Critique of the Insolvency & Bankruptcy Code, 2016

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This paper aims to examine the institutional framework contemplated by the Code, and highlight the opportunities and challenges posed in such framework. The same is segregated into – Adjudicating Authorities (for individuals, partnership firms, and corporate persons), Bankruptcy Trustees, Committee of Creditors, Insolvency Professional Agencies and Insolvency Professionals, Information Utility, and finally the Insolvency and Bankruptcy Board of India. The paper outlines the contemplated role and functions of each while providing a critique inline.

Introduction

Debt is a necessity in the modern day age, whether for individuals, corporates or even the government, as it fulfills the need to fund investments or

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expenses. Debt is good when it can be serviced and repaid as per the agreed terms, and it is within the means of the debtor to do so easily and conveniently. Debtors could default on their payment or repayment obligations, and in certain situations it may be because they are technically insolvent or bankrupt.

The statement of objects and reasons for the Insolvency & Bankruptcy Code, 2016 (the "Code") recognizes that:

> "(t)here is no single law in India that deals with insolvency and bankruptcy" and that there are several "statutes (that) provide for creation of multiple fora such as the Board for Industrial and Financial Reconstruction (the "BIFR"), the Debt Recovery Tribunal (the "DRT"), the National Company Law Tribunal (the "NCLT"), and their respective Appellate Tribunals. Liquidation of companies is handled by the High Courts. Individual bankruptcy and insolvency is dealt with under the Presidential Towns Insolvency Act, 1909 and the Provincial Insolvency Act, 1920 and is dealt with by the courts. The existing framework for insolvency and bankruptcy is inadequate, ineffective and results in undue delays in resolution, and therefore the proposed legislation."[1] (Emphasis supplied).

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1 The full text of the Statement of Objects and Reasons is as follows:

"(t)here is no single law in India that deals with insolvency and bankruptcy. Provisions relating to insolvency and bankruptcy for companies can be found in the Sick Industrial Companies (Special Provisions) Act, 1985, the Recovery of Debt Due to Banks and Financial Institutions Act, 1993, the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 and the Companies Act, 2013. These statues provide for creation of multiple fora such as the Board for Industrial and Financial Reconstruction (BIFR), Debt Recovery Tribunal (DRT) and National Company Law Tribunal (NCLT) and their respective Appellate Tribunals. Liquidation of companies is handled by the High Courts. Individual bankruptcy and insolvency is dealt with under the Presidential Towns Insolvency Act 1909 and the Provincial Insolvency Act, 1920 and is dealt with by the courts. <u>The existing framework for insolvency and bankruptcy is inadequate, ineffective and results in undue delays in resolution, and therefore the proposed legislation</u>.

The objective of the Insolvency and Bankruptcy Code, 2015 is to consolidate and amend the laws relating to reorganization and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximization of value of assets of such persons, to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders including alteration in the priority of payment of government dues and to establish an Insolvency and Bankruptcy Fund, and matters connected therewith or incidental thereto. An effective legal framework for timely resolution of insolvency and bankruptcy would support development of credit markets and encourage entrepreneurship. It would also improve ease of doing business, and facilitate more investments leading to higher economic growth and development."

The Code seeks to provide for designating the NCLT and DRT as the Adjudicating Authorities for corporate persons and firms and individuals, respectively, for resolution of insolvency, liquidation and bankruptcy. The Code separates commercial aspects of

Hence, resolving multiplicity of laws on the subject, streamlining the number of fora dealing with the subject, and finally, ensuring an adequate, effective and speedy resolution are the key objectives of the Code.

This paper aims to examine the institutional framework contemplated by the Code, and highlight the opportunities and challenges posed in such framework.

The institutional framework contemplated by the Code that has been analyzed and examined in this paper is segregated into – Adjudicating Authorities (for individuals, partnership firms, and corporate persons), Bankruptcy Trustees, Committee of Creditors, Insolvency Professional Agencies and Insolvency Professionals, Information Utility, and finally the Insolvency and Bankruptcy Board of India. The paper outlines the contemplated role and functions of each while providing a critique inline.

A. Adjudicating Authority

Section 78(3) of the Code states that the Adjudicating Authority for the purposes of Part III Insolvency Resolution and Bankruptcy For Individuals and Partnership Firms shall be the Debt Recovery Tribunal (DRT) constituted under the Recovery of Debts Due to Banks and Financial Institutions Act, 1993. This is in contrast to the district courts dealing with insolvency under the Provincial Insolvency Act, 1920 (other than cities governed by the Presidency Towns Insolvency Act, 1909, viz. Madras, Calcutta and Bombay where the respective High Courts have the jurisdiction).[2]

Constituting DRTs as the adjudicating authority for individuals and partnership firms will only add to the beleaguered status of DRTs that were set up primarily for aiding in summary proceedings for recovery of debts due to banks and financial institutions. The current DRTs set up across the country have huge pendency of recovery proceedings, and are already beset with

insolvency and bankruptcy proceedings from judicial aspects. The Code also seeks to provide for establishment of the Insolvency and Bankruptcy Board of India ("Board") for regulation of insolvency professionals, insolvency professional agencies and information utilities. Till the Board is established, the Central Government shall exercise all powers of the Board or designate any financial sector regulator to exercise the powers and functions of the Board. Insolvency professionals will assist in completion of insolvency resolution, liquidation and bankruptcy proceedings envisaged in the Code. Information Utilities would collect, collate, authenticate and disseminate financial information to facilitate such proceedings. The Code also proposes to establish a fund to be called the Insolvency and Bankruptcy Fund of India for the purposes specified in the Code."

[2] Section 78(3), Insolvency and Bankruptcy Code, 2016.

inadequate infrastructure and staffing.[3] Whilst multiple benches have been set up, DRTs are largely set up and operating in state capitals. Apart from adjudicating on debt recovery proceedings, they also consider appeals made against actions taken under SARFAESI Act vide Section 17 of such Act.

DRTs are already viewed as not having delivered on their primary role effectively. Clearly, this creaking and overburdened framework is ill-equipped to deal with the role envisaged for resolution of insolvency and bankruptcy of individuals and partnership firms, and will be further inundated with both existing and new matters that make for significant hurdles in justice delivery (both for the primary role of DRTs and also for the role envisaged under the Code). In comparison or as an alternative, civil courts at the district level may have been better fora to act as the adjudicating authority, given the multitude of matters that can arise since the parties comprised are individuals and partnership firms, besides ensuring that the judicial forum is available at a place closest to where the individual resides or the partnership firm is constituted.

Finally, it is submitted that a Judicial Impact Assessment should be especially undertaken in this respect. A Judicial Impact Assessment is a process where the Government anticipates the likely cost of and the infrastructure necessary for the implementation of a legislation to ensure the timely delivery of justice to litigants.[4] Stock must be taken of the pending matters under the Presidential Towns Insolvency Act and the Provincial Insolvency Act that would be transferred to the adjudicating authority that is finally designated, and for fresh matters that will arise, and the same should be taken

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3 *See*, following website for data published by DRT/DRAT, which mentions that pending matters in April 2016 before DRT are 50511 matters (for original application pendency) and 19430 matters (for securitization application pendency) [Source: *http://drt.gov.in/Pendency.aspx?page=DRTOAMonthWiseDisposal*], whilst in the same month, the disposal of matters is 796 (for original applications) and 294 (for securitization applications) [Source: *http://drt.gov.in/OADisposal.aspx?page=DRTOAMonthWiseDisposal*]. Further following news articles: http://timesofindia.indiatimes.com/business/india-business/Forget-grounding-defaulters-DRTs-ill-equipped-for-recovery/articleshow/51386635.cms; http://www.dnaindia.com/money/report-average-annual-loan-recovery-rate-under-debt-recovery-tribunal-estimated-at-25-report-2188028; http://articles.economictimes.indiatimes.com/2016-03-10/news/71382272_1_drts-debt-recovery-lakh-crore; http://www.thehindubusinessline.com/economy/unsettled-cases-with-debt-recovery-tribunals-on-the-rise-economic-survey/article8286181.ece; http://www.livemint.com/Politics/hNLONGGdDhODVNmiRyxHlM/Pending-cases-pile-up-at-debt-recovery-tribunals.html.

4 *See*, Report of the Task Force on Judicial Impact Assessment (June 15, 2008), *available at*: http://lawmin.nic.in/doj/justice/judicialimpactassessmentreportvol1.pdf, (Last visited on November 24, 2015) and N.R. Madhava Menon, *Judicial Impact Assessment and Timely Delivery of Justice*, The Hindu (June 27, 2008), *available at* http://www.thehindu.com/todays-paper/tp-opinion/judicial-impact-assessment-and-timely-delivery-of-justice/article1285106.ece (Last visited on November 23, 2015).

into account before bringing the law into force. Undertaking Judicial Impact Assessment may also be necessary for the Adjudicating Authority constituted for corporate persons, i.e. the NCLT and its appellate body, given the various references that would arise before it under the Companies Act, 2013 and the Code, and the transfer of matters from the various forums NCLT replaces, to ensure adequate staffing and constitution of multiple benches of NCLT.

B. Bankruptcy Trustee

Section 79(9) of the Code defines "bankruptcy trustee" to be the insolvency professional appointed as a trustee for the estate of the bankrupt under Section 125.[5] It is noted that the final report of the Bankruptcy Law Reform Committee states that the Bankruptcy Trustee is responsible for administration of the estate of the bankrupt and for distribution of the proceeds on the basis of priority.[6] The report does not dwell on the reason or logic for designating the administration and distribution role to a trustee.

The key legal concern around the concept of bankruptcy trustee is that the Code treats the insolvency professional so appointed as a 'trustee'. The law of trust (as contained in the Indian Trusts Act, and various case laws), and the role, responsibilities and duties of a trustee being imported into the Code (and hence operating in addition to the statutory responsibilities and duties specified in the Code), if unintended, can result in significant challenges to the mode and manner in which the insolvency professional is required to discharge the role, responsibilities and duties as a bankruptcy trustee. The unintended nature of designating the role as a trustee is discernable from the BLRC report, which has no mention made of the logic or reason for doing so. By way of illustration, any stakeholder could claim being a beneficiary for whom the bankruptcy trustee is responsible, and could prompt other stakeholders to raise rival demands. This would stall and indeed stymie the process that the bankruptcy trustee is charged with.

Designating the office as that of a bankruptcy administrator, who would be bound by the statutory responsibilities and duties specified in the Code (and also avoid unintended applicability of the law of trust), would be more appropriate and conducive towards the objectives envisaged.

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5 Section 79(9), Insolvency and Bankruptcy Code, 2016.

6 *See*, SUMMARY OF RECOMMENDATIONS OF THE BANKRUPTCY LAW REFORM COMMITTEE REPORT, *available at* http://finmin.nic.in/reports/BriefBLRCReport04112015.pdf (Last visited on November 16, 2015) and BANKRUPTCY LAW REFORM COMMITTEE REPORT VOLUME 1: RATIONALE AND DESIGN, *available at* http://finmin.nic.in/reports/BLRCReportVol1_04112015.pdf (Last visited on November 23, 2015).

C. Committee of Creditors

In case of corporate insolvency resolution process, the Committee of Creditors is constituted by the interim resolution professional vide Section 21 of the Code. The composition of the Committee of Creditors is required to be all the financial creditors of the corporate debtor, excluding related parties of the corporate debtor, and also the operational creditors. Financial creditors who are also operational creditors will be given representation on the committee of creditors only to the extent of their financial debts owed. Members are required to have the capability to assess the commercial viability of the corporate debtor and the willingness to modify the terms of the debt contracts in negotiations between the creditors and the corporate debtor. The Committee shall also have the power to call for information from the resolution professional. All decisions of the Committee shall be taken by a vote of not less than seventy-five per cent of the voting share.[7]

Exclusion of operational creditors has been explained in the Notes to Clauses of the Code as being on account of such creditors typically not being able to decide on matters relating to commercial viability of the corporate debtor, and their usual reluctance to take the risk of restructuring their debts in order to make the corporate debtor a going concern.[8] Nevertheless, in order to ensure that the financial creditors do not treat the operational creditors unfairly, a resolution plan is required to ensure that the operational creditors receive an amount not less than the liquidation value of their debt (assuming the corporate debtor were to be liquidated).

In the event there are no financial creditors for a corporate debtor, the composition and decision-making processes of the corporate debtor shall be specified by the Insolvency and Bankruptcy Board.

Section 22 provides that one of the main functions of the Committee of Creditors is the appointment of the resolution professional, and provides that at the first meeting of the Committee of Creditors, the Committee may decide to either appoint the interim resolution professional as the resolution professional or propose the name of another insolvency professional to be appointed as the resolution professional.[9] The Notes to Clauses recognize that the Committee of Creditors is likely to be most incentivized to select the person who is best suited for the task. As the fees payable to the resolution professional will in all probability be taken out of the company's

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[7] Section 21, Insolvency and Bankruptcy Code, 2016.
[8] *See*, Clause 21(2) in the Notes on Clauses appended to the Bill.
[9] Section 22, Insolvency and Bankruptcy Code, 2016.

assets (which will eventually affect the final repayment to the creditors), the committee tends to choose a person who is familiar with the company's business, activities or assets, or has skills, knowledge or experience in handling the particular circumstances of the case.[10]

The role of the Committee of Creditors is also enunciated by requiring the resolution professional to take actions only with the prior approval of the committee as per the terms of section 28.[11] Finally, it is the resolution plan that the Committee of Creditors receives through the resolution professional and determines whether to approve of the same or not,[12] or makes a determination to liquidate the corporate debtor.[13] The resolution professional notifies the Adjudicating Authority accordingly, for necessary orders.

In case of insolvency resolution and bankruptcy process for individuals and partnership firms, the Committee of Creditors is constituted by the bankruptcy trustee under Section 134.[14] The provisions in this behalf are not *in parimateria* with the provisions governing Committee of Creditors in the corporate insolvency resolution process.

There are several key differences between the two. For starters, the composition of the Committee is determined solely by the Bankruptcy Trustee and the provisions thereat clearly mention that a creditor shall not be entitled to vote in respect of a debt for an unliquidated amount, or any debt the value of which is not ascertainable, except where the Bankruptcy Trustee

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10 *See,* para 2 under Clause 22 in the Notes on Clauses appended to the Bill.

11 Section 28(1), Bankruptcy and Insolvency Code, 2016. This is required on items such as: "(a) raising any interim finance in excess of the amount as may be decided by the committee of creditors in their first meeting; (b) creating any security interest over the assets of the corporate debtor; (c) changing the capital structure of the corporate debtor, including by way of issuance of additional securities, creating a new class of securities or buying back or redemption of issued securities in case the corporate debtor is a company; (d) record any change in the ownership interest of the corporate debtor; (e) giving instructions to financial institutions maintaining accounts of the corporate debtor for a debit transaction from any such accounts in excess of the amount as may be decided by the committee of creditors in their first meeting; (f) undertaking any related party transaction; (g) amending any constitutional documents of the corporate debtor; (h) delegating its authority to any other person; (i) disposing of or permitting the disposal of shares of any shareholder of the corporate debtor or their nominees to third parties; (j) making any change in the management of the corporate debtor or its subsidiary; (k) transferring rights or financial debts or operational debts under material contracts otherwise than in the ordinary course of business; (l) making changes in the appointment or terms of contract of such personnel, as specified by the committee of creditors; or (m) making changes in the appointment or terms of contract of statutory auditors or internal auditors of the corporate debtor."

12 Section 30, Bankruptcy and Insolvency Code, 2016.

13 Section 33(2), Bankruptcy and Insolvency Code, 2016.

14 Section 134, Bankruptcy and Insolvency Code, 2016.

agrees to assign a value to such debt for the purposes of entitling the creditor to vote, and that the following creditors shall not be entitled to vote under this section, namely :– (*a*) creditors who are not mentioned in the list of creditors under Section 132 and those who have not been given a notice by the bankruptcy trustee; (*b*) creditors who are associates of the bankrupt.

Even in terms of oversight, the Bankruptcy Trustee is required to convene a meeting of the Committee of Creditors on completion of the administration and distribution of the estate of the bankrupt in accordance with the provisions of Chapter V. The Bankruptcy Trustee is to provide the Committee of Creditors with a report of the administration of the estate of the bankrupt in the meeting of the said committee. The Committee of Creditors shall approve the report submitted by the Bankruptcy Trustee under sub-section (2) within seven days of the receipt of the report and determine whether the Bankruptcy Trustee should be released under Section 148.

Whilst there is an element of control specified in Section 153 of the Code,[15] what is also noteworthy is that the Code proceeds to recognize the ability of the Bankruptcy Trustee to make decisions without requiring approval, wherein the Committee of Creditors may then ratify the actions of the Bankruptcy Trustee, only where the Bankruptcy Trustee has acted due to an urgency and has sought ratification without undue delay. This provision is absent in the corporate insolvency resolution process.

All these end up not providing the same level confidence and credibility for an effective role of creditors in case of insolvency resolution process for

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[15] The section provides that:

"The bankruptcy trustee for the purposes of this Chapter may after procuring the approval of the committee of creditors,— (*a*) carry on any business of the bankrupt as far as may be necessary for winding it up beneficially; (*b*) bring, institute or defend any legal action or proceedings relating to the property comprised in the estate of the bankrupt; (*c*) accept as consideration for the sale of any property a sum of money due at a future time subject to certain stipulations such as security; (*d*) mortgage or pledge any property for the purpose of raising money for the payment of the debts of the bankrupt; (*e*) where any right, option or other power forms part of the estate of the bankrupt, make payments or incur liabilities with a view to obtaining, for the benefit of the creditors, any property which is the subject of such right, option or power; (*f*) refer to arbitration or compromise on such terms as may be agreed, any debts subsisting or supposed to subsist between the bankrupt and any person who may have incurred any liability to the bankrupt; (*g*) make compromise or other arrangement as may be considered expedient, with the creditors; (*h*) make compromise or other arrangement as he may deem expedient with respect to any claim arising out of or incidental to the bankrupt's estate; (*i*) appoint the bankrupt to— (*i*) supervise the management of the estate of the bankrupt or any part of it; (*ii*) carry on his business for the benefit of his creditors; (*iii*) assist the bankruptcy trustee in administering the estate of the bankrupt."

individuals and partnership firms that the Code has recognized and provided expressly *vis-à-vis* insolvency resolution process for corporates.

A further aspect which the Code omits *vis-à-vis* the Committee of Creditors is in the case of liquidation of corporate persons when an insolvency professional is appointed as the liquidator. The role is intrinsically driven by the Adjudicating Authority, and can become beset with the same issues one has seen in the current regime governing winding up and liquidation. The interest of creditors when the corporate person has to be liquidated cannot be understated, after all it is the release of economic value that is embedded in the assets comprising the enterprise which repays the creditor, besides releasing such assets for more productive use.

That the liquidator is required to only consult all stakeholders – which would include the creditors – is articulated in the following manner: *The liquidator shall have the power to consult any of the stakeholders entitled to a distribution of proceeds under section 53: Provided that any such consultation shall not be binding on the liquidator.*[16] There is a provision that empowers the creditors to require the liquidator to provide them any financial information relating to the corporate debtor in such manner as may be specified, and the liquidator is required to provide information to such creditors who have requested for such information within a period of three days from the date of such request. However, he has also been given the power to refuse to provide such information by providing reasons for the same.[17]

There will undoubtedly be situations where the liquidator needs to be independent of the creditors,[18] and in those limited instances the Adjudicating Authority can be the final word. But for the day-to-day management and disposal of assets, the Committee of Creditors can indeed play an important and essential role in the overseeing and functioning of the liquidator.

In a similar manner, the Code omits the role that the Committee of Creditors can play in respect of insolvency resolution for individuals. The creditors are expected to provide information and receive information including in the resolution plan (except those who have initiated the insolvency process), while the resolution professional and the Adjudicating Authority drive the process.

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[16] Section 35(2), Insolvency and Bankruptcy Code, 2016.

[17] Sections 37(2) and (3), Insolvency and Bankruptcy Code, 2016.

[18] A couple of instances that frequent arise are: avoidance being sought of extortionate credit transactions under Section 50 of the Code or rejection of claim of a person being a creditor under Section 40.

One particular item that is reiterated in this context is that the Notes on Clauses which recognize that – *the committee of creditors are likely to be most incentivized to select the person who is best suited for the task — as the fees payable to the resolution professional will in all probability be taken out of the company's assets (which will eventually affect the final repayment to the creditors), they will often choose a person who is familiar with the company's business, its activities or assets or has skills, knowledge or experience in handling the particular circumstances of a case*[19] – holds true for insolvency resolution process for individuals and partnership firms too, as well as for the Bankruptcy Trustee and the liquidators of corporate persons. It is recommended that the provisions be aligned in the chapter dealing with insolvency resolution process for individuals and partnership firms with that of corporate insolvency resolution process in respect of the Committee of Creditors, and the omissions outlined above be addressed.

D. New set of professionals underpinning the resolution, insolvency and bankruptcy framework contemplated by the Code

As per Section 3(20), "insolvency professional agency" means any person registered with the Board under Section 201 as an Insolvency Professional Agency.[20]

Sections 199 prohibits any person from carrying on its business as an Insolvency Professional agency and enroll Insolvency Professionals as its members except under and in accordance with a certificate of registration issued in this behalf by the Board. Section 200 lays down the principles governing registration of Insolvency Professional Agencies. It provides that the Board must have regard to the following principles: a) to promote the professional development of and regulation of Insolvency Professionals; b) to promote the services of competent Insolvency Professionals to cater to the needs of debtors, creditors and such other persons as may be specified; c) to promote good professional and ethical conduct amongst Insolvency Professionals; d) to protect the interests of debtors, creditors and such other persons as may be specified; e) to promote the growth of Insolvency Professional Agencies for the effective resolution of insolvency and bankruptcy processes under the Code.[21]

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19 *See*, para 2 under Clause 22 in the Notes on Clauses appended to the Bill.

20 Section 3(20), Insolvency and Bankruptcy Code, 2016.

21 Section 199, Insolvency and Bankruptcy Code, 2016.

As per Section 3(19) of the Code, an "insolvency professional" means a person enrolled with an Insolvency Professional Agency as its member and registered with the Board as an Insolvency Professional under Section 207.[22]

Section 207 prohibits any person from rendering his services as an Insolvency Professional under this Code without being enrolled as a member of an Insolvency Professional Agency. It states that every Insolvency Professional shall, after obtaining the membership of any Insolvency Professional Agency, register himself with the Board within such time, in such manner and on payment of such fee, as may be specified.[23]

Section 208 lays down the functions and obligations of Insolvency Professionals. An Insolvency Professional must take action with respect to the following matters: (a) a fresh start process under Chapter II of Part III; (b) individual insolvency resolution process under Chapter III of Part III; (c) corporate insolvency resolution process under Chapter II of Part II; (d) individual bankruptcy process under Chapter IV of Part III; and (e) liquidation of a corporate debtor firm under Chapter III of Part II.[24]

In essence, the various roles contemplated in the Code *viz.*, Resolution Professional (for individuals and partnership firms,[25] and for corporate persons[26]), Bankruptcy Trustee (for individuals and partnership firms[27]), and Liquidator (for corporate persons[28]) are to be played by the Insolvency Professional.

This makes the Insolvency Professional a cornerstone and a very essential player within the various resolution and insolvency processes contemplated by the Code.

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[22] Section 3(19), Insolvency and Bankruptcy Code, 2016.
[23] Section 207, Insolvency and Bankruptcy Code, 2016.
[24] Section 208, Insolvency and Bankruptcy Code, 2016.
[25] As per Section 79(20), a "resolution professional" means insolvency professional appointed under this Part (Part III) as a resolution professional for conducting the fresh start process or insolvency resolution process.
[26] As per Section 5(27), a "resolution professional", for the purposes of this Part (Part II Insolvency Resolution and Liquidation for Corporate Persons), means an insolvency professional appointed to conduct the corporate insolvency resolution process and includes an interim-resolution professional.
[27] As per Section 79(8), a "bankruptcy trustee" means the insolvency professional appointed as a trustee for the estate of the bankrupt under section 125.
[28] As per Section 5(18), a "liquidator" means an insolvency professional appointed as a liquidator in accordance with the provisions of Chapter III or Chapter V of this Part (Part II Insolvency Resolution and Liquidation For Corporate Persons), as the case may be.

What is also noteworthy is the role of the Insolvency Professional Agency contemplated by the Code. Section 204 provides that an Insolvency Professional Agency shall perform the following functions:

(a) Grant membership to persons who fulfil all requirements set out in its bye-laws on payment of membership fee;

(b) Lay down standards of professional conduct for its members;

(c) Monitor the performance of its members;

(d) Safeguard the rights, privileges and interests of Insolvency Professionals who are its members;

(e) Suspend or cancel the membership of Insolvency Professionals who are its members on the grounds set out in its bye-laws;

(f) Redress the grievances of consumers against Insolvency Professionals who are its members; and

(g) Publish information about its functions, list of its members, performance of its members and such other information as may be specified by regulations.[29]

Section 205 provides for the subject matter of the bye-laws of Insolvency Professional Agencies. It states that every Insolvency Professional Agency, after obtaining the approval of the Board, shall make bye-laws to provide for:

(a) the minimum standards of professional competence for its members;

(b) the standards for professional and ethical conduct of its members;

(c) requirements for enrolment of persons as its member which shall be non-discriminatory;

(d) the manner of granting membership to persons who fulfill its requirements;

(e) setting up of a governing board for its internal governance and management in accordance with the regulations specified by the Board;

(f) the information required to be submitted by its members including the form and time for submitting such information;

(g) the specific classes of persons to whom services shall be provided at concessional rates or for no remuneration by its members;

[29] Section 204, Insolvency and Bankruptcy Code, 2016.

(h) the grounds on which penalties may be levied upon its members and the manner thereof;

(i) a fair and transparent mechanism for redressal of grievances against its members;

(j) the grounds under which the Insolvency Professionals may be expelled from its membership;

(k) the quantum of fee and the manner of collecting fee for inducting persons as its members;

(l) the curriculum for enrolment of persons as its members which shall not be less than the curriculum specified by the Board;

(m) the manner of conducting examination of the curriculum specified by the Board for enrolment of Insolvency Professionals;

(n) the manner of monitoring and reviewing the working of Insolvency Professionals who are its members;

(o) the duties and other activities to be performed by its members;

(p) the amount of registration bond and performance security to be furnished by an Insolvency Professional for the performance of his duties, and the form and manner in which such registration bond and performance security shall be furnished to the Insolvency Professional agency;

(q) the manner of conducting disciplinary proceedings against its members and imposing penalties; and

(r) the manner of utilizing the amount received as registration bond or performance security in case where penalty imposed against any Insolvency Professional remains unpaid.[30]

The exposition of these makes clear that the Insolvency Professional Agency is contemplated on lines akin to how a stock exchange operates (in having stockbrokers as its members and regulating their activities and conduct of business), with Insolvency Professionals becoming members of such an agency and being governed by its bye-laws on the matters specified.

Some thoughts and concerns for consideration are as under:

- The draft of the rules and norms governing registration and functioning of Insolvency Professional Agencies and Insolvency Professionals and the draft byelaws (or model byelaws to ensure uniformity of

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[30] Section 205, Insolvency and Bankruptcy Code, 2016.

approach amongst Insolvency Professional Agencies) should hence be issued for public comments.

- The interest of persons interested in establishing such agencies or becoming such professionals should be duly assessed and encouraged, or else the framework may lack sufficient number of such agencies and professionals.
- An additional concern would be that an Insolvency Professional should not gravitate towards only one role (among the four contemplated), and should be required to undertake each of such roles, regardless of whether such diversity is ensured continually or periodically (semi-annually or annually)and fresh mandates/roles should be barred in roles which are disproportionate/excessive to required norms.
- The final concern is regarding a major disincentive for persons to become Insolvency Professionals or an Insolvency Professional Agency – the concept of performance bond/security that is contemplated in the Code. Whilst the Bill in Section 206 provided for posting of a performance bond/security, following the report of the Joint Parliamentary Committee, this requirement has been eliminated.[31]

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[31] The provision as it stood under the Bill, stated that:

"On the commencement of an insolvency resolution process, where an insolvency resolution professional is appointed:

(a) the insolvency professional agency where such insolvency professional is registered as a member, shall post a performance bond with the Board in such form and manner as may be specified; and

(b) the insolvency professional shall deposit with the insolvency professional agency a performance security of an amount and in a manner as specified.

The performance bond so posted shall provide for:

(a) the concerned insolvency professional agency to act as a surety for the obligations of the insolvency professional and to be jointly and severally liable for losses in relation to any person whose interests are prejudicially affected by any act of fraud or gross misconduct of the insolvency professional; and

(b) the payment of claims in respect of losses mentioned in (a), which shall be equal in amount, to at least the value of the assets of the corporate debtor or the debtor as on the insolvency commencement date or the insolvency commencement date of the debtor, as the case may be.

This creates three levels of issue: firstly, the performance bond (from the insolvency professional agency) is in favour of the Insolvency & Bankruptcy Board. This could have been fashioned as being in favour of the Adjudicating Authority, since any accusation made of fraud or gross misconduct are bound to arise before the Adjudicating Authority, which would also adjudicate over such accusations.

Secondly, the insolvency professional agency is made into a surety and jointly and severally liable, rather than such liability being that of the insolvency professional. It adds an unnecessary layer within a chain of direct accountability, and also can be a disincentive for formation and establishment of insolvency professional agencies.

E. Creation of an Information Utility by the Code

As per section 3(21), "information utility" means a person who is registered with the Board as an information utility under Section 210.[32]

Section 210 provides that the form and manner of an application for registration of an information utility may be specified. It puts a time limit of 7 days for acknowledgement of the application. On receipt of the application, the Board may, grant a certificate of registration to the applicant, or reject, by order, such application. It provides that no order rejecting the application shall be made without giving the applicant an opportunity of being heard, and that every such order shall be communicated to the applicant within a period of fifteen days. If the application is accepted, the Board may issue a certificate of registration to the applicant in such form and manner and subject to such terms and conditions as may be specified. The Board may renew such certificate from time to time in such manner and on payment of such fee as may be specified.[33]

It further provides that the Board may, by order, suspend or cancel the certificate of registration granted to an information utility on any of the following grounds: (a) if it has obtained registration by making a false statement or misrepresentation or by any other unlawful means; (b) if it has failed to comply with the requirements of the regulations made by the Board; (c) if it has contravened any of the provisions of the Code, or the rules made thereunder; (d) any other ground as may specified. It provides that no order shall be made under this sub-section without giving the information utility concerned a reasonable opportunity of being heard. It also provides that no

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Finally, the extent of moneys to be secured by the performance bond has been specified as being equal in amount to at least the value of assets of the corporate debtor or the debtor. This extent of security having to be furnished will result in a very high entry barrier, if not discourage entry itself - for persons desirous of being insolvency professionals or insolvency professional agencies. The financial implications of requiring such extent of security need to be reconsidered, given that corporates (or even individuals), faced with prospects of debt that is rendering them insolvent or bankrupt or requiring resolution can have very high quantum of assets on their books/balance sheet.

While the objective of requiring direct accountability of the insolvency professional for fraud or gross misconduct cannot be denied, it is submitted that the current mode and manner of specifying the same renders the keystone/cornerstone of the insolvency, bankruptcy and resolution framework in form of insolvency professional and insolvency professional agency an unviable proposition and hence one should not expect persons to enter this activity as a reasonable prudent business decision with the current requirements remaining in place."

[32] Section 3(21), Insolvency and Bankruptcy Code, 2016.

[33] Section 210, Insolvency and Bankruptcy Code, 2016.

such order shall be passed by any member except whole-time members of the Board.[34]

The role and responsibility of an information utility is provided in Section 214, which states that an information utility has the following obligations:

(a) Create and store financial information in a universally accessible format;

(b) Accept electronic submissions of financial information from persons who are under obligation to submit financial information under sub-section (2) of Clause 215, in such form and manner as may be specified;

(c) Accept, in specified form and manner, electronic submissions of financial information from persons who intend to submit such information;

(d) Meet such minimum service quality standards as may be specified;

(e) Get the information received from various persons authenticated by all concerned parties before storing such information;

(f) Provide access to the financial information stored by it to any person who intends to access such information in such manner as may be specified;

(g) Publish such statistical information as may be specified.[35]

Section 215 provides that any person who intends to submit financial information to the information utility or access the information from the information utility shall pay such fee and submit information in such form and manner as may be specified. It also provides that a financial creditor or, as the case may be, an operational creditor shall submit financial information and information relating to secured assets in such form and manner as may be specified.[36]

Section 216 provides for the rights of persons submitting financial information to an information utility. They shall have the following rights: (a) to correct errors or update or modify any financial information so submitted in such manner and within such time as may be specified; and (b) to demand the information utility to remove from its records the information

[34] Section 210, Insolvency and Bankruptcy Code, 2016.
[35] Section 214, Insolvency and Bankruptcy Code, 2016.
[36] Section 215, Insolvency and Bankruptcy Code, 2016.

so submitted, with the concurrence of all counterparties to any contracts or agreements, in such manner and within such time as may be specified.[37]

The information utility envisaged as above and in the Code adds to the number of repositories of information that are already present, and does not serve to consolidate, or in essence become a super-repository.

Specifically, under the Companies Act, the Registrar of Companies is already a key repository of vital and important records that companies are required to file. In terms of limited liability partnerships (LLPs), a similar registrar of LLPs plays a similar role especially within the register of charges that records security interest. For pledge of shares, the depositories established under the Depositories Act, 1996 are the repository of information on such pledges (apart from being a repository of ownership of securities). In the financial services sector, there are the credit information bureaus registered and regulated by the Credit Information Companies Act, 2005, a central registry for recording security interest (presently equitable mortgages in favour of banks but proposed to be expanded for a variety of assets that are secured) established under the Securitisation and Asset Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI), and the Central Repository of Information on Large Credits (CRILC)[38] constituted by the Reserve Bank of India, which capture security or credit facility details. Finally, there are various registries under the laws governing civil aviation,[39] maritime activities,[40] motor vehicles,[41] and so on that both record ownership and security interest (and hence relevant for secured financing transactions involving such assets) as also the Sub-registrar of assurances in every state under the Inspector General of Stamps & Registration,[42] that record ownership of land, buildings, property and security interest therein (and hence relevant when security is taken in the form of English mortgage or registered mortgage and in some states filings made for equitable mortgages).

By adding the Information Utility as a further repository, without requiring the existing repositories to pool the available information and records

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37 Section 216, Insolvency and Bankruptcy Code, 2016.

38 See, *Master Circular - Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances* bearing number RBI/2015-16/101 DBR.No.BP.BC.2/21.04.048/2015-16 dated July 1, 2015, *availableat* https://rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9908#25 (Last visited on November 24, 2015).

