



ARBITRATION AND CONCILIATION

Contractual Bar on Interest in Arbitration: Supreme Court Clarifies Limits on Arbitrator's Powers

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Introduction

In a significant ruling on the scope of arbitral powers under the Arbitration and Conciliation Act, 1996, the Supreme Court of India in *Union of India v. Larsen & Toubro Ltd.*¹ has reaffirmed the primacy of contractual terms in determining the arbitrator's authority to award interest. The Court clarified that where a contract expressly prohibits the payment of interest, an arbitral tribunal cannot grant pre-award or pendente lite interest, even if such amounts are framed as compensation. At the same time, the Court reiterated that post-award interest operates under a distinct statutory framework and may still be granted in the absence of an explicit contractual prohibition. This decision is particularly relevant in the context of infrastructure and government contracts, where clauses restricting interest are commonly incorporated in standard contractual conditions.

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Factual Background

The dispute arose out of a contract dated 27 January 2011 between the Union of India, acting through the North Central Railway Administration, and Larsen & Toubro Limited for modernization works at the Jhansi Workshop. The project was awarded at a negotiated contract value of approximately ₹93 crore and was initially scheduled to be completed within eighteen months. However, the execution of the project encountered several operational and administrative challenges, resulting in repeated extensions of the completion timeline. Ultimately, the work was completed after a delay of nearly forty months beyond the original deadline. During the course of the project, disputes arose between the parties concerning delayed payments, variation costs, and other contractual claims. As the agreement incorporated an arbitration clause under the General Conditions of Contract (GCC), Larsen & Toubro invoked arbitration seeking resolution of the disputes.

Arbitral Proceedings and Award

Pursuant to the arbitration clause, a three-member arbitral tribunal was constituted. Larsen & Toubro raised multiple claims, including financing charges arising from delayed payments, foreign exchange variation costs, price variation component claims, final bill payments, and reimbursement of arbitration costs. The Union of India also filed a counterclaim alleging losses due to delayed commissioning of certain machinery. After considering the material on record and submissions of the parties, the tribunal delivered its award on 25 December 2018. The tribunal awarded Larsen & Toubro a net amount of ₹5,53,57,597. It further directed that if the awarded sum was not paid within sixty days, it would carry post-award interest at the rate of 12% per annum until realization.

Challenge Before the Courts

The Union of India challenged the arbitral award before the Commercial Court at Jhansi under Section 34 of the Arbitration and Conciliation Act, 1996. The principal contention was that the contract expressly prohibited payment of interest under Clause 16(3) and Clause 64(5) of the GCC, and therefore the arbitral tribunal had exceeded its jurisdiction in granting amounts which effectively included interest. The Commercial Court rejected the challenge, observing that the scope of judicial interference with arbitral awards under Section 34 is limited. The Union of India then preferred an appeal under Section 37 before the Allahabad High Court, which also upheld the award. Aggrieved by the concurrent findings of the lower courts, the Union of India approached the Supreme Court.

Issues Before the Supreme Court

The Supreme Court considered the following principal issues:

1. Whether the arbitral tribunal was justified in awarding pre-award or pendente lite interest despite the contractual prohibition contained in the GCC.
2. Whether the tribunal was entitled to grant post-award interest under the Arbitration and Conciliation Act, 1996.
3. Whether the courts below erred in refusing to interfere with the arbitral award under Sections 34 and 37 of the Act.

Supreme Court's Observations

The Court examined the contractual provisions governing interest, particularly Clause 16(3) and Clause 64(5) of the GCC. Clause 16(3) stipulated that no interest would be payable upon earnest money, security deposits, or amounts payable to the contractor under the contract. Clause 64(5) further provided that where an arbitral award directed payment of money, no interest would be payable on such amounts for any period until the date of the award. Interpreting these provisions in conjunction with Section 31(7)(a) of the Arbitration and Conciliation Act, the Court emphasized that the arbitrator's power to award interest is expressly subject to the agreement between the parties. The statutory language "unless otherwise agreed by the parties" makes it clear that party autonomy governs the question of pre-award interest.

The Court rejected the respondent's argument that the amounts awarded were merely compensatory in nature and not interest. It held that an arbitral tribunal cannot circumvent a contractual prohibition on interest by labeling such amounts as compensation. Since the contract expressly barred payment of interest, the tribunal lacked authority to award pre-award or pendente lite interest. However, the Court drew a distinction with respect to post-award interest. Under Section 31(7)(b) of the Act, a sum directed to be paid by an arbitral award carries interest from the date of the award until payment, unless the award itself provides otherwise. The Court noted that the contractual clauses in the present case only barred interest up to the date of the award and did not expressly exclude post-award interest.

Judgment of the Court

Allowing the appeal in part, the Supreme Court held that the arbitral tribunal had erred in awarding pre-award or pendente lite interest in violation of the contractual prohibition. Accordingly, the award was set aside to that extent. At the same time, the Court upheld the grant of post-award interest, observing that such interest flows from the statutory scheme under Section 31(7)(b) of the Act and cannot be impliedly excluded by contractual provisions that only restrict interest prior to the award. However, the Court found that the rate of 12% per annum awarded by the tribunal was excessive in the prevailing economic conditions. Exercising its powers, the Court modified the rate of post-award interest to 8% per annum from the date of the award until realization.

Conclusion

The Supreme Court's decision reinforces a fundamental principle of arbitration law: arbitral tribunals must operate within the confines of the contract agreed between the parties. Where a contract expressly prohibits the payment of interest, an arbitrator cannot award pre-award or pendente lite interest, even if framed as compensation. At the same time, the judgment clarifies that post-award interest is governed by a distinct statutory regime under the Arbitration and Conciliation Act, which ensures that successful parties are compensated for delays in the enforcement of arbitral awards.

The ruling is particularly significant for public infrastructure and government contracts, where clauses barring interest are frequently included in standard conditions of contract. It highlights the importance of carefully drafting and interpreting contractual provisions relating to interest, while also reaffirming the balance between party autonomy and statutory safeguards within India's arbitration framework.

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1. *Union of India v. Larsen & Toubro Ltd.* ??

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