KIIT

Student Law Review

KIIT STUDENT LAW REVIEW (KSLR)
Special Issue: Corporate & Commercial Laws
Volume 1, Issue 1, 2014
Cite this volume as 2014 KSLR, 1:1
ISSN No. 2348 – 4381

CHIEF PATRON'S MESSAGE

Law Schools across the globe have one cardinal objective, to educate the youth about a science which will always stay viable and which truly and justifiably decides the entire way of living in a society. Law is a pedagogy which closely perceives all the aspects of society and subsequently deals with them. It is only obvious that the amalgamation of legal education with the requirements of the corporate world is almost a necessity for the modern-day law student.

With this in mind the students of School of Law, KIIT University, Bhubaneswar have taken the initiative to come up with the inaugural issue KIIT STUDENT LAW REVIEW on the broad theme of 'Corporate and Commercial Laws'. This is an effort on behalf of the students to create awareness about the burning issues of corporate law which would definitely enhance the knowledge of the readers.

I welcome all those who would like to share the feeling of happiness and contentment with the success of the KIIT STUDENT LAW REVIEW and thank all those who have extended and would continue to extend their valued support in the much awaited endeavour of our beloved students.

Dr. ACHYUTA SAMANTA
Founder, KIIT and KISS
Bhubaneswar, Odisha

EDITORIAL

India, a developing nation in this century of corporate domination has witnessed tremendous leaps of growth alongside immense challenges and issues. These challenges often further entangle with the ever changing international commercial scenario. To keep abreast with these as well as simultaneously address issues specific to the Indian corporate setup, KIIT School of Law through its Student Law Review has made a modest attempt to review the present Corporate and Commercial laws of the country, thereby exploring the immense possibilities and plausible improvements in this bracket.

The inaugural issue of the KIIT Student Law Review (KSLR) is a student-edited and peer-reviewed publication of the School of Law, KIIT University. The first issue of the Review comprises of articles, short articles, book reviews, legislative briefs and case comments on multi-disciplinary issues relating to various aspects of corporate and commercial laws. The KSLR shall be an Annual issue which would meet the demands and the expectations of the readers with respect to the contemporary issues gaining momentum in the legal arena.

In an effort to ensure the highest quality of student research, the Review is published with consultation of both the Advisory Board and the Student Editorial Board collectively referred to as the 'Editorial Board'. We would also extend our heartfelt gratitude and thank to *Mr. Praveen Tripathi*, (Research Associate, NLSIU, Bangalore) for his never ending support in our small endeavour.

The inaugural issue of the KSLR received an overwhelming response from the students across myriad law colleges and universities across India which confirmed our credence on the effervescent spirits within the student community. It is a strong belief of the Editorial Board that the KSLR will continue to thrive in the upcoming years with an enhanced quality of publications.

The Editorial Board hopes that the inaugural issue of the KSLR generates impending observations in the minds of the readers.

The Editorial Board
KIIT STUDENT LAW REVIEW

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BLACK MONEY AND VOLUNTARY DISCLOSURE OF INCOME SCHEME: TWO SIDES OF THE SAME COIN?

Sachet Singh and Abhishek K. Singh[*]

ABSTRACT

Business enterprises as well as individuals around the world have been engaged in the practice of generating black money and money laundering for some time now and recent developments have brought to fore the urgent need to take strict action against them. This paper traces how black money is generated and ways and means through which it is laundered. The Government's White Paper on the issue of Black Money has failed to identify approaches through which it can prevent the generation and investment of black money in the market and bring back the huge amounts money stashed abroad. The paper answers these two critical questions by analyzing such black money-generating mechanisms as well as looking into tax benefit schemes like the Voluntary Disclosure of Income Scheme and its these answers which will contribute to the existing body of literature.

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INTRODUCTION

In 2011, the Supreme Court dealt with a complex issue unaccounted money being hoarded in foreign banks and constituted a Special Investigation Team (SIT) to probe into the matter, as well as, prepare an action plan to establish institutional mechanisms to curb the menace.[1] Earlier in the year, Baba Ramdev initiated a protest movement against the UPA government, on the ground that the government had not done enough to bring back black money, stashed away in foreign shores.[2]

After intensive pressure from the Opposition and Members of the Civil Society the Government brought a *White Paper on Black Money* enumerating steps that have been taken and steps that need to be taken in future in order to bring back the black money stashed abroad. The *White paper* defined black money, "*as assets or resources that have neither been reported to the public authorities at the time of their generation nor disclosed at any point of time during their possessio*n".[3] Even though the Government has appointed several committees to estimate the total amount of black money generated till date, the *White Paper* fails to provide anything definitive on this subject,[4] but believes that around 9,295 crores of black money is stashed abroad.[5] It becomes extremely necessary to keep a check on black money because once this money is laundered and its nature is changed from 'black' to 'white; it can be further re invested in the economy or used to finance illegal activities like terrorism.

While the issue of black money and money laundering is not new, recent developments have again thrown light on the urgent need to take strict action in order to curb it. This issue has probably been the catalyst in the demand for a strong Lokpal Bill. Through this paper, the authors shall aim to trace origins of the generation of black money and suggest certain measures to put a check on it and ways in which black money stashed abroad be brought back. Part I shall look into the various means through which black money is generated. Part II shall throw light on

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[1] See Ram Jethmalani &Ors. v Union of India, 2011 (4) UJ 2237 (SC).

[2]Bureau News, *Baba Ramdev's black money deadline today*, The Economic Times, August 11, 2012.

[3]Ministry of Finance, Government of India, *White Paper on Black Money*, 2 (2012). For the criticism of the definition adopted by the Government, See Arun Kumar, *The White Paper on Black Money is Blank*, May 26, 2012, http://www.thehindu.com/opinion/lead/this-white-paper-on-black-money-is-blank/article3456558.ece(last accessed on 2nd Jan., 2013); M.R.Venkatesh, *UPA's white paper on black money a farce*, http://mrv.net.in/index.php?option=com_content&view=article&id=291%3Aupas-white-paper-on-black-money-a-farce-&catid=1%3Agovernance&Itemid=2 (last accessed on 2nd Jan., 2013).

[4] For list of committees, techniques used for estimation and their conclusion See *White Paper on Black Money, supra* note 3 at 9-13.

[5]White Paper on Black Money, *supra* note 3 at 14.

money laundering, i.e. converting 'black money' to 'white money', while Part III suggests certain measures to curtail the generation of black money. Part IV analyses the efficacy of the Voluntary Disclosure of Income Scheme (VDIS). And the last part comprises of the authors' conclusions.

GENERATION OF BLACK MONEY

There are various modus operandi through which black money can be generated. It is often done by undertaking illegal or impermissible activities, which is then laundered in order to make such money legitimate and accountable. Black money can also be generated by making various manipulations in accounts so as to mislead tax authorities.[6]

(i) Manipulation of Accounts

There are numerous ways by which individuals can fudge their accounts. All transactions that are entered into by an individual must be mentioned in financial statements like the balance sheet, profit and loss account or income and expenditure account. Taxes could be evaded by omitting or falsifying the books of accounts,[7] e.g. people often visit grocery shops and purchase items without asking for a receipt. This enables shopkeepers to omit entering the sale of such items from the books of accounts or only showing a partial receipt.

Many individuals, who have an obligation under the law to maintain books of accounts, maintain two parallel books of accounts, one for their own use and other for the perusal of tax authorities. It is with respect to this other book of accounts that omissions and falsifying of entries takes place.[8]

Taxpayers are also required to pay taxes on profits or receipts. This goes on to encourage many taxpayers to fudge their sales or receipts in the books in order to evade tax.[9] For example, a vendor sells goods worth Rs 5 lakhs but issues a bill only to the tune of Rs 3 lakh. This way, he manages to keep the balance of Rs 2 lakh beyond the taxing net.

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[6] See White Paper on Black Money, *supra* note 3 at 3.
[7] Time News Network, *Foreign investment, market manipulation blamed for black money*, The Times of India, May 22, 2012, http://timesofindia.indiatimes.com/india/Foreign-investment-market-manipulation-blamed-for-black-money/articleshow/13369458.cms, (3rd Jan., 2013).
[8] *Id.*
[9] Gaurav Choudhary, *The true colours of a black economy*, Hindustan Times, May 22, 2012, available at http://www.hindustantimes.com/business-news/Features/The-true-colours-of-a-black-economy/Article1-859767.aspx, (last accessed on January 3, 2013).