39 *See*, Aircraft Act, 1934.

40 *See*, Merchant Shipping Act, 1958.

41 *See*, Motor Vehicles Act, 1988.

42 *See*, Registration Act, 1908.

with them and thereby consolidate such information, is a very big missed opportunity.

It is noteworthy that the obligation is cast on the financial creditors and operational creditors to submit financial information and information relating to assets in relation to which any security has been created against payment of fees. The debtor in question, whether a corporate person or an individual or a partnership firm, is not enjoined with any obligation, and in reality, the creditors can have information only as pertains to their credit facility and security, if any, obtained, but not necessarily the financial or asset information of the corporate person or the individual/partnership firm – unless tendered by them at the time of availing the credit facility or thereafter as part of contractual terms governing the credit facility (which many times suffer from being delayed in submission, and ascertaining the veracity or authenticity of which is beyond the ability of the creditor, who necessarily has to rely on the auditors certification if any made on such information).

In the course of resolution, insolvency or bankruptcy process, the critical information, apart from the credit facilities and the security for such facility, is really the knowledge of unencumbered assets, (i.e. assets that have not been secured to any creditor), assets under hire purchase but possession of the debtor, details of encumbrances such as leases, unpaid taxes of the properties or assets, the status of the debtors' properties and assets, and so on. These have unfortunately not been made a mandatory part of the information to be furnished or maintained by the Information Utility.

Taking the above into account, the utility of the Information Utility to the resolution, insolvency or bankruptcy process as envisaged in the Code is highly debatable.

F. Insolvency and Bankruptcy Board of India

Section 188 establishes the Insolvency and Bankruptcy Board of India. It provides that the board will be a body corporate having perpetual succession and a common seal. The Board will have its head office in Mumbai, and have the power to establish offices at other places in India.[43]

Section 189 provides for the constitution of the Insolvency and Bankruptcy Board. It provides that the Board shall consist of members who shall be appointed by the Central Government. It shall have one chairperson, three ex-officio members from the Central Government (one each to represent the

43 Section 188, Insolvency and Bankruptcy Code, 2016.

Ministry of Finance, the Ministry of Corporate Affairs and the Ministry of Law), one member nominated by the RBI (ex-officio), and five other members of whom at least three shall be whole-time members. It further provides that every appointment made under this clause (other than for the ex-officio members) shall be made after the recommendation of a selection committee. The term of office of the Chairperson and the members (other than ex-officio members) shall be five years or till they attain the age of sixty five years, whichever is earlier. The salaries and allowance, and the terms of conditions of service of all members (other than the ex-officio members), shall be such as may be prescribed.[44]

Among the innovative approaches adopted in the Code is the establishment of the Insolvency and Bankruptcy Board. With the envisaged resolution, insolvency and bankruptcy framework creating new types of entities such as the Insolvency Professionals, the Insolvency Professional Agencies [*which in turn are to undertake four different roles – Resolution Professional (for individuals, partnership firms, and corporate persons), Bankruptcy trustee (for individuals and partnership firms), Liquidator (for corporate persons), to be played by the insolvency professional*] and the information utility, the need for a regulatory body cannot be overstated and hence deserves commendation.

The key test for the success of the Insolvency and Bankruptcy Board is in being open and transparent in terms of specifying the norms for registration and regulation of the entities, including publishing drafts for public comments (which is enshrined in the articulation of its functions), and ensuring it involves all the stakeholders in rolling out the new regime for resolution, insolvency and bankruptcy.

A brief snapshot of the role and functions are outlined here:[45]

(a) "Register insolvency professional agencies, insolvency professionals and information utilities and renew, withdraw, suspend or cancel such registrations;

(b) Specify the minimum eligibility requirements for registration of insolvency professional agencies, insolvency professionals and information utilities;

(c) Levy fee or other charges for the registration of insolvency professional agencies, insolvency professionals and information utilities;

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[44] Section 189, Insolvency and Bankruptcy Code, 2016.

[45] Extracts from Section 196, Bankruptcy and Insolvency Code, 2016.

(d) Specify by regulations standards for the functioning of insolvency professional agencies, insolvency professionals and information utilities;

(e) Lay down by regulations the minimum curriculum for the examination of the insolvency professionals for their enrolment as members of the insolvency professional agencies;

(f) Carry out inspections and investigations on insolvency professional agencies, insolvency professionals and information utilities and pass such orders as may be required for compliance of the provisions of this Code and the regulations issued hereunder;

(g) Monitor the performance of insolvency professional agencies, insolvency professionals and information utilities and pass any directions as may be required for compliance of the provisions of this Code and the regulations made thereunder;

(h) Call for any information and records from the insolvency professional agencies, insolvency professionals and information utilities;

(i) Publish such information, data, research studies and other information as may be specified by regulations;

(j) Specify by regulations the manner of collecting and storing data by the information utilities and for providing access to such data;

(k) Collect and maintain records relating to insolvency and bankruptcy cases and disseminate information relating so such cases;

(l) Constitute such committees as may be required including in particular the committees laid down in section 197;

(m) Promote transparency and best practices in its governance;

(n) Maintain websites and such other universally accessible repositories of electronic information as may be necessary;

(o) Enter into memorandum of understanding with any other statutory authorities;

(p) Issue necessary guidelines to the insolvency professional agencies, insolvency professionals and information utilities;

(q) Specify mechanism for redressal of grievances against insolvency professionals, insolvency professional agencies and information utilities and pass orders relating to complaints filed against the aforesaid for compliance of the provisions of this Code and the regulations made thereunder;

(r) Conduct periodic study, research and audit the functioning and performance of the insolvency professional agencies, insolvency professionals and information utilities at such intervals as may be specified by the Board;

(s) Specify mechanisms for issuing regulations, including the conduct of public consultation processes before notification of any regulations;

(t) Make regulations and guidelines on matters relating to insolvency and bankruptcy as may be required under this Code; and

(u) Perform such other functions as may be prescribed."

More importantly, the ability of the Insolvency and Bankruptcy Board to act with the speed and the timelines the Code contemplates as being one of the key roles of the Insolvency and Bankruptcy Board within the resolution, insolvency and bankruptcy process is critical. That is, if such a role is indeed desired – ideally, what is outlined below, could be done away with and this paper proceeds to outline the issues and possible alternatives:

Take for example, Section 82 that deals with appointment of a resolution professional (which provision is part of chapter applicable to individuals or partnership firms governed by the resolution, insolvency and bankruptcy process) that states:

> "(1) Where an application under section 80 is filed by the debtor through a resolution professional, the Adjudicating Authority shall direct the Board within two days of the date of receipt of the application and shall seek confirmation from the Board that —
>
> (a) there are no disciplinary proceedings against the resolution professional who has submitted the application; and
>
> (b) such resolution professional has relevant expertise or is suitable to act as a resolution professional for the fresh start process.
>
> (2) The Board shall communicate to the Adjudicating Authority in writing either —
>
> (a) confirmation of the appointment of the resolution professional who filed an application under sub-section (1); or
>
> (b) rejection of the appointment of the resolution professional who filed an application under sub-section (1) and nominate a resolution professional suitable for the fresh start process.

(3) Where an application under section 80 is filed by the debtor himself and not through the resolution professional, the Adjudicating Authority shall direct the Board within two days of the date of the receipt of an application to nominate a resolution professional for the fresh start process.

(4) The Board shall nominate a resolution professional within ten-days of receiving the direction issued by the Adjudicating Authority under sub-section (3).

(5) The Adjudicating Authority shall by order appoint the resolution professional recommended or nominated by the Board under sub-section (2) or sub-section (4), as the case may be.

(6) A resolution professional appointed by the Adjudicating Authority under sub-section (5) shall be provided a copy of the application for fresh start.

(7) The resolution professional appointed by the Adjudicating Authority shall furnish a performance security in accordance with section 206."[46]

The approach outlined where there is back and forth between the Adjudicating Authority and the Insolvency and Bankruptcy Board on the status and qualification of the Insolvency Professional (here designated as a resolution professional) makes redundant the fact of the Insolvency and Bankruptcy Board having created and established a registration and regulatory regime governing Insolvency Professionals.

It is akin to a situation where a court desires a bank guarantee to be furnished, and its writing to RBI seeking confirmation that the bank is licensed, can issue such a guarantee, and honour the guarantee. It is also akin to professionals governed by self-regulated statutory bodies such as the Institute of Chartered Accountants of India or the Bar Council of India being asked to vouchsafe the credentials of the chartered accountant or a lawyer and their expertise, and is a mark of either being over-cautious to a fault or not anticipating the benefit of the Insolvency Professional being duly registered and regulated.

The approach in Section 82 is by no means unique. It also finds a place in Sections 16(3)(a) and 16(4) (*Appointment of interim resolution professional*), Section 22(4) (*Appointment of resolution professional*), Sections

[46] Section 82, Insolvency and Bankruptcy Code, 2016.

34(4)(b) and 34(6) (*Appointment of liquidator*), Section 97 (*Appointment of Resolution professional*), Section 125 (*Appointment of insolvency professional as bankruptcy trustee*), as well as provisions governing replacement of such professionals whether on account of resignation or removal sought by the Committee of Creditors or the Adjudicating Authority or the Insolvency and Bankruptcy Board itself. It is also noteworthy that whilst all the provisions cited above capture the role of the Insolvency and Bankruptcy Board, the specification of its functions in Section 196 do not even dwell on the same, including the procedure it would specify and adhere to for such situations.

One particular situation – namely, when the debtor has filed the application himself and not through an Insolvency Professional – requiring the regulator to recommend and nominate an Insolvency Professional appears to be an over-reach, and could lend itself to accusations of favoritism and arbitrariness.

It is submitted that for the former situation, where the application has been filed through an Insolvency Professional, the professional can append the certificate of registration and self-attest the lack of a disciplinary proceeding and affirm having due expertise. In the latter situation, just as a court identifies a lawyer for indigent litigant, Insolvency Professionals can be identified and appointed by the Adjudicating Authority, and following the constitution of the Committee of Creditors, either the continuance can be affirmed or the professional can be changed. Similarly, should the credentials of the Insolvency Professional be challenged, the website of the Insolvency and Bankruptcy Board can be utilized or specific confirmation can be sought. Finally, should an Insolvency Professional resign or be removed, the onus of identifying the replacement can be placed on the Committee of Creditors.

Having said that, it is reiterated that the process underpinning the resolution, insolvency and bankruptcy process should be one which is clear and smooth so as to be able to meet the objectives of the Code, and which explicitly recognizes that the regime currently operating (which the Code seeks to replace) is "*inadequate, ineffective and results in undue delays in resolution*", and that it would be incumbent to ensure we do not repeat or indeed create fresh procedures which would result in the same conclusions being drawn from the resolution, insolvency and bankruptcy process contemplated by the Code.

Conclusion

The overarching objects as set forth in the statement of objects and reasons are laudatory and indeed much needed for reform of the resolution, insolvency and bankruptcy regime governing corporate persons as well as individuals and partnership firms.

One fundamental aspect that the statement of objects and reasons also touches upon, and could potentially shape judicial decisions, is that the Code aims to separate the commercial aspects of insolvency and bankruptcy proceedings from the judicial aspects. In India, as with everything, it is mainly the procedures and the institutional infrastructure that hold back the substantive reforms, and it is borne out in the institutional framework contemplated by the Insolvency and Bankruptcy Code as analyzed and examined above.

The lawmakers are urged to attend urgently to making this infrastructure and institutional framework efficacious. Not addressing the issues identified could plague the corporate sector and the common man alike. Duly addressing the issues can further the objectives of development of the credit markets, encouraging entrepreneurship, improving the ease of doing business and facilitating investments leading to higher economic growth and development.

The Indian Equalisation Levy: Inelegant but not Unexpected

*Shreya Rao**

The taxation of income from cross border e-commerce is a difficult issue on which there has been little international consensus over the last two decades. This paper argues that the challenge of finding a suitable solution is even more difficult for a developing country like India on account of distributive iniquities in the international tax treaty framework. Although BEPS efforts have made some progress in recognising these iniquities, they stop short of recommending a feasible, internationally acceptable alternative. This has left countries to find their own unilateral measures, such as the Indian equalisation levy. However, such responses are imperfect, short-term solutions that are likely to create more issues than they will resolve. An internationally workable solution may only be possible through a deeper engagement with distributive allocations and the principle of nexus.

Introduction

India has often favoured transaction taxes as the solution to difficult questions of income tax design. For example, we replaced our dividend withholding system with a dividend distribution tax ("DDT") in 1997[1] to resolve

* I would like to thank Sriram Govind and Samira Varanasi for valuable inputs. Any inadvertent errors that may remain are mine alone.

the issue that "the procedure for tax collection is cumbersome and involves a lot of paper work"[2]. We replaced our long-term capital gains tax on listed securities with the securities transaction tax in 2004[3] to "simplify the tax regime on securities transactions"[4]. We briefly introduced a banking cash transaction tax[5] (the "BCCT")"to prevent generation and laundering of black money through the banking channels"[6] and a fringe benefits tax[7] (the "FBT") as an expenditure tax coexisting alongside employee level perquisite taxes, to maintain equity in relation to taxation of fringe benefits which were not individually attributable to employees.[8]

In 2016, this theme was extended to the complex issue of taxation of e-commerce, through introduction of an equalisation tax under Finance Bill 2016. By charging a flat rate of tax on the consideration paid for digital services, the levy hopes to address the challenges endemic to *income* taxation of the digital economy.

Unfortunately, the history of the Income Tax Act, 1961 ("ITA") demonstrates that we have tended to falter when we have included non-income based levies within the framework of the ITA. The DDT accorded us the dubious distinction of being the only country amongst the Organisation for Economic Cooperation and Development ("OECD") and Brazil, Russia, India, China and South Africa ("BRICS") countries, aside from Estonia, which taxes the distribution transaction rather than income in the hands of shareholders. Its incompatibility with the international tax framework and Indian domestic tax provisions has led to a call for it to be replaced by a dividend withholding tax.[9] The BCCT was deleted in 2009[10], a mere 5 years after its introduction, for reasons that are not provided in the Explanatory

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1 Introduced by the Finance Act, 1997.

2 Explanatory Notes to the dividend tax provisions introduced by Finance Act, 2007, *available at* http://indiabudget.nic.in/ub1997-98/mem/MEM2.HTM (Last visited on May 17, 2016).

3 Chapter VII, Finance Act, 2004.

4 Explanatory Notes to Chapter VII of Finance Act 2004, *available at* http://indiabudget.nic.in/ub2004-05/mem/mem1.pdf (Last visited on May 17, 2016).

5 Introduced by the Finance Act, 2005.

6 Explanatory Notes to the Banking Cash Transaction Tax contained in Circular No 3/ 2005, *available at* http://www.incometaxindia.gov.in/Communications/Circular/910110000000000482.htm (Last visited on May 17, 2016).

7 Introduced by the Finance Act, 2005.

8 Explanatory Notes to the Banking Cash Transaction Tax contained in Circular No 3/ 2005, *available at* http://www.incometaxindia.gov.in/Communications/Circular/910110000000000498.htm (Last visited on May 17, 2016).

9 Indraneel Roy Chaudhury, *Taxation of Dividend Income* (Occasional Paper No. 6, International Tax Research and Analysis Foundation, 2016), *available at* http://www.itraf.org/document/OccasionalPaper-6.pdf (Last visited on May 17, 2016).

10 Section 95 of the Finance Act, 2008 with effect from April 1, 2009.

Notes.[11] The FBT was cursed as beingill - conceived[12] constitutionally challenged[13], and then finally deleted in 2009[14] after causing several years of difficulty to taxpayers. These taxes failed, in spite of having a legitimate objective, because they were imposed without investing sufficient thought into preserving the conceptual harmony of the ITA.

The structure of the new equalisation levy leaves one with a sense of foreboding that it may suffer a similar fate. It has been introduced as a separate code in itself, removed from the other parts of the ITA. It is unclear whether it is intended to function as a withholding tax on the income of the non-resident or a transaction tax on the payment of consideration for specified services. Questions have also been raised as regards its constitutionality and whether it results in a treaty override. However, most importantly, it may not solve existing problems with the taxation of non-residents on their e-commerce income, since there is a growing refrain that its economic burden is likely to be passed on to Indian payers.

Against this background, this piece sets out to create a bird's eye mapping of the terrain relating to e-commerce taxation in India. I highlight some instances of conceptual dissonance in income characterisation, examine the inequity of distributive rules and then analyse the usefulness of the equalisation levy in this context. My primary argument is, that while the current tax framework makes it challenging for us to effectively tax non-residents on their Indian source e-commerce income[15], the equalisation levy is an inelegant solution that will create more issues than it will solve. What we need instead is a deeper thinking domestically as well as internationally on the challenges relating to e-commerce taxation.

At an immediate level, this means that India needs to structure its Base Erosion and Profit Shifting ("BEPS") based levies in a manner that respects

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11 *See* Clause 46.3 of the Explanatory Notes to Finance Act 2008, *available at* http://incometaxindia.gov.in/Communications/Circular/910110000000000152.htm (Last visited on May 17, 2016).

12 Arvind P Datar, KANGA & PALKHIVALA'S THE LAW AND PRACTICE OF INCOME TAX, 1940 (10th edn., 2014).

13 Subhoy Bhattacharjee and Tina Ediwn, *SC Upholds the Constitutional Validity of fringe tax* THE ECONOMIC TIMES (March 11, 2006), *available at* http://articles.economictimes.indiatimes.com/2006-03-11/news/27454652_1_fbt-fringe-constitutional-validity (Last visited on May 18, 2016). The case itself seems to be unreported.

14 The Explanatory Notes to Finance Act 2009 justify the deletion on the basis that FBT provisions were sought to be rationalised. *See,* the notes *available at* http://incometaxindia.gov.in/Communications/Circular/910110000000000152.htm (Last visited on May 17, 2016).

15 Resident taxpayers earning e-commerce income are subject to Indian income tax on their worldwide income, which is why the issues discussed below are largely irrelevant in their case.

our treaty obligations and preserves the conceptual integrity of the ITA. At an international level, more definitive criteria are required as to when the BEPS Action Plan 1 ("AP 1") recommendations should be applied. Further, the nexus test must be re-evaluated to address the inequities surrounding existing distributive rules in tax treaties.

A. Challenges with the current system of e-commerce taxation: Royalty and FTS

There are three main possibilities for taxation of e-commerce under Indian domestic law, namely, royalties, fees for technical services (the "FTS") and business income. This section discusses the Indian statutory and treaty framework and case law relating to royalty and FTS.

To set the context, payments are characterized as royalties if they are made for the transfer or use of intellectual property or provision of information or services concerning such IP.[16] Payments are considered FTS if they are made for managerial, technical or consultancy services.[17]

Judicial precedents on FTS are not as fractious as those dealing with royalty. Cases tend to agree on some broad principles – that services require a technical element to result in FTS beyond the fact that they are provided via a media involving technology[18], and that automated services without a human element should be excluded from the purview of the FTS provision.[19]

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[16] Explanation 2, Section 9(1)(vi), Income Tax Act, 1961.

[17] Explanation 2, Section 9(1)(vii), Income Tax Act, 1961.

[18] *See*, Bharati Axa General Insurance Co. Ltd., In re, 2010 SCC OnLine AAR 27, Software Technology Parks of India v ITO, 3 SOT 529; Wipro Ltd. v ITO, 80 TTJ 191; Ebay International Ag, Mumbai v Assessee, ITA, No.6784/M/2010. For more nuanced examples of how the OECD and Indian revenue authorities would classify an activity as resulting in FTS *see,* Organisation for Economic Co-operation and Development, Technical Advisory Group, *Tax Treaty Characterisation Issues Arising from E-Commerce*, (2001), *available at* http://www.oecd.org/tax/consumption/1923396.pdf (Last visited on May 18, 2016) ("OECD Report") and Central Board of Direct Taxes, High Powered Committee, *Electronic Commerce and Taxation*, (1999), *available at* http://www.rashminsanghvi.com/articles/taxation/electronic_commerce/finmin.html (Last visited on May 18, 2016) ("CBDT Report"). As per these reports, the OECD would classify an activity as resulting in business income if it relates to application hosting (separate contract) or customer support. Activities relating to data warehousing, application hosting in a bundled format, software maintenance may result in business income or FTS. The activity of providing professional advice such as consultancy over an electronic medium would typically result in FTS. In comparison, the Indian position is that application hosting (whether relating to a separate or bundled license) would result in royalty or FTS income. Data warehousing would result in royalty income, while customer support and professional consultancy online would result in FTS income. Software maintenance may result in business or FTS income depending on the nature of the activity.

[19] CIT v Bharti Cellular Ltd., 44 DTR 190.

In comparison, royalty income characterisation has seen substantial, often discordant, litigation on characterisation issues. For this reason, the following section focuses exclusively on royalty income and attempts to provide a flavour of how Indian case law has found it difficult to apply consistent standards on royalty characterisation. I then try to explain this variance by briefly touching upon the distributive rules in tax treaties as applied to royalty income, which are more equitable than the rules relating to FTS. To put it differently, we may explain the royalty tax debate as deriving from a struggle between what the law is and what it should be.

I. CHARACTERISATION AS ROYALTIES

As discussed above, payments are typically characterised as royalty if they are made for the transfer or use of intellectual property or information or services concerning such IP. Explanation 2 to section 9(1)(vi), ITA contains an exhaustive definition of the term, and states as follows:

> "Explanation 2— For the purposes of this clause, "royalty" means consideration (including any lump sum consideration but excluding any consideration which would be the income of the recipient chargeable under the head "Capital gains") for—
>
> (i) <u>the transfer of all or any rights (including the granting of a licence)</u> in respect of a patent, invention, model, design, secret formula or process or trade mark or similar property;
>
> (ii) <u>the imparting of any information concerning the working of, or the use of</u>, a patent, invention, model, design, secret formula or process or trade mark or similar property;
>
> (iii) <u>the use of</u> any patent, invention, model, design, secret formula or process or trade mark or similar property;
>
> (iv) <u>the imparting of any information</u> concerning technical, industrial, commercial or scientific knowledge, experience or skill;
>
> (iva) <u>the use or right to use any industrial, commercial or scientific equipment but not including</u> the amounts referred to in section 44BB;
>
> (v) <u>the transfer of all or any rights (including the granting of a licence)</u> in respect of any copyright, literary, artistic or scientific work including films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting,

but not including consideration for the sale, distribution or exhibition of cinematographic films; or

(vi) the rendering of any services in connection with the activities referred to in sub-clauses (i) to (iv), (iva) and (v). [Emphasis Suppled]"

This definition has been examined and interpreted by various cases. Of these, there are two sub-categories which are particularly relevant to e-commerce– a) those dealing with supply of software or information in digital form and b) those dealing with supply of services such as advertising or hosting services over the internet. The distinction between intangible goods and services is to some extent artificial, since e-commerce may blur the difference between income from sale of goods and income from provision of services[20] – however, in an Indian context, it may be justified by the difference in reasoning applied by the courts based on their reliance on different parts of Explanation 2. Cases on digital goods typically apply sub-clause (v) whereas the service related cases typically apply (iva), (vi) or one of the other service related provisions.

a. Supply of digital goods

A key debate in e-commerce taxation is whether the sale of digital goods involves an underlying element of transfer of IP i.e. whether it involves the sale of a copyright or copyrighted product.[21] In the absence of such underlying IP, proceeds from the sale would be considered business income and subject to a different set of source rules than those applicable to royalty.

The issue has seen heavy litigation on account of the unique nature of digital goods, which typically involve an end user license agreement or a copy being made on the random access memory of the user's/ distributor's computer, even if the commercial agreement is closer to a sale than a license. Therefore, the position of the Technical Advisory Group of the OECD has been that when income is generated from goods provided online, it should be treated as business profits and not royalties.[22] Indian courts have ruled both ways on the issue.

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20 *See*, Jeffery Owens, *The Tax Man Cometh to Cyberspace,* 14 Tax Notes International, 1833 (1997).

21 For cases on this point in a non e-commerce context, *see* the Karnataka High Court ruling in CIT v Samsung Electronics Co. Ltd., (2011) 203 Taxman 477, Delhi High Court rulings in DIT v Nokia Networks, OY 253 CTR 417 (Delhi) and DIT v Ericsson AB, (2012) 66 DTR 1 and ruling of the Authority for Advance Rulings ("AAR") in Citrix Systems Asia Pacific Pty Ltd, In re (2012) 18 taxmann.com 172 (AAR - New Delhi).

22 OECD Report.

The seminal case on this point is the Supreme Court ruling in *Tata Consultancy Services* v *State of A.P.*[23], which held in the context of sales tax that the sale of shrink wrap software involved the sale of a copyrighted article and not the transfer of copyright.

This distinction has been applied by income tax cases in the context of shrink wrap software and other IP protected products provided in the digital format. One such decision is the Mumbai Income Tax Appellate Tribunal ("ITAT") ruling in *Dun & Bradstreet Information Services* v *ADIT*[24]. Here, a US resident company providing credit information in the form of "business information reports" ("BIRs") stored these reports on a server situated in the US. The BIRs were sold worldwide through subsidiaries set up in the relevant region - for the Asia Pacific region, the distributor and server were in Singapore. Neither the US nor the Singapore entity had a Permanent Establishment ("PE") in India. The payments were made by purchasers resident in India. Revenue authorities argued that the payment for the BIRs should be characterised as royalty and therefore subject to tax in India. The Mumbai ITAT rejected this argument and held that the BIRs were akin to books and that their sale involved the sale of a copyrighted product rather than the underlying copyright. Thus, it was held that the income of Dun & Bradstreet from these sales would be business income, which would not be taxable in India in the absence of a PE in India. Other cases have made a similar distinction in the context of digital products sold over the internet, upholding the business income characterisation of proceeds, and reiterating that they should not be taxable in the absence of a PE in India.[25]

At the same time, other courts have rejected this position in the context of very similar digital products. One instance is the Karnataka High Court ruling in *CIT* v *Wipro Ltd.*[26] Here, an Indian resident, M/s Wipro Limited made payments to the M/s Gartner Group, a company with entities in the US and Ireland, for access to Gartner's research reports. The Bangalore ITAT examined the nature of subscription payments and information provided by Gartner, and held that the payments were not royalty since a) the proprietory rights in the information continued to remain with Gartner, b) the customer had a very limited right of internal use over the information, and c) the Gartner products were essentially in the nature of

[23] Tata Consultancy Services v State of A.P., (2005) 1 SCC 308.
[24] Dun & Bradstreet Information Services v ADIT, 2010-TII-59-ITAT-MUM-INTL.
[25] DIT v Solid Works Corpn., 2012 SCC OnLine ITAT 205; Infrasoft Limited v ADIT, 2009-TIOL-21-ITAT-DEL (2009); CIT v Metapath Software International Ltd., (2006) 9 SOT 305.
[26] CIT v Wipro Ltd., (2011) 203 TAXMAN 621 (Kar).

publications rather than an individually provided information or advice.[27] On appeal, the Karnataka High Court overturned this ruling and classified the payments as royalty on the basis that the payment was for "imparting of information" under sub clause (ii) of Explanation 2.[28] The High Court in this case also placed reliance on a previous Karnataka High Court ruling in *CIT* v *Samsung Electronics Co.*[29] where sale of shrink wrap software was considered to result in royalty.[30] This reliance is problematic, because the *CIT* v *Samsung Electronics Co.* ruling arrives at its conclusion on the basis of an incomplete appreciation of the distinction between a copyright and the copyrighted product made in *Tata Consultancy Services* v *State of A.P.*[31]

However, the Karnataka High Court rulings spurred several subsequent decisions where payment for digital goods was classified as royalty[32] and the issue continues to be litigated and subject to inconsistent standards notwithstanding a 2012 legislative amendment that attempted to put the matter to rest.[33] What is also troublesome, is the manner in which the reclassification of Gartner's product from a "publication" to "technical information" ena-

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[27] Wipro Ltd. v Income Tax Officer, 2005 278 ITR 57 Ban.

[28] CIT v Wipro Ltd., (2011) 203 TAXMAN 621 (Kar).

[29] CIT v Samsung Electronics Co., ITA No 2808/2005 and others.

[30] *See also*, Microsoft Corporation v ADIT,(2010) 134 TTJ 257 (Del); ING Vysya Bank Ltd. v DDT, (I.T.A. No.160(Bang.)(2010).

[31] In Tata Consultancy Services v State of A.P., (2005) 1 SCC 308 : (2004) 271 ITR 401, the Supreme Court held that a shrink wrap software was a good, stating as follows: "*That a computer program may be copyrightable as intellectual property does not alter the fact that once in the form of a floppy disc or other medium, the program is tangible, moveable and available in the marketplace.*"In CIT v Samsung Electronics Co. Ltd., 2011 SCC OnLine Kar 3973, the Karnataka High Court held:

> "In the said TCS's case, it has been held that copyright in computer program may remain with the originator of the program, but, the moment copies are made and marketed, it becomes goods, which are susceptible to tax. The contention of the assessee that the consideration received by the non-resident supplier towards the software products would amount to 'royalty' within the meaning of DTAA with respective country was not at all considered in the said case. Therefore, the said decision in TCS's case is not helpful to the respondents in the present cases."

[32] *See*, Gartner Ireland Limited v ADIT, ITA No. 7101/ Mum/ 2010; CIT v Synopsys International Old Ltd., ITA No. 11/2008; Microsoft Corporation v ADIT, (2010) 134 TTJ 257 (Del), ING Vysya Bank Ltd. v DDT, (I.T.A. No.160(Bang.)/2010).

[33] The Finance Act, 2012 introduced Explanation 4 to Section 9(1)(vi), Income Tax Act, 1961 which states as follows:

> "For the removal of doubts, it is hereby clarified that the transfer of all or any rights in respect of any right, property or information includes and has always included transfer of all or any right for use or right to use a computer software (including granting of a license) irrespective of the medium through which such right is transferred. This amendment was unfortunate for two reasons – firstly, it was applied retrospectively with effect from 1976. Secondly, it did not do much to change the position regarding taxation of non-residents, since most of them were situated in treaty jurisdictions and the narrower treaty definitions continued to exclude goods such as shrink wrap software from the definition of royalty, notwithstanding the amendment of Indian domestic law".

bled the Bangalore ITAT and the Karnataka High Court to arrive at such divergent views regarding the same product. Digital products tend to allow for ample opportunity for such reclassification – this makes it likely that tax laws will be applied with more subjectivity when technological innovations take place.

b. Supply of services in digital form

Decisions relating to the taxation of digital services mirror the inconsistency observed in the context of digital products.

In *ITO* v *People Interactive (I) Pvt. Ltd.*,[34] the taxpayer was the company behind the shaadi.com portal, which has resident as well as non-resident users. Web hosting services were availed from Rackspace, a US based provider of cloud hosting services. The services provided by Rackspace included bandwidth and connectivity services, server management and data security. The revenue officer relied on United Nations Model Double Taxation Convention between Developed and Developing Countries, 2011 ("UN Model Treaty")[35] commentary to argue that Rackspace had allowed shaadi.com the right to use its server, which should result in characterisation as royalty. Arguments were also made as regards the "control" exercised by shaadi.com over the server space to determine whether the relationship between the parties was of a lease of server capacity or mere provision of a hosting service. The Mumbai ITAT came to the conclusion that the services were merely in the nature of hosting, partly on the basis that the payer could not operate or "even have no physical access" to the equipment system.

While the ruling appears to be correct, its reasoning leaves one wondering whether control may be thus objectively determined in a digital / cloud services context. There is likely to be a very subjective line dividing payment for a dedicated service of providing server space and hosting (amounting to business income) and payment for leasing of cloud capacity (amounting to royalty). Clearer and more crystallised criteria are required while dealing with technology that defies these classifications. For example, in *Cargo Community Network (P)Ltd.*,[36] the Authority for Advance Rulings ("AAR")

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34 ITO v People Interactive (I) Pvt. Ltd., TS-129-ITAT-2012.

35 *See*, United Nations Model Double Taxation Convention between Developed and Developing Countries, 2011, *available at* http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf (Last visited on May 18, 2016) and Commentary on UN Model Double Taxation Convention between Developed and Developing Countries.

36 Cargo Community Network (P) Ltd., In re, 2007 SCC OnLine AAR 1 : (2007) 289 ITR 355.

held that payments made for access to an off-shore portal were royalties on the following reasoning:

> "The use of the portal is not possible without the use of the server that provides internet access to the cargo agents/subscribers on the one hand and to different airlines on the other hand for to and fro communication. Therefore, the portal and the server together constitute integrated com-mercial-cum-scientific equipment and for obtaining internet access to airlines the use of the portal without the server is unthinkable… Therefore, payments made for concurrent access to utilize the sophisticated services offered by the portal, would be covered by the expression "royalties".

The AAR based its ruling on the fact that the portal was accessible at will, disregarding the emphasis that *ITO* v *People Interactive (I) Pvt. Ltd.* had placed on "control", which should ordinarily be essential to making a distinction between the leasing of portal space and the service of hosting.[37] Similarly, in *Thoughtbuzz Pvt. Ltd.* v *DIT*[38] the AAR's ruling swung on the basis of "access" rather than "control" when it held that amounts received from offering of subscription services in India were taxable as royalties.[39] Rulings such as *In Re, Dishnet Wireless Ltd.,*[40] and *Globus Stores P. Ltd., Mumbai* v *Department Of Income Tax,*[41] *Pinstorm Technologies Pvt Ltd* v *ITO,*[42] *Yahoo India Pvt Ltd* v *DCIT*[43] *and ITO* v *Right Florists Ltd.*[44] further emphasise the unpredictability of the standard being applied by courts and tribunals on this point.[45]

A. Distributive Rules & their Correlation to Tax Rates

The examples above are not exhaustive but are intended to provide a flavour of how there is much subjectivity in application of tax principles in the

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37 *See also*, Kotak Mahindra Primus Ltd. v DIT, 105 TTJ (Mumbai) 578 or Standard Chartered v DIT, Mumbai ITA, No. 3824/Mum/2006 & Others.

38 Thoughtbuzz Pvt. Ltd. v DIT, (2012) 250 CTR (AAR) 1.

39 The AAR accepted the revenue's argument that the subscription mechanism enabled the customer to access data, through a sophisticated computer system maintained by the applicant.

