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Supreme Court of India reaffirms party autonomy and the "Legitimate Interest" test in commercial arbitrations

The Hon'ble Supreme Court of India ("**Supreme Court**"), in the matter of ***BPL Limited v. Morgan Securities and Credits Private Limited***[1], has delivered a landmark judgment reinforcing the sanctity of commercial contracts and the doctrine of party autonomy. The Supreme Court held that in transactions between sophisticated commercial entities, a high rate of interest (36% p.a. with monthly rests) triggered by a default cannot be characterised as unconscionable or penal, provided it serves a legitimate business interest of the lender.

Brief Facts

BPL Limited ("**Appellant**") and its subsidiary entered into a bill discounting facility with Morgan Securities and Credits Private Limited ("**Respondent**"). The facility was governed by sanction letters issued in 2002 and 2003, which stipulated a concessional interest rate of 22.5% p.a., contingent upon timely repayment. Crucially, the agreement provided that in the event of default, the concession would be withdrawn, and a "normal" rate of 36% p.a. with monthly rests would be applicable from the date of the default.

Following a default exceeding INR 25 crore (Indian Rupees twenty five crore), the Respondent initiated arbitral proceedings. The arbitral tribunal awarded the claims with interest at the agreed rate of 36% p.a. with monthly rests up to the date of the award. This award was subsequently upheld by the Delhi High Court. The Appellant challenged the rate before the Supreme Court, contending that the interest was "penal", "expropriatory", and "opposed to public policy".

Issues

The Supreme Court identified and adjudicated upon the following core legal questions arising for its consideration:

1. Whether a high rate of interest (36% p.a. with monthly rests) stipulated in a commercial contract between sophisticated parties is hit by the rule against "penalties" under Section 74 of the Indian Contract Act, 1872?
2. Whether the arbitral tribunal's power to award interest under Section 31(7)(a) of the Arbitration and Conciliation Act, 1996 is restricted by the express agreement of the parties, thereby making such agreement the "bedrock" of the award?

[1] 2024 INSC 1380.

3. Whether an arbitral award can be set aside as being "opposed to the public policy of India" on the sole ground that the rate of interest awarded is allegedly high or unconscionable?
4. Whether the "Legitimate Interest" test—evaluating if a detriment is out of all proportion to the innocent party's interest—is applicable to determine the validity of deterrent contractual clauses in the Indian legal context?

Key Precedents Analysed:

The Supreme Court conducted a rigorous analysis of these judicial authorities, structuring its findings to resolve the core issues of penalty, statutory discretion, and public policy:

Addressing the Limits of Tribunal Discretion and Award Structure (Issue 2)

1. *Delhi Airport Metro Express Private Limited v. DMRC*[2]: The Supreme Court relied on this to establish the "supremacy of the agreement" under Section 31(7)(a) of the Arbitration and Conciliation Act, 1996. It held that when parties have agreed on interest, the Tribunal "cease(s) to have any discretion" and must be guided by the agreement. This served as a decisive bar against substituting the agreed rate with a "reasonable" alternative.
2. *Hyder Consulting (UK) Limited v. Governor, State of Odisha*[3]: Utilised to justify the compounding of interest, the Supreme Court affirmed that the word "sum" awarded simply means "a particular amount of money" which may include interest. Once merged, the components "lost their separate identities", rendering the challenge against "interest on interest" legally unsustainable.

Evaluating the Rule Against Penalties and "*in terrorem*" Clauses (Issues 1 & 4)

1. *Banke Behari v. Sundar Lal*[4]: The Supreme Court revived this full bench ruling to distinguish between a penalty and an "alternative arrangement". It held that a higher rate for default is strictly enforceable because "no sum is named as the amount to be paid in case of such breach"; rather, the terms on which the debtor holds the money simply become "less favourable".
2. *K.P. Subbarama Sastri v. K.S. Raghavan*[5]: Applied to determine that the 36% rate was not a move to drive the promisor "*in terrorem*" (in fear) but was a reflection of the "economic risk inherent in unsecured bill discounting", evaluated against the "background of the transaction".
3. *Fateh Chand v. Balkishan Dass*[6]: The Court distinguished this legacy ruling to update the standard for damages under Section 74 of the Indian Contract Act, 1872. It held that modern commercial realities require protecting a lender's "legitimate business interest", specifically the ability to redeploy capital rather than merely compensating for a proven, granular loss.

Applying the Modern "Legitimate Interest" Standard (Issue 4)

1. The *Cavendish Square Holding BV*[7] judgment serves as the pivotal analytical framework for the Supreme Court's determination of whether deterrent interest clauses are opposed to the public policy of India. By observing that the "Legitimate Interest" test has been embraced across diverse foreign jurisdictions, including Australia (*Andrews v. ANZ Banking Group Ltd*), New Zealand (*127 Hobson Street Ltd v. HKPL Ltd*), Malaysia (*Cubic Electronics Sdn Bhd v. Mars Telecommunications Sdn Bhd*), and Germany. The Supreme Court established that the modern global trend in commercial law has moved away from a purely compensatory view of damages.