Manipulating or under-reporting production has become a popular method of evading central tax, sales tax and income tax.[10] Manipulation of expenses is another common method of evading tax, as the tax to be paid is estimated only after deducting the expenses of the business from its overall revenue. This can be done under different heads and also by under-reporting of income.[11]

(ii) Transfer Pricing

When two distinct enterprises enter into a business transaction, the price of goods or services will always be determined by market forces.[12] However when two connected enterprises enter into a transaction, such transactions between the parent and subsidiary of the same corporation or inter subsidiary, one of which is situated in a high tax jurisdiction and the other in a low tax jurisdiction, the aim is to shift the profit in the lower jurisdiction so as to decrease the overall tax in a given transaction thereby increasing post tax profit. This shifting of profit so as to increase the post-tax return in called *Transfer Pricing*. According to OECD, transfer price *"is a price, adopted for book- keeping purposes, which is used to value transactions between affiliated enterprises integrated under the same management at artificially high or low levels in order to effect an unspecified income payment or capital transfer between those enterprises."*[13] In order to determine the true taxable income in a given jurisdiction, Revenue uses the '*arm's length standard*' i.e. the price of goods and services, had a similar transaction under the same circumstances been effected between two non-related enterprises.[14] Since transfer pricing is a form of tax evasion and hence illegal, the difference in transfer price and arm's length price is the amount of illegal money generated through transfer pricing. Most of this illicit money is routed through tax havens and re-invested in financial system. According to the *White Paper* on *Black Money* transfer pricing cost 160 billion US$ to developing countries.[15]

[10]*Id*.
[11]White Paper on Black Money, *supra* note 3 at 5.
[12]Eugene E. Lester, *International Transfer Pricing Rules: Unconventional Wisdom*, 2 ILSA JOURNAL OF INT'L &COMPARATIVE LAW 283, 285 (1995).
[13] OECD Definition of Statistical Terms, available athttp://stats.oecd.org/glossary/detail.asp?ID=2757 (last accessed on January 3, 2013).
[14]MICHAEL J. GRAETZ, FOUNDATIONS OF INTERNATIONAL INCOME TAXATION 407 (2003). According to §92F (ii) of Income Tax Act, 1961, "*Arm's length price means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions*."
[15]*White Paper on Black Money*, *supra* note 3 at 8.

The following example will illustrate transfer pricing and how it is used to generate black Money. Consider a case where a Multinational Corporation X, market leader in manufacturing smart phones, has parent company in USA and subsidiary in China. Assume, majority of the customers of X are based in the United States and it is from there that it derives 80% of its revenue and due to availability of cheap labour and host of other sound business reasons; it manufactures its smart phones in China. Also assume that cost of manufacturing 100 million smart phones is 10 million US$ and rate of corporate taxation in China is 10 % & and in United States of America is 30 %. In an arm's length transaction, the parent company would try to buy goods at the minimum price possible so as to make maximum profit while selling it in its jurisdiction. However in case of transfer pricing or rather mispricing, if the intention of the parent company is to make pre- tax profit of 5 million US$,then it will buy goods from the subsidiary at 14 million US$ and sell it in the United States thereby making only 1 million US$ as profit in the United States. This will however result in higher post tax profit to the company than if it had dealt with its subsidiary at an arm's length. In this case the subsidiary would pay 400,000 US$ (10 % of {14 million-10 million})as tax while the parent company 300,000 US$ (30% of {15 million- 14 million})as tax, hence total tax of 700,000 US$ and hence post tax, the total profit of multi -national corporation would be 4.3 million US$. Had there been an arm's length transaction and say the parent company would have bought the smart phones at 12 million US $ from the subsidiary and sold it at a profit of 3 million US$ in the United States, then even though its pre -tax profit would remain the same at 5 million US$, due to its tax of 1.1 million US$ (200,000 in China and 900,000 in United States), its post-tax profit would be 3.9 million US$. Since transfer pricing is a method of tax evasion and hence illegal money this difference in money of around 0.4 million US$ is black money.

(iii) Under Valuation of Property

Investment in real estate property has become a very widespread method of stashing unaccounted money. This is primarily because sale and purchase of real estate property contains a very high rate of transaction taxes, especially stamp duty. In addition, there are other high transaction costs such as commissions, advertising and potential litigation costs as well.

With a view to avoid such high taxes, taxpayers sell or purchase property at a lower value. This benefits the purchaser as he has to pay a lower stamp duty and is advantageous to the

seller as he now pays a lower capital gains tax.[16] The balance that is created out of the transaction results in the generation of black money.

As the existence of such black money cannot be revealed, individuals cannot use such money in order to pay sales tax or excise taxes as these transactions must keep off official records.[17] Hence, there is a *'cascading effect'* throughout the whole process as all activities must be kept undisclosed.[18]

(iv) Corruption

Today, corruption has become arguably the biggest issue plaguing the country. Corruption originates from the lowest levels of bureaucracy in order to procure various services from government officials. Public officials earn huge commissions through mega projects as well as leakage in public spending.[19] The biggest victims of such corrupt practices are the poor and middle class.

The electoral process requires huge expenditures. Most political parties are not in a position to bear such a financial burden. Therefore, it is widely believed that election campaigns are funded through the use of black money.[20] In return, holders of such black money expect political patronage and various concessions.

Corruption has been alleged in various sectors like procurement of weapons for national security, petroleum and gas sectors as well as sale and purchase of aircrafts.[21] Money worth thousands of crores was involved in the recent 2G-Spectrum and Commonwealth scams. All these practices have led to generation of vast amounts of black money. As a result, there is added pressure on the government to create a strong Lokpal Bill to check such corruption.[22]

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[16]Isher Judge Ahluwalia, *Property tax reform can fund our cities*, The Indian Express, June 29, 2011, on http://www.indianexpress.com/news/property-tax-reform-can-fund-our-cities/810078 (4th Jan, 2013).
[17]JAMES ALM, PATRICIA CLARKE ANNEZ AND ARBIND MODI, STAMP DUTIES IN INDIAN STATES: A CASE FOR REFORM 25 (2004).
[18]*Id.*
[19]*Measure to Tackle Black Money in India and Abroad*, Report of Chairman, CBDT, Government of India 10 (2012).
[20]*Id.*
[21]*Id.*
[22]ET Bureau, *Government panel on black money backs creation of Lokpal*, The Economic Times, August 15, 2012, available at http://articles.economictimes.indiatimes.com/2012-08-15/news/33216822_1_tackle-black-money-panel-denomination-currency-notes (last accessed on January 7, 2013).

(v) Price Control Policies of the Government

The government regularly adjusts the price of certain commodities like sugar, cement, fertilizers, etc. The pricing of such commodities is seldom flexible and fails to take into account the various ups and downs in demand and supply. This directly results in activities like hoarding, which leads to the generation of black money.[23]

CHANGING THE NATURE OF BLACK MONEY AND RE-INVESTMENT

Black Money, which is either generated through illegal means or generated through legal means but not reported to tax authorities, is laundered so as to change its nature in order to utilize it without the risk of getting caught. Just as in a washing machine dirty clothes are cleaned similarly by exploiting and employing corporate structures, banks and financial institutions, 'dirty' money is laundered to make it 'white' so that it can be further re-invested in the financial systems.[24] The Prevention of the Money Laundering Act, 2002 (PLMA) defines money laundering as;[25]

> "*whosoever directly or indirectly attempts to indulge or knowingly assists or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime and projecting it as untainted property shall be guilty of offence of money laundering.*"

Money Laundering is essentially a three step process wherein, *firstly*, black money is parked in the banks and financial institutions and later removed by converting cash into negotiable instruments like traveler's checks, bill of exchange, promissory notes, etc.[26] This step is called placement and since in most jurisdictions, banks have to report money transactions over a certain limit, instead of depositing bulk of money in a single bank account, a cash below threshold is placed in a number of bank amounts, and this process is called smurfing.[27]*Secondly*,

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[23] Fiona M. Scott Morton, *The Problems of Price Controls*, available at http://www.cato.org/pubs/regulation/regv24n1/morton.pdf, (last accessed on January 7 , 2013)

[24]BHURE LAL, MONEY LAUNDERING AN INSIGHT INTO THE DARK WORLD OF FINANCIAL FRAUDS 12 (2003).

[25] Prevention of Money Laundering Act, § 3 (2002)

[26]Scott Sultzer, *Money laundering, The Scope of the Problem and Attempts to Combat it*, 63 TENNESSEE LAW REVIEW149 (1995).

[27] According to § 4 of the Prevention of Money Laundering Regulations, 2005, all banks and financial institutions need to monitor "*all cash transactions above Rs. 10 lakh or integrally connected series of transactions above Rs 10 lakh and undertaken with one month*". Directions in this regard were also issued by, Reserve Bank of India, by way of Master Circular No.: RBI/2012 - 13/45 DBOD. AML. BC. No. 11 /14.01.001/2012-13, dated, July 2,

placed money is made to travel throughout the world by performing a series of complex transactions without any commercial justifications so as to conceal the identity of owner and source of black money. This is called Layering and generally money is transferred to off shore bank accounts in countries like Panama, Bahamas, Switzerland and Liechtenstein, which have strict bank secrecy laws or through shell corporations in tax haven jurisdictions to add further level of complexity to the transaction.[28]*Finally*, the layered money is re-invested in the financial system by buying stocks, participatory notes or depository receipts like American depository receipts. This stage is called Integration.

(i)Misuse through use of Corporate Structure

There has always been a raging debate as to when a corporate structure is legitimate and when it should be overlooked? With financial transactions becoming more complex by the day, corporations have increasingly started to utilize multiple corporate entities as a part of their overall structure.[29]

Corporate structuring is a legitimate medium of bringing together the various units involved in the process of production with the objective of assisting the business and overall economy of the country.[30] However, numerous corporations have started taking undue advantage of the 'separate legal personality' status granted to corporations and created multiple corporate entities that own each other, especially in specific jurisdictions which grant secrecy in order to facilitate such malpractice.[31]

According to a World Bank Report, the misuse of the corporate structure by various companies and trusts was found to be in the tune of about US$ 50 billion.[32] According to the *White Paper on Black Money* published by the Government of India, the *Vodafone tax* case was cited as an instance wherein such corporate structure was misused in order to avoid payment of

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2012.availableathttp://www.rbi.org.in/scripts/NotificationUser.aspx?Id=5472&Mode=0 (last accessed on January 9, 2013).

[28]S. SUNDAR, ANTI MONEY LAUNDERING AND KNOW YOUR CUSTOMER10 (2007).