40 Dishnet Wireless Ltd., In re, 2012 SCC OnLine AAR 49.

41 Globus Stores P. Ltd. v Department Of Income Tax, (2013) 140 ITD 103 (Mum).

42 Pinstorm Technologies (P) Ltd. v ITO, (2012) 54 SOT 78 (Mum).

43 Yahoo India Pvt Ltd v DCIT, (2011) 140 TTJ 195 (Mum).

44 ITO v Right Florists Ltd., I.T.A. No: 1336/ Kol/ 2011.

45 *See also*, AAR ruling in P. No. 30 of 1999; Frontline Soft Ltd v DCIT, 12 DTR 131; Asia Satellite Telecommunication Co. Ltd. v DIT, 85 ITD 478 (Delhi) and Millennium Infocom Technologies Ltd. v ACIT, 117 ITD 114 (Delhi); Dell International Services (India) P. Ltd., In re 305 ITR 37; In Re, ISRO Satellite Centre 307 ITR 59.

digital economy. The inequitable nature of distributive rules contained in tax treaties, in juxtaposition with the opportunity offered by new technologies to reinterpret treaty rules, further emphasizes this point. Let us take a closer look at how royalty taxing rights are shared between countries.

Article 12 of the OECD Model Tax Convention on Income and on Capital, 2014 ("OECD Model Treaty") gives the residence country the entire rights to tax royalties and technical services.[46] Furthermore, it does not recognise the "fees for technical services" classification at all, except where such services are ancillary to actions resulting in royalty income.[47]

Indian treaties broadly follow the OECD Model Treaty provisions[48] with elements of the UN Model Treaty.[49] However, on the subject of royalties, India rejects the inequitable distributive allocation prescribed by Article 12 of the OECD Model Treaty - we typically apply limited taxes at 10-15% on the gross amount of outgoing royalties and FTS.[50] This is similar to the limited payer-based tax suggested by the UN Model Treaty[51] and similar to, though narrower than, our domestic tax provisions which follow a payer based approach.[52]

46 Article 12, OECD Model Convention with respect to taxes on Income and on Capital, 2014, *available at* https://www.oecd.org/ctp/treaties/2014-model-tax-convention-articles.pdf (Last visited on May 18, 2016). The United Nations Model Double Taxation Convention between Developed and Developing Countries, 2011 recognises the inequitable sharing of royalty taxing rights as an issue with Article 12 of the OECD Model. It notes that "royalty payments flow almost entirely from developing countries to developed countries" before going on to recommend a payer based royalty source provision through the introduction of Article 12(5)". *See*, The United Nations Model Double Taxation Convention between Developed and Developing Countries, 2011and Commentary on UN Model Double Taxation Convention between Developed and Developing Countries, Paragraph 4 and 9, on Articles 12 (1)&(2), 208.

47 *See*, the United Nations Model Double Taxation Convention between Developed and Developing Countries, 2011 and draft commentary on this point, which seeks to carve out a separate FTS provision in tax treaties, *available at* http://www.un.org/esa/ffd/wp-content/uploads/2015/10/11STM_CRP.5_Services.pdf (Last visited on May 20, 2016).

48 OECD Model Convention with respect to taxes on Income and on Capital, 2014.

49 United Nations Model Double Taxation Convention between Developed and Developing Countries, 2011.

50 *See*, for example, Article 12 of the double taxation avoidance agreements that India has entered into with Australia, Canada, China and USA, or Article 13 of the India-UK treaty.

51 Article 12, United Nations Model Double Taxation Convention between Developed and Developing Countries, 2011.

52 *See*, the royalty source rule contained in Section 9(1)(vi), Income Tax Act, 1961 or the FTS source rule contained in Section 9(1)(vii), Income Tax Act, 1961. These payer-based source provisions are not the most elegant, and result in unintended consequences as I have argued in the past(*See*, Shreya Rao, *India's Right to Tax*, 49(1) Tax Notes International 75-82 (2008). Their expansive nature may also be considered unconstitutional and result in them being read down, if they are challenged in a court of law. (*See*, Arvind P Datar, Kanga & Palkhivala's The Law and Practice of Income Tax, 352-353 (10th edn., 2014). However, a large section of Indian case law dealing with royalty and FTS income does not

Even so, most Indian treaties continue to follow the narrower OECD Model Treaty definition of "fees for technical services".[53] This means that there is a greater possibility that income may be considered as FTS under Indian law, but characterised as "business income" under a tax treaty and thus subject to Article 5 read with Article 7 of the relevant treaty.[54] To put this differently, the structural format of Indian treaties is often as inequitable as that of the OECD Model Treaty on the subject of source taxation of FTS - this may also be one way to explain the relative absence of discordant case law in the context of FTS, in comparison to the large amount of Indian litigation on royalty taxation.

A word of caution is important here. While India has successfully rejected the inequities of the OECD Model Treaty in the context of royalties, we have failed to be mindful of the fact that expenses continue to be claimed by the recipient in the country of residence. The commentary to the UN Model Treaty also emphasises this point when it urges source countries to consider the cost of development of the IP.[55] Indian royalty and FTS withholding provisions are applied at 25% on a gross basis.[56] If this tax is to be equitable, the recipient should at least have a profit margin of 75%, with the residence country having no taxing rights! I have elaborated on this in some greater detail in the section below on the equalisation levy.

B. Existing regime for taxation of e-commerce: Business Income

The third category of characterisation pertains to business income. This section attempts to highlight the narrowness of situations where e-commerce entities satisfy the taxable presence threshold for business income, through the creation of a PE. The emphasis again is on the inequity of distributive rules.

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apply these Income Tax Act, 1961, based source rules, in favour of a tax treaty provision, on account of section 90(2) of the Income Tax Act, 1961 which states as follows:

> "(2) Where the Central Government has entered into an agreement with the Government of any country outside India or specified territory outside India, as the case may be, under sub-section (1) for granting relief of tax, or as the case may be, avoidance of double taxation, then, in relation to the assessee to whom such agreement applies, the provisions of this Act shall apply to the extent they are more beneficial to that assessee."

[53] *See*, United Nations Model Double Taxation Convention between Developed and Developing Countries, 2011 and draft commentary for this point, which seeks to carve out a separate FTS provision in tax treaties, *available at* http://www.un.org/esa/ffd/wp-content/uploads/2015/10/11STM_CRP.5_Services.pdf (Last visited on May 20, 2016).

[54] Please see the analysis in the next section on why this threshold fails to protect source country tax rights in a digital economy context.

[55] Commentary on UN Model Double Taxation Convention between Developed and Developing Countries, Paragraph 8 and 9 on Articles 12 (1) & (2), 210.

[56] Section 115A, Income Tax Act, 1961.

To set the context, non-resident business income is only taxable in India under the ITA if there is a business connection[57] or under a tax treaty if there is a PE.[58] The term business connection is not statutorily defined, but is much broader than the concept of PE[59]. Case law has interpreted business connection to mean a "*real and intimate connection between trading activity carried on outside the taxable territories and trading activity within the territories, the relation between the two contributing to the earning of income by the non- resident*"[60]. The definition is fluid enough to be applied to e-commerce, but never is, as taxpayers rely on Section 90 of the ITA to apply the beneficial PE concept under the relevant treaty.

The PE concept, contained in Article 5 of the model treaties is an exhaustive list that applies geography based factors which are very difficult to adapt to the digital economy[61] – in several situations, they fail to create a PE even

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[57] Section 9(1)(i), Income Tax Act, 1961.

[58] Article 5 of most Indian double taxation avoidance agreements contains this provision. *See*, for example India's agreements with Australia, Canada, China and USA.

[59] An inclusive list contained in Explanation 2 to section 9(1)(i), Income Tax Act, 1961 only states as follows:

"Explanation 2.—For the removal of doubts, it is hereby declared that "business connection" shall include any business activity carried out through a person who, acting on behalf of the non-resident,—

(a) has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident, unless his activities are limited to the purchase of goods or merchandise for the non-resident; or

(b) has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident; or

(c) habitually secures orders in India, mainly or wholly for the non-resident or for that non-resident and other non-residents controlling, controlled by, or subject to the same common control, as that non-resident."

[60] CIT v R.D. Aggarwal & Co., AIR 1965 SC 1526.

[61] Article 5:1, UN Model Convention with respect to taxes on Income and on Capital, 2014 states–

"For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on. 2. The term "permanent establishment" includes especially: a) a place of management; b) a branch; c) an office; d) a factory; e) a workshop, and f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources. 3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months. 4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include: a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise; b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery; c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise; e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

when substantial activity is involved, merely because there is no physical setup. The OECD has frequently discussed and rejected expansion of the PE definition to include servers, websites, ISPs or other digital representatives of a tax presence. The only change has been to the OECD commentary, which has been expanded to include servers/ computer equipment as constituting sufficient threshold, provided that they meet the conditions of being "fixed"[62] and performing an "essential and significant part of the business activity of the enterprise as a whole".[63] These are already conditions required by the basic rule PE contained in Article 5(1) and therefore the changes do not materially resolve the problem.

Now, let us examine how Article 5 has been applied in the Indian context, particularly in relation to websites and servers. India's position on Article 5 is that (aside from servers), websites can also constitute a PE in certain circumstances. *ITO* v *Right Florists Ltd, I.T.A.*,[64] ("Right Florists") examines the impact of this position and states as follows:

> "…the Government of India 's reservations on the OECD Commentary are relevant only to the extent that OECD Commentary, to that extent, cannot be treated as a fair index of intention of the Government of India and as contemporanea expositio in respect of tax treaties entered into by India after so expressing its reservations… even the

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. 5. Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 6 applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. 6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. 7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other."

[62] *See*, Paragraph 42.4 on the changes to the commentary on Article 5 of the OECD Model Convention with respect to taxes on Income and on Capital, 2014, *available at* http://www.oecd.org/tax/treaties/1923380.pdf (Last visited on May 18, 2016).

[63] *See,* Paragraph 42.8 on the changes to the commentary on Article 5 of the OECD Model Convention with respect to taxes on Income and on Capital, 2014, *available at* http://www.oecd.org/tax/treaties/1923380.pdf (Last visited on May 18, 2016).

[64] ITO v Right Florists Ltd, I.T.A. No: 1336/ Kol/ 2011.

> reservations expressed by the Government of India merely states the view that website may constitute a permanent establishment in certain circumstances, but it does not specify what are those circumstances in which, according to tax administration, a website could constitute the permanent establishment. In effect, these reservations only reserve a right to set out the circumstances in which a website per se can be treated as permanent establishment, even though these reservations do not really constitute actionable statements."

Taking this analysis further, the Kolkata ITAT held that, notwithstanding India's position on the OECD commentary, a website does not ordinarily constitute a PE except where other considerations such as a server are present in India. Thus, it was held that when Google provides online advertising services in India, it does not necessarily carry on business through a PE in India and therefore its business income should not be taxable in India. No other cases have interpreted the impact of India's position on websites as PEs, except to the extent discussed in the section on royalties. The equalisation levy is, to some extent, an immediate response to this position.

There are some cases in the context of servers as PEs. However, the only category of cases where creation of a PE has constantly been upheld is those relating to computer reservation systems used by the travel industry.[65] Other cases such as *Ebay International Ag, Mumbai* v *Assessee, ITA*[66] ("Ebay") have held that there is no PE, even when an e-commerce website carried on substantial activities in India and was supported by collection agents situated in India.[67] There is no central theme driving the few remaining cases.[68]

The paucity of decisions on this point maybe explained by the high threshold that needs to be met by an e-commerce company to create a tax presence in India. There is often little scope for creation of PE, notwithstanding

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65 Galileo International v DCIT (2008) 19 SOT 257 (Del.) and Amadeus Global Travel v Deputy Commissioner Income Tax (2007) 113 TTJ 767 (Del.).

66 Ebay International Ag, Mumbai v Assessee, ITA, ITA No.6784/M/2010.

67 It is relevant to note that BEPS Action Plan 7, which deals with the artificial avoidance of PE status also seeks to address situations where e-commerce infrastructure is applied along with the splitting up activities, to result in back end and ancillary functions being carried on in the source country – once these changes come into effect, the ruling in cases such as Ebay International Ag, Mumbai v Assessee, ITA may indeed find that a PE has come into being in the source country. However, we still need to prepare for the growing digitisation of businesses, which the BEPS proposals may not completely address.

68 In AREVA T&D India Ltd., In re, 2012 SCC OnLine AAR 5, the AAR found that a PE was constituted on account of the presence of personnel required to maintain an India based server. In Western Union Money Transfer v DIT (IT A nos. 1572 to 1574/D/2010), Indian resident personnel accessed software from the international host server of a payment transfer entity. It was held that this would not result in the constitution of a PE.

substantial business activity, except in *Ebay* type situations involving an online-offline element, or a computer reservation type situation where the nature of technology requires a physical server.[69] This situation again reminds us of the difficulty that India has had in applying source taxation to e-commerce, notwithstanding that there may have been substantial business activity.[70]

C. The equalisation levy

Indian cases have dealt with various aspects of e-commerce, including sale of intangibles online[71], website hosting[72], online advertising[73], as well as services involving an online and offline element[74] such as computer reservation systems[75]. As the analysis above demonstrates, it has been difficult to find unifying strands or objective standards within this sea of precedents. Even when these standards exist, their application is often muddled – partly on account of a lack of appreciation of technological nuances, partly due to the tension created by inequitable distributive rules and the leeway that new technologies offer for a reinterpretation.

This is the background against which India set forth to apply the equalisation levy proposed by the BEPS AP 1.

Let us briefly examine the BEPS AP 1 proposals and the provision introduced by India. In BEPS AP 1, the OECD's Task Force on Digital Economy ("TFDE"), dug deeper and dealt more inclusively with the question of

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[69] This excerpt from ITO v Right Florists Ltd, I.T.A. No: 1336/ Kol/ 2011 and its reference to the CBDT Report is relevant to highlight in this context:

> "The Committee, therefore, supports the view that the concept of PE should be abandoned and a serious attempt should be made within OECD or the UN to find an alternative to the concept of PE." Clearly, conventional PE tests fails in this virtual world even when a reasonable level of commercial activity is crossed by foreign enterprise. It is a policy decision that Government has to take as to whether it wants to reconcile to the fact that conventional PE model has outlived its utility as an instrument of invoking taxing rights upon reaching a reasonable level of commercial activity and that it does fringe neutrality as to the form of commercial presence i.e. physical presence or virtual presence, or whether it wants to take suitable remedial measures to protect its revenue base. Any inertia in this exercise can only be at the cost of tax certainty."

[70] *Id.*

[71] Dun & Bradstreet Information Services v ADIT (2010-TII-59-ITAT-MUM-INTL); *Wipro* v CIT (2011) 203 TAXMAN 621 (Kar).

[72] ITO v People Interactive (I) Pvt. Ltd., TS-129-ITAT-2012; Millennium Infocom Technologies Ltd. v ACIT, 117 ITD 114 (Delhi).

[73] ITO v Right Florists Ltd., I.T.A. No: 1336/ Kol/ 2011.

[74] Ebay International Ag v Assessee, ITA No.6784/M/2010.

[75] Galileo International v DCIT, (2008) 19 SOT 257 (Del.) and Amadeus Global Travel v CIT, (2007) 113 TTJ 767 (Del.).

framing of source rules than any previous efforts in the past. Amongst the changes proposed, it was agreed that:

a) The PE definition should be amended to restrict activities that are considered "preparatory or auxiliary", so that closely related enterprises do not benefit from a fragmentation of business.[76] Changes would also be made to prevent artificial avoidance of PE in the context of conclusion of contracts – for example, when an online seller has a local subsidiary with a substantial sales force.[77] These changes would result in creation of a PE in an *Ebay*[78] kind of situation, for example.

b) Changes relating to transfer pricing and controlled foreign corporation rules were agreed to, which are not dealt with in this paper but would also impact certain aspects of digital economy taxation.[79]

The BEPS AP 1 states that these changes should substantially address several of the issues surrounding taxation of the digital economy[80] but also accepts that there are broader challenges for tax policy makers that need to be dealt with.[81] It then touches upon three approaches considered by the TFDE, which are as follows:

(i) A new nexus in the form of a significant economic presence

(ii) A withholding tax on certain kinds of digital transactions

(iii) An equalisation levy

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[76] Organisation for Economic Co-operation and Development, *Executive Summary, Report on Addressing the Challenges of the Digital Economy*, *Action 1*, 12 (2015), *available at* http://www.oecd.org/ctp/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en.htm (Last visited on May 19, 2016) ("Digital Economy Report").

[77] *Id.*

[78] Ebay International Ag v Assessee, ITA No.6784/M/2010.

[79] Digital Economy Report, 12.

[80] *Id.*, at 13.

"It is expected that the implementation of these measures as well as the other measures developed in the BEPS Project (eg. minimum standard to address treaty shopping arrangements, best practices in the design of domestic rules on interest and other deductible financial payments, application to IP regimes of a substantial activity requirement with a "nexus approach"), will substantially address the BEPS issues exacerbated by the digital economy at the level of both the market jurisdiction and the jurisdiction of the ultimate parent company, with the aim of putting an end to the phenomenon of so called stateless income."

[81] *Id.*, at 13. "*The digital economy also raises broader tax challenges for policy makers. These challenges relate in particular to nexus, data and characterisation for direct tax purposes, which often overlap with each other.*"

The report does not make recommendations one way or the other in favour of any of these options, but states that countries may introduce any of these three provided they respect existing treaty obligations.[82] The broad leeway provided was likely to result in countries implementing a piecemeal and unilateral approach to the e-commerce tax issue, and India has been one of the front-runners to initiate this trend.[83]

Now, let us examine the broad provisions relating to the equalisation levy in India.

The charging provision states as follows:

> "162. (1) On and from the date of commencement of this Chapter, there shall be charged an equalisation levy <u>at the rate of six per cent of the amount of consideration for any specified service</u> received or receivable by a person, being a non-resident from— (i) a person resident in India and carrying on business or profession; or (ii) a non-resident having a permanent establishment in India."[84] (Emphasis supplied).

Further, the deduction provision states that:

> "163. (1) Every person, being a resident and carrying on business or profession or a non-resident having a permanent establishment in India (here in this Chapter referred to as assessee) shall <u>deduct the equalisation levy from the amount paid or payable to a non-resident in respect of the specified service</u> at the rate specified in section 162, if the aggregate amount of consideration for specified service in a previous year exceeds one lakh rupees."[85] (Emphasis supplied).

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[82] *Id.*, at 13.

"Countries could however introduce any of these three options in their domestic law as additional safeguards against BEPS, provided that they respect existing treaty obligations, or in their bilateral tax treaties. Adoption as domestic law measures would require further calibration of the options in order to provide additional clarity about the details, as well as some adaptation to ensure consistency with international legal commitments."

[83] For an idea of the wide variance in income tax measures adopted internationally, *see* Israel's draft Circular 4/2016 dated April 11, 2016, the UK's diverted profits tax introduced by the Finance Act 2015 (The HMRC interim guidance is *available at* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/480318/Diverted_Profits_Tax.pdf (Last visited on May 19, 2016) and the Italian digital tax proposed to be introduced as the "Rules on the prevention of online tax avoidance", discussion *available at* http://www.reuters.com/article/us-italy-tax-internet-analysis-idUSKCN0RU1HS20150930 (Last visited on May 19, 2016). Several countries such as Japan, Australia, New Zealand and China have also amended their GST/ consumption tax regimes in the last couple of years.

[84] Section 162(1), Income Tax Act, 1961.

[85] Section 163(1), Income Tax Act, 1961.

We need to pause to examine the language of the provisions again. Section 163(1) is worded as a deduction/ withholding provision, when it refers to how every resident shall "deduct" the levy. In comparison, transaction tax provisions such as the DDT[86] or STT[87] are worded in a manner that casts attention to the underlying transaction of "declaration, distribution or payment"[88] or "purchase, sale"[89] etc. This would suggest that the equalisation levy is a deduction made towards a tax on income. However, unlike other income withholding provisions, the code exempts non-resident recipients from income tax, if the equalisation tax has been paid, which is similar to the regimes for these transaction taxes[90] and unlike any withholding tax or income tax provision contained in the ITA.[91] There is no reference in the code or the explanatory notes to the income of the non-resident taxpayer, except in relation to provisions of the ITA. The levy is referred to as being applicable to "consideration for specified services".[92] We should also note that the committee which proposed the equalisation levy itself reaffirms that the equalisation levy is not a tax on income[93] and would hence not be covered by tax treaties.[94]

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86 Section 115-O, Income Tax Act, 1961.

87 Chapter VII, Finance Act, 2004.

88 Section 115-O, Income Tax Act, 1961 states as follows:

"In addition to the income-tax chargeable in respect of the total income of a domestic company for any assessment year, any amount declared, distributed or paid by such company by way of dividends (whether interim or otherwise) on or after the 1st day of April, 2003, whether out of current or accumulated profits shall be charged to additional income-tax (hereafter referred to as tax on distributed profits) at the rate of fifteen per cent."(Emphasis supplied).

89 Section 98, Chapter VII of Finance Act, 2004.

90 *See*, Section 10(50) of the Finance Act, 2016, compared to Section 10(34), Income Tax Act, 1961 which exempts income on which DDT has been paid and 10(38), Income Tax Act, 1961 which exempts income on which STT has been paid.

91 Provisions which prescribe a lower rate of tax, typically relate back to the income of the assesse. *See*, for example Section 112(c), Income Tax Act, 1961. The non-resident withholding provision contained in Section 195, Income Tax Act, 1961 refers to a "sum chargeable" to tax, rather than income. However, as I have argued in the past, the provision refers to the income of the recipient and not any sum. (*See*, Shreya Rao and Bijal Ajinkya, *Groping in the Dark: The Extending Arms of the Indian International Withholding Tax* 22(1) NATIONAL LAW SCHOOL OF INDIA REVIEW (2010).

92 *See*, the proposed additions to the Income Tax Act, of Section 10(50) and Section 40(a)(ib), both of which refer to the "income" of the taxpayer.

93 Central Board of Direct Taxes, Committee on Taxation of E-commerce, *Proposal for Equalisation Levy on Specified Transactions, available at* http://www.incometaxindia.gov.in/news/report-of-committee-on-taxation-of-e-commerce-feb-2016.pdf (Last visited on May 19, 2016). It states:"*The Equalisation Levy imposed on the payment for digital transactions, would not be a tax on income, and hence would not be covered by tax treaties. As Equalisation Levy is not proposed as tax on income, it would need to be imposed outside the Income-tax Act, 1961*"

94 *Id*.

This creates two difficulties. The first, relates to classification of the levy. If it is not conceptualised as a tax on income, is it then a tax on consumption, or the transaction of paying for specified services. To ask this is not intellectual hair-splitting.

If it is a tax on consumption, it becomes important to examine the constitutionality of the levy, which in turn would require us to analyse what the specified services involve. The Centre's rights to tax income derive from Entry 82 of List 1[95], which pertains to "Taxes on income other than agricultural income". If the equalisation levy does not fall within this category, the other possibility is for the legislation to be passed under Entry 97 of List 1[96], which pertains to "Any other matter not enumerated in List II or List III including any tax not mentioned in either of those Lists." This is the entry under which the Centre's right to levy service tax has been upheld in the past.[97]

However, the protection afforded by Entry 97 would depend on the "specified services" sought to be taxed under section 162. For instance, the definition of "specified service" currently includes services relating to "online advertisement". This is also a subject covered by Entry 55 of List 2, which gives the states the right to levy "Taxes on advertisements other than advertisements published in the newspapers and advertisements broadcast by radio or television". Previous case law has examined the constitutional validity of service tax on advertising services and held that the Centre has competence to levy a tax as there is a "clear distinction between the advertisement and the advertising services."[98] However, the service tax ruling was in the context of services provided by an advertising agency engaged in the business of creating advertisements, rather than a tax on the advertisements themselves. In a situation where the tax is sought to be levied on mere sale of advertising space by Google or Facebook, a situation similar to that examined in the *Right Florists* decision, there may be grounds to challenge the legislative competence of the Centre.

We should not rule out the possibility that the equalisation levy continues to fall within the Centre's rights to tax income, under Entry 82 of List 1, notwithstanding the drafting inconsistencies and the statement made by

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95 Article 246 read with Schedule VII, Constitution of India.

96 Article 246 read with Schedule VII, Constitution of India.

97 Laghu Udyog Bharati v Union of India, (1999) 6 SCC 418 : (1999) 112 ELT 365; T.N. Kalyana Mandapam Assn. v Union of India, (2004) 5 SCC 632 : (2004) 167 ELT 3.

98 Addition Advertising v Union of India, (1998) 98 ELT 14 (Gujarat). In this case it was held that "*As a result of the advertising services rendered, it results in an advertisement which can be published and republished and copied.*" *See also*, Zodiac Advertisers v Union of India, (2004) 166 ELT 25 (Kerala).

the Committee on E-commerce regarding the nature of the equalisation levy. This is because, courts have constantly emphasised that the legislative entries in the Constitution must be interpreted liberally[99] and that the limits imposed by the ITA cannot constrain a determination of what is income for the purposes of Entry 82.[100]

This would place us in a situation where an income tax levy is introduced as a separate code outside the purview of the ITA, so as to exclude the applicability of section 90 of the ITA. India follows the dualist approach to treaties which means that, where there is an express irreconcilable conflict between domestic law and treaty law, the treaty can only triumph if there is a specific legislation by the Parliament allowing it to do so.[101] Section 90 of the ITA is unlikely to cover codes such as the equalisation tax if they fall outside the purview of the ITA.

This in turn requires a consideration of whether the equalisation levy results in a treaty override, in a manner that violates our *pacta sunt servenda* obligations towards our bilateral tax treaties. The new code may not derive legitimacy from the BEPS AP 1, whose central emphasis in relation to the equalisation levy is that treaty obligations should be respected.

The constitutional and treaty override issues are a subject of separate analysis in themselves, and this paper does not dwell on them further on account of paucity of space. However, there are other execution challenges to the design of the levy which may make it difficult for it to achieve its end objective. Since the levy is drafted as a tax on the consideration amount, it is likely to be challenging for non-residents to claim tax credit for it in their home country. Foreign tax credit is typically available only for levies in the nature of income tax — while the position will ultimately depend on the domestic laws of the relevant country, it is likely that we may see issues similar to those faced by exempted non-resident shareholders who are exempt from tax when income is subject to DDT.[102] This may prompt the larger e-commerce companies such as Facebook and Google to either gross up the price they charge to Indian payers, or pass on the burden of the

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99 Navinchandra Mafatlal v CIT, AIR 1955 SC 58; Western India Theatres Ltd. v Cantonment Board, AIR 1959 SC 582.

100 Navinchandra Mafatlal v CIT, AIR 1955 SC 58; Western India Theatres Ltd. v Cantonment Board, AIR 1959 SC 582.

101 Gramophone Co. of India Ltd. v Birendra Bahadur Pandey, (1984) 2 SCC 534 : AIR 1984 SC 667; Jolly George Varghese v Bank of Cochin, (1980) 2 SCC 360 : AIR 1980 SC 470.

102 For elaboration on this issue, *see* Indraneel Roy Chaudhury, *Taxation of Dividend Income* (Occasional Paper No. 6, International Tax Research and Analysis Foundation 2016).

equalisation levy on to Indian payers.[103] If this happens, we may have mitigated the impact of erosion of our tax base, but we would not have solved our problem relating to the taxation of non-residents on their e-commerce income.

The structure and rate of the equalisation levy also emphasise the prescience of UN commentary observations on source country taxation of royalties. The levy is applied at 6% on a gross basis, which means that there is an assumption of a profit margin of at least 18% to the non-resident. If we assume that the non-resident is subject to a similar rate of tax of 30% in the home country as well, this maybe onerous for low margin businesses (since the country of residence is unlikely to allow credit for the taxes paid in India). This is why one of the proposals in the BEPS AP 1 was that the equalisation tax should only be applied in a situation where the non-resident was situated in a low tax jurisdiction. It is true that equity and administrative simplicity need to go hand in hand, and it is not always possible to tailor taxes to different kinds of situations – however, we need to ask ourselves whether, as a developing country, we aspire to have domestic measures that are compatible with the prevailing (possibly inequitable) international tax regime.

Conclusion

This paper tries to provide a flavour of the issues relating to two main themes: the first relates to how inequitable distributive rules in tax treaties may have influenced Indian litigation on taxation of e-commerce.

Historical debates on taxation of e-commerce have tended to revolve around whether existing source rules can be effectively adapted to digital transactions.[104] Until BEPS AP 1, there was not sufficient analysis on whether traditional source rules and distributive principles continued to be effective and equitable. We need to complete the loop initiated by BEPS AP 1 by investing more thought into the broader policy suggestions particularly the recommendations made on a new nexus rule. This is a complex exercise, true, but also necessary; the proposed changes such as the ones to the PE

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[103] *Per practitioner views: Levy on online ads may hit start ups,* The Hindu (March 5, 2016), *available at* http://www.thehindu.com/business/Industry/levy-on-online-ads-may-hit-startups/article8318329.ece (Last visited on May 19, 2016) ; *Equalisation levy not so equal*, Financial Express (May 17, 2016), *available at* http://www.financialexpress.com/article/fe-columnist/equalisation-levy-not-so-equal/257045/ (Last visited on May 19, 2016).

[104] OECD Report and CBDT Report.

definition may resolve the anomalies caused by decisions such as *Ebay* but are unlikely to be substantially fairer.

Meanwhile, internet usage patterns continue to emphasise the growing value contributed by markets in developing economies,[105] a subject that OECD countries have been reluctant to engage with deeply in the past.[106] The international tax system will continue to be inequitable if it ignores this,

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[105] Our distributive rules have historically tilted towards the value generated by production and distribution related activity, without considering the role of consumption and markets in the economic chain. In a digital economy, particularly where to consumers face technologies that derive value from network effects, the production and distribution costs are negligible and significant value is derived from consumers. In this regard, internet usage data shows that usage numbers are skewed in favour of developing countries. 46% of the world population has an internet connection today. Of these, most OECD countries have internet penetration of more than 80%. Mexico, the OECD country with the lowest penetration stands at 45%, with 58 million of its population with internet connectivity i.e. about 71 million without connectivity. In comparison, India has a penetration of 34.8%, with 462 million users i.e. about 864 million without connectivity. China has a penetration of 52% with 721 million users i.e. about 660 million without connectivity. The markets represented by India and China are currently and potentially, several times the markets of most OECD countries. It is for this reason that large businesses based in developed countries are increasing their focus on India and China. *See*, *India is our Second Largest Market in terms of New Customers*, THE FINANCIAL EXPRESS, (May 17, 2016), *available at* http://www.financialexpress.com/article/industry/companies/face-off-india-is-our-second-largest-market-in-terms-of-the-number-of-new-customers-says-amit-agarwal-amazon-india/257021/ (Last visited on May 19, 2016); *Here's how Google is increasing its focus on e-commerce*, FORBES (May 19, 2016), *available at* http://www.forbes.com/sites/greatspeculations/2016/05/19/heres-how-google-is-increasing-its-focus-on-e-commerce/#4fc9dada7f23 (Last visited on May 19, 2016); *Internet.org to continue; Facebook to shift focus to other parts of the programme*, DNA (February 23, 2016), *available at* http://www.dnaindia.com/money/report-internetorg-to-continue-facebook-to-shift-focus-to-other-parts-of-programme-2181135 (Last visited on 19 May, 2016); Internet data from http://www.internetlivestats.com/internet-users-by-country/(Last visited on May 19, 2016).

[106] When the OECD last considered this issue, the early committees were reluctant to engage with it more deeply – this was partly because the e-commerce economy was too nascent to result in obvious depletion of revenue to capital importing countries, but also because these committees often had little material participation from developing countries which now provide large markets for e-commerce businesses. *See* for example, this excerpt from an early report which rejects a supply-demand ie. market based approach to source taxation without deeper consideration of issues of inter-nation equity:

> "A large majority of the TAG members implicitly rejected the "supply-demand" approach. For them, the mere fact that the realization of business transactions requires an interaction between the supply of goods or services by an enterprise and the demand in a market state has not historically been considered by countries to provide a sufficient link for considering that the profits of the enterprise arising from these transactions should, for purposes of income taxation, be sourced in the market state."
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> Organisation for Economic Cooperation and Development, *Technical Advisory Group, Monitoring the Application of Existing Norms for Business Profits*, 41 (2005), *available at* http://www.oecd.org/ctp/treaties/35869032.pdf (Last visited on May 18, 2016).

and countries will attempt to address the issue through inefficient, piecemeal and unilateral measures.

The second theme relates to issues of tax system design. It asks what factors should be emphasized when a new levy is introduced. We need to move beyond tax design solutions that are quick fix approaches to looming issues. Conceptual harmony demands that we invest deep thought into solutions that depart from the framework of the ITA and rely on non-income based levies. The constitutional emphasis on respect for treaty obligations demands that we attempt to find solutions that do not result in a treaty override – the means to address inequitable distributive rules is not to renege on commitments that we have made to treaty partners. Finally, legislative prudence demands that we consider softer issues such as the power differential of non-resident e-commerce companies and the Indian residents who make payments to them – the consequence of our actions should not be that we burden legitimate resident taxpayers more, in our haste to capture a nebulous non-resident tax base.

Both themes relate to issues that are difficult to resolve. However, it is important for us to set parameters for what we would like to work towards, if there is to be light at the end of the tunnel.

Who Will Watch the Watchmen? – A Study of the Law on Self-Dealing Transactions by Company Directors

*Vanshaj Jain**

Indian law provides a three-level safeguard against unfair self-dealing transactions between companies and their directors. The first consists of the requirement that a director disclose any personal interests that s/he may have in the transactions that the company enters into, and abstain from the subsequent proceedings on the transaction. The second level targets specific categories of transactions, mandating that they be carried out only with the prior approval of the Board of Directors and the Central Government. The final level of protection is aimed at a particularly dangerous transaction – loans to directors – which are regulated in a far more stringent manner than any other self-dealing transaction. This paper attempts to examine each of these three levels separately through a comparative study of the provisions of the 1956 and 2013 Companies Acts, and seeks to provide suggestions that could further the development of Indian law on the subject.

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Introduction

The No-Conflict rule mandates that a director, or any other fiduciary of a company, must not place himself in a position where his duties towards the company are in conflict with his own personal interests, or with his duty towards others.[1] One of the principal means by which a fiduciary can breach this duty is through 'self-dealing' – a process by which they engage in transactions with their own company, either directly or indirectly, whereby their personal, pecuniary interests conflict with the commercial interests of the company.[2] This is often problematic, as, in these circumstances, the fiduciary may give in to such personal interests, and use his position of influence within the company to ensure that it receives a deal whose outcome is less advantageous than if the transaction had been agreed to by a rational, well-informed decision maker who was independent and loyal.[3]

The above possibility may certainly lead one to believe that all self-dealing transactions ought to be prohibited. However, this would be an incorrect conclusion to draw, as it is not every form of self-dealing that harms the company. For example, a director may be the best source of a service or asset that the company wishes to acquire, and so a ban on self-dealing would cause great detriment to the company's interests. Similarly, the company may wish to avail the services that a director may offer in his professional capacity, so that he could use his experience and knowledge of the company's functioning to serve its interests better than any other professional in the field.[4] In every such case, one may observe that the possibility of self-dealing

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1 Gower & Davies' Principles of Modern Company Law 559 (9th ed. 2012).

