was provided in the mutually agreed terms of the contract entered into between the parties, the respondent herein was entitled to claim interest as per the terms of the contract, i.e., at the rate of 36% p.a. with monthly rest.

iii. There is no merit worth the name in the contention raised on behalf of the appellant that no specific notice was issued to it by the respondent for withdrawal of the concessional rate of 22.50% p.a. No such plea had been taken either before the arbitrator or in the proceedings before the High Court under Section 34 and Section 37 of the Act, 1996 respectively. This aspect does not find mention even in any of the responses to the notice of arbitration dated 28.06.2007, issued by the respondent herein or even in the statement of defence before the arbitrator or in the pleadings under Section 34 and Section 37 of the Act, 1996 respectively wherein, the rate of interest at the rate of 36% p.a. with monthly rest stood firmly embedded in the claim amount/award amount. Even if, we have to accept the contention, the same deserves to be rejected as no prejudice could be said to have been caused to the appellant due to lack of such notice.

iv. The discretion to grant interest would be available to the Arbitral Tribunal under clause (a) of sub section (7) of the Section 31 of the Act, 1996 only when there is no agreement to the contrary between the parties. When the parties agree with regard to any of the aspects covered in clause (a) of sub section (7) of the Section 31 of the Act, 1996, the arbitral tribunal would cease to have any discretion with regard to the aspects mentioned in the said provision. Once there is an agreement between the parties which provides that interest shall be at a particular rate, the arbitral tribunal thereafter is left with no discretion. In such circumstances, the arbitral tribunal would be bound by the terms of the agreement.

v. The maxim "*verba chartarum fortius accipiuntur contra proferentem'* has no application at all to the case in hand. This principle would not apply in case of commercial contracts for the simple reason that a clause in a commercial contract is bilateral and has mutually been agreed upon.

vi. The business model of the Respondent was posited on the grant of such unsecured facilities for very short periods of time, thereby enabling the Respondent to repeatedly redeploy the principal plus interest in its business. In the event of default, this cycle would stand disrupted for decades, as in the present case, thereby resulting in loss to the Respondent. Hence the compensatory contractual requirement of compounding, in the case of defaulters cannot be faulted or termed as penal.

vii. The express use of "*Unless otherwise agreed by the Parties*......" as the opening words of Section 31(7) (a) of the Act, 1996 is a clear instance of "Party Autonomy" which forms the bedrock of the arbitral process and will prevail in all cases, except where the legal provision is strictly non-derogable in nature e.g. the bar of limitation. The principle of unconscionability is inapplicable to voluntary commercial agreements between parties of equal bargaining strength.

viii. Significantly, the contractual clause for interest, in the present case provides for the levy of a concessional rate of interest, as an incentive for punctual repayment. The withdrawal of such concession for failure to abide by the terms thereof and the consequential levy of a higher rate, with compounding, cannot be faulted as being penal.

141. For all the foregoing reasons, the appeals fail and are hereby dismissed.

142. Pending application(s), if any shall stand disposed of.

.. J.
(J.B. PARDIWALA)

.. J.
(SANDEEP MEHTA)

New Delhi,
4th December, 2025.