[29] Steven L. Schwarcz, *Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, 70 University of Cincinnati Law Review 1309, 1314-1315 (2002).

[30]White Paper on Black Money, *supra* note 3 at 18.

[31]*Id.*

[32] Emile Willebois, Emily M. Halter, Robert A. Harrison, Ji Won Park and J.C. Sharman, *The Puppet Masters: How the Corrupt use Legal Structures to hide Stolen Assets and What to do about it?*, The World Bank and UNODC14 (2011).

tax to the Government of India.[33] Corporations devise different means of finding loopholes in the existing legal system and the signing of various Double Taxation Avoidance Agreements (DTAAs) has only gone to facilitate such practice by corporations.

(ii) Misuse through use of Shell Companies

A '*shell corporation'* is a company which has a *de jure* existence without any commercial justification and does not own any significant assets.[34] These corporations are either located in tax haven jurisdictions like Mauritius, Luxembourg and British Virgin Islands or in countries with strict bank secrecy laws like Panama, Bahamas, Switzerland and Liechtenstein.

Shell corporations may be used either at the layering or integration stage of money laundering.[35]At layering stage these companies are used to layer laundered money and due to their presence in tax haven or bank secrecy jurisdiction it becomes impossible to trail black money. At integration stage shell corporations are employed to re-invest in financial system and often black money is blended with money derived from legitimate sources so as to prevent detection of source of investment and owner of black Money.

(iii) Misuse through use of Treaty Provisions

Government of India has entered into Double Taxation Avoidance Agreement (DTAA) with a number of countries to prevent taxation of same income by two different jurisdictions[36] and ensure certainty as to which country will get the right to tax income when residents of one country has source of income in another country or vice- versa.[37]India has entered one such DTAA with Mauritius, in which Mauritius has been given the right to tax income generated by

[33]White Paper on Black Money, *supra* note 3 at 18.

[34] According to OECD, a shell company, "*is a company that is formally registered, incorporated, or otherwise legally organized in an economy but which does not conduct any operations in that economy other than in a pass-through capacity. Shells tend to be conduits or holding companies and are generally included in the description of Special Purpose Entities*", available at http://www.oecd.org/investment/investmentpolicy/2487495.pdf (last accessed on January 10, 2013).

[35]Bhure Lal, *supra* note 24 at 227.

[36] According to OECD, "*International double taxation arises when comparable taxes are imposed in two or more states on the same taxpayer in respect of the same taxable income or capital, e.g. where income is taxable in the source country and in the country of residence of the recipient of such income*", available athttp://www.oecd.org/ctp/glossaryoftaxterms.htm#D (last accessed on January 10, 2013).

[37] For more reasons for entering into DTAA See, Antonio Hugo Figueroa, *International Double Taxation: General Reflections on Jurisdictional Principles, Model Tax Conventions and Argentina's Experience*, 59 BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION 379-386 (2005).

Mauritius 'residents' from transfer of capital gains.[38]Offshore companies[39] are able to obtain Tax Residence Certificate (TRC) in Mauritius by registering themselves under the Mauritius Offshore Business Activities Act (MOBA)[40] and due to lower level of corporate governance, strict secrecy laws[41], effective rate of corporate taxation to mere 3% and use of Indo- Mauritius DTAA, these companies have become an effective means to route black money in India. This can be substantiated by the fact that in the last decade, around 42% of the FDI and 15% of FII has come from the Mauritian route[42] which is much more than the GDP of the country.[43]It is believed that the beneficial owners in most of these off shore companies are Indian nationals who use these shell companies to round trip their black money in India. In May, 2012 the Central Bureau of Investigation has alleged that Y S Jagan Mohan Reddy son of former Chief Minister of Andhra Pradesh Y R Rajasekhara Reddy involved in disproportionate asset case[44] had routed around Rs. 124 crore of black money via two Mauritian companies 2i Capital and Pluri Emerging Company into Sandur Power Company, a company owned by him.[45]

[38]§13 of the Indo- Mauritius DTAA; also Central Board of Direct Taxes had issued Circular No. 682 dated 30 March, 2000 in which the Government of India clarified that capital gains of any resident of Mauritius by alienation of shares of an Indian company shall be taxable only in Mauritius according to Mauritius taxation laws and will not be liable to tax in India, available athttp://law.incometaxindia.gov.in/DIT/File_opener.aspx?page=CIR&schT=&csId=8e5b6291-2674-4a89-b0de-6e5640389a24&crn=682&yr=ALL&sch=&title=Taxmann%20-%20Direct%20Tax%20Laws (last accessed on January 11, 2013).

[39] According to OECD an offshore company is, "*a company registered in a country (often a tax haven) other than the country or countries in which it carries on its business activities*", http://www.oecd.org/ctp/glossaryoftaxterms.htm#O (last accessed on January 12, 2013). By virtue of §26 of the Mauritius Offshore Business Activities Act, 1992, companies registered under MOBA are not allowed to acquire property, invest or conduct business in Mauritius.

[40]§ 18 of the Mauritius Offshore Business Activities Act, 1992.

[41] The fact that Manutius has a low level of corporate governance and strict laws which substantially harm India is further testified by a report of *OECD (2011), Global Forum on Transparency and Exchange of Information for Tax Purposes Peer Reviews: Combined Mauritius 2011: Combined: Phase 1+ Phase 2: Legal and Regulatory Framework*, OECD, available at http://www.keepeek.com/Digital-Asset-Management/oecd/taxation/global-forum-on-transparency-and-exchange-of-information-for-tax-purposes-peer-reviews-mauritius-2011_9789264097230-en (last accessed on January 15., 2013).

[42]As per Data from the Department of Industrial Policy and Promotion, Government of India Ministry of Commerce and Industry, Country wise FDI equity inflow, available athttp://dipp.nic.in/English/Publications/FDI_Statistics/TOP-COUNTRIES-INFLOWS.pdf (last accessed on January 15, 2013).

[43]In 2010, FDI from Mauritius had crossed $50 billion whereas its GDP was around $9.496 billion, Data from US Department of State, available athttp://www.state.gov/r/pa/ei/bgn/2833.htm (last accessed on January 15, 2013).

[44] A Srinivasa Rao, *How Jagan Mohan Readdy became the richest Lok Sabha MP in India, and what is his real worth*, May 28, 2012, India Today, available at http://indiatoday.intoday.in/story/how-jagan-reddy-became-the-richest-mp-in-india-and-what-is-his-real-worth/1/197981.html, (last accessed on January 15, 2013).

[45]U Sudhakar Reddy, *Jagan Routed Black Money from Mauritius*, May 29, 2012, Deccan Chronicle, available at http://www.deccanchronicle.com/channels/nation/south/jagan-routed-black-money-mauritius-661, (last accessed on January 15, 2013).

PREVENTING GENERATION OR INVESTMENT OF BLACK MONEY IN THE ECONOMY

(i) Closing the Mauritian Gap

As illustrated in the previous section of this paper, since the majority of routing of black money in form of FDI and FII happens through Mauritius, the researchers are of the opinion that there is an urgent need to redress this problem. It is not that government is not aware of the misuse of treaty provisions via Mauritius route. In 2003, a Ministry of Finance Report had recommended the incorporation of provisions to deal with treaty shopping which may be based on, "*UN/OECD model or other global practices*"[46] and even a Joint Parliamentary Committee (JPC) on Stock Market Scam and Matters had recommended that, "*Companies investing in India through Mauritius, should be required to file details of ownership with RBI and declare that all the Directors and effective management is in Mauritius*."[47] Even in the *White paper on Black Money* the Government has recognized the problem of round tripping from the Mauritian route. However till date no positive action has been taken from the side of the government to prevent misuse of treaty provision.[48]

The Mauritian government issues Tax Resident Certificate (TRC) as a proof that companies investing in India are residents of Mauritius hence they should be given the benefit of Indo- Mauritius DTAA. Even Central Board for Direct Tax has issued Circular no. 789[49] which makes a TRC conclusive proof with respect to residence of a corporation. The Supreme Court in *Union of India (UoI) v. Azadi Bachao Andolan*[50] has upheld the constitutional validity of the

[46]§3.3.1, *Applicability of anti-abuse concept in relation to DTTA*, Report on the Working Group on Non Resident Taxation p. 14, constituted by the Ministry of Finance and Company Affairs vide order F. No. 153/221/2002-TPL dated 14 November, 2002 which submitted its report in January, 2003, available at http://finmin.nic.in/reports/NonResTax.pdf (last accessed on January 15, 2013).

[47]§12.205, *Joint Committee on Stock Market Scam and Matters Relating Thereto*, Volume 1 Report, 13thLokSabha, full report available at http://www.watchoutinvestors.com/JPC_REPORT.PDF (last accessed on January 17, 2013).

[48]See *White Paper on Black Money*, *supra* note 3 at 17.

[49]Circular 789 issued on 13 April 2000 by the CBDT reads, "*734. Clarification regarding taxation of income from dividends and capital gains under the Indo-Mauritius Double Tax Avoidance Convention (DTAC) 1. The provisions of the Indo-Mauritius DTAC of 1983 apply to 'residents' of both India and Mauritius. § 4 of the DTAC defines a resident of one State to mean "any person who, under the laws of that State is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature." Foreign Institutional Investors and other investment funds, etc., which are operating from Mauritius are invariably incorporated in that country. These entities are 'liable to tax' under the Mauritius Tax law and are, therefore, to be considered as residents of Mauritius in accordance with the DTAC.*" Full text available at http://law.incometaxindia.gov.in/DIT/File_opener.aspx?page=CIR&schT=&csId=952f7443-2ab3-4ba5-b6b8-76f40acfbac0&crn=789&yr=ALL&sch=&title=Taxmann%20-%20Direct%20Tax%20Laws (last accessed on January 20, 2013).