2 Palmer's Company Law 652 (22nd ed. 1977).

3 Gore-Browne on Companies 1034 (45th ed. 2015). *Also see*, Lord Cranworth LC in Aberdeen Railway Co. v Blaikie Bros., (1843-60) All ER Rep 249 (HL): "…it is a rule of universal application that no one having such duties [fiduciary duties as an agent] to discharge shall be allowed to enter into engagements in which he has or can have a personal interest conflicting or which may possibly conflict with the interests of those whom he is bound to protect." Lord Herschell in Bray v Ford, 1896 AC 44 (HL): "It is an inflexible rule of a Court of Equity that a person in a fiduciary position, such as the respondent's, is not, unless otherwise expressly provided, entitled to make a profit; he is not allowed to put himself in a position where his interest and duty conflict. It does not appear to me that this rule is, as has been said, founded upon principles of morality. I regard it rather as based on the consideration that, human nature being what it is, there is danger, in such circumstances, of the person holding a fiduciary position being swayed by interest rather than by duty, and thus prejudicing those whom he was bound to protect. It has, therefore, been deemed expedient to lay down this positive rule."

4 Lord Herschell in *Bray* v Ford, 1896 AC 44 (HL): "But I am satisfied that it [the rule of No Conflict] might be departed from in many cases, without any breach of morality, without any wrong being inflicted, and without any consciousness of wrong-doing. Indeed, it is obvious that it might sometimes be to the advantage of the beneficiaries that their trustee should act for them professionally rather than a stranger, even though the trustee were paid for his services".

could actually provide unexpected advantages to the company. Thus, it is only when such self-dealing results in an unfair outcome that it ought to be curtailed. Consequently, the aspiration of any legal system should be to provide a procedure that prevents any conflicting interests from tainting the transaction, in order to ensure that a company receives equitable results even while engaging in transactions with its fiduciaries.[5]

In recent years, a number of writers have observed that abusive self-dealing is an important issue for corporate governance in Asian countries, and specifically, in India.[6] The reason for this can be attributed to two specific characteristics of the ownership structure in Indian companies. The first is the high concentration of shareholding in the hands of particular individuals or families, which grants them actual or effective control of the management of such a company.[7] As per a study conducted in 2007, the average BSE 100 Company had a promoter who owned more than 48% of its stake.[8] In fact, only ten of such BSE 100 companies had promoters who possessed a shareholding of less than 25%. Even if one were to observe the broader set of BSE 500 Companies, similar statistics would be found: the average promoter possesses a 49% stake, whereas less than 9% of them have a holding below 25%.[9] The second feature of Indian companies is that a large number of them are grouped together under the common control of a single shareholder or family.[10] Thus, not only are most companies effectively controlled by such promoter groups, but the same promoter group often controls a large number of firms.

Such a pattern of ownership and management creates a heightened potential for the promoter group to divert the company's profits away from the minority investors, into other companies where they possess a greater share of ownership, thereby capturing a higher share of the firm's profits than they are entitled to, while depriving the company and its shareholders of their due. Such a 'tunneling' of profits is achieved through numerous different self-dealing transactions between the promoters/directors and companies,

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5 SEALY'S CASES AND MATERIALS IN COMPANY LAW 339 (7th ed. 2010).

6 *See, generally*: Organization for Economic Co-operation & Development, *Guide on Fighting Abusive Related Party Transactions in Asia* (September 2009); Asian Corporate Governance Association, *ACGA White Paper on Corporate Governance in India* (January 2010).

7 A. Galani & N. Rehn, *Related Party Transactions: Empowering Boards and Minority Shareholders to Prevent Abuses*, 20(2) NLSIR 134, 137 (2010).

8 S. Mathew, *Hostile Takeovers in India: New Prospects, Challenges, and Regulatory Opportunities*, 3(1) COLUMBUS LR 800, 833 (2007).

9 *Supra*, note 8.

10 V. Umakanth, *A Cautionary Tale of the Transplant Effect on Indian Corporate Governance*, 21(1) NLSIR 1, 16 (2009).

for instance, through the provision of loans at low (or high) interest rates, or the sale of assets at prices far below (or above) market value.[11] In fact, several recent corporate scandals in India have witnessed the use of such self-dealing mechanisms, such as the ones involving Subhiksha Trading and Satyam Computer Services.[12]

Such a pervasive climate of unfair dealing between related parties, and an absence of transparency, also has harmful repercussions on the country's capital markets, by reinforcing investors' fears of potential abuse.[13] Hence, the issue of self-dealing transactions is certainly a pertinent one for the Indian legal system at present, while the nation seeks to expand its markets and attract foreign capital.

Indian law provides a three-level safeguard against unfair self-dealing transactions between companies and their directors. The first level consists of the requirement that a director disclose any personal interests that s/he may have in the transactions that the company enters into, and abstain from the subsequent proceedings on the transaction. The second level targets only specific types of transactions, and mandates the requirement of prior approval from the Board of Directors, and the Central Government. The final level of protection is aimed at a particularly dangerous transaction – that of loans to directors – which are regulated in a far more stringent manner than any other self-dealing transaction. Each of these levels is examined separately below through a comparative study of the provisions of the 1956 and 2013 Companies Acts. The paper then concludes with suggestions that could further the development of Indian law on self-dealing by examining provisions on this subject in other common law jurisdictions.

A. The Requirements of Disclosure & Abstention

The director of a company owes a fiduciary duty to the company, to act in its best interests, in a bona fide manner, and to avoid any conflict between his own interests and those of the company. When a director, acting on behalf

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11 M. Bertrand et al., *Ferreting Out Tunnelling: An Application to Indian Business Groups*, 117 QJE 121, 122 (2002).

12 *See, generally:* R. Sriram, *Why Subhiksha Trading Services Collapsed*, Economic Times, 25 August, 2011; M.L. Bhasin, *Corporate Accounting Fraud: A Case Study of Satyam Computers Limited*, 2(1) Open Journal of Accounting 26 (2013).

13 A. Asharipour, *Corporate Governance Convergence: Lessons from the Indian Experience*, 29 NWJIL 335, 364 (2009). *See also*: A. Guha, *Ownership Pattern of the Indian Corporate Sector: Implications for Corporate Governance* 1, 11, Insti. for Stud. in Indus. Dev., Working Paper No. 2006/09 (2006) *available at* http://isidev.nic.in/pdf/wp0609.pdf; Rajesh Chakrabarti, *Corporate Governance in India - Evolution and Challenges*, 11 (2005) *available at* http://ssrn.com/abstract=649857.

of the company, enters into any arrangement or transaction with himself or with a company or firm in which he is interested, it is a rule of common law that such a transaction can be set aside by the company, even without any inquiry as to the fairness of the deal, or the extent of loss suffered by the company.[14] However, one of the defenses that can be claimed against such avoidance is that the conflicting interest in question had been disclosed to the shareholders of the company, who have assented to the transaction.[15]

The Companies Act, 1956 adopted the aforementioned rule of common law, with certain important modifications. While it made disclosure of a director's interests mandatory, under Section 299, such disclosure was to be made to the Board of Directors, instead of the shareholders. Similarly, it was the assent of the Board of Directors, and not that of the shareholders, which was made compulsory under Section 297 – and that too for only certain types of transactions. This position was extremely problematic because, as mentioned above, the management of Indian companies is often under the control of a particular promoter group. As a consequence, disclosure to the Board of Directors served no purpose, as it allowed interested parties to approve their own transactions, while the shareholders of the company were kept in the dark.[16]

This was witnessed in several cases, such as *Globe Motors Ltd.* v *Mehta Teja Singh and Co.*,[17] *Ravi Raj Gupta* v *Hansraj Gupta & Co.*,[18] and *Suryakant Gupta* v *Rajaram Corn Products (Punjab) Ltd.*,[19] where transactions with promoters or directors were approved by a Board that was composed almost entirely of relatives or associates of the interested party. As a consequence, despite the possible inequity of the transaction, in each such case the Court's hands were tied as the provisions of Section 299 had not been violated. While the requirement of shareholder approval for every self-dealing transaction may be an impractical one,[20] it is the researcher's firm belief that disclosure to shareholders, or to some other body such as an audit committee (made up of independent directors), is essential for the more

[14] Aberdeen Railway Co. v Blaikie Bros., (1843-60) All ER Rep 249 : 1854 UKHL 1 (HL); A.B. Cook v George S. Deeks, (1916) 1 AC 554 : 1916 UKPC 10; Regal (Hastings) Ltd. v Gulliver, (1967) 2 AC 134 : (1942) 1 All ER 378 : 1942 UKHL 1 (HL).

[15] *Id.*

[16] A. Ramaiya, Guide to Companies Act 2045 (17th ed. 2010).

[17] Globe Motors Ltd. v Mehta Teja Singh *and* Co., 1983 SCC OnLine Del 193 : (1984) 55 Comp Cas 445.

[18] Ravi Raj Gupta v Hansraj Gupta & Co., 2011 SCC OnLine Del 2608 : (2010) 94 CLA 1 (Del).

[19] Suryakant Gupta v Rajaram Corn Products (Punjab) Ltd., 2001 SCC OnLine CLB 5 : (2001) 2 Comp LJ 155.

[20] Gower & Davies' Principles of Modern Company Law 562 (9th ed. 2012).

risky transactions, involving large assets or amounts – in order to provide some form of oversight over the actions of the Board.

Another particularly troublesome aspect of this provision could be found under sub-clause (3) of Section 299, which permitted a director to simply provide a 'general notice', declaring that s/he was to be considered interested in transactions dealing with a particular company henceforth. The section specifically provided that such a general disclosure would be a sufficient alternative to specific disclosures, for the period of that financial year.[21] This provision is problematic for two reasons.

First, it permits a director to avoid any detailed disclosure on specific transactions, specifying the precise nature and extent of his interest in the company.[22] As Lord Cairns observed in *Imperial Mercantile Credit Assn.* v *Coleman*,[23] '*a man declares his interest, not when he states that he has an interest, but when he states* ***what his interest is*** [Emphasis added].'[24] Without such a detailed disclosure, which explains what the interest of the director is with respect to a specific transaction, it would be very difficult for the Board to make an informed choice and take precautions that would be appropriate for each individual transaction.[25] *Second*, following such a general notice, this provision places the burden on the Board to peruse the minutes of its prior meetings, and uncover any potential conflicts of interest, for each transaction, rather than on the director, who is better placed to disclose the same, but who can now keep silent without incurring any liability.[26]

The permissive manner in which the Indian judiciary has interpreted the requirement of disclosure is also problematic. For instance, in *A Sivasailam Tractors and Farm Equipment Ltd.* v *ROC*,[27] the Company Law Board noted that, when the daughter of the company's chairman-cum-managing director was to be appointed as the vice-president, there was no requirement

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[21] Section 299(3)(a), The Companies Act (1956).

[22] A. Galani & N. Rehn, *Related Party Transactions: Empowering Boards and Minority Shareholders to Prevent Abuses*, 20(2) NLSIR 134, 137 (2010).

[23] Imperial Mercantile Credit Assn. v Coleman, (1871) LR 6 Ch App 558 (CA).

[24] Gray v New Augarita Porcupine Mines Ltd (1952) 3 DLR 1 PC.

[25] A. Ramaiya, Guide to Companies Act 2078 (17th ed. 2010).

[26] Admittedly, the Company Law Committee, in its report on this provision, acknowledged the issues outlined above. To overcome these problems, the Committee saw it fit to adopt certain recommendations that had been made earlier by the Millin Commission in South Africa, namely: to require that such general notices be renewed annually; and to place an obligation on the declaring director to take reasonable steps to bring up, read and discuss the notice at the next Board meeting. Nonetheless, such measures seem woefully inadequate in comparison to the problems outlined above, especially keeping in mind the gravity of harm that may be caused through such self-dealing transactions.

[27] A Sivasailam, Tractors and Farm Equipment Ltd. v ROC, (1995) 83 Comp Cas 141.

of an explicit and formal disclosure at the meeting, as the other members of the Board were already cognizant of this fact. Several similar decisions have assisted in carving out such an exception against disclosure, for matters already known to the Board.[28] This type of an interpretation of the provision is dangerous, as it contradicts the specific wording of the provision, which mandates that a director explicitly '***disclose** the nature of his concern or interest* ***at a meeting of the Board*** [emphasis added].'[29] One must keep in mind that the purpose of this disclosure is not merely for the benefit of the directors in status quo, but also other individuals – such as future directors or auditors, who may require access to the minutes of the Board's meetings to determine when a fiduciary of the company is interested in a transaction. This was precisely why, in *Neptune (Vehicle Washing Equipment) Ltd.* v *Fitzgerald*,[30] the Court held that even in the case of a Company which possessed only one director, the sole director would be required to remind himself of his duties to make a disclosure and record it in the company's records and minutes book.

Another exception against the requirement of disclosure may be found under sub-clause (6) of Section 299, which states that if the interested director (or directors) in question did not possess a shareholding greater than 2% in the party with which the transaction took place, they would not be required to make known this interest to the Board of Directors. This clause has faced criticism from writers, for the use of the word "hold", which seems to suggest that only the concept of direct ownership would be capable of creating a conflict of interest, especially when contrasted with the wording used in other provisions of the Act, which speak of the broader conception of "beneficial ownership".[31] This criticism is supported by the narrow interpretation given to the term "hold" by the Supreme Court in *Howrah Trading Co. Ltd.* v *CIT*,[32] where it held that '*the expression "holder of a share" denotes, in so far as the company is concerned,* ***only a person who, as a shareholder, has his name entered on the register of members*** [Emphasis added]'. As a consequence, it can be argued that the phrasing of Section 299(6) may be capable of exempting a large number of transactions,

[28] Guntur Cotton Mills v Venkatachalapathy, AIR 1932 PC 244; Ramakrishna Rao (S.M.) v Bangalore Race Club Ltd., (1970) 40 Comp Cas 674. *See also* Lee Panavision Ltd. v Lee Lighting Ltd., (1992) BCLC 22 (CA); MacPherson v European Strategic Bureau, (1999) 2 BCLC 203 (Ch D); Runciman v Walter Runciman plc, (1992) BCLC 1084.

[29] Section 299(1), The Companies Act (1956).

[30] Neptune (Vehicle Washing Equipment) Ltd. v Fitzgerald, (1995) 1 BCLC 352 (Ch D).

[31] *See*: W. Megginson et al, *Corporate Governance in India*, 20(1) JOURNAL OF APPLIED CORPORATE FINANCE 59 (2008); E. Wahab, *Does Corporate Governance Matter? Evidence from Related Party Transactions*, 14(1) ADVANCES IN FINANCIAL ECONOMICS 131 (2011).

[32] Howrah Trading Co. Ltd. v CIT, AIR 1959 SC 775.

in which a director may possess a great indirect interest, while owning less than 2% of the other company's shares.[33]

A failure to comply with the provisions of Section 299 would cause the vacation of the office of the director, under Section 283(1)(i), and also render him liable to pay a fine which could extend to fifty thousand rupees.[34] In addition, these provisions do not affect the common law remedy, which renders the self-dealing transaction or arrangement voidable, at the option of the company.[35] Finally, as observed by Vaughan Williams, L. J. in *Costa Rica Rail Co. Ltd.* v *Forwood*,[36] equity would also mandate that a Court deprive the directors of any profits they may derive, by entering into contracts in which they have a conflicting interest. This principle has also been applied in the Indian context.[37]

In addition to the requirement of disclosure, discussed above, the 1956 Act also mandated that an interested director abstain from any discussion or vote on the transaction in question.[38] Moreover, such director's presence on the Board was not to be counted for the purposes of determining quorum.[39] However, strangely, this provision was only made applicable to public companies.[40] Moreover, exemptions were made for transactions between a public holding company and its private subsidiary company,[41] as well as for contracts of indemnity, in which the director would serve as a surety on behalf of the company.[42] Finally, similar to the provisions on disclosure, directors whose only interest in the transacting company was a shareholding of 2% (or of the minimum stake required to qualify him to be a director) were also excluded from the scope of the provision.[43] A breach of the

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33 *See*: A. Galani & N. Rehn, *Related Party Transactions: Empowering Boards and Minority Shareholders to Prevent Abuses*, 20(2) NLSIR 134 (2010). However, this argument is incorrect, as it fails to notice that Section 299 specifically accounts for both direct and indirect interests, under sub-clause (1). Moreover, the Indian judiciary has given a wide interpretation to the phrase 'indirect interest', mandating that a director make a disclosure, even if it is merely his relatives or his partnership firm, and not himself, who possesses an interest in the company with which the transaction is to take place. See: Fire Stone Tyre and Rubber Co. Ltd. v Synthetics & Chemicals Ltd., (1970) 2 Comp LJ 200; Needle Industries (India) Ltd. v Needle Industries Newey (India) Holding Ltd., (1981) 51 Comp Cas 743 at 815.

34 Section 299(4), The Companies Act (1956).

35 Amritsar Rayon & Silk Mills Ltd. v Amirchand Saideh, (1988) 64 Comp Cas 762 (P&H); Movitex Ltd. v Bulfield, 1988 BCLC 104 (Ch D).

36 Costa Rica Rail Co. Ltd. v Forwood, (1901) 1 Ch 746, 761).

37 See*:* Pandalai (K.C.) v S.I.G. Assurance Co. Ltd, (1941) 11 Comp Cas 327.

38 Section 300(1), The Companies Act (1956).

39 Section 300(1), The Companies Act (1956).

40 Section 300(2)(a), The Companies Act (1956).

41 Section 300(2)(b), The Companies Act (1956).

42 Section 300(2)(c), The Companies Act (1956).

43 Section 300(2)(d), The Companies Act (1956).

requirements under this provision warranted two consequences: *first*, any vote cast by such interested director would be rendered void;[44] and *second*, the director who contravened the provision would be liable for a fine which may extend to fifty thousand rupees.[45]

The Companies Act, 2013 provides for the requirement of disclosure of interests, and abstention in subsequent proceedings under Section 184 of the statute. This provision makes major advances over its equivalent in the 1956 Act (Section 299). As discussed above, one of the most important difficulties, with respect to the framework for disclosure under the 1956 Act, was the possibility of a director to simply provide a general notice of the companies in which he was interested at the start of each financial year, which would exempt him from making any detailed disclosures on the nature and extent of his interest, with respect to specific transactions. This was worrisome, as it made it very difficult for the Board of Directors to determine the character of his conflicting interest, and to account for it in their deliberations on the transaction.

This issue is resolved, quite effectively, by Section 184, which mandates that all directors '*disclose (their) concern or interest in any company or companies or bodies corporate, firms, or other association of individuals*', at the start of every financial year, and also whenever there is a change in their declared interests. However, in addition to this *mandatory* general notice, directors are also bound to make specific disclosures with respect to each transaction that the company enters into, in which they have an interest. By doing so, Section 184 ensures that the fact of the director's interest cannot be overlooked by the Board, as it places the burden on the concerned director to make such disclosure (rather than on the Board, to peruse the minutes of their meetings and uncover such interests, as was the case under the 1956 Act).[46] Moreover, it does not permit a director to substitute a specific disclosure with a general one, but mandates both, thereby ensuring that the Board possesses sufficient information, to enable them to safeguard the company against the conflict of interest.[47]

However, there is also, in the researcher's opinion, a defect in the drafting of Section 184. While Section 299 of the 1956 Act was phrased broadly, to bring within its ambit all transactions in which the director may have an interest, '*whether directly or indirectly*', the same cannot be said of Section

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44 Section 300(1), The Companies Act (1956).

45 Section 300(4), The Companies Act (1956).

46 A. RAMAIYA, GUIDE TO COMPANIES ACT 1389 (18th ed. 2014).

47 G. Vijay, *Corporate Governance Under the Companies Act, 2013: A More Responsive System of Governance*, 4(4) INDIAN JOURNAL OF APPLIED RESEARCH 7 (2014).

184. Admittedly, Section 184 also uses similar phrasing, and mandates that a direct or indirect interest be disclosed. However, it qualifies this statement by specifying that only two specific forms of interest require disclosure: - first, if the director '*holds more than two per cent shareholding of that body corporate, or is a promoter, manager, Chief Executive Officer of that body corporate*' with which the company transacts; and second, if the director '*is a partner, owner or member*' of a firm with which the company transacts.[48]

The issue with this provision, therefore, is the same issue pointed out above, for several provisions of the 1956 Act – it is far too specific, and thereby excludes from its ambit several types of transactions.[49] Thus, if a company were to enter into an agreement with another company, which was owned or controlled by a director's relatives, he would not be bound to make any disclosure under Section 184, although it would have been required under Section 299 of the 1956 Act. Although Section 184 desires to encompass such 'indirect' interests, as per the wording of sub-clause (2), by specifying precisely which interests mandate disclosure (all of which happen to be direct interests, in the form of a shareholding or position of management in the transacting company), the provision actually ends up having the effect of excluding all such indirect interests from its scope.[50] This is certainly a critical issue, which must be addressed to ensure an effective regulatory mechanism for self-dealing transactions. Although Section 184 has not yet come up for interpretation before our judiciary, it seems likely that the above-mentioned problem of excluding important transactions will occur, given the Supreme Court's narrow interpretation of the word "hold" in Howrah Trading Co., discussed above in relation to Section 299. However, there is a possible solution by which this issue could be mitigated – if our Courts were to interpret the word 'holding' to include equitable ownership, as has been done by Courts in other jurisdictions.[51] If this were done, then transactions where a director has an indirect interest in another company would also be hit by Section 184, as they would fall within the scope of the first qualification, mentioned above. This would also, perhaps, be the most effective interpretation of Section 184. Nonetheless, it is the opinion of the researcher that our legislators would do well to return to the phrasing found

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48 Section 184(2), The Companies Act (2013).

49 S. Jain & N. Nigam, *Companies Act 2013 – A New Wave in Corporate Governance*, 3(12) Indian Streams Research Journal 54 (2014).

50 Deloite & ASSOCHAM, *Report on Companies Act, 2013 – "New Rules of the Game"*, 24 (2013).

51 For instance, in the Australian case *Re Bennet* (decd), 1957 VR 113, at 116, Lowe J. stated that '*the word "hold" is not a term of art. The word must be construed in its ordinary English meaning. In my opinion it is a normal use of English to say that one holds shares when one possesses or owns them, and* ***that this is true whether the ownership is by means of a legal or an equitable title***' [emphasis added].

under Section 299 of the 1956 Act, and simply mandate disclosure for all interests that a director may possess in a company, whether direct or indirect – while deleting the list of specific interests, which they have inserted in Section 184.

The remedies available in case of non-disclosure remain the same under the 2013 Act except for a few minor changes. While any self-dealing contract entered into without disclosure to the Board would remain voidable at the option of the company,[52] it is the penal consequences that have been amended by Section 184. A director who fails to make a disclosure when required would be liable to pay a fine of at least Rupees Fifty Thousand, but up to Rupees One Lakh, and may also face a term of imprisonment for up to one year.[53] Moreover, while the 1956 Act limited the requirement that a director abstain from subsequent proceedings and voting only to public companies, the 2013 Act has now extended this obligation to all companies.[54]

B. The Requirement of Prior Approval

The Companies Act, 1956 provides for the requirement of prior approval for self-dealing transactions under Section 297. Although there is a considerable overlap between this provision and Section 299 of the Act, discussed above, there are some differences that must be noted. While the requirement of disclosure, under Section 299, applies to all existent and '*proposed contract(s) or arrangement(s)*' in which a director may have a direct or indirect interest, the requirement of prior approval is narrower, and governs only two specific types of contracts, namely - '*for the sale, purchase or supply of any goods, materials or services*' and '*for underwriting the subscription of any shares in, or debentures of, the company*' – which are brought before the Board.[55] Moreover, while self-dealing transactions between two public companies fall outside the ambit of Section 297, they are certainly subject to the disclosure requirements under Section 299.[56] Finally, Section 297 specifically details the parties with whom a contract would require prior approval – '*a director of the company or his relative, a firm in which such a director or relative is a partner, any other partner in such a firm, or a private company of which the director is a member or director*'. On the other hand, Section 299 used broader phrasing, and includes within its ambit all contracts in

[52] Section 184(3), The Companies Act (2013).
[53] Section 184(4), The Companies Act (2013).
[54] Sections 174(3) & 184(2), The Companies Act (2013).
[55] Rabindra Nath Mitra v Emperor, (1938) 8 Comp Cas 176.
[56] Ministry of Corporate Affairs, *Circular No.* 8/299/56-PR (15th June, 1956).

which the director of a company is in '*any way, whether directly or indirectly, concerned or interested*'.

The primary defect that Section 297 suffers from, in the opinion of the researcher, is narrow drafting. By choosing to use specific rather than general phrasing, the section unintentionally excludes several forms of abusive self-dealing from within its ambit, creating lacunae that a dishonest director could exploit with ease.

For instance, although the provision attempts to specify parties with whom contracts would constitute self-dealing, it fails to account for several vital relationships. While the provision accounts for transactions with a private company in which a director may have a *direct* interest (by owning a stake in it or being placed on its Board), it overlooks similar agreements with companies in which only an *indirect* interest exists (companies which may be owned or controlled by the family members of the director).[57] It seems absurd for the drafters of the provision to have made such an error, considering that Section 299 specifically accounts for identical indirect interests. Moreover, the provision simply excludes all transactions between two public companies, even though the director of one may have a controlling stake in another, thereby enabling him to engage in transactions between the two, to further his own self-interest rather than that of either company.[58]

However, perhaps the more significant error made by the drafters of the provision was to restrict the scope of contracts for which approval must be sought to those for the sale or purchase of *goods*, materials or services.[59] As the Companies Act, 1956 does not provide a definition of "goods", one must resort to the definition under the Sale of Goods Act, 1930[60] which restricts the phrase 'goods' to only moveable property.[61] The difficulty that arises out of this is that all transactions in immoveable property, which almost always constitute the most valuable assets owned by a company, are not governed by the requirements of approval.[62] This fault in drafting permits

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57 V. Khanna, *The Relation between Firm-Level Corporate Governance and Market Value: A Case Study of India*, 11(4) Emerging Markets Review 319 (2010).

58 V. Umakanth, *India's Corporate Governance: Rhetoric or Reality?*, 21(1) NLSIR 132 (2010).

59 Section 297(1)(a), The Companies Act (1956).

60 Hindustan Lever Employees' Union v Hindustan Lever Ltd., 1995 Supp (1) SCC 499 : 1994 Supp (4) SCR 723; Morgan Stanley Mutual Fund v Kartick Das, (1994) 4 SCC 225.

61 Section 2(7), Sale of Goods Act (1930).

62 This lacuna was specifically acknowledged by the Department of Corporate Affairs, when Sona Steering Systems Ltd., a joint venture of Maruti Udyog Ltd., made an application to the Department for approval under Section 297(1) of the Companies Act, 1956, for taking on rent office premises for the company from a firm in which directors of the company were interested. The Department responded through Clarification No.9/41/90—CL-X,

the most destructive form of self-dealing to occur without prior approval, the repercussions of which could be potentially fatal for the company in question. Moreover, due to such narrow drafting, the section does not apply to loans made by a director to a company, as such a transaction does not constitute a sale or purchase of goods, or a contract to render personal services.[63] In fact, the problematic nature of this provision's narrow drafting became evident in *Renuka Datla* v *Biological E. Ltd.*,[64] where the Andhra Pradesh High Court was forced to concede that, due to the specific wording of Section 297 requiring a *contract* for sale of *goods, materials or services*, the transfer of a company's shares by a director to his daughter did not require prior approval. Similarly, the Court found that the appointment of two other daughters as employees of the Company, in the same case, could also not be challenged under Section 297.

The provisions under Section 297 provide for a two-layer mechanism of approval. The *first* mandates that, for all transactions specified in the section, consent must be sought from the Board of Directors, and this approval is to be obtained only through a resolution passed at a meeting of the Board.[65] Such approval can be sought either prior to the contract, or within three months of the date on which it is signed.[66] However, if the company in question possesses a paid-up share capital of Rupees one crore or more, than a *second* level of approval must be sought – that of the Central Government.[67]

The problems associated with only requiring approval from the Board of Directors in the Indian environment, where the entire management of companies is often controlled by a single promoter group, are evident. In numerous cases, Courts have encountered Boards, where a majority of the members are related to one another, that have granted approval to the most grossly unfair transactions.[68] For instance, in A. *Jawahar Palaniappan* v *Kumudam Publications (P) Ltd.*,[69] a Board of Directors composed of the chairman's family members approved a purchase of LED panels worth Rs.8

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dated 27–3–1990, stating that such transactions involving immoveable property fell outside the ambit of Section 279, and thus did not require prior approval.

[63] R. Chakrabarti, *Corporate Governance in India – Evolution and Challenges* (2005) *available at* http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=649857 (Last visited on 14 May, 2015).

[64] Renuka Datla v Biological E. Ltd, (2015) 193 Comp Cas 356.

[65] Sections 297(1) & (4), The Companies Act (1956).

[66] Section 297(4), The Companies Act (1956).

[67] Proviso to Section 297(1), The Companies Act (1956).

[68] *See*: Jai Surgicals Ltd. v CIT, (2014) 150 ITD 60 (Del); Yashovardhan Saboo v Groz-Beckert Saboo Ltd., (1995) 83 Comp Cas 371 (CLB); Subhash Chand Agarwal v Associated Limestone Ltd., (1998) 92 Comp Cas 525 (CLB); Francis Cleetus v Rashtra Deepika Ltd., (2013) 115 CLA 299 (CLB).

[69] A. Jawahar Palaniappan v Kumudam Publications (P) Ltd., 2015 SCC OnLine CLB 83.

lacs from the chairman's company for a whopping price of Rs. 3 crores. Thus, *prima facie*, it may seem that the additional requirement of government approval in such transactions involving large-capital companies would be beneficial, as it would provide another layer of protection when the Board may fail to check an unfair self-dealing transaction. While this reasoning may make sense, theoretically, it has failed in practice, because the impracticality of examining and approving each such self-dealing transaction has forced the government to delegate this function to regional directors,[70] and to carve out numerous broad exceptions to this requirement,[71] which have severely diminished its effectiveness.

For instance, Circular No.13/75, which excludes agreements for employment in a professional capacity, waters down the regulations under Section 297, as it permits a director to appoint his relatives or friends as employees of the Company, or to hire them in any other professional capacity, without the approval of the Board. In fact, this was precisely what took place in *Shailesh Harilal Shah* v *Matushree Textiles Ltd.*,[72] in which the Bombay High Court was forced to uphold the appointment of a sitting director's relative as an employee, as such transactions had been excluded from the ambit of Section 297 and Section 300. This creates considerable difficulty, as there is great potential for abuse in such agreements of employment, whereby a director may allow his personal relations to motivate his selection of candidates, and hire his own family members, who may be unqualified and inefficient, against the best interests of the company – thereby breaching the No Conflict rule.

Section 297 also creates certain exceptions to the rule requiring prior approval. It exempts transactions in cash, which take place at prevailing market prices,[73] as well as transactions involving goods or services in which one of the parties regularly trades or does business, provided that the value of such a contract (or contracts) with a specific related party does not exceed Rupees Five Thousand for any given year.[74] The provision also excludes from its ambit any transactions entered into by a Banking or Insurance Company,

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70 Central Government has delegated to the Regional Directors at [Bombay, Calcutta, Madras and Kanpur], the powers and functions under the proviso to sub-section (1) through Notification No. GSR 563(E), dated 19–8–1993.

71 *See*: *Circular No*.13/75, dated 5–6–1975 (Excludes agreements for professional services); *Circular* No. 13/75, dated 5–6–1975 (Excludes contracts for the appointment of a director as a managing director or a whole-time director); *Notification* GSR 233, dated 31–1–1978 (Excludes transactions between Government Companies).

72 Shailesh Harilal Shah v Matushree Textiles Ltd., AIR 1994 Bom 20.

73 Section 297(2)(a), The Companies Act (1956).

74 Section 297(2)(b), The Companies Act (1956).

in the ordinary course of its business.[75] Finally, sub-section (3) also permits such self-dealing transactions to take place without prior approval, in circumstances of urgent necessity, provided that Board sanction is sought within three months of the transaction.

If the provisions of Section 297 are breached, and approval of the Board is not obtained prior to, or within three months of, the relevant related-party transaction, then the Company is granted the right to avoid the transaction.[76] On the other hand, if it is the Central Government's consent which has not been sought, then the contract is rendered void *ab initio*.[77] Moreover, although no penalty is prescribed under this provision, specifically, Section 629A would, nonetheless, be applicable to a director who has failed to acquire such approval under Section 297, and he would be liable to pay a fine of up to Rupees Five Thousand, as witnessed in Otto Burlingtons Mail Orders (P) Ltd., In re,[78] as well as Dintex Dyechem Ltd., In re.[79]

The provisions regulating prior approval of self-dealing transactions under the 2013 Act are, in the researcher's opinion, an excellent improvement on those under the 1956 regime. They overcome almost all the issues pointed out above, and even go further – providing additional checks and safeguards to ensure fair dealing among related parties. One of the foremost concerns, under the earlier Act, was that all self-dealing transactions merely required approval from the Board of Directors. However, as shown above, the management structure of Indian companies is such that most Boards are comprised of relatives and associates of the promoter group, who would gladly approve anything that they are required to – rendering the requirement of their consent a superficial and ineffective one. This was why the Act was amended,[80] to provide an additional means of oversight – that of the Central Government. However, as discussed above, this provision was also ineffective, due to the impracticality of obtaining government approval for such transactions.