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[2] (2024) 6 SCC 357.
[3] (2015) 2 SCC 189.
[4] ILR (1893) 15 All (FB).
[5] (1987) 2 SCC 424.
[6] 1963 SCC OnLine SC 49.
[7] *Cavendish Square Holdings BV v. Makdessi*, [2013] 1 All ER (Comm) 787.

2. This comparative analysis allowed the Supreme Court to adjudicate that the rule against penalties is not a "*quasi*-statutory code" but a substantive principle that must adapt to the "uncertain and fluctuating" nature of public policy in a globalized commercial landscape.

3. Consequently, when addressing whether "penal interest on penal interest" is opposed to public policy, the Supreme Court utilized the *Cavendish*[8] lens to conclude that such stipulations are valid if they serve a "legitimate business interest" that is not purely punitive. The Supreme Court held that in high-risk financial transactions like bill discounting, the lender's interest lies in the "cycle of redeployment of capital and maintaining liquidity". By adopting the *Cavendish*[9] standard, the Court determined that as long as the detriment imposed is not "out of all proportion" to the protection of this legitimate interest, the clause does not shock the conscience of the Court or violate public policy. This shift reinforces that party autonomy remains the "bedrock of the arbitral process", ensuring that sophisticated entities are held to their bargains even when the secondary obligations are deterrent in nature.

4. *Dunlop Pneumatic Tyre* (UK)[10]: Adjudged as no longer an absolute "*quasi*-statutory code". The Supreme Court held that the traditional *Dunlop*[11] tests for penalties are "helpful considerations" for simple contracts but are "insufficient for complex financial instruments".

Scrutinising Public Policy and Commercial Estoppel (Issue 3)

1. *Indian Bank v. Blue Jaggers Estates Limited*[12]: Affirmed that borrowers who have enjoyed facilities for years cannot later claim the terms are "unconscionable, expropriatory and contrary to law". The Supreme Court applied this to estop the Appellant from resiling from its bargain, noting that the Appellant was not a "vulnerable party" and the award did not shock the conscience of the Supreme Court.

2. *Central Bank of India v. Ravindra*[13]: The Supreme Court distinguished this case, holding that its observations on penal interest apply only to "non-corporate borrowers" and Section 34 of the Code of Civil Procedure, 1908. It clarified that *Ravindra* cannot be treated as an authority for Section 31(7) arbitrations where party autonomy is the absolute "bedrock".

Analysis and Findings

The Supreme Court held that the powers of an arbitral tribunal are inherently circumscribed by the arbitration agreement and the underlying contract. It observed that the express use of "*Unless otherwise agreed by the Parties..*". as the opening words of Section 31(7)(a) of the Arbitration and Conciliation Act, 1996, is a clear instance of "Party Autonomy" which forms the "bedrock of the arbitral process". Consequently, the Tribunal is "denuded of its discretion" to award interest at any other rate once the parties have reached a consensus.

Further, the Supreme Court has observed that a contractual provision for an enhanced rate of interest (36% p.a.) upon default is not a penalty if it protects a "legitimate business interest" that extends beyond mere pecuniary compensation. In this case, the interest rate served to protect the Respondent's cycle of capital redeployment and liquidity. The Supreme Court held that the law will not interfere with a remedy unless its adverse impact on the defaulter "significantly exceeds the legitimate interest" of the innocent party.

Following on the above, the Supreme Court drew a clear distinction between a traditional loan and a bill discounting facility. The latter is a high-risk, short-term funding mechanism where the lender's ability to redeploy principal and

[8] *id.*
[9] *id.*
[10] [1915] AC 79.
[11] *id.*
[12] (2010) 8 SCC 129.
[13] 2001 SCC OnLine SC 1266.

interest is critical. Consequently, the compensatory requirement of compounding in the case of default is a commercially justifiable safeguard against the disruption of the lender's business cycle.

It has been held that the principle of unconscionability is inapplicable to voluntary commercial agreements between entities of equal bargaining strength. The Appellant, being a sophisticated corporate entity, having wilfully entered into the agreement and enjoyed the benefit of the funds for decades, is estopped from assailing the interest clause as penal. Corporate borrowers are presumed to be the "best judges of what is legitimate" at the time of contracting.

Conclusion

This judgment clarifies that courts and tribunals must respect the interest rates agreed upon by commercial parties. The Supreme Court distinguished legacy statutory restrictions, most notably the *Central Bank of India vs. Ravindra*[14] precedent, by clarifying that such limitations apply to Section 34 of the Code of Civil Procedure, 1908 and are intended to protect non-corporate, vulnerable borrowers. In contrast, for commercial arbitrations under the Arbitration and Conciliation Act, 1996, the non-derogable principle of party autonomy prevails over generic statutory caps. The "Legitimate Interest" test is now the recognised standard in India to determine if a clause is penal, ensuring that "Party Autonomy" remains the fundamental principle of the arbitral process.

[14] *supra.*

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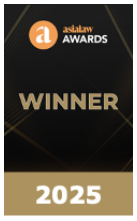

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