[50](2004) 1 Comp LJ 50 SC, hereinafter referred as Azadi Bachao case.

circular. Every time there is uproar with respect to black money the government considers withdrawing its circular[51] with a view to differentiate between shell corporations and genuine companies on a case to case basis. A number of times it has been argued that there is a need to insert a Limitation of Benefit (LOB) clause in the Indo- Mauritius DTAA so as to prevent treaty shopping, however it is submitted that there is no need to either withdraw circular nor insert LOB as it may lead to tax uncertainty.[52]

It is pertinent to point out that in the *Vodafone case*,[53] Justice Radhakrishnan in his separate yet concurrent ruling had held that TRC is not a conclusive proof and tax department may pierce the corporate veil where there is evidence of illegal activities. In his words, "*TRC does not prevent enquiry into a tax fraud, for example, where an OCB is used by an Indian resident for round-tripping or any other illegal activities, nothing prevents the Revenue from looking into special agreements, contracts or arrangements made or effected by Indian resident or the role of the OCB* (Overseas Corporate Bodies) *in the entire transaction"*.[54] Hence in light of this recent decision, there is no need to withdraw the circular as the judiciary has given sufficient power to the Revenue to disregard the corporate structure in case shell corporations based in Mauritius are used to route black money in India.

However there is a need to increase information exchange between Mauritius and India. In the Harshad Mehta scam, when SEBI requested certain information from Mauritius Offshore Business Activities Authority regarding name of beneficiaries and source of money, the same was denied on the grounds that offences investigated by SEBI fall outside the list of offences regarding which 'disclosure order' may be passed.[55]In 2002, OECD mandated all countries to implement its "*Standard of transparency and exchange of information*."[56] However an OECD Report in 2011 on Mauritius has highlighted the opaque system within which its banks and

[51]Hema Ramakrishnan, *Post Vodafone verdict, govt to clamp down on Mauritius deals*, January 23, 2012, The Economic Times, available at http://articles.economictimes.indiatimes.com/2012-01-23/news/30655716_1_tax-residency-tax-treaty-indo-mauritius, (last accessed on January 20, 2013).

[52]Insertion of LOB clause is further resisted on the grounds that investments from Mauritius needs to be looked holistically and loss of revenue cannot be a ground to revamp treaty because if on one hand the Government has lost Capital Gains Tax on the other hand, investments have led to increase in revenue from corporate tax, dividend tax, other indirect tax and creation of millions of job in the country.

[53]Vodafone International Holdings B.V. v. Union of India &Anr, CIVIL APPEAL NO.733 OF 2012.

[54]*Id*. at 98, ¶ 184.

[55]§ 8.7.3, *Joint Committee on Stock Market Scam and Matters Relating Thereto*, Volume 1 Report, 13thLokSabha, available at http://www.watchoutinvestors.com/JPC_REPORT.PDF (last accessed on January 24, 2013).

[56]*Global Forum on Transparency and Exchange of Information for Tax Purposes*, OECD, available at http://www.oecd.org/tax/transparency/abouttheglobalforum.htm (last accessed on January 24, 2013)

financial institutions works and that there is no effective exchange of information as mandated by its standard.[57]Hence there is an urgent need to enter into Tax Information Exchange Agreement (TIEA) with Mauritius[58] and build international pressure on Mauritius to come clean on corporate governance and working of its financial institutions.

(ii) Reverse Piercing of Corporate Veil

While the traditional concept of piercing the veil makes the individual liable for the fraudulent acts of the corporation, reverse piercing holds the corporation liable for acts of its individual members or the subsidiary company liable for acts of the parent company.[59] Like traditional veil, reverse piercing also requires promotion of fraud and injustice.[60]

The concept of reverse piercing of the corporate veil is far less established.[61] It refers to an attempt by any third party, shareholder or the company itself to pierce the corporate veil between the company and its shareholders.[62] This concept attacks the very principle of the conformist corporate entity as it goes on to eliminate the demarcation between a corporation and its owners and shareholders. For example, if an individual 'X' has generated Rs 100 crores through black money, he can form a shell company and transfer the amount to such company. By reverse piercing, the court does not allow 'X' to benefit from the company's separate legal existence and can force the company to return such illegal money.[63]

In a recent judgment in 2012, the New York District Court held that a subsidiary company could be made accountable for a breach of contract on the part of the parent company.[64] The Court further held that it would have jurisdiction over the subsidiary company as it was a mere department or agent of its parent corporation.[65]

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[57]White Paper on Black Money, *supra* note 33

[58]For a detailed discussion on TIEA please read § 5 below. At present India has entered into TIEA agreement with 8 other countries, Bermuda, Bahamas, Isle of Man, British Virgin Islands, Cayman Islands, Jersey, Guernsey and Liberia. For more, available at http://law.incometaxindia.gov.in/DIT/intDtaaTIEA.aspx# (last accessed on January 24, 2013).

[59] Nicholas B. Allen, *Reverse Piercing of the Corporate Veil: A Straightforward Path to Justice*, 85 ST. JOHN'S LAW REVIEW 1153 (2011).

[60] See *State v Easton*, 169 Misc. 2d 282, 289, 647 N.Y.S 904, 909 (Sup. Ct. Albany Cnty. 1995).

[61]WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS 41.70 (2011).

[62]*Id* (rev. perm. Ed. 1983).

[63] This will not be possible through the traditional piercing method as through traditional piercing of the corporate veil, there is only a claim against the individual and not the company.

[64] See *Frederick W. Gundlach v International Business Machines Corp., etc*, No. 11-CV-846 (S.D.N.Y 2012). The case was related to various breaches of contract claims against IBM, USA and several non-US affiliates, including

As early as 1968, the respondents in a case argued before the Delhi High Court that a subsidiary company should not be permitted to raise further capital when winding up proceedings have been initiated against the parent company.[66]

This doctrine originated in the US and has not yet been recognized by courts in India.[67]Therefore, it is about time that Indian courts refrain from turning a blind eye to the presence of this principle and accept it as a potential counter to certain cases of corporate fraud. With the amount of lawsuits with respect to corporate transgression on the rise, one can only expect wronged parties to use this principle as a means in obtaining justice. Consequently, it shall become increasingly difficult for courts in India to ignore the fact that in certain cases, reverse piercing provides the most suitable answer to wronged creditors against individuals of a company.[68]

Reverse piercing permits courts in ensuring that the substance of the relationship takes priority over its mere form.[69] Nevertheless, the application of this doctrine should not be the norm but only be used in certain specialized situations, wherein individuals take advantage of a corporation's separate legal existence in order to carry out fraudulent activities. This is how the majority of black money is generated, wherein companies create shell corporations, which have no economic or commercial value of their own, in tax havens or low tax jurisdictions. The money generated through these corporations is then used to invest in India. Such practices can be

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IBM, Japan. The Court noted that it might have jurisdiction over an out-of-state defendant if it engages in "continuous and systematic business activities within New York" or does business "with a fair measure of permanence and continuity."

[65]*Id*.

[66]Freewheels (P) Ltd., New Delhi v Veda Mittra & Anr, AIR 1969 Del 258. The Court rejected the respondent's contention by holding that the fundamental concept to be always kept in mind is that each company is a distinct legal entity.

[67](1) Nepc India Ltd; (2) Nepc Agro Foods Ltd; (3) Skyline Nepc Ltd v SEBI, SAT Appeal No. 40/2001 (March 31, 2003).

[68]Jones v Lipman, [1962] 1 All ER 442, wherein the defendant sold a piece of land to the plaintiff. He then, subsequently, went on to form a company in which he was the majority shareholder and transferred the sold land to the company. The objective in doing so was that he could avoid any award for specific performance of the contract as the land was no longer in his name, but that of the company. However, the Court allowed the plaintiff to enforce the award for specific performance against the company, thus, entitling him to claim damages. Also see Gilford Motor Co. v Horne, [1933] Ch. 935, wherein the defendant left the employment of the plaintiff. However, there was a restrictive covenant that prescribed that he would not solicit customers of the plaintiff. The defendant then went on to form another company, of which he was the majority shareholder, and solicited the plaintiff's customers. The defendant argued that it was not him but the company that went ahead and solicited the customers. Nevertheless, the Court successfully granted the plaintiff an injunction order against the company for the breach of the defendant's obligations.

[69] Jeffrey B. Klaus, *Reverse Piercing*, 31 COLORADO LAW 112 (2002).

restricted to a large extent if courts begin to eliminate the guise of the company's separate legal personality and reverse pierce corporations indulging in such corporate fraud.

(iii) Introduction of GAAR to prevent Misuse of Corporate Structure

The Indian economy was liberalized in the year 1991, since then the country's economy has seen a steady growth in matters of business and investments. With the liberalized and *laissez faire* economy, there was a growing interest in the Indian markets by foreign investors. Over the years, the increase in foreign investments led to a better understanding of country's legal systems and statutes. This awareness not only led to better transactional activities but also the knowledge of loop holes in the system. Foreign companies thus began colluding with Indian entities to enter into arrangements that would benefit them in a *mala-fide* manner or with additional fiscal benefits through devices not recognized under the Indian law.

With the trend of globalization the archaic Indian tax statute has been largely unable in handling the various devious and innovative methods of tax evasion. However, the inefficacy of the taxing statute cannot only be blamed for the widespread practice of sidestepping it. The phenomenon of colorful devices and sham transactions to evade tax was becoming a global phenomenon.