Section 188 of the Companies Act, 2013 has found an innovative method to check abuse by the Board, and provide an additional means of supervision – through three different steps. *First*, for transactions whose value crosses 10% of the Company's net worth (or turnover, depending on the nature of the transaction), or exceeds Rupees One Hundred Crores (whichever is

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[75] Section 297(2)(c), The Companies Act (1956).
[76] Section 297(5), The Companies Act (1956).
[77] A. RAMAIYA, GUIDE TO COMPANIES ACT 2103 (17th ed. 2010).
[78] Otto Burlingtons Mail Orders P. Ltd., In re, (1999) 96 Comp Cas 525.
[79] Dintex Dyechem Ltd. In re, (2001) 104 Comp Cas 735.
[80] Section 28, The Companies (Amendment) Act (1974).

lower), this provision mandates that the consent of the shareholders be taken, by means of a special resolution.[81] *Second*, while obtaining such consent, the provision bars any members who may be related parties to the transaction from voting on the special resolution.[82] *Third*, the section also creates an obligation for the Board to include, in its report to the shareholders, a list of all such related-party transactions, which the company has entered into, along with a justification for the same.[83] Through these three steps, Section 188 manages to significantly reduce the possibility of the Board abusing its powers, and granting consent to abusive self-dealing transactions, as supervisory powers are taken away from the central government, which has no direct interest in regulating such deals, and granted to the party that has the greatest stake in preventing them – the shareholders.[84]

In addition, Section 188 also accounts for several types of transactions that had been unwittingly excluded from within the ambit of Section 297 of the Companies Act, 1956. For instance, it explicitly brings within its scope all transactions involving the Company's immoveable property,[85] which had been excluded from the 1956 regime due to the use of the word 'goods'. Moreover, it also specifically includes within its scope agreements to appoint a related party to an office of profit within the company or a subsidiary or associate company, thereby putting an end to the trend of nepotism that was permitted under Section 297 of the earlier statute. This was witnessed in *Jagran Prakash Ltd.* v *Union of India*[86] and *Madhu Ashok Kapur* v *Rana Kapoor*,[87] where the Delhi and Bombay High Courts found that the appointment of a director's relative as an employee of the company would now require approval under Section 188 – in sharp contrast with the decisions in *Shailesh Harilal Shah* v *Matushree Textiles Ltd.* and *Renuka Datla* v *Biological E. Ltd.*, under Section 297 of the 1956 Act, discussed above. Further, by providing a broad definition for the word 'related party',[88] the section also accounts for several possible transactions in which the director may have possessed only an indirect interest, through his relatives, which were not governed by the 1956 Act's provisions on self-dealing.

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81 Proviso to Section 188(1), The Companies Act (2013) read with Rule 15, Companies (Meetings of Board and its Powers) Rules (2014).

82 Second Proviso to Section 188(1), The Companies Act (2013).

83 Section 188(2), The Companies Act (2013).

84 N.Kumar, *A Study of Corporate Governance under Companies Act, 2013*, 2(6) Asian Journal of Multidisciplinary Sciences 43 (2014).

85 Sections 188(1)(b) & (c), The Companies Act (2013).

86 Jagran Prakash Ltd. v Union of India, (2016) 131 CLA 27 (Del).

87 Madhu Ashok Kapur v Rana Kapoor, 2015 SCC OnLine Bom 5818.

88 Section 2(76), The Companies Act (2013).

Finally, the 2013 Act also streamlines the variety of different exceptions to the requirement of prior approval that were provided for under the 1956 Act – such as cash transactions at market price, contracts in areas of regular trade, and transactions in circumstances of urgent necessity – and replaces them with a singular, simplified exception. The section exempts all '*transactions entered into by the company in its ordinary course of business … on an arm's length basis*' from the requirement of prior approval.[89] Although the rationale for such an exception is easy to understand, and it does bring much needed clarity to the provisions, there are two points that must be noted with respect to this provision. *First*, it makes an unmistakable departure from a long history of common law rulings, which declare that a breach of the fiduciary duty to avoid conflicts is not determined by the fairness of the terms of a transaction, but rather by whether or not the procedural elements of disclosure and approval have been met.[90]

Second, the 2013 Act's definition of '*arm's length*' transactions - those conducted between two related parties as if they were unrelated – is an ambiguous one, and writers have observed that it is capable of different interpretations.[91] One may construe it as a procedural requirement, that neither the two related parties nor their agents participate in the negotiation and conclusion of the transaction. Alternatively, one may also interpret it as empowering courts to examine the terms of each agreement and evaluate their fairness by comparing them to the market value of such transactions.[92] Given the importance of this sole exception to Section 188, as well as its wide scope, it is essential that the legislature or the Courts clarify the means of ascertaining when a transaction has been conducted on an arm's length basis. The only case where the meaning of an '*arm's length*' transaction under Section 188 has come up for discussion is that of *Madhu Ashok Kapur* v *Rana Kapoor*,[93] in which the reappointment of the Managing Director of Yes Bank was argued to be a related party transaction that should have been carried out only with shareholder approval through a special resolution. The Bombay High Court, however, dismissed this objection on the ground that the transaction was conducted at arm's length. Although the objection is dealt with very briefly, and the Court sheds very little reasoning on the meaning of '*arm's length*' transaction, one can gather – from the

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89 3rd Proviso to Section 188(1), The Companies Act (2013).

90 Aberdeen Railway Co. v Blaikie Bros., (1843-60) All ER Rep 249; Hutchinson v Brayhead Ltd., (1967) 3 All ER 98 (CA).

91 N. Sharma, *Corporate Governance: Conceptualization in the Indian Context*, 3(5) INDIAN JOURNAL OF MANAGEMENT & SOCIAL SCIENCES RESEARCH 17 (2014).

92 N. Kumar, *A Study of Corporate Governance under Companies Act, 2013*, 2(6) ASIAN JOURNAL OF MULTIDISCIPLINARY SCIENCES 43 (2014).

93 Madhu Ashok Kapur v Rana Kapoor, 2015 SCC OnLine Bom 5818.

Court's discussion on the nature of perquisites that Managing Directors are ordinarily entitled to – that it opted for the second of the two interpretations outlined above, i.e. it chose to look at the substantive provisions of the transaction and compare them to those carried out in the market, rather than consider the test of '*arm's length*' transactions a mere procedural one. This is also the manner in which the Supreme Court has interpreted arm's length transactions in *Atic Industries Ltd.* v *H.H. Dewa*[94] and *A.K. Roy* v *Voltas Ltd.*,[95] in the context of Section 4 of the Central Excise Act, and in *Inder Singh* v *Union of India*,[96] in the context of Section 51A of the Land Acquisition Act. Thus it is fair to observe, provisionally, that the meaning of '*arm's length*' transactions under Section 188 is to be interpreted as a substantive test, and not a procedural one.

The remedies available for a violation of the requirement of prior approval have also been significantly altered by the 2013 Act. *First*, such a contract is rendered voidable, at the option of the Company, and the interested director, as well as any other director who authorized the transaction, are made liable to indemnify the Company for any loss it may have suffered as a consequence of the transaction.[97] *Second*, the Company can also initiate proceedings against any director or employee who entered into such a contract without approval, for the recovery of any loss suffered from the transaction.[98] *Third*, such directors and employees are also liable to penal sanctions – a fine that shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees, as well as imprisonment that may extend to one year (in case of a listed company).[99] *Fourth*, the office of such a director may also be vacated, if he acts in contravention of Section 184 of the Act.[100] *Fifth*, any individual convicted for violating the provisions of Section 188 is also rendered ineligible to be appointed as the director of any company, for a period of five years.[101] Thus, we can conclude that the new regime, under the 2013 Act, provides for significant deterrence to directors who seek to engage in self-dealing transactions without appropriate prior approval.

94 Atic Industries Ltd. v H.H. Dewa, (1979) 1 SCC 499 : AIR 1975 SC 960.
95 A.K. Roy v Voltas Ltd., (1973) 3 SCC 503 : AIR 1973 SC 225.
96 Inder Singh v Union of India, (1993) 3 SCC 240 : (1993) 3 SCR 371.
97 Section 188(3), The Companies Act (2013).
98 Section 188(4), The Companies Act (2013).
99 Section 188(5), The Companies Act (2013).
100 Section 167, The Companies Act (2013).
101 Section 164(1)(g), The Companies Act (2013).

C. The Regulation of Loans

Loans are transactions which pose a special danger, in the realm of self-dealing. Loans constitute an easy method of avoiding the regulations that restrict the disposal of assets, and are capable of camouflaging transactions that, in reality, are nothing more than a gift – either because the loan in question is never expected to be returned, or because the terms on which the loan is granted are not of a commercially beneficial nature.[102] In fact, in 1945, the Cohen Committee in the UK recommended that the legislature ought to completely prohibit companies from granting loans to their directors, as they believed that such transactions were never justifiable.[103] Their reasoning was as follows: If the director desiring a loan was able to offer good security, it should not be difficult for him to borrow the amount he desires from other sources. If, on the other hand, he cannot offer good security, then it would not be in the best interests of the company to offer him credit, which he would not be able to obtain from elsewhere.[104]

The Companies Act, 1956 comes close to adopting the recommendations of the Cohen Committee, under Section 295. This provision prohibits the granting of any loans, directly or indirectly, to a director or his relatives, or to any shadow director, or to a company or firm in which such director is interested, without the prior consent of the Central Government. There are, however, two significant defects that this provision suffers from. The *first*, is that the provision limits its scope only to public companies (and private companies that are subsidiaries of public companies).[105] By doing so, the provision eliminates from its ambit a large number of private companies, for which there seems to be no easily discernible reason or policy concern. Consequently, a lacuna exists in the law, which permits directors of private companies to engage in unfair credit transactions with themselves, or other related parties.

The *second* problem with this provision is the use of the specific word 'loan', rather than a broader phrase – such as 'credit transactions' – which has resulted in the judiciary being forced to adopt a technical interpretation of this provision.[106] For instance, in *Fredie Ardeshir Mehta* v *Union*

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[102] Farrar's Company Law 452 (4th ed. 1998).

[103] Report of the Committee on Company Law Amendment, Cmnd. 6659, 1945, para 94. Interestingly, one of the corporate governance measures introduced in the USA, following the Enron affair, was the introduction of the Sarbanes-Oxley Act 2002, which contains an absolute prohibition on loans by companies to their directors, under Section 402(a).

[104] Gower & Davies Principles of Modern Company Law 567 (9th ed. 2012).

[105] Section 295(2)(a)(i), The Companies Act (1956).

[106] N. Kumar & J. Singh, *Outside Directors, Corporate Governance and Firm Performance: Empirical Evidence from India*, 4(2) Asian Journal of Finance & Accounting 32

of India,[107] the Bombay High Court held that the provisions of Section 295 would only be attracted if a loan was granted to a director – the essential requirement of which was the grant of a sum of money, upon the understanding that it would have to be returned by a certain date, with or without interest. As a consequence, the transaction in that case – which was the sale of a company flat to a director, on part payment of the full amount, with the rest being due on credit – was not found to constitute a 'loan'.

This is quite clearly problematic, as it allows directors to achieve, through indirect means, what the law prohibits them from doing directly. Instead of directly taking a loan from the company to purchase a house, a director could, instead, use the company's funds to purchase the house in its name, and then sell it to himself on credit, without attracting the prohibition under Section 295.[108] A similar outcome was also seen in *M.R. Electronic Components Ltd.* v *Registrar of Companies*,[109] in which a managing director transferred sums to his wife, who was an employee of the company, under the guise of advance salaries, but whose actions were still considered to be consistent with Section 295, because they did not fall within the narrow definition of a loan.

A breach of the provisions under Section 295 makes any party which knowingly participated in the transaction liable to pay a fine of Rupees Fifty Thousand, or a term of simple imprisonment for six months.[110] However, if the loan amount is repaid in full, then the section mandates that no imprisonment should be awarded.[111] In addition to the above criminal sanctions, each such party is also jointly and severally liable to the lending company, for the amount of the loan so granted.[112] It would be important to note, however, that unlike the other remedies available for a breach of the No-Conflict rule, this remedy is a personal one, which renders only the director liable to pay the requisite amount, and not a proprietary one, which would make him a constructive trustee of the company with respect to the amount lent, as per the decision in *Ciro Citterio Menswear plc*.[113] Further, by making all parties with knowledge liable for this breach, the section extends sanction from merely the interested director, to the entire Board, if they were cognizant of the transaction. Finally, in addition to the above, the office of the

(2012).

107 Fredie Ardeshir Mehta v Union of India, (1991) 70 Comp Cas 210, 213.

108 A. Ramaiya, Guide to Companies Act 2089 (17th ed. 2010).

109 M.R. Electronic Components Ltd. v Registrar of Companies, (1987) 61 Comp Cas 8.

110 Section 295(4), The Companies Act (1956).

111 Proviso to Section 295(4), The Companies Act (1956).

112 Section 295(5), The Companies Act (1956).

113 Ciro Citterio Menswear plc. (in admn.) Re, (2002) 1 BCLC 672 (Ch D).

interested director shall also become vacant if he, or any firm in which he is a partner or any private company of which he is a director, accepts a loan or any guarantee or security for a loan, from the company in contravention of Section 295.[114]

The 2013 Act provides for the regulation of loans, under Section 185 of the 2013 Act. This provision is, largely, identical to the provisions under the 1956 Act. However, it has made *three* important changes, which have helped made such regulation more efficacious. *First*, Section 185 extends the scope of the prohibition of loans to directors from one that merely applied to public companies (under the 1956 Act), to one that now govern all companies.[115] *Second*, although the issues pointed out above, caused by the strictly technical use of the phrase 'loan' would still continue under the 2013 Act, Section 185 does seek to mitigate this effect, by '*including any loan represented by a book debt' within its scope*'.[116] The term 'book debt' is certainly a broader one than 'loan', and it includes within its ambit transactions such as the sale of goods on credit, or the provision of advances to employees,[117] which would earlier have been excluded. However, with respect to other types of credit transactions, it is likely that Courts will interpret the word 'loan' in Section 185 of the 2013 Act narrowly, as was done in Fredie Ardeshir Mehta case for Section 295 of the 1956 Act, discussed above. Although there is still much to be desired from the narrow drafting of this provision, it is still, definitely, an improvement from that of Section 295 of the 1956 Act.

Finally, the section also does away with the requirement of Central Government approval, which prevailed under the 1956 Act, and thereby completely prohibits all loans to a director or to persons in whom the director is interested. Thus, our jurisdiction has finally adopted, in full, the recommendations of the Cohen Committee.

Section 185 has also altered the remedies available for a breach of the provisions that regulate loans. It mandates that any director or related party who receives such a loan shall be liable to imprisonment for six months or with a fine which shall not be less than five lakh rupees but which may extend to twenty-five lakh rupees, or with both.[118] It further provides that

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[114] Section 283(1)(h), The Companies Act (1956).

[115] Section 185(1), The Companies Act (2013).

[116] Deloite & ASSOCHAM, *Report on Companies Act, 2013 – "New Rules of the Game"*, 24 (2013).

[117] See: Independent Automatic Sales Ltd. v Knowles & Foster (1962) 3 All ER 27; Paul & Frank Ltd. v Discount Bank Overseas Ltd., (1966) 2 All ER 922; K.M. Mohommed Abdul Kadir Rowther v S. Muthich Chettiar, (1960) 2 Mad LJ 13 at 15; Raja of Venkatagiri v Krishnayya Rao Bahadur, AIR 1948 PC 150 at p. 155.

[118] Section 185(2), The Companies Act (2013).

the company granting the loan shall also be punishable with a fine, which shall not be less than five lakh rupees but which may extend to twenty-five lakh rupees.[119]

CONCLUSION

The Companies Act, 2013 has successfully addressed numerous issues that were present under the 1956 Act's provisions on self-dealing. Nonetheless, the efficacy of the 2013 Act is a matter that cannot be predicted – it is only their implementation that will inform us of any further shortcomings that may need to be tackled. At the same time, it would be beneficial to outline the areas in which the 2013 Act could improve, and the lessons it could learn from the law on self-dealing transactions in other jurisdictions.

A. Enhancing Supervisory Mechanisms over the Board of Directors

As has been emphasized above, India's ownership and management structure renders it particularly vulnerable to unfair self-dealing transactions, at the hands of interested directors. As a consequence, leaving a majority of the task of regulating such transactions to the Board itself is a dangerous idea. Although the 2013 Act makes significant advances in this field, by introducing the original, common-law rule of shareholder approval, there are still means by which it could improve. For instance, Clause 49(VII)(D) of SEBI's Equity Listing Agreement mandates that each and every self-dealing transaction must be submitted to the Board's Audit Committee for verification and approval. This is certainly a novel idea, which ought to be extended to all companies. It should be noted, however, that this proposal could only be achieved if the mandatory requirement of independent directors were to be extended to *all* companies, instead of simply the public listed ones.

Furthermore, both Hong Kong and Singapore have developed an innovative method of providing an additional layer of oversight over the Board, by mandating that all material self-dealing transactions must be announced publicly, which allows investors as well as other members of the public to remain constantly informed and to investigate further, if need be.[120] In addition, while each of these jurisdictions has adopted a similar rule as the one in

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[119] *Id.*

[120] Stock Exchange of Hong Kong, Listing Rule 14A (2010); Singapore Exchange Listing Manual, Rule 9A06.

India, which requires shareholder approval for valuable related-party transactions, and only permits independent shareholders to vote, they go a step further in ensuring that such independent shareholders make an informed and educated choice. Both Hong Kong and Singapore mandate that in the event that such shareholder approval is required, the independent directors of the company must form a committee to advise them and, further, they must appoint an external financial advisor to issue an opinion on the fairness of the transaction.[121] It would certainly be beneficial to adopt similar requirements in India.

Moreover, it may also be beneficial to consider adopting the strategy used in the UK for determining when shareholder approval ought to be required. The UK's laws make such approval contingent on the nature of the transaction,[122] rather than the *quantum* or *value*, as is the case with the 2013 Act. This seems to be a more efficient strategy, as it enables the State to target only the particularly risky categories of transactions, while the others need not be put through the tedious process of obtaining shareholder approval.[123] Finally, it may also be beneficial to update the Accounting Standards that we follow. Accounting Standard 18, which regulates related party transactions, has significant loopholes in it: it does not apply to associate companies; it does not mandate the disclosure of important details, such as the pricing of the transaction, the reason it was chosen, the other available options, or why the choice was a fair one.[124] Addressing each of these concerns would be necessary, in order to ensure that we provide for a cohesive and exhaustive regulatory mechanism for self-dealing transactions.

B. Addressing Issues of Drafting in the Statute

As has been outlined, in the sections above, the 2013 Act is not without its flaws. However, it is pertinent to point out the two most important ones, that must be addressed. First, it is important to expand the scope of Section 185's prohibition against 'loans' to directors, which is excessively narrow

121 *Id.*

122 These categories include substantial property transactions, credit transactions, Directors' service contracts and gratuitous payments to directors, as well as donations and expenditure of a political nature. *See*: GOWER & DAVIES PRINCIPLES OF MODERN COMPANY LAW 563 (9th ed. 2012).

123 It would be pertinent to note that it was the very inefficiency and difficulty of obtaining shareholder approval for self-dealing transactions that had caused jurisdictions to abandon this common law rule in the first place, and to opt for simplified methods of disclosure and approval by the Board. *See*: GOWER & DAVIES' PRINCIPLES OF MODERN COMPANY LAW 564 (9th ed. 2012).

124 A. Galani & N. Rehn, *Related Party Transactions: Empowering Boards and Minority Shareholders to Prevent Abuses*, 20(2) NLSIR 134 (2010).

and has been subjected to a very technical interpretation by the judiciary. It may be more appropriate to adopt the English position on this subject, by mandating that the prohibition apply not only to "loans", but also to "quasi-loans", "credit transactions" and other such "related arrangements", to ensure that directors do not use indirect means to circumvent the prohibition on taking direct loans.[125]

Second, it is also necessary to provide greater flexibility in the statute to determine when a particular party, with which a transaction is sought, is a related one or one in whom a director may have an indirect interest, thereby attracting the requirements of disclosure and/or approval. This issue is made evident by the phrasing of Section 184, which narrows the transactions it covers to such an extent, that it completely excludes any form of indirect interest a director may have in a contracting party. Jurisdictions such as the USA, Hong Kong and Singapore have sought to avoid such an outcome by using very broad definitions for related or associated parties, and also by avoiding any classification of transactions to which the requirements of disclosure and approval apply.[126] Perhaps it is time we do the same.

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[125] Sections 197-203, UK Companies Act (2006).

[126] A. Galani & N. Rehn, *Related Party Transactions: Empowering Boards and Minority Shareholders to Prevent Abuses*, 20(2) NLSIR 134 (2010).

INSIDER TRADING REGULATIONS: IMPLICATIONS FOR M&A TRANSACTIONS, SEBI'S INVESTIGATIVE POWERS AND PENALTIES IMPOSED

Rajat Sethi, Sudip Mahapatra and Jinaly Dani

This article explores a key issue for practitioners in relation to the implications of the insider trading law in India on the due diligence process undertaken in relation to mergers and acquisitions ("M&A Transactions"). At a more conceptual level, this article also briefly discusses investigative powers of the SEBI in relation to transactions suspected of involving insider trading and penalties for violations of insider trading regulations in the context of recent developments.

I. INTRODUCTION

Insider trading is the act of trading in the securities of a publicly listed or proposed-to-be listed company, by any person having the advantage of asymmetrical access to unpublished information in relation to the company or its securities, which when published, is likely to materially affect the market price of such securities.

Insider trading is prohibited in most countries based on the rationale that it erodes investor confidence in the market. Prohibitions on insider trading are rooted in theories of fairness that view trading with material non-public information as either dishonest and fraudulent on account of the fiduciary duty owed by the insider to the common investor or undesirable on account of unequal access to insider information.[1] In India, the Securities and Exchange Board of India Act, 1992 (the "SEBI Act") prohibits a person from engaging in any direct or indirect form of insider trading or trading while in possession of material non-public information or communicating such information.[2] The Securities and Exchange Board of India (the "SEBI") has enacted the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015 (the "Insider Trading Regulations, 2015") under the SEBI Act. The Insider Trading Regulations, 2015 are the principal regulations that regulate and prohibit transactions involving insider trading.

Restrictions on insider trading are also included in the Companies Act, 2013,[3] which prohibits individuals including any director or key managerial personnel "of a company" from engaging in insider trading. The language of this provision leaves scope for interpretation that insider trading restrictions under the company law apply to all companies i.e., private, public listed and public unlisted companies. Evidently, in the case of private and public unlisted companies (which do not intend to get their securities listed), such restrictions would be of limited use on account of the lack of public involvement in the price discovery of their securities. It is for this reason that the Companies Law (Amendment) Bill, 2016 has sought to omit this provision.[4]

II. BRIEF SUMMARY OF THE INSIDER TRADING REGULATIONS, 2015

In January 2015, more than two decades since the enactment of the first primary insider trading law in India, the SEBI enacted the Insider Trading Regulations, 2015 to replace the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992 (the "Insider Trading Regulations, 1992"). The Insider Trading Regulations, 2015 were enacted keeping in mind the recommendations of a panel headed by Justice N.K.

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1 Charles C. Cox and Kevin S. Fogarty, *Bases of Insider Trading Law*, 49 OHIO STATE LAW JOURNAL 353, 385-360 (1988).
2 Section 12A, Securities and Exchange Board of India, 1992.
3 Section 195, Companies Act, 2013.
4 Section 63, Companies (Amendment) Bill, 2016.

Sodhi[5] and introduced significant changes including strengthening the definition of "insider", "connected person" and "unpublished price sensitive information" ("UPSI"), rationalizing disclosure events and permitting trading plans.

The Insider Trading Regulations, 2015 restrict:

(a) Trading[6] while in possession of UPSI[7]: Insiders are prohibited from trading in listed or proposed to be listed securities when in possession of UPSI.

(b) Communicating and Procuring UPSI[8]: Insiders are prohibited from communicating, providing or allowing access to any UPSI relating to a listed or proposed-to-be listed company or its securities, to any person. In addition, all persons are prohibited from procuring or inducing communication of UPSI from an insider. Communication or procurement of UPSI is however permitted in furtherance of a legitimate purpose or performance of duties or discharge of legal obligations.

The exemptions in relation to "legitimate purpose", "performance of duties" and "discharge of legal obligations" remain undefined under the Insider Trading Regulations, 2015. They were also absent under the Insider Trading Regulations, 1992 which permitted communication of UPSI required in the ordinary course of business, profession or employment or under any law. In the absence of any guiding jurisprudence on these terms, it will be interesting to see how the regulator interprets these terms.

The Insider Trading Regulations, 2015 recognise that some individuals such as directors and key managerial personnel of a company may perpetually be in possession UPSI. With the introduction of trading plans[9], such individuals now have the option to formulate pre-scheduled trading plans of not less than 12 months duration. Trading plans are required to be disclosed to the public and strictly adhered to. No trade in securities of the company

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5 Report of the High Level Committee to review the SEBI (Prohibition of Insider Trading) Regulations, 1992 (December 7, 2013), *available at* http://www.sebi.gov.in/cms/sebi_data/attachdocs/1386758945803.pdf (Last visited on August 1, 2016) (the "Sodhi Committee Report").

6 "Trading" has been defined to mean and include subscribing, buying, selling, dealing, or agreeing to subscribe, buy, sell or deal in any securities.

7 Regulation 4, Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015.

8 Regulation 3, Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015.

9 Regulation 5, Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015.

can be made before six months from the public disclosure of the trading plan.[10]

The Insider Trading Regulations, 2015 prescribe certain initial and continual disclosure requirements for every promoter, director and key managerial personnel of a listed company.

- Initial Disclosure Requirement[11]: Every person on appointment as a key managerial personnel or a director of the company or upon becoming a promoter is required to disclose his or her holding of the securities of the company as on the date of appointment or as on the date of becoming a promoter, within seven days of such appointment or becoming a promoter.
- Continual Disclosure Requirement[12]: Every promoter, employee and director is required to disclose the number of securities of the company acquired or disposed of within two trading days, if the aggregate value of the securities traded (in one trade or in a series of trades over any calendar quarter) is in excess of Rs.1,000,000. In case of trade in derivatives, the traded value of derivatives shall be taken into account.

Unlike the Insider Trading Regulations, 1992, the Insider Trading Regulations, 2015 do not require (i) disclosures by a substantial shareholder i.e., a person holding 5% or more of the shares or voting rights of a company other than promoters, directors or key managerial personnel; and (ii) a person holding 5% or more of the shares or voting rights of a company to disclose any acquisition or disposal resulting in a change of 2% or more in the total shareholding or voting rights in the company.[13] A listed company may also, at its discretion, formulate its own disclosure requirements for other connected persons in order to monitor compliance with the regulations.

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[10] Notwithstanding the 6 months cool-off period, commencement of the trading plan can further be deferred if the UPSI is not generally available to the public. Additionally, trading pursuant to a trading plan is not permitted for specified time periods around the declaration of financial results by a company.

[11] Regulation 7(1), Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015.

[12] Regulation 7(2), Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015.

[13] These disclosures continue to be required under the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011.

III. Permissible Disclosures under the Insider Trading Regulations, 2015 and Implications for M&A Transactions

A. Permitted Disclosures

As stated earlier, the Insider Trading Regulations, 2015 permit communication and procurement of UPSI in furtherance of a legitimate purpose or performance of duties or discharge of legal obligations. In addition to these general exemptions, communication and procurement of UPSI is also permissible in connection with transactions:

(a) when there is an obligation to make an open offer under the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011,[14] (the "Takeover Code") (i.e. acquisition of control or an acquisition of 25% or more of the voting rights in a listed company or an acquisition of more than 5% or more voting rights in a financial year where the acquirer already holds 25% or more of the voting rights in the company) and the board of directors of the company is of the informed opinion that the proposed transaction is in the best interests of the company,[15] and

(b) when there is no obligation to make an open offer under the Takeover Code including transactions such as a slump sale, asset purchase or other transactions exempted under the Takeover Code but the board of directors of the company is of the informed opinion that the proposed transaction is in the best interests of the company and the information constituting UPSI is made generally available to the public at least two trading days prior to the proposed transaction being effected in such form as the board of directors may decide.[16]

Prior to providing any access to UPSI under the abovementioned exceptions, the Insider Trading Regulations, 2015 require the company to enter into confidentiality and non-disclosure agreements with the persons accessing UPSI.[17] Such persons are also prohibited from otherwise trading in the

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14 Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011.

15 Regulation 3(3)(i), Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015.

16 Regulation 3(3)(ii), Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015.

17 Regulation 3(4), Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015.

securities of the company when in possession of UPSI.[18] Accordingly, the company would also be required to enter into standstill agreements, which would restrict such persons accessing UPSI from trading in the company's securities for a specified period of time and otherwise when in possession of UPSI.

B. Implications for M&A Transactions

The disclosures permitted under the Insider Trading Regulations, 2015 have clarified a long standing ambiguity under the Insider Trading Regulations, 1992[19] wherein information including UPSI shared by companies to prospective investors/acquirers, as a part of the due diligence process, could be considered as a violation of insider trading regulations. This created practical difficulties in investment/acquisition transactions where it was important for a prospective investor/acquirer to undertake due diligence of the listed company prior to an investment decision. In India, existing market disclosures by listed companies such as quarterly results or even details of material contracts and transactions in the public domain may not be adequate to enable an investor/acquirer to make a reasonable investment decision and the investor/acquirer may need specific information and representations regarding the target company. The SEBI has recognised this practical difficulty and accordingly introduced the exemptions referred in paragraph (1) above. However, such exemptions are not devoid of ambiguity. Certain issues which need to be considered include:

(a) Best Interests of the Company

The Insider Trading Regulations, 2015 require the board of directors of a listed company to consider whether a prospective investment transaction is in the best interests of the company. In this regard the report by the committee headed by Justice N.K. Sodhi noted that "*First, the board of directors will need to come to a clear view that permitting exercise of due diligence is in the best interests of the company. It is the company that is the owner of the UPSI relating to the company and it should be the responsibility of its board of directors to justify permitting the conduct of a due diligence exercise.*"[20]

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[18] Regulation 3(4), Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015.

[19] Pursuant to the provisions of the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 1992, a company alleged to have indulged in insider trading could take a "defense" that the acquisition of shares was of a listed company in accordance with the Takeover Code.

[20] Sodhi Committee Report, 28.

As a practical matter, a due diligence exercise is undertaken by the prospective investor/acquirer at a preliminary stage of the transaction at which the parties do not enter into binding commitments. Often, this may be too early to form a view that the proposed transaction is in the best interests of the company. If the company is receiving fresh issue proceeds, such a view may be easily formed. However, in a secondary sale transaction i.e. a sale of shares of the company by a shareholder to a third party investor/acquirer, it may be challenging for the board of directors to take such a view before communicating the UPSI to the investor/acquirer. In such cases, the board of directors may need to evaluate, *inter alia*, the identity of the new acquirer and the benefits of having the new acquirer as a shareholder of the company.

(b) Disclosure of Board Decision

The Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, as amended (the "Listing Regulations"), requires listed companies to disclose all material events to the stock exchanges, including any acquisition or an agreement to acquire or any sale or disposal of any unit(s), division(s) or subsidiary.[21] Further, the listed company is also required to disclose the outcome of all board meetings which consider, *inter alia*, agreements including shareholders' agreement and joint venture agreements that may impact the management and control of the listed entity.[22]

Accordingly, once the board of directors of the listed company is of the informed opinion that a proposed investment transaction is in the best interests of the target company, the issue is whether it needs to disclose this decision to the stock exchanges. This has not been dealt with under the Insider Trading Regulations, 2015 but needs to be considered, especially since stock exchanges in India have been active in reaching out to listed companies to confirm or deny news reports on potential transactions. A due diligence exercise is undertaken at a preliminary stage of the transaction and any disclosure to the stock exchanges at such stage may be misleading and trigger speculative trading. If no binding document for the acquisition of shares has been executed by the parties, the listed company could take a view that the decision to provide due diligence access to a potential investor/acquirer may not be a material event that requires public disclosure. An additional safeguard in this regard is that the investor/acquirer will have entered into confidentiality and standstill agreements with the listed company.

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[21] Regulation 30 read with Part A of Schedule III, The Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015.

[22] Regulation 30 read with Part A of Schedule III, The Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015.

(c) Disclosure of UPSI to the Public

In transactions other than open offer transactions, the target company is required to disclose the UPSI to the public at least two trading days prior to the date on which the "transaction is effected". This is also referred to as a cleansing announcement undertaken to ensure parity of information amongst all shareholders. However, it is not clear if the date on which the "transaction is effected" would mean the date of execution of the definitive transaction documents or the closing date i.e., the date when the shares are issued or transferred. The Sodhi Committee Report had recommended that the UPSI should be made generally available at least two trading days prior to the proposed"trading".[23] While it appears logical to disclose UPSI to the public before the definitive transaction documents are executed, the target company may not be aware of the timing of execution of the definitive transaction documents in a secondary sale transaction and as such the company will need to evaluate the timing of release of UPSI to the public. In addition, since the form and manner of disclosure is left to the discretion of the board of directors of the target company, it is possible that such cleansing announcements are fraught with disagreements between the target company and the investor in relation to what information should be disclosed to the public.[24]

(d) Deal Failure or Delay

The Insider Trading Regulations, 2015 do not provide any guidance on the treatment of insider information, acquired through due diligence, upon the failure of or delay in an acquisition or investment transaction. Potential investors may continue to be restricted from investing in the securities of the target company since they remain in possession of UPSI. Further, cleansing announcements in such situations may be problematic for the target company, especially if the transaction has reached a stalemate.[25]

IV. Investigative Powers of the SEBI

Insider trading, on account of the very nature of the offence, is difficult to prove by way of direct evidence. In most cases, the insider communicating UPSI or trading on the basis of UPSI or any individual procuring UPSI to the

23 Sodhi Committee Report, 28.

24 Umakanth Varottil, *Due Diligence in Share Acquisitions: Navigating the Insider Trading Regime*, 11 (Working Paper No. 16/01, Centre for Law & Business, The National University of Singapore, 2016).

25 *Id,* at 26.

detriment of the general public may only be prosecuted or penalised on the basis of circumstantial evidence surrounding the transaction. In this context, the scope and exercise of investigative powers of the SEBI gain importance.

Transactions suspected of violating insider trading norms can be investigated by the SEBI under a wide amplitude of powers granted to it pursuant to the SEBI Act.[26] The functions of SEBI, as provided by the SEBI Act include, *inter alia*, taking measures to prohibit fraudulent and unfair trade practices and insider trading in the securities market, calling for information and records from any person and conducting inquiries and audits of stock exchanges, intermediaries and any other person associated with the securities market.[27] The SEBI has also been given specific powers to undertake inspection of any books, registers, documents or records of a listed or proposed-to-be listed company if it has reasonable grounds to believe that the company has engaged in insider trading.[28] In doing so, the SEBI has powers, which are comparable to the powers of a civil court under the Code of Civil Procedure, 1908.[29] These relate to powers of discovery, production and inspection of books of accounts and other documents, summoning and enforcing the attendance of any person and examining them on oath and issuing commissions for the examination of witnesses or documents.[30] In the event, SEBI has reasonable grounds to believe that transactions in the securities market are being dealt in a manner detrimental to investors or that any intermediary or person associated with the securities market has violated any provisions of the SEBI Act or any regulations thereunder, it may also constitute an investigating authority to investigate the transaction or person involved in such transaction.[31] Non-cooperation with the investigating authority including failure to furnish any information to or appearing before such investigating authority may attract a penalty of imprisonment and/or a fine.[32]

The term "reasonable grounds to believe" indicates that a preliminary inquiry should have warranted a detailed examination of the transaction in question. Indicators that may create reasonable grounds to believe that the transactions were insider trading dealings could include, *inter alia,*

[26] Sections 11(2)(i), 11(2)(ia), 11(2A) and 11C, Securities and Exchange Board of India Act, 1992.
[27] Sections 11(2)(i) and 11(2)(ia), Securities and Exchange Board of India Act, 1992.
[28] Section 11(2A), Securities and Exchange Board of India Act, 1992.
[29] Section 11(3), Securities and Exchange Board of India Act, 1992.
[30] Section 11(3), Securities and Exchange Board of India Act, 1992.
[31] Section 11(C), Securities and Exchange Board of India Act, 1992.
[32] Section 11(C), Securities and Exchange Board of India Act, 1992

abnormal daily volumes of trades or trading in and around major corporate announcements or unusual variation in the price of a stock.

There has been some debate on whether SEBI can access call data records ("CDRs") of individuals. This issue was considered in *Indian Council of Investors* v *Union of India*,[33] where the Bombay High Court held that the powers of the SEBI under the SEBI Act were wide enough to permit them to seek CDRs from telecom service providers. It observed that unlike interception of calls, this information was static in nature. However, the court also recognised that SEBI's power cannot be exercised for conducting a fishing enquiry. It can only be exercised in the event of a pending inquiry or investigation by an officer duly authorised in this regard. In addition, the opinion of the officer should be recorded in writing before calling for such information.

This decision by the Bombay High Court took note of the Securities Laws (Amendment) Ordinance issued in July 2013, September 2013 and subsequently in March 2014. Prior to the promulgation of these ordinances, the investigative powers of the SEBI in relation to calling for information and records only extended to stock exchanges, mutual funds, intermediaries and self-regulatory organisations in the securities market, banks or any authority established under a central, state or provincial legislation and "any other person associated with the securities market". The ordinances extended this scope by permitting the SEBI to call for information from "any person". This position was reiterated by the actual amendment of the SEBI Act in 2014.[34]

V. PENALTIES FOR VIOLATIONS OF INSIDER TRADING REGULATIONS

Insider trading is penalised under the SEBI Act. Both civil and criminal proceedings may be initiated against a person who has engaged in insider trading.

(a) CIVIL REMEDIES

If a contravention of the Insider Trading Regulations, 2015 is established or even in instances of pending investigations or inquiry into an insider trading transaction, the SEBI may, *inter alia*, suspend the trading of the security,

33 Indian Council of Investors v Union of India, (2014) 186 Comp Cas 512.

34 The Securities Laws (Amendment) Act, 2014 issued with retrospective effect from July 18, 2013.

restrain or prohibit the alleged individuals from accessing the capital markets or impound and retain the proceeds or securities in respect of such transaction.[35] In addition, if any insider is found to be guilty of dealing in securities on the basis of UPSI or communicating UPSI to any person or counselling or procuring for any person to deal in securities on the basis of UPSI, such person may be liable to a penalty which is not less than Rs. 10 lakh but which may extend to Rs. 25 crore or three times the amount of profits made out of insider trading, whichever is higher.[36] The quantum of penalty is adjudged keeping in mind the factors of (a) the amount of disproportionate gain or unfair advantage made as a result of the default; (b) the amount of loss caused to the investor(s); and (c) the repetitive nature of the default.[37] Prior to the Securities Laws (Amendment) Act, 2014, the SEBI Act prescribed a penalty which was the higher of Rs. 25 crores or three times the profits made as a result of the insider trading transaction. While this would mean that the SEBI had no discretion while adjudicating the quantum of penalty, in practice however, mitigating circumstances including the factors listed above were often taken into consideration to reduce the penalties attracted by the alleged violation.

(b) Consent Orders

Prior to amendments in 2012,[38] the offence of insider trading was also permitted to be settled by way of consent orders. Such consent orders, comparable to compounding of criminal offences, ensured that individuals alleged to have engaged in insider trading could settle proceedings.[39] Consent orders are often viewed as an efficient and speedy mechanism for collecting fines and closing cases. However, the use of this mechanism in the case of offences such as insider trading has been considered problematic since the accused would not even be required to admit or deny any guilt.[40] Additionally, infor-

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[35] Section 11(4), Securities and Exchange Board of India Act, 1992.

[36] Section 15G, Securities and Exchange Board of India Act, 1992.

[37] Section 15J, Securities and Exchange Board of India Act, 1992.

[38] SEBI Circular CIR/EFD/1/2012 dated May 25, 2012 - Amendment to the Consent Circular dated 20th April 2007. This circular has subsequently been rescinded and provisions thereof have been incorporated in the Securities and Exchange Board of India (Settlement of Administrative and Civil Proceedings) Regulations, 2014.

[39] Consent Order in the matter of Rakesh Agarwal dated January 23, 2008; Consent Order in respect of Lakshmi Energy and Foods Ltd dated April 17, 2009; Consent Orders in respect of Hitech Drilling Services India Limited dated September 2, 2009 and October 22, 2010; Consent Order in respect of Ms. Chhaya Patel in the matter of Sterling Biotech Limited dated January 14, 2011; Consent Order in the matter of ATN International Limited dated June 20, 2011.

[40] *Should Sebi have barred insider trading from consent orders?* – Business Standard, (June 6, 2012), *available at* http://www.business-standard.com/article/opinion/should-sebi-have-barred-insider-trading-from-consent-orders-112060600021_1.html (Last visited on July 31, 2016).

mation pertaining to the alleged act of insider trading may never be fully disclosed to the market. Insider trading has broader implications on the market that may not be monetarily quantifiable. Although consent orders and penalties would disgorge the benefits gained by the accused individual, they may not be an adequate deterrent mechanism for future violations nor would they compensate the market for the loss of investor confidence on account of insider trading.

(c) Criminal Remedies

The SEBI Act prescribes a criminal penalty for the contravention of any provisions of the SEBI Act or any rules or regulations thereof. An individual, accused of violations, may be punishable with imprisonment for a term which may extend to ten years or with a fine which may extend to Rs. 25 crore or with both.[41]

Since the enactment of the Insider Trading Regulations, 1992, criminal prosecution on account of insider trading has been initiated in a limited number of cases[42]:

1. 1998: The matter involving Hindustan Lever Limited and its directors;
2. 2002: The matter involving Rakesh Agarwal, managing director of ABS Industries Limited;
3. 2002: The matter in relation to insider trading of securities of Sahney Paris Rhone Limited;
4. 2003: The matter in relation to insider trading by DSQ Holdings Limited;
5. 2003: The matter in relation to insider trading of securities of Tata Finance Limited by J.E. Talaulicar, Dilip Pendse and Jhunjhunwala Stock Brokers;
6. 2003: The matter in relation to insider and fraudulent trading of securities of Information Technologies India Limited;
7. 2003: The matter of fraudulent trading of securities of V.B. Desai Financial Services Ltd. by Kamlesh J. Shroff; and
8. 2010: The matter involving manipulative trading of securities of Sound Craft Industries Limited by Rajkumar Basantani.

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41 Section 24, Securities and Exchange Board of India Act, 1992.

42 SEBI Data of Prosecution cases launched for violation of SEBI cases other than Collective Investment Schemes (As on May 31, 2016), *available at* http://www.sebi.gov.in/cms/sebi_data/attachdocs/1466066529241.pdf (Last visited on July 27, 2016).

However, none of these proceedings have resulted in conviction. While some proceedings such as those in relation to *Sahney Paris Rhone Limited*[43] and *Rakesh Agarwal*[44] have been settled, a number of proceedings continue to remain pending at the lower courts.

Criminal prosecution can be an effective deterrent and can encourage future compliance in the securities market. However, it would not be appropriate in every case of alleged violation of insider trading regulations. Whether or not criminal prosecution is initiated in a particular case is a matter of discretion for the SEBI. The question is then of how, and based on what factors, this discretion be exercised. It must also be considered how a determination of whether a particular case warrants criminal prosecution and an elevated level of deterrence that is not satisfied by civil penalties is to be made. Relevant factors in arriving at such answers could include for example, the factors specified in the SEBI Act in relation to quantum of penalties, such as, the amount of disproportionate gain or unfair advantage and the repetitive nature of the default. Other relevant factors could be the number of people affected by the trade and the duration of the illegal activity. Given the low conviction rates in matters involving violation of insider trading regulations, the level of evidence available to establish wrongdoing in a criminal trial would also be an important factor. One other factor that may also be taken into account is the perceived deterrent value of criminal prosecution – there may be a higher justification for initiating criminal prosecution in situations where a person with fiduciary responsibilities is alleged to have violated the insider trading regulations.

VI. CONCLUSION

Due diligence is a key exercise undertaken before an M&A Transaction and the Insider Trading Regulations, 2015 have provided significant relief to prospective investors/acquirers by clarifying the legality of such an exercise. However, practical difficulties in implementing the exemptions under the regulations including issues such as determination of best interest of the company, disclosures to stock exchanges under the Listing Regulations, timing, manner and nature of cleansing announcements to the public and treatment of insider information upon a deal failure or delay still remain. Further

[43] SEBI List of cases resulted in compounding in the prosecution filed by SEBI (As on March 31, 2014), *available at* http://www.sebi.gov.in/cms/sebi_data/attachdocs/1352176318874.pdf (Last visited on July 31, 2016).

[44] SEBI v Rakesh Agarwal, Criminal Appeal No. 230 of 2007 (Bom).

guidance is required from the regulator on these issues to ensure a more robust framework for M&A Transactions.

While the SEBI Act grants extensive powers to SEBI in relation to the investigation of irregularities in the securities market including insider trading, successful detection of such irregularities, and evidence gathering in such cases, remain challenging. This is especially relevant for criminal prosecutions as the standard of proof required in such cases is high. In this context, the amendment of the SEBI Act in 2014 has further strengthened the powers of the SEBI. It remains to be seen whether, and to what extent, such extended powers can be effectively used to tackle technological advancements and complicated structures that may be adopted to manipulate the market.

On a related note, the successful enforcement of insider trading law in India is dependent not just on the successful detection of insider trading, but also on a strong deterrent mechanism. A determination as to whether to launch criminal prosecution in a particular case of insider trading is based on a number of factors. Given the challenges of evidence gathering in cases of insider trading, high standard of proof required for successful criminal prosecutions, and the historical trend of judicial pendency and low conviction rates of such offences, it is imperative that the regulator uses its discretion to launch criminal prosecutions in a judicious manner.

Arbitration and Conciliation (Amendment) Act, 2015: Arbitrators and Conflict of Interest

*Professor Anurag K. Agarwal**

The advent of the year 2016 witnessed the passing of the Arbitration and Conciliation (Amendment) Act, 2015, amending the arbitration law – the Arbitration and Conciliation Act, 1996 – in India. It had earlier been promulgated as an ordinance in October 2015. Based on the recommendations of the 246th Report of the Law Commission of India, the Amendment sought to minimise interference of courts in arbitration proceedings, expedite the process, introduce safeguards to ensure greater fairness in the conduct of arbitration proceedings, bring the 1996 Act in conformity with international best practices, and thereby, enhance the overall effectiveness and efficiency of arbitration as the method for the resolution of business disputes. This paper provides an insight into the issue of arbitrators and conflict of interest, as under the 2015 Amendment Act.

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I. Introduction

Arbitration is a quasi-judicial process. Therefore, it is imperative that it is conducted in accordance with principles of natural justice. The impartiality and independence of the arbitral tribunal is vital to ensuring this. Section 12 of the Arbitration and Conciliation Act, 1996 ("Act") is primarily concerned with this aspect and the Arbitration and Conciliation (Amendment) Act, 2015 ("Amendment Act")[1] has introduced substantial changes in this regard. In this paper, I have attempted to evaluate the extent to which these will contribute towards achieving the objectives of the Amendment Act. This is done by *first*, examining the practical basis for the requirement of independence and impartiality in arbitration. *Secondly*, the Indian law on the subject matter before and after the amendment is laid out. *Thirdly*, the changes introduced by the amendment are analyzed in light of international best practices and the practical modalities of arbitration in India.

II. The Need for Neutrality

Arbitration, albeit lacking state sponsorship, is essentially an adjudicatory mechanism which has a bearing on the legal rights and liabilities of the parties involved. Therefore, it is essential that it is conducted in accordance with principles of fairness. The maxim – *nemo iudex in causa sua*, i.e. no man should be a judge in his own cause is one of the fundamental principles of natural justice. It posits that the dispute be adjudicated by a neutral third party. In addition, certain unique characteristics of commercial arbitration require that enhanced attention be paid to the neutrality of arbitrators. Arbitrators are not public officials and are most often chosen from among a small group of persons. Since they are paid only upon selection, there is an inherent incentive to favour parties that are likely to choose them in the future.[2] This is particularly true in major international disputes, where the pool consists of a few prominent barristers, senior law firm partners and law professors. The roles also display a great degree of reversibility – a party that is an arbitrator for one matter may be counsel for the other and *vice versa*.[3]

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1 The Arbitration and Conciliation (Amendment) Act, 2015; No. 3 of 2016, dated December 31, 2015. Deemed to have come into force on the October 23, 2015.

2 Dezalay, Y. & Garth, B.G., Dealing in Virtue: International Commercial Arbitration and the Construction of a Trans-National Legal Order, 50 (1996).

3 *Id.*

However, this familiarity, while problematic from a neutrality perspective, also aids to improve the efficiency and effectiveness of the arbitral process and has contributed to making it an attractive form of business dispute resolution.[4] Therefore, the legal regime governing arbitral neutrality must account for this reality and attempt to strike a balance between considerations of fairness and efficiency that are unique to arbitration.

III. THE INDIAN LEGAL REGIME: BEFORE AND AFTER

Under the Act, the standard for neutrality is prescribed by Section 12 which provides that "*An arbitrator may be challenged only if (a) circumstances exist that give rise to justifiable doubts as to his independence or impartiality...*"[5] Thus, the test is not whether given the circumstances there is *actual* bias, for that would entail an onerous standard of proof but whether the circumstances create room for *justifiable apprehensions* of bias.

AMENDMENTS TO SECTION 12(1)

Two major amendments have been introduced to Section 12. First, a requirement of specific disclosures by an arbitrator at the stage of his possible appointment, concerning the presence of any relationship or interest that is likely to create justifiable doubts regarding his neutrality. For this purpose, Section 12(1) has been entirely replaced.[6] The amended sub-section provides as follows:

> "8. In Section 12 of the principal Act,—
>
> (i) for sub-section (1), the following sub-section shall be substituted, namely:—

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[4] Sam Luttrell, BIAS CHALLENGES IN INTERNATIONAL COMMERCIAL ARBITRATION: THE NEED FOR A "REAL DANGER" TEST, INTERNATIONAL ARBITRATION LAW LIBRARY, Vol. 20, 7 (2009).

[5] Section 12(3), Arbitration and Conciliation Act, 1996: *Grounds for Challenge:*
(3) *An arbitrator may be challenged only if–*
(a) circumstances exist that give rise to justifiable doubts as to his independence or impartiality, or
(b) he does not possess the qualifications agreed to by the parties.

[6] Prior to the 2015 amendment, Section 12(1) of the Arbitration and Conciliation Act, 1996 was as follows:
"12. *Grounds for challenge.- (1) When a person is approached in connection with his possible appointment as an arbitrator, he shall disclose in writing any circumstances likely to give rise to justifiable doubts as to his independence or impartiality.*"

"(1) When a person is approached in connection with his possible appointment as an arbitrator, he shall disclose in writing any circumstances,—

(a) such as the existence either direct or indirect, of any past or present relationship with or interest in any of the parties or in relation to the subject-matter in dispute, whether financial, business, professional or other kind, which is likely to give rise to justifiable doubts as to his independence or impartiality; and

(b) which are likely to affect his ability to devote sufficient time to the arbitration and in particular his ability to complete the entire arbitration within a period of twelve months.

Explanation 1.—The grounds stated in the Fifth Schedule shall guide in determining whether circumstances exist which give rise to justifiable doubts as to the independence or impartiality of an arbitrator.

Explanation 2.—The disclosure shall be made by such person in the form specified in the Sixth Schedule.[7]""

o The Fifth Schedule

Section 12(1) makes a reference to the Fifth Schedule which has also been introduced by the Amendment. The same has been drawn from the Red and Orange Lists of the Guidelines of the International Bar Association Guidelines of Conflict of Interest in International Arbitration (hereinafter "IBA Guidelines").[8] It lists 34 grounds, which give rise to justifiable doubts as to the independence or impartiality of arbitrators. These grounds have been classified under seven heads, which are as follows:

- Arbitrator's relationship with the parties or counsel
- Relationship of the arbitrator to the dispute
- Arbitrator's direct or indirect interest in the dispute
- Previous services for one of the parties or other involvement in the case

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7 Section 8, The Arbitration and Conciliation Amendment (Ordinance), 2015.

8 International Bar Association Guidelines on Conflicts of Interest in International Arbitration, Adopted by resolution of the IBA Council on October 23, 2014.

- Relationship between an arbitrator and another arbitrator or counsel
- Relationship between arbitrator and party and others involved in the arbitration, and
- Other circumstances.[9]

o The Sixth Schedule

The disclosure referred to in Section 12(1) has to be made in the form specified in the Sixth Schedule. This requires providing the contact details of the prospective arbitrator, experience in general and experience with arbitrations in particular; the number of ongoing arbitrations that the arbitrator is conducting; list of circumstances related to conflict of interest, if any; and also list of all the circumstances which may have an effect on his working preventing him to finish the entire arbitration within a period of 12 months.

The language employed in the un-amended section "*...disclose in writing any circumstances likely to give rise to...*", without mention of any such circumstances, was highly subjective, relying primarily on the discretion and inner conscience of any arbitrator. Such an approach leads to confusion among both arbitrators and parties as to the exact scope of the disclosure requirements. In disputes involving transnational businesses and lawfirms, questions about disclosures and conflicts of interest becomes even more complex. The resulting uncertainty is exploited by both arbitrators and parties alike. Parties have more opportunities to use frivolous challenges to delay the arbitrations, or restrain the opposite party from appointing an arbitrator of its choice. On the other hand, arbitrators use vague standards to their advantage to make incomplete disclosures. This results in challenges at a later stage, including after the final award has been made.[10] It was therefore imperative to implement a standardised disclosure regime that balances the interests of the parties, their representatives, arbitrators and arbitral institutions.

The IBA Guidelines are widely regarded as a representation of international best practices and are based on statutes, case law and juristic opinion from a cross-section of jurisdictions.[11] The wholesale adoption of these guidelines is definitely a positive step for the Indian regulatory framework.

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9 Fifth Schedule, The Arbitration and Conciliation Act, 1996.
10 IBA Guidelines, at 2.
11 IBA Guidelines, at 2.

Amendments to Section 12(5)

The other change introduced by the Amendment Act is the addition of Section 12(5). It deems certain categories of persons ineligible for appointment as an arbitrator and reads as follows:

> "8. In Section 12 of the principal Act,—
>
> (ii) after sub-section (4), the following sub-section shall be inserted, namely:—
>
> "Notwithstanding any prior agreement to the contrary, any person whose relationship, with the parties or counsel or the subject-matter of the dispute, falls under any of the categories specified in the Seventh Schedule shall be ineligible to be appointed as an arbitrator:
>
> Provided that parties may, subsequent to disputes having arisen between them, waive the applicability of this sub-section by an express agreement in writing."

The proviso allows parties to waive the requirements of Section 12(5) by an express agreement in writing after the disputes have arisen between them. This concession has been made to account for family arbitrations, where the objective is to minimize interference to promote harmony and quick resolution of disputes. It also acknowledges other situations where both parties demonstrate complete faith in the arbitrator, notwithstanding objective doubts as to his impartiality and independence.[12]

o The Seventh Schedule

Further details for theenforcement of this sub-section have been provided in the Seventh Schedule of the Act. This schedule is a sub-set of the Fifth Schedule and reflects the Red List of the IBA Guidelines. Thus, disclosures are required to be made in respect of a broad range of categories (both the red and orange lists of the IBA Guidelines), and a person is ineligible to act as an arbitrator only when a smaller and more serious set of situations is met (only the red list of the IBA guidelines).[13]

In the next part of the paper, I have discussed significant case law under Section 12 and its relationship with other provisions of the Act. This is done

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[12] Report No. 246, Law Commission of India, Amendments to The Arbitration and Conciliation Act, 1996, August, 2014 at 31, *available at* http://lawcommissionofindia.nic.in/reports/Report246.pdf; (Last visited on August 9, 2016.)

[13] *Id.*

with the objective of throwing some light on how the Amendment will actually be implemented, and some concerns brought up by it.

IV. In- House Arbitrators

Section 12, in its unamended form, has been subject to much litigation in the context of state undertakings appointing particular persons/designations related to the undertaking as a potential arbitrator. In a slew of decisions, the Indian Supreme Court has upheld the validity of such clauses.[14] In *Indian Oil Corpn. Ltd.* v *Raja Transport (P) Ltd.*[15] it succinctly summed up its stance on the issue. It observed that:

> "Arbitration is a binding voluntary alternative dispute resolution process by a private forum chosen by the parties. If a party, with open eyes and full knowledge and comprehension of the relevant provision enters into a contract with a Government/statutory corporation/public sector undertaking containing an arbitration agreement providing that one of its Secretaries/Directors shall be the arbitrator, he cannot subsequently turn around and contend that he is agreeable for settlement of the disputes by arbitration, but not by the named arbitrator who is an employee of the other part.
>
> ...Senior officer/s (usually heads of department or equivalent) of a government/statutory corporation/ public sector undertaking, not associated with the contract, are considered to be independent and impartial and are not barred from functioning as Arbitrators merely because their employer is a party to the contract."

Only two narrow exceptions existed to this rule. *First*, when the arbitrator "was the controlling or dealing authority in regard to the subject contract or if he is a direct subordinate (as contrasted from an officer of an inferior rank in some other department) to the officer whose decision is the subject matter of the dispute." This was applied by the court in *Denel (Proprietary) Ltd.* v *Ministry of Defence*.[16] In this case, the Respondent was an enterprise under

14 See Executive Engineer v Gangaram Chhapolia, (1984) 3 SCC 627; Secy. to Govt., Transport. Deptt. v Munuswamy Mudaliar, 1988 Supp SCC 651; International Airports Authority v K.D. Bali, (1988) 2 SCC 360; *S.* Rajan v State of Kerala, (1992) 3 SCC 608; Indian Drugs & Pharmaceuticals Ltd. v Indo Swiss Synthetics Gem Mfg. *Co. Ltd.*, (1996) 1 SCC 54; Union of India v M.P. Gupta, (2004) 10 SCC 504; Ace Pipeline Contracts (P) Ltd. v Bharat Petroleum Corpn. Ltd., (2007) 5 SCC 304.

15 Indian Oil Corpn. Ltd. v Raja Transport (P) Ltd., (2009) 8 SCC 520.

16 Denel (Proprietary) Ltd. v Ministry of Defence, (2012) 2 SCC 759 : AIR 2012 SC 817.

Ministry of Defence of the Government of India. It didn't clear its dues pursuant to a direction issued by the Ministry of Defence due to which disputes arose between parties. The Court refused to enforce a clause for the appointment of the Managing Director of the Respondent as an arbitrator. It noted that the independence of the appointee couldn't be guaranteed because he was appointed and bound by directions of the Ministry and the disputes had arisen only because of the order of the Ministry.

Secondly, appointments have also been struck down in cases where an arbitrator displays impartiality in the matter, but these actions are not performed in official capacity. Thus, where a bureaucrat who had to act as an arbitrator in case of disputes relating to a government contract wrote letters which justified the imposition of damages in relation to that contract, he was held to be disqualified to act as an arbitrator.[17]

While admittedly, party autonomy is fundamental to arbitration and it is possible that clauses providing for in-house arbitrators are freely negotiated, this seldom happens in practice. Government tenders are highly coveted and fiercely bid for, leaving bidders with little bargaining power. Such clauses violate basic principles of natural justice and it is unfair to create a special exception for the state in this regard. In fact, when the state is involved, independence and impartiality should be ensured with even greater rigour, since the state enjoys inherent advantages *vis-a-vis* the other party by virtue of its status.[18] The Amendment Act seeks to address these concerns and in *Assignia-VIL JV* v *Rail Vikas Nigam Ltd*.[19] its effect on in-house arbitrators was discussed. As per the arbitration agreement between the parties, the tribunal would comprise of three members. One being a working or retired officer of the Indian Railways Accounts Service, the other being a working or retired officer of any engineering service of the Indian Railways and the presiding member being a serving railway/ RVNL officer. Placing reliance on Entry I of Schedule VII, the court declined to make the appointment in terms of the clause.

V. Arbitrators, Lawyers and Law Firms

Another area that has been subjected to some litigation is the relationship of arbitrators with the lawyers appearing in the arbitration process. The

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17 BSNL v Motorola India (P) Ltd., (2009) 2 SCC 337 : (2008) 3 Arb LR 531.

18 *Supra*, note 12.

19 Assignia-VIL JV v Rail Vikas Nigam Ltd., 2016 SCC OnLine Del 2567.

decision in *Laker Airways Inc.* v *FLS Aerospace*[20] is considered to be the *locus classicus* on the subject. In this case, the court held that the involvement in an arbitration of two barristers from the same set of chambers, as arbitrator and counsel didn't taint the impartiality of the arbitrator. The court reasoned that there was no conflict of interest because barristers, even if they belonged to the same chambers, didn't share income and were self-employed. It was also noted that preventing barristers from appearing against, or in front of, one another would place severe constraints upon access to justice. In India, this issue was litigated in *Impex Corpn.* v *Elenjikal Aquamarine Exports Ltd.*[21] where the court was guided by a logic similar to the one applied in *Laker Airways*. In this case, the court held that where the lawyer for one of the parties was a junior in the chambers of the arbitrator, it didn't give any reason to suspect the neutrality of the arbitrator. In support of this decision, it has been pointed out that in the Indian context, it is routine for lawyers who shared the same set of offices, or were in a junior-senior set up, to subsequently start independent practice. In such situations, it is not possible to impute any bias on the arbitrator, actual or apparent by virtue of his past relationship.[22]

The Amendment Act directly addresses the relationship between lawfirms, arbitrators and counsel. The Fifth and Seventh Schedule contain a clear embargo against the appointment of arbitrators in situations where they represent the lawyer or lawfirm acting as counsel/representing one of the parties while the dispute is ongoing.[23] When the arbitrator's lawfirm had a previous but terminated involvement in the matter without the arbitrator being involved himself or an ongoing commercial relationship with one of the parties/affiliate of one the parties, the possibility of bias may be inferred.[24] In addition, if the arbitrator was within the past three years a partner of, or otherwise affiliated with, another arbitrator or any of the counsel in the same arbitration, or a lawyer in the arbitrator's law firm is an arbitrator in another dispute involving the same party or parties or an affiliate of one of the parties, independence and impartiality will be jeopardized.[25]

Prima facie it seems that under the Amendment Act, these cases would be decided differently. However, the IBA Guidelines from which these schedules are drawn acknowledge the need for flexibility due to the growing size

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20 Laker Airways Inc. v FLS Aerospace, (1999) 2 Lloyds Rep 45.

21 Impex Corpn. v Elenjikal Aquamarine Exports Ltd., 2007 SCC OnLine Ker 125 : (2008) 2 Arb LR 560.

22 Justice R.S. Bachawat's LAW OF ARBITRATION AND CONCILIATION, 981 (5th ed., 2005).

23 Entries 3 and 4, Fifth and Seventh Schedule, The Arbitration and Conciliation Act, 1996.

24 Entries 6 and 7, Fifth and Seventh Schedule, The Arbitration and Conciliation Act, 1996.

25 Entries 26 and 27, Fifth Schedule, The Arbitration and Conciliation Act, 1996.

and diversity of practice in lawfirms. The nature, timing and scope of work must be considered. Further, it is recognised that a lawyers' chambers must not be equated with a lawfirm and disclosures and conflicts of interest in cases involving them must be evaluated on a case to case basis.

This calls for a more nuanced approach under which many of the arguments made in *Laker Airways* would still hold good. It is hoped that Indian judges will acknowledge the peculiarities of different fact situations and abstain from a straitjacket application of the rules to all situations. In cases which don't squarely fall within the entries, a thorough analysis of the relations between parties must be undertaken.

VI. CONFLICT BETWEEN SECTIONS 12(4) AND 12(5)

If a party to the arbitration has any apprehension about the neutrality of the arbitrator, the appointment of an arbitrator may be challenged as per Section 12(3).[26] Section 13 of the Act allows the challenge to be made within 15 days after becoming aware of the constitution of the Arbitral Tribunal or after becoming aware of the lack of any circumstance affecting neutrality.[27] Section 12(4) imposes a limitation in this regard, and allows a party to challenge an arbitrator appointed by him, or in whose appointment he has participated, only for reasons of which he becomes aware *after* the appointment has been made.

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[26] Section 12(3), Arbitration and Conciliation Act, 1996: *Grounds for Challenge:*

(3) *An arbitrator may be challenged only if-*

(a) circumstances exist that give rise to justifiable doubts as to his independence or impartiality, or

(b) *he does not possess the qualifications agreed to by the parties.*

[27] 13. Challenge procedure.- (1) Subject to sub-section (4), the parties are free to agree on a procedure for challenging an arbitrator.

(2) Failing any agreement referred to in sub-section (1), a party who intends to challenge an arbitrator shall, within fifteen days becoming aware of the constitution of the arbitral tribunal or after becoming aware of any circumstances referred to in sub-section (3) of section 12, send a written statement of the reasons for the challenge to the arbitral tribunal.

(3) Unless the arbitrator challenged under sub-section (2) withdraws from his office or the other party agrees to the challenge, the arbitral tribunal shall decide on the challenge.

(4) If a challenge under any procedure agreed upon by the parties or under the procedure under sub-section (2) is not successful, the arbitral tribunal shall continue the arbitral proceedings and make an arbitral award.

(5) Where an arbitral award is made under sub-section (4), the party challenging the arbitrator may make an application for setting aside such an arbitral award in accordance with section 34.

(6) Where an arbitral award is set aside on an application made under sub-section (5), the Court may decide as to whether the arbitrator who is challenged is entitled to any fees.

Under Section 12(5), certain categories of persons are deemed *ineligible* for appointment. Thus, it would seem that their appointment could potentially be challenged at *any* stage including after the arbitral tribunal has been constituted, notwithstanding that a party was aware of the ineligibility. Unfortunately, the Amendment Act is silent on the consequences of an ineligible person being appointed as an arbitrator. This could result in confusion and litigation, delaying the arbitral processes. It is unfortunate that the recommendations of the Law Commission in this respect were not incorporated by the Amendment Act. It had recommend the addition of an explanation to Section 14 of the Act to declare that if a person who is ineligible for appointment under Section 12(5) is in fact appointed as an arbitrator, he shall *de jure* be incapable of performing his functions under Section 14 of the Act.[28] The inclusion of this proviso would have clarified that the appointment of an ineligible person as an arbitrator can be challenged at time since all actions taken by the tribunal would lack any force of law.

VII. Cut-off date for the Amendment

As per Section 26 of the Amendment Act, the changes contained in it apply only to arbitration proceedings commenced in accordance with Section 21 of the Act after the coming into force of the Amendment Act. The parties can choose to derogate from this provision.[29] Under Section 21 "commencement of arbitration proceedings" is deemed to take place on the date on which a request for the dispute to be referred to arbitration is received by the respondent. In *Panihati Rubber Ltd.* v *Northeast Frontier Railway*,[30] upon disputes arising between the parties, the petitioner had requested the respondent to refer the matter to arbitration in 2011 and subsequently due to the inaction of the respondents filed an application under Section 11 of the Act. The question before the court was whether the appointment of the arbitrator during the pendency of the petition was a valid one. In determining this question, the court placed reliance on the amended Section 12(5) to conclude that an interested party, as was in this case, couldn't be appointed as an arbitrator. In doing so, the court failed to take notice of Section 26 of the Amendment Act and created incorrect precedent. It is hoped that other High Courts do not err on this count.

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[28] *Supra*, note 12.

[29] Section 26, Arbitration and Conciliation (Amendment) Act, 2015.

[30] Panihati Rubber Ltd. v Northeast Frontier Railway, 2016 SCC OnLine Gau 69.

VIII. Conclusion

In this paper, I have attempted to provide a brief overview of the legal regime regulating the independence and impartiality of arbitrators after the Amendment Act. The changes introduced by the Amendment bring Indian law in line with international best practices–they seek to strike a balance between party autonomy and due process in arbitral proceedings. The subjectivity prevailing under the earlier regime is also countered with the inclusion of clear standards to indicate lack of neutrality. The changes will also end the unfortunate practice of appointing in-house arbitrators by the government through the abuse of its superior bargaining power. This will bring in more transparency into government procurement and tenders, thereby encouraging greater private investment in some core sectors of the economy.

However, the successful implementation of this regime requires a nuanced interpretation by courts. They must constantly endeavour to achieve the goals of the Amendment Act and account for the complexities of the relationships between different parties involved in commercial arbitrations. Else, there is a risk of jeopardizing the unique efficiency and effectiveness of the arbitral process, which has made it an attractive form of business dispute resolution.

Prospective Applicability of Section 34 Under the Arbitration Amendment Act, 2015

*D. Gracious Timothy**

The Arbitration and Conciliation (Amendment) Act, 2015 gave birth to an interesting controversy about its prospectivity after coming into force on the 23rd of October 2015. The insertion of Section 26 through the Amendment Act brought an even greater confusion, on which the High Courts of India are in a divide. This paper dwells into the ramifications of the Amendment Act on Applications to set aside an arbitral award under Section 34, both pre and post October 23, 2015. It goes in length to specifically argue against the rationale that the Amendment Act applies to any and all court proceedings after October 23, 2015, whether or not it is in relation to an arbitral proceeding which was instituted before the commencement date of the Amendment. Such a rationale may have a much wider impact leading to many absurdities. Take, for instance, the fate of court proceedings under Section 34 which is instituted after the commencement dated, but branches out of arbitral proceedings initiated before the commencement. Should it be equated to court actions in relation to arbitral proceedings initiated after the commencement? A closer look at Section 26 of Amendment Act, 2015 sheds light on that conundrum.