Thus, counties started evaluating the cause and effect of such activities and began formulating statutes and provisions that would battle this menace effectively. This brought to the fore, the formation of Special Anti-Avoidance Rules or SAAR which targeted specific tax evading transactions in order to bring certain transactions within the jurisdiction of Tax Authorities to enable them to persecute such sham transactions.[70] Nevertheless, parties interested in evading tax statutes were still finding ways to evade them. These rules thus needed a larger fish net to entrap every colourable device that was formulated to evade tax, which led to the formation of the General Anti-Avoidance Rules or GAAR.

GAAR was broader than SAAR and was enabled and equipped with provisions that could recognize multiple forms of arrangements that were being formed to take advantage of the

[70]Mayur Shah, *Safeguards on anti-avoidance rules welcome, but not enough*, http://www.dnaindia.com/money/report_safeguards-on-anti-avoidance-rules-welcome-but-not-enough_1400434, (26th Jan, 2013).

specificity of the SAAR.[71] The GAAR gives taxing authorities the power and discretion it requires to better deal with these deviant arrangements. The new rules allowed the authorities to not only reprimand the transaction but also every party involved in it whether directly or indirectly. GAAR is sought to be applied mainly in two cases. First, when the transaction is solely aimed at tax avoidance and second, if the transaction is allowed to be continued, would it go beyond the spirit of the applicable tax legislation.[72]

The ingenious use of treaty provisions is one of the reasons which prompted the government to introduce the GAAR provisions.[73] As per Indian law, the general rule is that the tax treaty will override the domestic legislation; however, the Code proposes to introduce limited treaty override provisions. In cases where GAAR has been brought into play, the treaty provisions would be disregarded.[74] Also, the principle of treaty over-riding is consistent with 'substance over form' rule[75] but there is still some amount of uncertainty with respect to those transactions in which the arrangement is eligible for tax treaty relief and whether or not GAAR can still be invoked by the revenue authorities to pierce the corporate veil and deny such treaty relief to the taxpayer.[76] It may be relevant to note that according to rules of legislative interpretation, specific legislation overrides general legislation.[77] Therefore, one can argue that a change in domestic law generally, which could be the case with GAAR, may not affect the treaty.

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[71]*General Anti-Avoidance Rules: India and International Perspective*, http://www.deloitte.com/assets/Dcom-India/Local%20Assets/Documents/Tax%20documents/GAAR%20%20India%20and%20International%20Perspective.pdf (26th Jan, 2013).GAAR was initially intended to be implemented to prevent constant amendment of the taxing statute to deal with various devices of tax evasion.

[72]*Id.* GAAR was first contemplated under the Direct Taxes Code Bill, 2009 (DTC). The Finance Bill 2012 proposes to introduce a Chapter X-A to the Current Income-tax Act, 1961 on General Anti-avoidance Rules (GAAR). The provisions relating to the General Anti-Avoidance Rules (GAAR) are contained in Part F of the DTC, in Chapter XI titled Special Provisions relating to Avoidance of Tax under Prevention of Abuse of Code and from Ss.95-102 of the Income Tax Act.

[73]Chapters XXIII and XXIV of the *Discussion Paper on Direct Taxes Code 2009,* http://india.gov.in/allimpfrms/alldocs/12780.pdf (26th Jan, 2013).

[74]*Id.*

[75]The 'substance over form' principle means that the substance of the transaction would be looked at and not the form in which the transaction is done. This significant change in the principle is done by introducing comprehensive GAAR provisions which provides wide powers to the Indian tax authorities for taxing 'impermissible avoidance arrangements', See § 96(1) of the Income Tax Act, 1961 as amended by Finance Act, 2012.

[76]Discussion Paper on Direct Taxes Code 2009, *supra* note 73.

[77]*Statutory Body Guide,* Queensland Government, available at http://www.treasury.qld.gov.au/office/knowledge/docs/statutory-body-guide/statutory-body-guide-sheet-1.pdf (last accessed on January 31, 2013).

Therefore, GAAR can become a very handy tool in restricting the scope of transactions that aim to evade taxes. One of the primary aims of the government in introducing GAAR is to target entities and investors who set up shell corporations in tax havens like Mauritius in order to route investments into India. Tax treaties like the one between India and Mauritius encourages both Indian and foreign investors to set up subsidiaries in Mauritius, primarily for the purpose of investing in India, without having any relevant business interest in Mauritius.[78]

Global Finance Integrity, which is a US based not-for-profit organization, estimates that around USD 462 billion has gone out of India between 1948-2008, which equals about 40 percent of India's GDP.[79] A major portion of these funds are routed back to India via jurisdictions like Mauritius, and this process is known as 'round tripping'. This way, the asserted FDI inflows are actually domestic funds being converted from 'black money' to 'white money'.[80] Thus, with its special focus on tax havens or low tax jurisdictions, GAAR can be an effective mechanism in checking the misuse of corporate structure.

(iv) Network of GST

Earlier in the year, the government approved the setting up of a special purpose vehicle (SPV) to provide IT infrastructure in order to facilitate the proposed new indirect tax regime known as Goods and Services Tax.[81] The stakeholders in this scheme shall include the central and state governments. The SPV would have an equity capital of Rs 10 crores, with the central and state governments having a share of 24.5 percent each.[82]

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[78] Mahesh Ravi, *GAAR: Issues, Implications and Impact*, *available at* http://www.albrightstonebridge.com/gaar_issues_092012/ (last accessed on January 31, 2013). According to the Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, the total FDI equity inflows from Mauritius to India between April, 2000 and April, 2011 came to about USD 55 billion or 42 percent of the total equity flows.

[79] *Id.*

[80] *Id.*

[81] Press Trust of India, *SPV approved to give IT support, services for roll out of GST*, Business Standard, April 12, 2012, available on http://www.business-standard.com/india/news/spv-approved-to-give-it-support-services-for-roll-outgst/162866/on (last accessed on January 31, 2013). Hereafter GST. The GST aims to facilitate the smooth flow of goods and services through various taxation points. It shall result in the optimal contact with taxmen significantly reduce the cascading adding effect of taxing the taxes. GST will be inclusive of various central and state taxes. There will be the central GST as well as the state GST, which are to be collected by the centre and state respectively, see Sumit Dutt Majumdar, *GST must be ushered in soon; no need to aim for a perfect tax right now*, The Economic Times, October 4, 2012, available at http://articles.economictimes.indiatimes.com/2012-10-04/news/34260226_1_gst-council-gst-rate-centre-and-states (last accessed on February 1, 2013).

[82] *Id* .Non-governmental institutions are to hold a stake of 51 percent in the SPV.

No single institution would be holding more than 10 percent of the equity, with the prospect of one single private institution holding a maximum of 21 percent stake. The Goods and Services Tax SPV[83] would be incorporated under section 25 as a not-for-profit, non-government, private limited company, with the government preserving strategic control.[84] The GST would include excise and service tax as well as state taxes like value added tax, purchase tax and entry tax.[85]

The GSTN, which will connect the central and state governments, will be used to implement registration through the use of the PAN ID[86], a payment processing system and a filing of returns.[87] The utilization of a common PAN ID for both direct and indirect taxes shall aid in checking tax evasion and ensuring precision as it will help the centre and states compare income tax, custom and excise duties as well as VAT paid by any individual and in the process, come across any discrepancies. A PAN based taxpayer registration shall provide a unified picture of all taxpayers.[88] The introduction of GST shall lead to a uniform rate of taxes across the country and ward off any ineptitude due to contrasting rates of taxes.

RECOVERING BLACK MONEY VIA VOLUNTARY DISCLOSURE OF INCOME SCHEME

In this part, the researchers shall first discuss the VDIS Scheme with primary focus on the last scheme announced in 1997 and based on it shall argue that in case the government announces another VDIS on similar lines, it shall lead to severe revenue loss. Moreover in case, there is any improvement in the new VDIS based on the lessons learnt from past, the new scheme will not be able to withstand judicial scrutiny in case it's constitutionally challenged. Hence in light of economic and legal principles, we reject the introduction of VDIS and suggest

[83]Hereafter GSTN SPV.
[84]Sushil Modi, *Goods and Services Tax Network will be used for VAT purposes for the time being*, The Economic Times, April 18, 2012, available at http://articles.economictimes.indiatimes.com/2012-04-18/news/31361705_1_sushil-modi-constitution-amendment-bill-indirect-tax-regime, (last accessed on February 1, 2013).
[85]*Id.*
[86] Permanent Account Number ID.
[87]*Goods and Service Tax Network*, available at http://upscportal.com/civilservices/article/goods-and-service-tax-network (last accessed on February 1, 2013).
[88]*Id.* The pre-GST stage would include a common return submission as well as a tracking mechanism for inter-state trade, common tax payment gateway and common registration for states (which is inclusive of VAT, central sales tax and central excise and service tax).

insertion of repartition clause in Tax Information Exchange Agreement,which will overcome vices of the VDIS and be more beneficial for the economy.