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I. INTRODUCTION

The Arbitration and Conciliation (Amendment) Act, 2015[1] (the "Amendment Act" or "Amendment") has had a celebrated entry into the Indian law of arbitration, with its high definition and adherence to international standards. In line with its entrusted task of reviewing the provisions of the Arbitration and Conciliation Act, 1996 (the "1996 Act"), the Law Commission of India published a report in August 2014, noting several inadequacies observed in the functioning of the 1996 Act.[2] This 246th Report of the Law Commission has been extensively relied upon for drafting the Amendment Act, 2015, which came into force on the 23rd October 2015.[3]

No doubt, the winds are a changing. Although the Amendment is a mould of good intentions, its practicality will become clear only with time. There are hurdles, like considering the effect of the Amendment over court proceedings in relation to arbitral proceedings, which commenced before the Amendment. The Arbitration and Conciliation (Amendment) Ordinance, 2015 (the "Arbitration Ordinance" or "Ordinance") was imprecise about whether, and how it would apply,[4] as the Law Commission's fix – Section 85A – was deliberately dismissed without discernment.[5] The Amendment Act, however, filled the vacuum by providing for Section 26, which clarified the applicability of the Amendment to a large extent.

1 The Arbitration and Conciliation (Amendment) Act, 2015, Ministry of Law and Justice, Legislative Department (Dec 31, 2015), http://lawmin.nic.in/la/ArbitrationandConciliation.pdf.

2 Report No. 246, LAW COMMISSION OF INDIA, AMENDMENTS TO THE ARBITRATION AND CONCILIATION ACT, 1996, August, 2014 at 31, available at http://lawcommissionofindia.nic.in/reports/Report246.pdf; (Last visited on August 9, 2016).

3 Amendment Act, § 1(2) (2015).

4 Arbitration Ordinance, § 1(2) (2015).

5 *Supra*, note 1. *Also See,* 1996 Act, § 85(2)(a).

With the Amendment coming into effect, there have been certain qualms about its intended application on fresh arbitrations and court actions.[6] Whether, and how, the amendments will affect pre and post-Amendment arbitral proceedings and court actions, is a crucial area which is currently in a divide.

The recent trend of the High Courts in India has been too diverse and unclear to arrive at the correct position of law as to the interpretation of Section 26 of the Arbitration Amendment Act and the prospective application of the Amendment Act. This piece discusses how the prospectivity of the Amendment Act is limited to the arbitral proceedings after the commencement of the Amendment Act, as well as the court proceedings in relation to the same. It further argues that Section 26 does not logically extend to include post-arbitration proceedings, for instance, where an award was passed before the commencement of the Amendment Act. Amongst the divergent views about Section 26, this piece is an attempt to highlight the relevant questions and provide clarity on the practical implementation of the old and the new regimes.

II. CLARIFYING THE CONUNDRUM IN SECTION 26 OF THE AMENDMENT ACT, 2015

The insertion of Section 26 was, in fact, clarificatory in nature. It had the best intentions of settling the issue, that unless the parties otherwise agreed, the Amendment would not apply to the arbitrations that were initiated prior to the commencement of the Amendment. The provision states –

> "26. *Nothing contained in this Act shall apply to the arbitral proceedings commenced, in accordance with the provisions of Section 21 of the principal Act, before the commencement of this Act unless the parties otherwise agree but this Act shall apply in relation to arbitral proceedings commenced on or after the date of commencement of this Act.*" [Emphasis supplied]

It is imperative here, to analyse certain uniquely worded portions in the provision. The first part declares that nothing contained in the Amendment Act shall apply to "*arbitral proceedings*", and then it provides that the Amendment Act shall apply "*in relation to arbitral proceedings*". The phrase "*in relation to arbitral proceedings*" only features in the second part

[6] *Supra*, note 2.

of Section 26, and is conspicuously absent in the opening line. Therefore, the significance of this term – "*in relation to arbitral proceedings*" – becomes absolutely essential to delve further into the discussion. It was in 1999 that the Supreme Court, in *Thyssen Stahlunion GmBH* v *SAIL*[7] ("*Thyssen*"), defined the very same expression to include not only arbitral proceedings, but also court proceedings relating to the arbitral proceedings. Accordingly, the expression would cover not only proceedings pending before the arbitrator, but also proceedings before the court which are in relation to the same arbitral proceedings. In *New Tirupur Area Development Corpn. Ltd.* v *Hindustan Construction Co. Ltd.*[8] ("*NTADCL*"), a matter under Section 34 of the 1996 Act was brought before the Madras High Court. The court discussed these two distinct phrases appearing in Section 26 of the Amendment Act – "*arbitral proceedings*" versus "*in relation to arbitral proceedings*". The question posed was concerning the effect of Section 26 on any proceedings in court (or to be taken in court), after the Amendment came into force. According to the court, the intention of the legislature was explicit – that the Amendment Act was prospectively applicable to "arbitral proceedings" that commenced before the Amendment, but retrospectively applicable to matters "in relation to arbitral proceedings" which commenced after the Amendment (including court proceedings, notwithstanding whether these court actions were in relation to arbitral proceedings commenced before, or after the Amendment Act). Ultimately, the Court generalized the application of Section 26, by applying the Amendment Act even to arbitration related court proceedings that commenced before October 23, 2015, and court proceedings initiated on or after October 23, 2015, which were in relation to the arbitral proceedings that commenced before October 23, 2015.

At this juncture, the gap in Section 26 of the Amendment becomes apparent. The law doesn't seem to cover one specific kind of court proceedings – the ones which are instituted after the commencement of the Amendment Act, but branch out of arbitral proceedings initiated before the Amendment Act. In interpreting Section 26, *NTADCL* conveniently applied the Amendment Act to a category of court proceedings, which are in relation to arbitral proceedings commenced before the Amendment Act, and therefore, making no difference between the said category and those court proceedings which are in relation to arbitral proceedings that commenced or would commence after the Amendment Act. This would mean that the arbitral proceedings which commenced before the new regime came into the picture, would have

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7 Thyssen Stahlunion GmBH v SAIL, (1999) 9 SCC 334.

8 New Tirupur Area Development Corpn. Ltd. v Hindustan Construction Co. Ltd., A. No. 7674 of 2015 in OP No. 931 of 2015, decided on 26-1-2016.

to be governed by the old regime, and all related court actions arising from said arbitral proceedings, if instituted on or after the new regime, would have to be governed by the new regime. Approaching the case at hand in that sense, an interpretation that the Amendment would apply to any and all court proceedings initiated after the commencement of the Amendment Act, is a potent formula for absurdities in the operation of the law of arbitration – something that was cautioned by the Supreme Court in *Thyssen*, which was heavily relied upon in *NTADCL*. The following Section exposes the incongruities which would emerge, if the interpretation in *NTADCL* is held to be good in law.

If an award was passed in an arbitration proceeding which commenced prior to 23rd October, 2015, and if a petition challenging the award was instituted after 23rd October, 2015, *NTADCL* suggests that the challenge would be governed by the Amendment (even though the award was passed in the old regime). This is logically fallacious. The *NTADCL* position ignores multiple complex repercussions that would emerge if the award, given under the old regime, is said to be enforced under the new regime.[9] Both the regimes are immensely different from each other. Therefore, it is apparent that an Amendment Act, while altering the principal 1996 Act (dealing with substantive rights, like those under Section 34), extensively changes the parameters, so much so that it affects the package of vested substantive rights of the parties.[10]

While the Amendment is a mould of good intentions, its practicality will only become clear in time. Besides, considering the effect of the Amendment over ongoing arbitrations, many hurdles have been noticed. For example, in an effort to solve this delinquency of prospective application of the Amendment Act one must consider the exact scope of Section 26. Where in so far as court proceedings relating to pre-Amendment arbitral proceedings are concerned, it is left unaddressed by Section 26. In which case, one would have to take the default rule of prospective application of an Amendment provision, especially wherein such a provision affects a substantive right (particularly in the case of Section 34 of the principal 1996 Act). On that rationale, any provision in the 1996 Act that is substantive in nature (which relates to the category of court proceedings not dealt by Section 26) would face no retrospective impact of the Amendment Act.

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[9] New Tirupur Area Development Corpn. Ltd. v Hindustan Construction Co. Ltd., A. No. 7674 of 2015 in OP No. 931 of 2015, decided on 26-1-2016.

[10] Videocon International Ltd. v SEBI, (2015) 4 SCC 33.

III. The Substantive Nature of Section 34 of the 1996 Act: Prospective Application of Section 34 under the Amendment Act

The following submissions specifically address the substantive nature of the right under Section 34 of the 1996 Act. It is submitted that the Amendment Act would have no retrospective impact on court proceedings under Section 34, where the said challenge is in relation to arbitral proceedings which commenced before the Amendment Act came into force. Therefore, in all such situations, the only question that matters is, whether there was a substantive right vested in the applicant at the date of the enforcement of the Amendment, or was it a mere matter of procedure?

A. Section 34 under the Old and New Regime

Section 34 under the 1996 Act

i. 'Public Policy' exception for setting aside an award

Section 34 of the pre-Amendment regime dealt with setting aside a domestic award, and a domestic award resulting from an international commercial arbitration. The phrase 'public policy of India' used in Section 34 was given a wider meaning in *ONGC Ltd.* v *Saw Pipes Ltd.*[11] ("*Saw Pipes*") since the concept connoted some matter which concerned public good and public interest.[12] It was held that an award could be set aside if it was contrary to: (a) fundamental policy of Indian law; or (b) the interest of India; or (c) justice or morality, or (d) in addition, if it is patently illegal.

ii. 'Automatic stay' on the execution of the award on the admission of challenge

Interestingly, Sections 34 and 36 of the pre-Amendment Act were not express about an 'automatic stay' on the execution of the award, and it actually came into existence by virtue of judicial interpretation in 2004. In *National Aluminium Co. Ltd.* v *Pressteel & Fabrications (P) Ltd.*,[13] the court observed from the mandatory language of Section 34 that, an award when challenged under Section 34, within the stipulated time therein,

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11 ONGC Ltd. v Saw Pipes Ltd., (2003) 5 SCC 705.

12 Central Inland Water Transport Corpn. Ltd. v Brojo Nath Ganguly, (1986) 3 SCC 156 : (1986) 2 SCR 278.

13 National Aluminium Co. Ltd. v Pressteel & Fabrications (P) Ltd., (2004) 1 SCC 540. *See*, Afcons Infrastructure Ltd. v Port of Mumbai, (2014) 1 Arb LR 512; Afcons Infrastructure Ltd. v Port of Mumbai, Appeal No. 538 of 2013 (Bom).

becomes inexecutable. It was interpreted that there is no discretion left to pass any interlocutory order in regard to the said award, except to adjudicate the correctness of the claim made by the Applicant therein.

SECTION 34 AS AMENDED BY THE AMENDMENT ACT, 2015

i. 'Public Policy' exception for setting aside and award.

The Amendment Act of 2015 is underlined by a simple principle, that the legitimacy of judicial intervention in the case of a purely domestic award is far more, than in cases where a court is examining the correctness of a foreign award or a domestic award in an international commercial arbitration. For instance, the amended Section 34 under the Amendment Act has clarified that an award is in conflict with the 'public policy of India', only if — (i) the making of the award was induced or affected by fraud or corruption or was in violation of Section 75 or Section 81; or (ii) it is in contravention with the fundamental policy of Indian law; or (iii) it is in conflict with the most basic notions of morality or justice. The Amendment further provides that the test as to whether there is a contravention with the fundamental policy of Indian law shall not entail a review on the merits of the dispute.

The amended Section 34(2A) under the Amendment clarifies that "an arbitral award arising out of arbitrations *other than international commercial arbitrations* may also be set aside by the court, if the court finds that the award is vitiated by patent illegality appearing on the face of the award". In order to provide a balance and to avoid excessive intervention, Section 34(2A) also states that "an award shall not be set aside merely on the ground of an erroneous application of the law or by re-appreciating evidence." This nullifies the unintended consequences of the decision of the Supreme Court in *Saw Pipes*, which although, in the context of a purely domestic award, had the effect of being equally extended towards awards arising out of international commercial arbitrations.[14]

ii. No 'automatic stay' on execution of award on the admission of challenge

In order to rectify the "mischief" of the automatic stay under the pre-Amendment regime, the amendments provide that the award will not become unenforceable merely upon the making of an application under Section 34. Where an application to set aside the arbitral award has been

[14] The Supreme Court has held in Shri Lal Mahal Ltd. v Progetto Grano Spa, (2014) 2 SCC 433, that the expansive construction accorded to the term "public policy" in *Saw Pipes* could not apply to the use of the same term "public policy of India" in § 48(2)(b) of the 1996 Act. However, this did not cover international commercial arbitrations seated in India.

filed in the court under Section 34, the filing of such an application shall not by itself render that award unenforceable, unless the court grants an order for stay of the operation of the said arbitral award on a separate application made for that purpose.[15]

B. Prospective Application of the Amendment Act where a Challenge under Section 34 is in relation to Arbitral Proceedings which Commenced before the Amendment Act came into force

In the event of a fresh challenge (with respect to an award under a pre-Amendment arbitration) being brought after the Amendment, the said application would be purely subject to the pre-Amendment regime. As was stated in *Thyssen,*[16] once the arbitral proceedings have commenced, it cannot be stated that the right to be governed by an old regime, for enforcement of the award, is an inchoate right. It is certainly a right accrued. It would be illogical to suggest that for a right to accrue, i.e., to have an award enforced under the old regime, some legal proceedings for its enforcement must be pending under the old regime at the time the new regime came into force. The argument can be stated in the following three limbs.

i. The right of Appeal is a Substantive Right

It is a settled law that the right of appeal is not a mere matter of procedure, but is a vested right inherited by a party from the commencement of the action in a court of first instance, and such a right cannot be taken away except by an express provision or by necessary implication. This also preempts any counter-submissions like, termination of arbitral proceedings and the setting aside of the award are two separate proceedings[17] and therefore, after the proceedings are terminated and final award is made, reference has to be made to the new regime for setting aside the award.[18]

An appeal is a continuation of a suit, and it is not merely that a right of appeal cannot be taken away by a procedural enactment which is not made retrospective, but the right cannot be impaired or imperilled, nor can new conditions be attached to the filing of the appeal; nor can a condition already

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15 Amendment Act, 2015, §§ 36(2) and 36(3). Refer, Code Civ. Proc., Or. 41, R. 5 (A guiding factor is the existence of sufficient cause in favour of the appellant on the availability of which the appellate court would be inclined to pass an order of stay).

16 Thyssen Stahlunion GmBH v SAIL, (1999) 9 SCC 334.

17 1996 Act, § 32 (Termination of proceedings).

18 The submissions of Mr. F.S. Nariman, who appeared for Thyssen Stahlunion GmBH in *Thyssen*. *Supra*, note 7, ¶ 14.

existing be made more onerous or more stringent so as to affect the right of appeal arising out of a suit instituted prior to the enactment.[19] Therefore, the right to set aside an award under Section 34 of the pre-Amendment 1996 Act is a substantive right.

ii. Accrual of Substantive Right under the 1996 Regime

Clearly, substantive rights would accrue when arbitration proceedings are invoked under the pre-Amendment regime. These accrued rights include, for instance, a wider ground like 'patent illegality' against an arbitral award from an 'international commercial arbitration'[20] seated in India; an automatic suspension of the enforcement of the award without affecting the challenge in rendering it infructuous, etc.[21] The Amendment Act, however, puts an embargo on the use of the wider ground of 'patent illegality' against arbitral awards in international commercial arbitrations, and besides, it makes the right under Section 34 more onerous by the amputation of automatic suspension of the enforcement of the award.[22]

iii. The Amendment Act affecting an Accrued Substantive Right cannot be applied

The fact that the Amendment has placed a restriction, or that it has had an impact on the right under Section 34, cannot be disputed. Therefore, the question is whether such a restriction or burden can be imposed on the right to set-aside an award (arising from pre-Amendment arbitral proceedings). That would not be the case going by the decision of the Judicial Committee in *Colonial Sugar Refining Co. Ltd.* v *Irving*[23] which stated that, any interference with the existing rights is contrary to the well-known principle that, statutes are not to be held to act retrospectively unless a clear intention to that effect is manifested. This principle was notably applied by the Supreme Court in *Hoosein Kasam Dada (India) Ltd.* v *State of M.P.*[24] which stated that "*a pre-existing right of appeal is not destroyed by an amendment if the amendment is not made retrospective by express words or necessary intendment. The fact that the pre-existing right of appeal continues to exist must necessarily imply that the old law which created that right of appeal must also exist to support the continuation of that right. The old Act continues to*

[19] *Supra*, note 18.
[20] 1996 Act, § 2(1)(e).
[21] ONGC Ltd. v Saw Pipes Ltd., (2003) 5 SCC 705.
[22] New Tirupur Area Development Corpn. Ltd. v Hindustan Construction Co. Ltd., A. No. 7674 of 2015 in OP No. 931 of 2015, decided on 26-1-2016.
[23] Colonial Sugar Refining Co. Ltd. v Irving, 1905 AC 369 (PC) : (1904-07) ALL ER Rep 1620 (PC).
[24] Hoosein Kasam Dada (India) Ltd. v State of M.P., AIR 1953 SC 221.

exist for the purpose of supporting the pre-existing right of appeal."[25] The rationale was also applied by the Calcutta High Court in *Nogendra Nath Bose* v *Mon Mohan Singha*[26]. Therefore, it necessarily follows that Section 26 of the Amendment Act would be rendered illogical when applying the new regime to court proceedings (commenced after the Amendment) which are in relation to pre-Amendment arbitral proceedings, while applying the old regime to said arbitral proceedings.

The position of law makes it clear that, a right to set-aside under Section 34 would not be affected by an Amendment in the case of pending challenges before the court.[27] This is true even in the case where a challenge is made after the Amendment came into force that is connected to pre-Amendment arbitral proceedings. Ultimately, the question of when the Amendment Act commenced is immaterial. The date that really needs to be looked into is the date of the original arbitral proceeding (pre or post-Amendment) which, eventually culminates into a challenge under Section 34.[28]

IV. Conclusion

There is no doubt that the Amendment Act raises some difficulties. However, the court must set to work on the constructive task of giving 'force and life' in the application of the Amendment Act, and in that process, it must not alter the material by which the Act is woven, but it can and should iron out the creases.[29] It is hoped that the view of the Madras High Court in *NTADCL* would be rendered bad in law for the atrocious effects that it might cause in the operation of law.

As for the general principles applicable to the present hypothesis, there is no controversy. The category of court proceedings unaddressed by Section 26 of the Amendment would have to be resolved by the general rule that a particular case, unprovided for, must be disposed-off according to the law, as it existed before such amending statute.[30] And where the amending law, dealing with substantive rights, is being applied retrospectively, it

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[25] Hoosein Kasam Dada (India) Ltd. v State of M.P., AIR 1953 SC 221 at ¶ 9.

[26] Nogendra Nath Bose v Mon Mohan Singha, 1930 SCC OnLine Cal 90 : (1929-30) 34 CWN 1009.

[27] 1930 SCC OnLine Cal 90 : (1929-30) 34 CWN 1009 Mitter J., at p. 1011.

[28] 1930 SCC OnLine Cal 90 : (1929-30) 34 CWN 1009.

[29] 1930 SCC OnLine Cal 90 : (1929-30) 34 CWN 1009.

[30] Jones v Smart, (1785) 1 TR 44 : 99 ER 963. See, Hussein Haji Abraham Umarji v State of Gujarat, (2004) 6 SCC 672.

must stand the test of fairness.[31] It is a well-settled principle that a new law dealing with substantive rights is ordinarily prospective in operation, unless the language of the statute indicates otherwise.[32] Therefore, the simple conclusion that may be drawn is that the 1996 Act would apply to the whole gambit of arbitration which commenced before the Amendment Act, right up to the culmination of the proceedings into a challenge or an enforcement of the award.

[31] Hitendra Vishnu Thakur v State of Maharashtra, (1994) 4 SCC 602.
[32] (1994) 4 SCC 602.

Discerning Lines to the Regulation of Chartered Accountants in India

Aman Chaudhary and Hiral Chheda***

This essay elucidates the laws regulating the profession of chartered accountants in view of the provisions of The Chartered Accountants Act, 1949, and the judgement of the Hon'ble Bombay High Court in "Price Waterhouse & Co. v SEBI." It also analyses the overlap in the jurisdiction of the proposed National Financial Reporting Authority (NFRA), which is to be constituted under Section 132 of the Companies Act, 2013 and the Institute of Chartered Accountants of India (ICAI), with regard to disciplinary proceedings in the case of professional misconduct by chartered accountants. The article analyses the prospect of giving ICAI the jurisdiction to probe into chartered accountant firms, along with individual chartered accountants.

I. Introduction

In order to regulate the profession of chartered accountants ("CA"), the Parliament enacted a comprehensive legislation in the form of the Chartered Accountants Act, 1949 ("CA Act"). The statute provided for constitution

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of the Institute of Chartered Accountants of India ("ICAI")[1] and a Council for the management of the affairs and proper functioning of ICAI.[2] The statute even provided for a Disciplinary Directorate, Board of Discipline and Disciplinary Committee, which would have the powers to adjudicate matters of professional misconduct on the part of the CAs.[3] However, ICAI is not given the powers to probe into CA firms, and its jurisdiction is restricted only to individual practitioners. Such a limited jurisdiction does not serve the object and purpose of the Act.

Further, in 2010, the Hon'ble Bombay High Court in *Price Waterhouse & Co.* v *SEBI*[4] ("*PWC case*") allowed the securities market regulator i.e., The Securities and Exchange Board of India ("SEBI") to probe into a firm of chartered accountants i.e., Price Waterhouse & Co. who were acting as auditors of a listed public company i.e. Satyam Computer Services Limited. This judgment was criticised by many as it was felt that the court had allowed SEBI to transgress its statutory authority by permitting them to inquire into the affairs of a firm of chartered accountants.

Interestingly, the Companies Act, 2013 provides for a National Financial Reporting Authority ("NFRA")[5], in order to replace the National Advisory Committee on Accounting Standards ("NACAS")[6]. NFRA has been given the jurisdiction to probe into matters of discipline and professional misconduct on the part of the chartered accountant firms and individual practitioners, whereas ICAI enjoys similar powers restricted to individual practitioners.[7] There has been a significant debate with regard to the disciplinary action which can be taken by the ICAI's Disciplinary Committee. The Committee can take action against any of its members/chartered accountants, but not the company or the auditing firm itself.[8] In view of the above, it is felt that there is an apparent overlap in the powers of ICAI, SEBI and also the proposed NFRA with regard to adjudication against professional misconduct.

Keeping this in mind, it is felt that the profession of chartered accountants has been subject to over-regulation.

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1 The Chartered Accountants Act, Act No. 38 of 1949, § 3 (1949).
2 *Id*, § 9.
3 *Id,* §§ 21, 21A and 21B.
4 Price Waterhouse & Co. v SEBI, 2010 SCC OnLine Bom 1197 : (2010) 103 SCL 96.
5 The Companies Act, Act No. 18 of 2013, § 132 (2013).
6 The Companies Bill, Financial Memorandum, Clause 132 (2011).
7 *Supra*, note 5, at § 132(4) (a).
8 A. Ramaiya, Guide To The Companies Act, 2437 (18th ed., 2015).

II. POWERS EXERCISED BY SEBI OVER CHARTERED ACCOUNTANTS

The preamble to the Securities and Exchange Board of India Act, 1992 ("SEBI Act") gives us a fair idea of the legislative intention of the statute, i.e. to establish a Board which shall protect the interests of those investing in securities, and also to promote the development and regulation of the securities market.[9] The statute establishes SEBI by way of Section 3 and lays down its powers and functions in Section 11.

Commensurate with the need to effectively discharge such an onerous duty in the context of one of the most dynamic and innovative markets, SEBI has been conferred with, unambiguously, the power through words of widest amplitude i.e., '*by such measures as it thinks fit*'.[10]

- WIDENED AMBIT BY WAY OF SUBSEQUENT AMENDMENTS

The scope of the provision has also been widened by way of the Securities Laws (Amendment) Act, 1995 which amended the provision by substituting the word '*stock exchange*' in Section 11(2)(i) by '*stock exchanges, mutual funds and other persons associated with the securities market*'.[11] The Amendment also inserted Section 11B which empowered the Board to issue appropriate directions necessary to realize the objectives of the statute, to any person specified under Section 12 or '*any person associated with the securities market*'.[12] The Statement of Objects and Reasons of the said Amendment Act does not provide any specific reason for the introduction of the same, however, it appears to have been inserted to aid SEBI to '*function more effectively*'.[13]

Further, with the SEBI (Amendment) Act, 2002, the Board was given the powers to pass any orders to restrain persons from accessing the securities market and to prohibit any person associated with the securities market to deal in securities at an interim stage, where even investigation or inquiry is pending.[14] Whether such an order is justified to be passed at an interim stage, depends upon the nature and gravity of the wrongdoing.[15]

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9 The Securities and Exchange Board of India Act, Act No. 15 of 1992, Preamble (1992).
10 SUMIT AGRAWAL & ROBIN JOSEPH BABY, AGRAWAL AND BABY ON SEBI ACT 48 (2011).
11 The Securities Laws (Amendment) Act, Act no. 9 of 1995, § 11(2) (i), (1995).
12 *Supra*, note 9, at § 11B.
13 *Supra*, note 11, at Statement of Objects and Reasons (w.e.f. 25-1-1995); AGRAWAL & BABY, *supra*, note 10, at 197.
14 *Supra*, note 9, at § 11(4).
15 Karvy Stock Broking Ltd. v SEBI, 2007 SCC OnLine SAT 2 : (2007) 73 SCL 261.

The Amendment was necessary to realise the objectives of the Act in the age of complex business transactions, where the capital market was open to 'market abuse' i.e., using of manipulative and deceptive devices, giving out incorrect or misleading information, so as to encourage investors to jump into conclusions, on wrong premises, by various intermediaries whose activities have a direct bearing on the securities market. The Apex Court cautioned that 'market abuse', if not properly curbed, would result in defeating the very object and purpose of SEBI Act.[16]

The Securities Appellate Tribunal ("SAT") analysed the need of the Amendment as follows[17]:

> "Under Section 11, as it then stood, the Board could regulate the securities market by taking such measures as it thought fit but it felt handicapped when it came to issuing directions to any market intermediary or persons associated with the securities market. On the basis of the past experience of the Board, a need was felt to amend the Act to enable it to issue directions, whenever necessary, for the purpose of protecting the interests of investors and the securities market."

Section 11(2)(i) of the SEBI Act empowers SEBI to, (a) call for information; (b) undertake inspection; (c) conduct inquiries; and (d) audits of persons associated with the securities markets. The phrase '*persons associated with the securities markets*' as interpreted judicially and noted subsequently, is a wider term which includes the intermediaries and the self-regulatory organizations.[18] The SEBI Act was enacted to achieve the twin purposes of promoting orderly and healthy growth of securities market and protecting the interest of the investors. Such an enactment was necessary in order to ensure the confidence of the investors in the capital market, by giving them some protection.[19]

In *Karnavati Fincap Ltd.* v *SEBI*,[20] the Gujarat High Court held that the phrase '*persons associated with the securities market*' is not restricted to the persons mentioned in Section 11(2)(ba), rather it would include each individual and entity whose activities have the potential of having some bearing on the securities market. It is to be noted that the securities market in this sense, is not confined to stock exchanges only. The words '*persons associated with*

[16] N. Narayanan v SEBI, (2013) 12 SCC 152 : AIR 2013 SC 3191.
[17] *Supra*, note 15, at ¶ 18.
[18] Agrawal & Baby, *supra*, note 10, at 139.
[19] 21st Century Entertainment (P) Ltd. v Union of India, 2010 SCC OnLine Raj 3814 : (2010) 104 SCL 476.
[20] Karnavati Fincap Ltd. v SEBI, 1996 SCC OnLine Guj 119 : (1996) 87 Comp Cas 186.

the securities market' are of a much wider import than intermediaries. While interpreting the powers given to the Board under Section 11B the Court observed that such power is two-fold, and interpreted the provision as follows:

> "Firstly, calling for information primarily before holding any inquiry, and, secondly the holding of an inquiry into the affairs of the persons named therein and transactions in securities which takes place under its precincts or through its agencies. While calling for information, a power may be restricted to the persons enumerated therein. But where calling for the information is incidental to the conducting of inquiries into the affairs of a stock exchange or persons associated with stock exchange then the persons whom such an inquiry would reach cannot be restricted. It would be self-defeating to hold that the investigation into any malpractice attached with any transaction or practice carried on in a stock exchange can be made only up to the intermediary but cannot reach the primary source of the transaction. It will be like searching for light in a tunnel without reaching its mouth. All the persons connected with the subject of enquiry are amenable to its reach."

Further, as it is clearly expounded above, the legislature by way of the 1995 Amendment wanted to fill up the shortcomings of the Act by widening the powers of the Board, so as to '*effectively*' exercise control over entities even other than those specified in Section 11(2)(ba) or Section 12 of the Act, who may have a direct or indirect bearing on the interests of the investors or the development of the securities market.

When the Supreme Court of India, in *Roopram Sharma* v *SEBI*[21], was faced with the question as to whether SEBI can issue directions to a person performing the functions of a company secretary of a company, it upheld the order of SEBI which prohibited the respondent from accessing the capital market and dealing in securities for a period of three years. On a collective perusal of Sections 11, 11A, 11B and 11C, it was held that the SEBI Act is a stand-alone enactment and SEBI's powers thereunder are unfettered by any other law including the Companies Act.[22] The power to issue directions, which has been conferred by Section 11B, is of the widest possible amplitude. Such an enabling provision must be construed so as to sub-serve the purpose for which it is enacted. It would be the duty of the court to further the legislative object of providing a remedy for the mischief.[23]

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[21] Roopram Sharma v SEBI, (2013) 120 SCL 156 (SC).

[22] Sahara India Real Estate Corpn. Ltd. v SEBI, (2013) 1 SCC 1 : (2012) 174 Comp Cas 154.

[23] Ramrakh R. Bohra v SEBI, 1998 SCC OnLine Bom 684 : (1999) 96 Comp Cas 623.

- Impact of Price Waterhouse & Co. v SEBI

It is a well settled principle of statutory construction that if the Parliament provides for a remedy for certain mischief or fraudulent behaviour, then it is the duty of the court to give such a construction to the enactment which would suppress the mischief, advance the remedy and avoid evasions for the continuance of the mischief.[24] The principle applicable is that if the Legislature enables something to be done, it gives power at the same time, by necessary implication, to do everything which is indispensable for the purpose of carrying out the purpose in view.[25]

The Hon'ble High Court of Bombay was seen to be acting in accordance with the above principle when a Division Bench in *PWC case*[26] held that SEBI has the jurisdiction to call for information from a firm of chartered accountants who were acting as auditors on behalf of a listed company, whose financial statements, balance sheet, etc. contained manipulations and misstatements which resulted in investors being misled. Arriving at such a judgment, the Bombay High Court observed that there is no direct association of the auditors with the securities market; however, an investor would rely on certain documents such as the balance sheet, which reflects the financial well-being of the company, before investing into the affairs of the particular company. If such a balance sheet is certified by a reputed firm of chartered accountants, the investor could presume that the contents of the balance sheet are true and correct. Going by the above judgement, it is clear that even though the chartered accountants do not have a direct association with the securities market activities, their statutory duty regarding auditing the accounts of the company and preparation of balance sheets may have a direct bearing on the interests of investors and the stability of the securities market.

The judgment of the Bombay High Court in *PWC case* creates a strange outlook towards the regulatory regime surrounding the profession of chartered accountancy, as it allowed SEBI to seek information and inquire into the affairs of a chartered accountants firm, even though the profession is governed by a pre-existing central legislation in the form of The Chartered Accountants Act, 1949, which also provides for a prohibitory clause making it an offence for any individual or entity to regulate chartered accountants. The question here is, can SEBI be seen to be transgressing the four corners of

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24 Anand Rathi v SEBI, 2001 SCC OnLine Bom 381 : (2002) 2 Bom CR 403.
25 *Supra*, note 24, at ¶ 18.
26 *Supra*, note 4, at ¶ 27.

the SEBI Act by regulating the profession of chartered accountancy, which is already governed by a separate legislation.

III. PRE-EXISTING COMPREHENSIVE LEGISLATION – CHARTERED ACCOUNTANTS ACT, 1949

The CA Act was enacted by the Parliament to make provisions for the regulation of the profession of chartered accountants in India.[27] In addition to the ICAI, a provision is made in the CA Act for the constitution of a Council of the Institute (i.e. Central Council) to manage the affairs of the ICAI and for discharging its functions under the CA Act.[28] The Central Council, inter alia, is vested with the power to admit members to the Institute, to take disciplinary action, and to regulate and maintain the status and standard of the professional qualifications of the members of the Institute.[29] The three bodies of the Council, namely the Disciplinary Directorate, Board of Discipline and the Disciplinary Committee, form the backbone of the disciplinary mechanism of the Institute.[30]

The legislation prohibits any person from regulating the profession of chartered accountants and the same would tantamount to an offence under the CA Act[31] i.e., if a regulatory body apart from ICAI conducts inquiry into the conduct of the chartered accountants and issues show-cause notices to them, such an act of the body can be construed as one encroaching upon the powers of the Institute, as ICAI is the body which is conferred with the power to adjudicate matters of discipline and professional misconduct amongst chartered accountants.

In view of the judgment of the Bombay High Court in *PWC case*[32], where the court allowed SEBI to seek information and inquire into the affairs of a CA firm for alleged misstatements in audited financial statements and balance sheets of a listed public company, it is pertinent to note that a similar direction can be taken against a chartered accountant under the CA Act. The CA Act empowers the Disciplinary Directorate, headed by the Director (Discipline), to refer a complaint to the Disciplinary Committee if it is of

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[27] Institute of Chartered Accountants of India v Vimal Kumar Surana, (2011) 1 SCC 534 : (2011) 161 Comp Cas 31.

[28] *Supra*, note 1, at § 9.

[29] H.A.K. Rao v Council of Institute of Chartered Accountants of India, AIR 1967 SC 1257 : (1967) 2 SCR 256.

[30] *Supra*, note 3.

[31] *Supra*, note 27.

[32] *Supra*, note 4.

the prima facie opinion that there is misconduct on part of the chartered accountant, as enlisted in the Second Schedule to the Act[33], which includes failure to disclose a material fact known to him which is not disclosed in the financial statement, or failure to report material misstatements in financial statements known to him to appear in a financial statement, or failure to exercise due diligence, or is grossly negligent in the conduct of his professional duties.[34] If the chartered accountant is found guilty of misconduct, then the Disciplinary Committee may remove the name of the member for a particular period, reprimand the member or impose a fine, as it may deem fit up to a limit of five lakh rupees.[35]

- Restrictions on the adjudicating powers of ICAI

Although, ICAI has a robust disciplinary process, such an adjudicatory mechanism can only probe into individual chartered accountants, who are the members of the ICAI. Under the current regime, ICAI does not have the power to take action against the erring CA firms, which is a major lacuna in the authority of the ICAI. However, under the new Companies Act, 2013, there is a provision to set up a NFRA[36] *(discussed in detail later)* with a mandate to take action against a CA firm for professional or other misconduct, although such a body has not been constituted yet.

In one case, The High Court of Gujarat upheld the order of the Council of the ICAI whereby it had debarred a CA from active practice for a period of one year, where the CA had shown gross negligence and carelessness in certifying a tax audit report which did not reflect a true and fair picture of the affairs of the company.[37]

Thus, when an appropriate provision for the adjudication of the same offense is provided under the CA Act, and an investigation/enquiry whereof is also being conducted by SEBI under Sections 11 and 11B of the SEBI Act, SEBI should not be allowed to proceed further, as it is the ICAI and not SEBI, who has the authority to take appropriate action against the chartered accountants, who are members of the ICAI. The rationale behind this is that, where there is a pre-existing separate statute enacted for the regulation of a particular profession and a statutory body has been established to discharge the appropriate functions, SEBI should not be allowed to do the same, as it would lead to confusion and cross-regulation by different regulatory bodies.

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33 *Supra*, note 1, at § 21.
34 *Supra*, note 1, at Second Schedule.
35 *Supra*, note 1, at § 21 B (3).
36 *Supra*, note 5, at § 132 (2013).
37 Rajesh v Dudhwala v Disciplinary Committee, 2013 SCC OnLine Guj 1549.

It is also to be noted that the members of the Disciplinary Directorate, the Board of Discipline and the Disciplinary Committee, are amongst persons of eminence in the field of law, business, economics, finance or accountancy and are competent to decide and adjudicate matters relating to professional and other misconduct on part of the chartered accountants and other matters incidental or collateral to the profession of chartered accountancy in India.[38]

A provision is also made for the constitution of an Appellate Authority to hear appeals against the decisions of the Board of Discipline and the Disciplinary Committee, comprising of a Judge of a High Court acting as the chairperson, two members from the Council of the Institute and two members nominated by the Central Government from amongst persons of eminence in the field of law, business, economics, finance or accountancy.[39] Furthermore, the Authority, the Directorate, the Disciplinary Committee and the Board of Discipline are vested with the powers of a civil court.[40]

In the PWC, which concerned one of the biggest corporate scandals in the country, the appellate authority upheld the decision of the disciplinary panel of the ICAI which found the two auditors, who were a part of Price Waterhouse & Co. in India, the statutory auditors of Satyam from 2000 to 2009, guilty of professional misconduct and gross negligence, and consequently slapped a penalty of Rs. 5 Lakhs each, besides removing their names from the Institute's register of members.[41]

Likewise, whether or not a chartered accountant has violated the auditing standards and professional norms of the Institute, or is guilty of professional misconduct under the CA Act, is a matter which falls within the purview of the ICAI and not SEBI. By holding an inquiry under the SEBI Act, SEBI cannot be allowed to proceed against the chartered accountants, alleging professional misconduct or negligence in conduct of his duties as an auditor of a company, violating the standards of auditing and other norms prescribed by the Institute because ICAI is the competent body with expert knowledge to interpret the same.

A provision under the Chartered Accountants (Procedure of Investigations of Professional and Other Misconduct and Conduct of Cases) Rules 2007, allows a statutory body like the Reserve Bank of India (RBI) or the Securities Exchange Board of India (SEBI) to file a complaint against any chartered

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38 *Supra*, note 1, at §§ 21 A-21 B.
39 *Supra*, note 1, at § 22 A.
40 *Supra*, note 1, at § 21 C.
41 *Supra*, note 4.

accountant to the ICAI.[42] In 2004, the RBI, finding significant differences between the audit firm's numbers and RBI's own numbers in the case of Global Trust Bank (GTB), filed a complaint with the ICAI. Thus on a prima facie view, the ICAI Council found two partners and one other employee of the auditing firm PricewaterhouseCoopers, guilty of understating the non-performing assets of the Bank (thereby showing a fictitious healthy position of GTB). This constituted professional misconduct under the Second Schedule and the matter was referred to the Disciplinary Committee for further investigation.[43]

Interestingly, in *B.P. Kanani* v *SEBI*[44], SEBI passed an order against the company and its directors, directing them to disassociate themselves from the capital market activities. SEBI was of the view that the auditor of the company, B.P. Kanani had made a misrepresentation regarding the use of the funds of the company which, according to SEBI, amounted to professional misconduct on the part of the CA. The Board thus decided to refer the matter to ICAI which could take appropriate action against him. An appeal was filed before the SAT challenging the order of SEBI, wherein it was held that there was no grievance as the decision of SEBI to refer the matter to ICAI was a proposal and different from an order under the SEBI Act and thus dismissed the appeal.[45]

- Preventive measures which SEBI and ICAI are empowered to take

Even though fetters have been cast by the words of the provision, SEBI under the wide ambit of its powers has to act within the four corners of the statute, and cannot impose penalties under the garb of directions. Only remedial and preventive measures can be undertaken under Section 11B of the SEBI Act.[46] Additionally, even the Disciplinary Directorate under the CA Act has the authority to reprimand the chartered accountant or suspend the chartered accountant for a limited time frame or even permanently. It can even impose a fine along with the preventive measures in case of professional misconduct specified in the Second Schedule.[47]

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42 The CA (Procedure of Investigations of Professional and Other Misconduct and Conduct of Cases) Rules, § 3(3) (2007).

43 PWC Partners found guilty of professional misconduct, The Economic Times (February 10, 2009), http://articles.economictimes.indiatimes.com/2009-02-10/news/28456548_1_icai-council-erring-auditors-accounting-regulator.

44 B.P. Kanani v SEBI, 2000 SCC OnLine SAT 7.

45 *Id*, at ¶¶ 9-13.

46 *Supra*, note 10, at 201.

47 *Supra*, note 1, at § 21A (3) and § 21B (3).

Analysing the measures the Board is empowered to take under Section 11B, SAT in *Libord Finance Ltd.* v *SEBI*[48] held as under:

> "If the nature of the misconduct is such which is likely to affect adversely the securities market or the interest of the investors in general, it is open to the Board to issue under Section 11B such directions as may be necessary to protect the integrity of the market or the interests of the investors including a direction to restrain the delinquent from accessing the capital market. When such directions are issued, the object is not to punish the delinquent but to protect and safeguard the market and the interest of the investors which is the primary duty cast on the Board under the Act. The directions may result in penal consequences to the entity to whom those are issued but that would be only incidental. The purpose or the basis of the order or the directions would nevertheless be to protect the securities market and the interest of the investors. In other words, the order or the directions under Section 11B have to be regulatory in nature and not punitive."

In view of the above, it is clear that when there is a pre-existing legislation in the form of the CA Act, to regulate the profession of chartered accountants, which empowers its Disciplinary Directorate to take adequate and preventive measures against professionals guilty of misconduct, it would not be justified to allow the securities market regulator, SEBI to probe into the conduct of chartered accountants. Moreover, both the bodies can impose equally stringent and preventive measures on chartered accountants. Thereby, in order to appreciate the authority and sanctity of the legislation, ICAI and the adjudicatory mechanism formulated under the CA Act, ICAI should be given the power to probe into CA firms as well, so that the comprehensive legislation can fully realise its purpose and regulate the profession of chartered accountancy by probing into both CA firms and individual CAs.

IV. POWERS OF THE NFRA OVER CHARTERED ACCOUNTANTS

The Companies Act, 2013 has introduced a new regulatory authority, to be constituted by the Central Government, in the form of the National Financial Reporting Authority ("NFRA"), which would be set up with a mandate to function as an independent quasi-judicial oversight body for better monitoring corporate financial management. NFRA not only continues

[48] Libord Finance Ltd. v SEBI, 2008 SCC OnLine SAT 46.

with the advisory functions of National Advisory Committee on Accounting and Auditing Standards ("NACAS") in relation to accounting standards, but also provides recommendations to Central Government on Auditing Standards. Additional mandate includes, monitoring and enforcing compliance with auditing and accounting standards; overseeing the quality of compliance with accounting and auditing standards to professionals so responsible; and suggest measures for improvement in quality of services in this regard.[49]

In its evaluation of the Companies Bill, 2009, the Parliamentary Standing Committee proposed setting up of an oversight body to set standards and supervise quality of audits '*in light of recent experiences in corporate mis-governance*', referring to the various cases of corporate frauds. While welcoming introduction of auditing standards as a concept in the bill, the committee also recommended that NFRA shall be institutionalized not only as a body for setting up standards, but also as a quasi-regulatory body for generally supervising the quality of the audit undertaken, and shall also be given sufficient mandate to monitor quality of audit undertaken across corporate sector. It should therefore be manned by professionals.[50]

As per the statements of objects and reasons accompanying the Companies Bill, 2011,[51] the NACAS was proposed to be renamed as National Financial Regulatory Authority (NFRA) with a mandate to ensure monitoring and compliance of accounting and auditing standards and to oversee quality of service professionals associated with compliance. The Authority shall consider the International Financial Reporting Standards and other internationally accepted accounting and auditing policies and standards while making recommendations on such matters to the Central Government, which will improve the competitiveness of our companies with other international companies. The Authority is also proposed to be empowered with quasi-judicial powers to ensure independent oversight over professionals.

Thus, the NFRA not only continues the advisory function of NACAS to the Central Government in relation to accounting standards, but also provides recommendations on auditing standards. Further, NFRA, by virtue of the new company legislation, is also responsible for supervising and enforcing compliance with the auditing and accounting standards, overseeing

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49 *Supra*, note 5.

50 *Supra*, note 8.

51 Companies Bill, 2011: Fifty-Seventh Report of the Standing Committee on Finance, Ministry of Corporate Affairs, Fifteenth Lok Sabha, 21 (2011-12); A. Ramaiya, *supra*, note 8, at 2436.

quality of service professionals associated with ensuring compliance with such standards and suggesting measures for improvement in the quality of the services and other matters of professionals.[52]

Mr. Sachin Pilot, the then Union Minister of Corporate Affairs, had stated that NFRA and ICAI shall co-exist and ICAI will be the overarching body, with a large canvas to operate and NFRA will be a nodal agency for financial reporting with quasi-judicial powers and the power to suspend auditors.[53] However, Manoj Fadnis, President - ICAI, stated that setting up of a NFRA should not be rushed as its domain would overlap with ICAI's in many ways, and NFRA needs some more deliberation and dialogue with the government.[54]

- OVERLAP OF POWERS AND FUNCTIONS OF ICAI AND NFRA

It is pertinent to note that ICAI has been exercising the same functions as proposed to be implemented by NFRA under the new Companies Act, such as making recommendations to the Central Government on the formulation of accounting and auditing standards[55], and probing into chartered accountants in matters of discipline and professional misconduct[56]. By introducing a new authority such as NFRA, it is feared that ICAI's role would be reduced to very trivial matters related to the profession of chartered accountancy. On such other matters that are fundamental and essential to the profession of a CA, such as professional misconduct, it is likely that there would be a conflict between NFRA and ICAI, as both the statutory bodies have powers to investigate and take action against professional misconduct.

However, the most distinguished and critical provision of the NFRA is that it also has the power to take action against the CA firms for professional or other misconduct, which was a major short-coming of the ICAI under the CA Act. NFRA has the power to initiate investigation for professional or other misconduct committed by a member or a firm of chartered accountants registered with the ICAI. Furthermore, once such proceeding is initiated by the NFRA, no other proceeding on the same matter shall

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52 *Supra*, note 7, § 132(2).

53 *ICAI tense over move to set up new watchdog*, ECONOMIC TIMES, January 14, 2013, available at http://articles.economictimes.indiatimes.com/2013-01-14/news/36332015_1_audit-firms-icai-vice-president-lovelock-lewes, (last visited on August 9, 2016).

54 *Don't rush with NFRA, says ICAI President*, ECONOMIC TIMES, February 24, 2015, available at http://www.business-standard.com/article/economy-policy/don-t-rush-with-nfra-says-icai-president-115022301221_1.html, (last visited on August 9, 2016).

55 *Supra*, note 5, §§ 143 (9)-(10).

56 *Supra*, note 5, § 132(3)(a); *supra*, note 3, §§ 21, 21A and 21B.

be continued or initiated by any other body.[57] Such a provision may affect the authority and sanctity of the ICAI in an adverse manner, to take action against professional or other misconduct by any member, if the same is initiated by NFRA.

NFRA, by virtue of its power, can impose a penalty on any such member or a firm if proven guilty i.e., the penalty could be five times the amount of fee received but not less than 1 lakh rupees in case of an individual and ten times the amount of fee received but not less than 10 lakh rupees in case of a firm. Moreover, NFRA can also debar a member or a firm from practicing for a term of six months and upto ten years.[58]

However, as NFRA has not been constituted yet, the Ministry of Corporate Affairs had invited suggestions to the proposed changes and features to be introduced by the Companies Bill, 2011. Few of the suggestions received on the Companies Bill, 2011 are[59]:

(i) Provision for a NFRA may be removed and furthermore the role of NACAS *vis-à-vis* the ICAI (which prescribed accounting standards and regulates the conduct of its member) may be clarified.

(ii) Issues such as independent and other ethical requirements with regard to auditors arise from the CA Act and the ICAI's Code of Ethics. Such requirement now proposed/provided in the Bill (through NFRA) may lead to a conflict between the ICAI and NFRA. The roles and power of the regulators should be rationalised such that there are no conflicts.

(iii) Matters of professional or other misconduct committed by any member or CA firm to be referred to ICAI firstly which may refer it to NFRA for final action. ICAI may be retained as regulating authority.

(iv) As per international norms, NACAS can continue the role of setting Accounting Standards and a separate body can be set up for regulating the auditing profession.

The Ministry of Corporate affairs, in its comment to such recommendations, observed that the provisions proposed in the new Bill were in accordance with such recommendations and assured that NFRA shall follow procedure that shall be fair to all concerned stakeholders.[60]

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[57] *Supra*, note 5, § 132(3) (a).
[58] *Supra*, note 5, § 132(3) (c).
[59] *Supra*, note 49, at 42.
[60] *Supra*, note 60.

- OVERSIGHT BODIES IN FOREIGN JURISDICTIONS

There are similar bodies such as NFRA and ICAI in foreign jurisdictions such as the United States in the form of Public Company Accounting Oversight Board ("PCAOB") and the American Institute of Certified Public Accountants ("AICPA"). Post the accounting failures such as Enron, one of the major corporate frauds in the United States, the Sarbanes-Oxley Act came into force which established the PCAOB.[61] For the first time in history, it requires the auditors of U.S. public companies to be subject to external and independent oversight. It oversees the accounting and auditing services by professionals in the public companies.[62] Thus, the function of the AICPA was reduced to conducting exams and issuing certificates. However, a major distinction between ICAI and AICPA is that, the former is a statutory body created by an Act of the Parliament, whereas the latter is an association or a body of certified public accountants.[63]

V. CONCLUSION

Owing to the increasing debate and fear over the multiplicity of regulators and over-regulating the profession of chartered accountancy, a plausible solution to tackle the menace would be to provide for more accountability and efficiency in the functioning of ICAI, thereby strengthening the existing system, than creating of a new system altogether, i.e. NFRA. By way of this article, we suggest that the mandate of ICAI should be increased to probe into the matters of discipline and professional misconduct of chartered accountancy firms as well, in addition to individual practitioners. This would be in line with the scope and object of the CA Act and would allow ICAI to be the chief regulator of the profession, which would avoid chaos and confusion.

Moreover, it is also suggested that the ICAI should be allowed to impose a higher monetary compensation than the present amount i.e., a maximum of one lakh rupees for any misconduct specified under the first schedule and a maximum of five lakh rupees for any misconduct specified under the second schedule.

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61 A. RAMAIYA, *supra*, note 8, at 2437; The Sarbanes–Oxley Act of 2002, Pub.L. 107–204, 116 Stat. 745 (2002).

62 *Supra*, note 62.

63 AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, http://www.aicpa.org/Pages/default.aspx.

The Case of *Darius Kavasmaneck* v *Gharda Chemicals*: A Missed Opportunity in The Jurisprudence of Derivative Actions?

*Bhavna Pattanaik**

Derivative actions, despite being a rarity in India, are an essential tool at the hands of a minority shareholder in protecting the interests of the company against mismanagement at the hands of the management of the company. Since the law on derivative suits has not been codified to this date, the jurisprudence has largely evolved through the efforts of the judiciary. The case of Darius Rutton Kavasmaneck v *Gharda Chemicals marks a crucial point in this development as the country strives to enhance the corporate governance regime. This paper seeks to analyse the judgment in light of the common law practice as well as the law in the United Kingdom.*

I. Introduction

The case of *Darius Rutton Kavasmaneck* v *Gharda Chemicals Ltd.*[1] marks a critical point in the development of the law regarding derivative action in India. At a time when India is beset with the lack of minority shareholder protection, the evolution of a robust derivative action mechanism is essential.

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1 2014 SCC OnLine Bom 1851 : (2015) 191 Comp Cas 52.

The case at hand is a derivative suit filed by a minority shareholder on behalf of the company, against the directors of the company. Considering the rarity of derivative action in the country, the manner in which the Bombay High Court has dealt with the suit holds great significance in helping develop the nascent field of derivative suits in India.

The Plaintiff, Darius Kavasmaneck, is a minority shareholder of the company, Gharda Chemicals, and holds 12 percent of the shares in the company. The directors of the company are the defendants in the case, however, the case has been brought primarily against Defendant No. 2, who is an estranged uncle of the Plaintiff and holds 60 percent of the shares in the company. The Defendant No. 2 is the registered owner of certain patents which the company also uses free of royalties. The present notice of motion is filed by the Plaintiff to claim that the company is the rightful owner of the patents and consequently, to restrain Defendant No. 2 from dealing with the patents in any manner. It is the contention of the Plaintiff that the Defendant being the managing director of the company, owes a fiduciary duty to the company, and any patent obtained in the course of his employment must belong to the company. The claims of the Plaintiff were rejected and the application was dismissed by a Single Judge of the Bombay High Court. The suit was rejected on the grounds that it did not fulfill the pre-requisites of a derivative suit. Further, the judgment has now been upheld by a Division Bench of the Bombay High Court without disturbing the findings of the Single Judge Bench.[2]

The analysis used by the court in this will have a huge bearing on the cases to follow and consequently, the manner in which the law on derivative actions develops in India. At a time when it seems the protection awarded to minority shareholders under the Companies Act, 2013 is being constantly diluted,[3] courts must exercise sufficient caution while dealing with derivative actions.

II. History of Derivative Actions

Derivative suits are known to be the pillars of corporate litigation across the world. On the hand, ... They have been regarded as tools of accountability

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[2] Darius Rutton Kavasmaneck v Gharda Chemicals Ltd., 2015 SCC OnLine Bom 4813 : (2015) 5 Bom CR 162.

[3] Palak Shah, *Experts Ask Sebi To Stand Its Ground On Related Party Transactions To Protect Minority Shareholders*, The Economic Times, (10 July, 2015), http://articles.economictimes.indiatimes.com/2015-07-10/news/64282545_1_related-party-transactions-minority-shareholders-new-companies-act.

of a company and the backbone of a strong corporate governance regime of a country.[4] On the other hand, they have often been viewed as vehicles of extorting money by disgruntled shareholders.[5] Widely differing views on the issue entails that a discussion on the most appropriate mechanism of derivative action along with judicial clarity on the subject is much needed.

It has been observed that ownership structures with dispersed shareholding and weak institutional structures are most suitable to developing a flourishing derivative action mechanism.[6] Owing to the absence of such a conducive environment, derivative suits have been and potentially will be a rarity in India.[7] However, the Indian economy has been rapidly transitioning to an environment with dispersed shareholding and weaker institutional structures, making it increasingly suitable for derivative suits.[8]

Derivative action in India is a part of common law practice and is yet to find its codified place in the company laws. The newly formulated Companies Act, 2013 while introducing class action suits, has failed to include a specific provision for derivative action. This is so, despite a recommendation being made by the Standing Committee to include a separate provision for derivative suits.[9] Class action suits are inherently different from derivative suits as they represent members or shareholders having a similar interest and are often against the company itself.[10] Alternatively, derivative suits are brought on behalf of the company against an injury suffered by the company at the hands of the management of the company or a third party.[11] As a result of this oversight in the Act, the jurisprudence on derivative action is entirely dependent on the common law principles espoused and followed by the judiciary in this regard. Unfortunately, the courts too have failed to draw the distinction between the terms and have used them interchangeably in the

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4 Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J. L., ECON. & ORG. 67 (1991).

5 William M. Mullooly & John W. Fuhrman, *A Proposed Reform in the Law Affecting Shareholders' Derivative Actions*, 24 ST. JOHN'S L. R. 327 (2013); Richard W. Duesenberg, *The Business Judgment Rule and Shareholder Derivative Suits: A View from the Inside*, 60 WASH. U. L. Q. 311, 331-35 (1982).

6 Vikramaditya Khanna & Umakanth Varottil, *The Rarity of Derivative Actions in India: Reasons and Consequences*, *in* THE DERIVATIVE ACTION IN ASIA 369, 372-373 (Dan W. Puchniak et al. eds., 2012).

7 *Id*. at 373.

8 *Supra*, note 7.

9 FIFTY SEVENTH REPORT OF THE STANDING COMMITTEE ON FINANCE, *Companies Bill, 2011* 73-74 (June, 2012).

10 Jaideep Halwasiya v Rasoi Ltd., 2008 SCC OnLine Cal 871 : (2009) 150 Comp Cas 1.

11 Note, *Distinguishing Between Direct and Derivative Shareholder Suits*, 110U. PA. L. REV 1147 (1962).

past.[12] This is unlike jurisdictions around the world which have usually been quick to distinguish the two.[13] In India, only recently has the Calcutta High Court recognised the distinction between the two.[14]

Courts in India have primarily relied on the common law principles developed in the United Kingdom with regard to derivative suits.[15] Meanwhile, the UK has codified its derivative action mechanism by way of the Companies Act, 2006.[16] Despite the codification of the concept in the UK, pre-codification judicial pronouncements of the English courts have played a vital role in shaping the law in India.

Prior to the introduction of the Companies Act, 2006 in the UK, the leading case concerning the subject was *Foss* v *Harbottle*.[17] The rule in *Foss* v *Harbottle* states that the company is a separate legal personality and the company alone is the 'proper Plaintiff' to sue on a wrong suffered by it.[18] Conversely, there are exceptions to this rule in order to protect minority interests in the company. Among the limited exceptions, the primary exception is that of a fraud on the minority, which must be caused by a wrongdoer who is in control of the company.[19] Ordinarily to bring a derivative suit, the shareholder was required to show that it fell within the exceptions to the rule in *Foss* v *Harbottle*.[20] It was also the case that the question of the Plaintiff's standing to sue was to be determined as a preliminary matter.[21] The Plaintiff bringing the suit must have approached the court with clean hands, as established in the commonly cited cases of *Towers* v *African Tug Co.*[22] and *Nurcombe* v *Nurcombe*.[23] Ulterior motive of the Plaintiff weighed strongly against the case, and the court promptly disallowed such claims.[24] Additionally, the action was to be in the best interest of the company and a majority of the independent shareholders of the company were required to support it.[25] Therefore, the rule laid down in *Foss* v *Harbottle* was treated

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12 Spectrum Technologies USA Inc. v Spectrum Power Generation Co. Ltd., 2000 SCC OnLine Del 472 : (2002) 3 CLC 539.
13 Wallersteiner v Moir (No. 2), 1975 QB 373 : (1975) 2 WLR 389 : (1975) 1 All ER 849.
14 Jaideep Halwasiya v Rasoi Ltd., 2008 SCC OnLine Cal 871 : (2009) 150 Comp Cas 1 at 4.
15 Khanna & Varottil, *supra*, note 6, at 383.
16 The Companies Act, 2006, c. 46, Part 11.
17 (1843) 2 Hare 461.
18 (1843) 2 Hare 461.
19 Arad Reisberg, Derivative Actions And Corporate Governance: Theory And Operation 90 (2007).
20 Prudential Assurance Co. Ltd. v Newman Industries Ltd. (No. 2)., 1982 Ch 204 : (1982) 2 WLR 31: (1982) 1 All ER 354.
21 1982 Ch204 : (1982) 2 WLR 31 : (1982) 1 All ER 354.
22 (1904) 1 Ch 558.
23 (1985) 1 WLR 370 : (1985) 1 All ER 65.
24 Barrett v Duckett, (1995) 1 BCLC 243.
25 Smith v Croft, 1998 Ch 114.

as sacrosanct by English and Indian courts alike, and exceptions were made in limited circumstances.

With the coming of the new Act in the UK, the law has undergone a drastic change. The requirement to fall under the exception to the rule in *Foss* v *Harbottle* has now been replaced with a judicial discretion to grant permission in accordance with the statutory provisions.[26] The application for permission is a two-stage process. Firstly, the shareholder must establish a *prima facie* case.[27] Once established, the court then determines whether the claim must be allowed to proceed based on factors such as good faith of the Plaintiff, best interest of the company, existence of alternate remedies, the view of independent members of the company, among others.[28]

What remains to be seen is whether the Bombay High Court in the present case has evolved with the evolution of the law concerning derivative suits in UK or whether it has chosen to apply the principles of the past.

III. The Case of *Darius Kavasmaneck* v *Gharda Chemicals*

The High Court in this case disallowed the notice of motion of the Plaintiff and relied heavily on certain factors to arrive at its decision. The court categorically recognized the suit to be a derivative action and applied the factors accordingly. In its analysis, the court emphatically clarified that since the reliefs sought would have a bearing on the final reliefs, the suit must be treated as a full fledged trial, dismissing the Plaintiff's claim that only a *prima facie* case must be shown to exist. The bench focused on three main factors to determine the case. *Firstly*, the intent or motive of the Plaintiff, *secondly*, best interest of the company and *lastly*, the opinion of the independent members of the company.

In understanding the motive of the Plaintiff, the court looked to the clean hands doctrine in *Nurcombe* v *Nurcombe*.[29] On examining the past cases

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[26] Andrew Keay & Joan Loughrey, *Something Old, Something New, Something Borrowed: an Analysis of the New Derivative Action under the Companies Act 2006*, 124L. Q. Rev 469 (2008).

[27] Companies Act, 2006, § 261 (2).

[28] *Id.* at§§ 263 (3), 263 (4) &172. The requirement of 'best interest of the company' was a common law principle advocated by the Law Commission Report on Shareholder Remedies. However, the recommendation did not find a direct place in the Act. Nevertheless, §172 prescribes a duty to promote the success of the company and is one of the factors laid down under § 263 as well.

[29] Nurcombe v Nurcombe, (1985) 1 WLR 370 : (1985) 1 All ER 65.

brought about by the Plaintiff against the Defendant, the court was of the belief that the Plaintiff was driven by family hostilities and personal interests in bringing this suit. Secondly, the Plaintiff was alleged to have sold his shares to a rival company and seemed to be acting at their behest. Since the action was for an ulterior purpose, according to the bench, the claim could not proceed.[30] Alternatively, independent shareholders holding about 13% of the shares in the company were of the opinion that the suit should not be pursued. Lastly, it was found that if the Plaintiff's contention was accepted, there was a chance of revocation of the patent of the Defendant and since the company was currently enjoying the benefits of the patent royalty fee, the action was not in the best interests of the company. Consequently, the notice of motion was dismissed.

The reasoning used by the bench to come to this conclusion is problematic in several ways. It is a well-accepted principle that the there are two stages in the determination of the claim in a derivative suit.[31] The court while recognizing the first stage of establishing a *prima facie* case, failed to make an express mention of the two-stage process. At the first stage, the Plaintiff was merely required to show that a *prima facie* case existed. The prima facie test is an established test required for interim injunctions.[32] In case of interim injunctions a substantial chance of success must be shown.[33] However, when applied to derivative suits this would constitute a fairly stiff test to pass and has been sufficiently warned against as it would lead to a mini-trial at a preliminary stage.[34] Precedent suggests that the test is less strict in case of common law derivative actions in comparison with interim injunction applications and a 50 percent chance of success need not be proved.[35] The court in the present case has failed to recognize this principle laid down in *Prudential Assurance* and has categorically held that the notice would be treated as a suit in itself, forcing a threshold test on the merits of the case. Thus, the court first recognized that a *prima facie* case is to be established, but refused to accept the lower threshold test in case of derivative suits as opposed to injunction applications.

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30 Barrett v Duckett, (1995) 1 BCLC 243.

31 Smith v Croft,1998 Ch 114.

32 F. Hoffmann-La Roche & Co. A.G. v Secy. of State for Trade and Industry, 1975 AC 295: (1973) 3 WLR 805: (1973)3 All ER 945.

33 Heydon & Loughlan, Cases and Materials on Equity and Trusts, 978 (5th ed. 1997).

34 Harald Baum & Dan W. Puchniak, The Derivative Action: an economic, historical and practice-oriented approach 71 (1st ed. 2012); Law Commission, Shareholder Remedies: Report on a Reference under Section 3(1)(e) of the Law Commissions Act 1965 7 (Law Com. No.246, Cm. 3769, 1997).

35 Prudential Assurance Co. Ltd. v Newman Industries Ltd. (No. 2)., 1982 Ch 204 : (1982) 2 WLR 31: (1982) 1 All ER 354.

Despite understanding that only a *prima facie* case was to be established in the first stage, the court followed its stance on holding a mini trial and continued to delve into the factors that are ordinarily considered in the second stage of the suit. The first factor discussed by the bench is that of the clean hands doctrine. A great amount of emphasis was laid on the past conduct of the Plaintiff and whether he approached the court with 'clean hands'. Ulterior motive of the Plaintiff was given great importance in this case, despite being said previously that having a personal interest does not preclude a Plaintiff from bringing a derivative action.[36] Meanwhile, the doctrine of 'clean hands' has been replaced with the 'good faith' doctrine in the UK. Since the suit is not a personal claim but a derivative claim brought on behalf of the company, the conduct of the Plaintiff should be irrelevant in determining a claim of the company.[37] The court has placed reliance on the *Nurcombe* case which in turn relies on the *Towers* judgment. In *Towers* the court failed to draw the distinction between a direct action of the shareholders and a derivative actions and hence, courts must be careful in applying the case.[38] Judges in *Nurcombe* too espoused a similar position.[39] Therefore, the judgments relied on by the bench used a doctrine relevant to personal actions, in a case of derivative action. Although the clean hands doctrine has been commonly applied in the past, albeit inappropriately, the court in this case missed the opportunity to move towards the more suitable doctrine of good faith. It is also relevant to note that the application of the good faith doctrine may not have had a bearing on the final outcome of the case. This is because of the ambiguity in the phrase 'good faith' which would have nevertheless entailed a discussion of the Plaintiff's motives based on past conduct. But the situation is peculiar to the particular fact scenario and an application of the right doctrine would have allowed for a better development of the law at a time when the subject is still evolving.

Interest of the company is another factor that is commonly taken into consideration. The court was of the opinion that *firstly*, since the company was enjoying the benefit of the patent of the defendant royalty free, the suit would not be in the best interest of the company. *Secondly*, the Plaintiff's pledge of shares to a rival company also weighed against him in holding that the action was not in the best interest of the company. It was felt that accepting the contention would make the susceptible to revocation under the Patents Act. However, considering the facts of the case, this factor should

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36 Barrett v Duckett, (1995) 1 BCLC 243.

37 Jennifer Payne, *"Clean Hands" in Derivative Actions*, 61(1) CAMBRIDGE L.J. 77 (Mar.2002).

38 Towers v African Tug Co., (1904) 1 Ch 558, 571.

39 Nurcombe v Nurcombe, (1985) 1 WLR 370, 378 : (1985) 1 All ER 65.

not have precluded the court from granting leave. The decision could have simply determined that the Defendant No. 1 was the rightful owner of the patent *after* having allowed the application to proceed at the preliminary stage.

Lastly, the court took into consideration the views of the independent members of the company. Relying on the *ratio decidendi* in *Smith* v *Croft*,[40] the court observed that shareholders holding 13 per cent of the shareholding of the company did not support the suit. These disinterested shareholders are the family members of the Plaintiff casting a huge shadow on their supposedly neutral position considering the history of family hostilities in the Kavasmaneck family. Other minority shareholders' views have not been mentioned in the judgment. It seems that the bench has selectively relied on the evidence produced to determine the opinion of the shareholders, quite possibly veiling the true position of the disinterested members.

After having weighed the factors against the Plaintiff at the preliminary stage, the court decided against elaborating on whether there were alternative remedies available to the Plaintiff or the company in this case. Consequently, the court faultily conducted a full-fledged trial at the very first stage and refused to allow the application based on the factors discussed.

IV. Conclusion

At this juncture of evolving company laws in India, the case of *Darius Kavasmaneck* marks a crucial point. Derivative actions have long been recognized as keeping checks and balances on the powers of the corporate management.[41] Despite the risk of frivolous litigation, derivative suits have been considered to be tools of accountability and in many instances, a manner of protection of minority shareholders.

Derivative action mechanism has vastly evolved throughout jurisdictions. India remains the only leading Asian country without a codified law on the subject[42] and therefore relies heavily on common law principles. As a result, the judgment at hand is watershed in shaping the law on derivative action.

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40 Smith v Croft, 1998 Ch 114.

41 Cohen v Beneficial Industrial Loan Corpn., 93 L Ed 1528 : 337 US 541, 548 (1949).

42 Dan W. Puchniak, *The Complexity of Derivative Actions in Asia: An Inconvenient Truth*, *in* The Derivative Action In Asia: A Comparative And Functional Approach 90, 93 (Dan W. Puchniak et al. eds., 2012).

The case, however, deviates from the procedure adopted across common law jurisdictions. The court rightly recognizes that a mere *prima facie* case must be established at the preliminary stage. Subsequently, it must be determined whether the claim must be allowed to proceed based on certain key factors. However, it deviates from this position by conducting a trial of sorts using these factors in the preliminary stage itself. Alternatively, it also fails to apply a more suitable doctrine, i.e. the doctrine of good faith, in place of the doctrine of clean hands, which is now statutorily recognized in the UK. The court also seems to have selectively relied on the evidence produced to come to its conclusion.

Had the court expressly recognized the principles followed in derivative claims and discussed the factors accordingly, the judgment would have set a good precedent for the cases to follow. Unfortunately, the case was a missed opportunity of the judiciary to establish a strong logical sequence to deal with derivative claims.