(i)**Voluntary Disclosure of Income Scheme**

Since 1951, Government of India has announced a host of schemes[89] like the VDIS Tyagi Scheme introduced in 1951; National Defence Gold Bonds, National Defence Remittance Scheme, Sixty- Forty Scheme, Block Scheme in 1965; Voluntary Disclosure Scheme in 1975, Special Bearer Bonds in 1981, Amnesty Scheme 1985 to 1986, Foreign Remittance Scheme, India Development Bonds, National Housing Bank Scheme in 1991 and Voluntary Disclosure of Income Scheme[90] in 1997. The stated objective of the Government in bringing these amnesty schemes is to recuperate tax on black money and utilize funds in nation building exercise.[91]

Finance Minister P. Chidambaram while presenting the 1997- 1998 Union Budget announced the VDIS scheme and to give effect to the intention of the Government Chapter IV was added to the Finance Act, 1997.[92] The mechanism was simple. Individuals or public servants could voluntarily disclose income and pay 35% tax in case of company or firm, and 30% in case of individuals[93] in exchange forimmunity from prosecution under the Foreign Exchange Regulation Act, 1973, Income Tax Act, 1961, Wealth Tax Act, 1957, and Companies Act, 1956. Moreover information given by declarants under the scheme was to be treated as completely secret and confidential by the Government.[94] The scheme came into effect from 1 July, 1997 and 4, 75,477subscribers took advantage of the scheme whereby total Rs. 33,697.32 crore of black money was declared, on which Rs. 9,729.02 croretax was paid.[95]

Even though the scheme was declared extremely successful by the Government, it suffered from several vices which harmed the economy rather than benefitting it. *Firstly*, there was no clause in the Scheme to prevent people who have already availed the benefit of amnesty

[89] T.N. Pandey, *Tax Amnesty (VDIS) For Offshore Black Money - Device to cover inefficiencies of tax administration*, available on http://www.taxmann.com/TaxmannFlashes/Articles/taxmann_com(ART)18-10-11-DTL-14(123).htm?aa= (3rd Feb, 2013).
[90] Hereinafter referred as, "VDIS".
[91] CAG Report No. 12 A of 2000 on Voluntary Disclosure on Income Scheme, 1997, available at http://www.cag.gov.in/reports/d_taxes/2000_book2/index.htm (last accessed on February 3, 2013).
[92] T.N. Pandey, *VDIS not right Course to tackle Black Money*, November 15, 2004, Business Standard, available at http://www.business-standard.com/india/news/t-n-pandey-vdis-not-right-course-to-tackle-black-money/195149/ (last accessed on February 5, 2013).
[93] § 64 Finance Act, 1997.
[94] *Id.* at § 72.
[95] CAG Report No. 12 A of 2000 on Voluntary Disclosure on Income Scheme, *supra* note 91.

scheme announced in previous years. As a result out of which out of 4,75,477 subscribers, only 77,107 were new assessees[96] which goes on to show that scheme like VDIS are constantly exploited by habitual offenders. *Secondly*, it would be penny wise pound foolish to rejoice over the fact that 9,729.02 crore of money was added to public exchequer because in fact the government lost 23,968.30 crore of revenue (total amount of black money declared – tax paid on such money). This is because in absence of amnesty, this is the amount which these assessees would have paid. *Thirdly*, even though the scheme was announced in the year 1997, in case of jewellery, its value was to be determined on the basis of market value on April 1, 1987. As a result of this severe undervaluation of jewellery,the government lost Rs. 2183.240- Rs. 2901.36 crore.[97]*Fourthly*, as Prof. UpendraBaxi rightly points out in his article, *The Crisis of the Indian Legal System,*[98] when honest tax payers, see that those generating black money can get away with amnesty schemes like VDIS, they feel cheated and it provides a general disincentive in the society to follow law. Hence schemes like VDIS besides affecting the economy of the country may be *counter-productive* in the sense that large number of people will be tempted to generate income through illegal means or not pay tax in the expectation of a VDIS at a later stage.

(ii)Constitutional Validity of VDIS

(a) Admissibility of writ petition

There is perhaps no doubt that tax amnesty schemes are bad in principle as well as strategically faulty. The constitutional validity of the VDIS scheme has been challenged before the Bombay High Court in the case of *All India Federation of Tax Practitioners v Union of India*.[99]

The Court upheld the constitutional validity of the VDIS scheme, primarily on the ground that the Court cannot interfere with any policy so brought about by the Parliament, in the process, upholding the doctrine of separation of powers.[100] The Court further noted that though the scheme may be unjust to honest tax payers, nevertheless, as per the Parliament, such scheme was paramount in preventing the menace caused by black money.[101] An honest tax payer does

[96]*Id.*
[97]*Id.*
[98]UPENDRA BAXI, THE CRISIS OF THE INDIAN LEGAL SYSTEM 8 (1982).
[99]1997 228 ITR 68 Bom.
[100] See *Id.*, ¶ 5.
[101]*Id*, ¶ 28.

not pay his taxes due to any inducement but because he is aware that it is his duty to pay taxes to the State.[102] The holding was upheld by the Supreme Court on appeal.[103]

While it is true that there have been cases where courts have desisted from intervening in matters of policy, this has not been a constant rule followed by the courts. Hence, there have also been cases where courts have interfered in matters exclusively in the executive domain. For instance, the Supreme Court looking into matters of budgetary allocation[104] and foreign policy.[105]

Article 142 of the Constitution empowers the Supreme Court to pass any decree or order to ensure that justice is dispensed with in matters pending before it. This power of the Court cannot be curtailed even by legislation.[106] The Court has held that it is advisable to leave its powers under Article 142 undefined so that it remains elastic enough to be moulded to suit the situation.[107] It has also been held that it is within the ambit of the Court under Article 32 to adopt whatever remedies necessary in order to protect the fundamental rights.[108]

The doctrine of separation of powers calls for a strict demarcation between the functions of the executive, legislature and judiciary. No one organ should exercise the powers of all three organs of the Government. There has been no strict adherence to this doctrine in India as is evident from the fact the Supreme Court has the power of judicial review and can strike down any law passed by the Parliament as unconstitutional. India, being a parliamentary form of democracy, therefore, requires a certain degree of harmonization between the executive and the legislature as the executive derives its authority from the legislature. In *Ram JawayaKapoor v State of Punjab,*[109] it was held that the Constitution follows a separation of functions and not powers. Hence, the doctrine cannot be followed in its rigidity.

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[102]*Id*, ¶ 31.
[103]See *All India Federation of Tax Practitioners v Union of India*, (1998) 231 ITR 24 (SC).
[104]Abhinav Chandrachud, *Dialogic judicial activism in India*, The Hindu, July 18, 2009, available at http://www.hindu.com/2009/07/18/stories/2009071852820800.htm (last accessed on February 8, 2013).
[105]Dhananjay Mahapatra, *SC to govt: Do More to protect Indian Students*, The Times of India, June 29, 2009, available athttp://articles.timesofindia.indiatimes.com/2009-06-30/india/28187187_1_indian-students-australian-government-racist-attacks(last accessed on February 8, 2013).
[106]Chandrakant Patil v State, (1998) 3 SCC 38, ¶ 10.
[107]Delhi Development Authority v Skipper Construction Co. (P) Ltd., AIR 1996 SC 2005, ¶ 16.
[108]Bandhua Mukti Morcha v Union of India, (1984) 3 SCC 161,¶ 17.
[109]AIR 1955 SC 549, ¶14.

Thus, in light of recent events like the *Ram Jethmalani* case, the *2G Spectrum* case[110] as well as the *SalwaJudum* case,[111] wherein the Supreme Court has exclusively dealt with the policy matters of the government, any holding which goes on endorse the view that courts cannot interfere in matters of the Executive, can no longer be sustainable today. These cases prove that the Court is willing to pitch camp in the Executive's domain when the need arises.

(b) VDIS violates Article 14 of the Constitution of India

The VDIS scheme is built by differentiating between honest tax payers and tax evaders. For any statute to stand the test of Article 14 there has to be certain intelligible differentia. By conferring benefits to tax evaders and denying them to honest tax payers, it is indeed questionable if such a classification can be called intelligible. Such a scheme is unethical as well as immoral. Principles of morality and ethics are imbibed in the very notion of reasonableness.[112] Therefore, there is no way that the VDIS scheme can stand the test of reasonableness as it uproots the very notions of morality and ethics which form the basis for the doctrine of equality under Article 14.

Infact, the Supreme Court has previously struck down the constitutional validity of tax amnesty schemes. One such instance is the case of *R.K. Garg v Union of India*,[113] more popularly known as the *Bearer Bonds* case. The factual matrix germane to the case was that the constitutionality of the Special Bearer Bonds (Immunities and Exemptions) Ordinance, 1981 and the Special Bearer Bonds (Immunities and Exemptions) Act, 1981 was questioned as they provided certain immunities and exemptions from direct taxes to holders of Special Bearer Bonds, 1991.

The Court held the above enactments to be unconstitutional and violative of Article 14 of the Constitution[114]. There has been a differentiation between honest tax payers and tax evaders, which is arbitrary and contrary to Article 14.[115] The Act does not pass the test of reasonableness,

[110]Center for Public Interest Litigation &Ors. v Union of India, WP No.423 of 2010. The case dealt with the allocation of national resources.
[111] See Nandini Sundar &Ors. v State of Chhattisgarh, WP No. 250 of 2007.
[112]*Id.* at ¶ 37.
[113](1981) 4 SCC 675.
[114]Article 14 of the Constitution of India Reads, "*The State shall not deny to any person equality before the law or the equal protection of the laws within the territory of India Prohibition of discrimination on grounds of religion, race, caste, sex or place of birth*".
[115]R.K. Garg v Union of India, *supra* note 113 at ¶35.

a prerequisite of Article 14, as it provides security and anonymity to tax evaders and prohibits any questions with respect to the source of possession of the Bonds.[116]

(iii) Recovering Black Money by entering into Tax Information Exchange Agreement with provisions for repatriation

Presently, there is an absence of any specific treaty with the help of which black money stashed abroad may be brought back.[117] The only exception is the United Nations Convention Against Corruption, which has provisions for asset recovery under Chapter V Article 51-59 of the Convention.[118]Since India has ratified the treaty in 2012, the Convention is an extremely effective way through which black money generated through corruption may be brought back. However since the Convention is only applicable when black money is generated through corruption[119] it becomes worthless whenever other means as pointed out in previous sections are employed to generate black money. Hence we recommend resorting to another way with which black money may be brought back.

In 2011, Hasan Ali, a Pune based scrap dealer was accused of stashing 8 billion of black money in UBS Bank in Switzerland.[120] However when the Income tax department and Enforcement directorate requested Switzerland authorities to grant them access to bank accounts of Hasan Ali the same was denied on the grounds that it is not a crime in Switzerland to report incorrect income to tax authorities.[121]This case goes on to show how difficult it is to prosecute persons accused of tax evasion and other illegal activities, in absence of free flow of information from one jurisdiction to another. Since in majority of cases generation of black money or money laundering happens via tax haven jurisdictions or countries with strict bank

[116]*Id.* at ¶ 34-35.
[117]White Paper on Black Money, *supra* note 3 at 66.
[118] For more see *United Nations Convention Against Corruption*, UN Office on Drugs and Crime, http://www.unodc.org/documents/treaties/UNCAC/Publications/Convention/08-50026_E.pdf (last accessed on February 12, 2013).
[119] According to §3 of the United Nation Convention Against Corruption, "*This Convention shall apply, in accordance with its terms, to the prevention, investigation and prosecution of corruption and to the freezing, seizure, confiscation and return of the proceeds of offences established in accordance with this Convention*", available on http://www.unodc.org/documents/treaties/UNCAC/Publications/Convention/08-50026_E.pdf (last accessed on February 12, 2013).
[120] Headlines Today Bureau, *Who is Hasan Ali Khan?*, India Today, March 3, 2011, available onhttp://indiatoday.intoday.in/story/who-is-hassan-ali-khan/1/131363.html(last accessed on February 12, 2013).
[121] Rahul Singh, *How Enforcement Directorate botched up Hasan Ali Case*, India Today, March 23, 2011,available on http://indiatoday.intoday.in/story/google-it-how-enforcement-directorate-botched-up-hasan-ali case/1/133189.html (last accessed on February 12, 2013).

secrecy laws it is very difficult to obtain any information. As a result, for effective exchange of information Government of India has entered into Tax Information Exchange Agreement (TIEA), bilateral agreements, with Bermuda, Bahamas, Isle of Man, British Virgin Islands, Cayman Islands, Jersey, Guernsey and Liberia.[122]

The researchers analyzed TIEA of all 8 countries and found that in all cases there is a provision for exchange of information when the same is requested by competent authority[123],"*without regard to whether the requested Party needs such information for its own tax purposes or whether the conduct being investigated would constitute a crime under the laws of the requested Party*."[124]Hence, had there been a TIEA between India and Switzerland, India's request in Hasan Ali case would not have been denied. However, it is worthwhile to mention that all these agreements lack any provision for repatriation of money stash abroad. So for instance if in a specific case say Mr. Robert has generated black money by undervaluing property and shifted all the black money to an account maintained in Banana Republic with which India has TIEA, then while he can be prosecuted in India based on information received because of TIEA due to absence of any provisions in treaty on repatriation, the said black money cannot be recovered. Hence in the researchers submission there is an urgent need to insert repatriation clause in all TIEA.

There are several reasons because of which we believe that resorting to insertion of reparation or asset recovery clause in TIEA is merited. *Firstly*, since Government derives its power to enter into TIEA by virtue of § 90 of the Income Tax Act, 1961[125] and they do not create any distinction between tax payers and tax evaders, they do not violate constitutional principles. *Secondly*, unlike VDIS, there is no need to grant any immunity from prosecution to tax evaders.

[122]For more, see Income Tax Department, available on http://law.incometaxindia.gov.in/DIT/intDtaaTIEA.aspx# (12th Feb, 2013).

[123] In case of India Ministry of Finance or its representative is the competent Authority, §4 (1) (d) of TIEA.

[124] This is generally provided in §5 of the TIEA. For specific example see §5 of TIEA between India and Bermuda, Notification No. 5/2011 [F. NO. 503/2/2009-FTD-I], Dated January 24, 2011, available at http://law.incometaxindia.gov.in/DIT/File_opener.aspx?fn=http://law.incometaxindia.gov.in/Directtaxlaws/cbdt/dta/A1_Bermuda.htm (last accessed on February 15, 2013).

[125]§ 90 of the Income Tax Act, 1961 reads, *"(1) The Central Government may enter into an agreement with the Government of any country outside India - … (c) For exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country, or investigation of cases of such evasion or avoidance, or (d) For recovery of income-tax under this Act and under the corresponding law in force in that country, and may, by notification in the Official Gazette, make such provisions as may be necessary for implementing the agreement.*"

Hence they would not create any disincentive in the society as noted in case of VDIS. *Thirdly*, on one hand while TIEA will facilitate exchange of information hence relative ease in prosecution in India with insertion of asset recovery clause it would help in bring black money stashed abroad. *Fourthly*, generating global consensus on mechanisms through which black money may be repatriated may lead to unnecessary delay as it would involve taking into account specific considerations and fears if any, of breach of sovereignty, of all nations henceinsertion of specific clause in bilateral agreements seems to be an easier way out.

CONCLUSION

Today, for any political economy to flourish, the State needs to take a considerable interest in determining the nature of transactions that take place within the legal framework. This can include preventing illegal or harmful modes of economic production as well as giving higher priority to certain activities. It is indeed a matter of grave concern when one sees not only the amount of money that has been stashed away in foreign banks but also the manner in which such funds have been taken away from the country. It is also a matter of grave concern when one notices the incapacity of institutional mechanisms and resources in keeping a check on such activities.

The very fact that such large amounts of money are stashed away in jurisdictions with low or negligible tax rates and strict privacy laws leads to the assumption that they have been generated through devious means. On the other hand, when large amounts of unaccounted money are transmitted outside the country in order to evade tax payments, it significantly reduces the country's ability to undertake many activities that would be in public interest.

Therefore, it is high time that the government takes the most stringent of measures to put a hold on such practices. The introduction of GAAR has been criticized on the grounds of being averse to investor-interest. Even if such assertions were to be true, implementing GAAR would perhaps be choosing the lesser of the two evils with respect to black money.

Tax amnesty schemes like VDIS are simply bad in principle and unethical. Allowing tax evaders to get away shall only prove to be a disincentive to honest tax payers. Hence, if swift measures on the government's front are not taken, it shall only go on to expose the weakness of the State's ability in collecting taxes from individuals and other entities. The rich shall keep getting richer at the cost of others.

Hence the researchers submit that, (a) schemes like the VDIS should not be introduced and an effective way of bring back black money stashed aboard would be entering into a Tax Information Exchange Agreement with countries with an added clause on asset recovery or repatriation in line with the existing clause found in United Nations Convention Against Corruption; (b) there is an urgent need to close the Mauritius gap and for host of economic principles, where on one hand we reject the introduction of Limitation of Benefit Clause in the Indo- Mauritius, on the other we believe that in light of Justice Radha Krishnan's opinion in the Vodafone case,a Tax Residence Certificate can be disregarded and the corporate veil could be pierced even in the presence of a Central Board of Direct Taxes Circular, (c) there is an urgent need for a network of Goods and Service Tax, (d) the doctrine of reverse piercing of corporate veil should be borrowed in Indian corporate jurisprudence to hold corporations liable for the acts of individuals and (e) even though there has been lot of negativity with respect to the introduction of General Anti-Avoidance Rules, it would go in a long way in preventing misuse of the corporate structure and would serve as an additional tool in the hands of tax authorities.

ADVANCE PRICING AGREEMENTS: THE WHOLE STORY

Saumya Dev and Stuti Bhatia[*]

ABSTRACT

The paper systematically introduces the concept of Transfer Price (*hereinafter referred to as 'TP') and the problems associated with it. Advance Pricing Agreements (hereinafter referred to as 'APA') have been introduced in India through the Finance Act, 2012. These agreements are entered into between tax payers and authorities to fix in advance the Arm's Length pricing of future transactions conducted on an international plane. The paper resolves to present APA as a possible solution to answer India's TP woes.*

The paper presents an elaborate analysis of the APA framework across multitudes of jurisdictions to facilitate a better understanding of what this new regime may mean in the Indian context. The complex process of APAs has been explained in a very comprehensive and easy manner to increase lucidity. Then finally the authors have explained the merits and demerits associated with this new process and have also included suggestions like introducing this process in the domestic transfer transactions as well.

The idea is to explain on why the process of APA should not be viewed with unwarranted criticism because at the end of the day it is a matter of choice and not a compulsion. The underlying ethos of the paper is to demonstrate the classic tradeoff of certainty that the process of APA would bring into the current TP scenario in India which is infested with unpredictable audits conducted by tax authorities and the painstakingly endless litigations that arise due to disagreement between the tax payers and tax authorities over the question of arm's length pricing.

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"Certainty? In this world nothing is certain, except death and taxes."

-Benjamin Franklin

INTRODUCTION

The idea of an Advance Pricing Agreement(s) (*hereinafter referred to as* 'APA') first originated when General Motors entered into APAs with 16 European countries during the 1980s.[1] Inspired by General Motors success, US developed its APA Program by working out pricing agreements with a few multinationals. This concept of APA had evolved in the backdrop of what we term as the "Global Tax War",[2] wherein tax administrations all over the world were trying to maximize their taxable income. Nearly half of the trade took place between related/associated[3] enterprises. The price at which these cross-border transactions between related enterprises happened was called the '*Transfer Price*' (*hereinafter referred to as* 'TP'). In this context, the action whereby one country increased its share of revenue through more rigorous Transfer Price laws depleted another country's revenue base. The issue of TP thus arises when two related enterprises involved in a cross-border transaction, transact at a price which is either higher or lower than the market price of such products/services only to take benefit of the low tax rates in one tax jurisdiction and avoid the high tax liability in another jurisdiction. As a means to combat the above issue, US revised its TP regulations under IRS Code making it stricter. Tax authorities of other countries like UK, Canada, Germany responded by implementing stringent TP legislations. Soon OECD laid down its guidelines in 1995.[4] The concept of Arm's Length Price (ALP) was developed which is the price at which unrelated enterprises transact in the free market. In this tax war, taxpayers were subjected to high and burdensome level of scrutiny and penalties by tax administrations.[5]Further, the traditional means to enforce TP statues was itself costly and time

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[1] Jose Manuel Calderon, APAS: A Global Analysis, 23 (Kluwer Law International 1998) (1998) , See also Matthews, K. and Eliot, E.E, *For Apple Computer, an APA Helps Keep Auditing Nightmares away*, Tax Notes, 280, (22 April 1991).

[2] Jose Manuel Calderon, *supra* note 1, at 17.

[3] Two enterprises are associated if one of the enterprises participates directly or indirectly in the management, control, or capital of the other or if "the same persons participate directly or indirectly in the management, control, or capital" of both enterprises, Art 9(1a), (1b) of OECD Model Tax Convention, OECD TP Guidelines for MNC's and Tax Administrations, July 22, 2010, available at <http://www.oecd.org/ctp/transfer-pricing/oecdapprovesthe2010transferpricingguidelines.htm>. (last accessed on September 6, 2013)

[4] OECD TP Guidelines for MNC's and Tax Administrations, July 22, 2010, available at http://www.oecd.org/ctp/transfer-pricing/oecdapprovesthe2010transferpricingguidelines.htm(last accessed on September 6, 2013September 6, 2013)

[5]Borkowski, S.C, *Section 482, Revenue Procedure 91-22, and the Realities of Multinational TP*, 18 International Tax J. 2, 65-66 (1992).

consuming.[6]This led to the problems like non-compliance with TP laws by taxpayers and manipulation of price. Non Compliance in turn led to increasing disputes and pending litigation. The APA programme was hence conceived and implemented to resolve TP disputes providing an alternative to prolonged, expensive and inefficient litigation.[7]

APA is an agreement between the taxpayer and the tax administration which determines in advance the criteria for determination of the ALP. The criteria include critical assumptions, comparables and the appropriate method of determination of TP. Critical assumptions here refer to the critical and significant factors or assumptions which if changed would annul the APA, as it would no longer be consistent with the ALP.[8]

The benefit of an APA in situation involving TP can be illustrated as below:

An MNC with its parent Company at India owns the technology in manufacturing of widgets. It has a subsidiary in Canada which is involved in manufacturing of widgets using the technology licensed from the Indian Company and pays some royalty to it as consideration. Canadian subsidiary is assessed by CRA (Canadian Tax Administration) every year, and though no adjustments to the amount of royalty payment have been made yet, there seems a threat in the future. Now it would be helpful for the Canadian Company to enter into a bilateral APA with the CRA and Indian Tax Administration. The taxpayer will have the benefit of having the Indian tax administration on his side while analysing and negotiating the ALP for the royalty transaction. This could be a huge benefit, especially if the Canadian subsidiary is expecting lower profitability in future years, or even a loss situation.[9]

A Bilateral APA as mentioned in the illustration refers to an agreement between two tax authorities of different jurisdictions. Similarly there exists the unilateral APA[10] and the multilateral APA.[11]

[6]Shwartz, M.N, Olson, L.S and Boykin, R.A, Working with the APA Process, 63 Tax Notes, 1359 (1994).
[7]Wrappe S.C., *APAs: The IRS Rediscovers Alternative Dispute Resolution*, 63 Tax Notes, 1334 (1994).
[8]Rule 10F (f) of Income Tax Rules (ITR), 1962.
[9] Gary Stone, *Certainty in the Uncertain World of Taxation, White Paper on APA's in India(PWC),* available at www.pwc.com/india, (last accessed on September 6, 2013)
[10] Arrangement solely between the taxpayer and the tax administration of the home country, para 4.130, OECD Transfer Pricing Guidelines, available at www.oecd.org/tax/transfer-pricing/38008392.pdf (last accessed on September 6, 2013)
[11] Agreement based on a single mutual agreement between the competent authorities of two tax administrations under the relevant treaty, para 5, Annex to OECD Transfer Pricing Guidelines, available at <www.oecd.org/tax/transfer-pricing/38008392.pdf>(last accessed on September 6, 2013)

GENESIS AND JURISPRUDENCE BEHIND APA

India with its continuing GDP growth is on its way to become the third largest economy[12] by 2030. These growth rates have been a direct consequence of increased levels of foreign inflow and cross border trade. However, these global interactions will continue to flourish only when there is an inherent stability in the system as was witnessed when the Indian economy was liberalized in the early 90's. The FDI figures[13] in India have dropped by 10% in 2009-2010 and by 13% in 2010-2011. A sound and stable tax policy are the imperative for FDI decisions and fiscal stability.[14] Studies[15] show that countries with greater uncertainty in their local tax system suffer from lower FDI. For instance, stable tax regimes like Philippines[16]have outpaced India in their business process outsourcing activities and countries like China, Vietnam and Sri Lanka are also slowly expanding.

APA brings with them, the promise of certainty, simplicity and predictability to the Indian scenario. The current TP regime is infested with onerous compliances, unpredictable audits and immense litigation. One may be tempted to argue in favor of improving the present system instead of venturing into unexplored territory. This however would be a mistake. The regime of APA is complementary to the present TP system in India[17]. Also most of the amendments which seek to improve the canvass of TP in India have either not been enforced or implemented properly. Certain problems associated with TP in India like those of increased audits stem from mounting fiscal demands by the government, the need to preserve tax base of an economy, constant competitive pressures to structure business operations and unprecedented collaboration between revenue authorities',[18]These problems are systemic flaws inherent to every expanding economy and can never be truly weeded out, until both taxpayers and tax authorities decide to agree otherwise.

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[12]Shanto Ghosh, *APAs in India: The Last Frontier in Dispute Resolution,* Vol. 6 International Taxation, 87-93, 87(April 2012*).*

[13]Shanto Ghosh, *supra* note 12, at 89.

[14]Shanto Ghosh, *supra* note 12, at 90.

[15]Shanto Ghosh, *supra* note 12, at 90.

[16]Shanto Ghosh, *supra* note12, at 92.

[17] Please note that *Section* 92CC and 92 CD and *Rules* 10F to 10T of ITR, 1962 rely on section 92 C for deciding on which TP method has to be used and section 139 of the IT Act, 1961 which provide provisions in cases of reassessment by the tax authorities. APA's main constructs borrow heavily from the present provisions on TP in India.

[18]Hasnain Shroff and A. Pradeep, *TP Landscape in India-A Statutory update*, Vol 1 International Taxation, 77-82, 77 (February 2010).

EVOLUTION OF APAS: A COMPARATIVE OUTLOOK

It's important to understand how the international scenario is culled out with respect to implementing APA, in order to best appreciate their utility and adopt the best international practices in the Indian context.

Japan was one of the first countries to give effect to APA. It had issued a directive in 1987[19] providing that '*To ensure proper and smooth enforcement of TP Regulation, administrative confirmation would be the most rationale method of calculating ALP'*.[20]Japan is one of the few countries which have advance pricing arrangements and not APA[21] and yet they are successfully enforced by the taxpayers and tax authorities. The rationale behind the inception of APA in Japan was the factum of no guidance on determination of the ALP, to increase predictability and obtain acceptance for products which would normally not fall within the domestic TP regime.[22]

USA established IRS revenue procedure for Advance Determination Rulings[23] in January 1991, thereby establishing a frame work for successfully implementing APA. Since then almost 36jurisdictions like South America, Mexico, China, Netherlands, Germany, Spain etc. have implemented Advance pricing Regimes. OECD also developed guidelines[24] on formulating a framework for these agreements. They define APA as

> *"An arrangement for controlled transactions that determines in advance, an applicable set of criterion (e.g. Method, comparables, adjustments made thereto, Competent Authority as to future events) for determination of Transfer Price for those transactions over a fixed period of time".*

The US Revenue procedure establishes APA as an alternative to the traditional examination process stating that "*They are supplemental to traditional adjustments and treaty mechanism for resolving TP disputes.*"[25] This framework was adopted to tackle the adversarial nature of TP scenario.

The OECD guidelines[26] provide that in the jurisdictions which permit unilateral APA, should allow it with a provision which prescribing the taxpayers to compulsorily inform the authorities

[19]Anshu Khanna, *APAs: A welcome move Indeed*, Vol 6 INTERNATIONAL TAXATION, 104-110, 106(April 2012).
[20]Anshu Khanna, *supra* note 19, at 107.
[21]Anshu Khanna, *supra* note 19, at 107.
[22]Anshu Khanna, *supra* note 19, at 107.
[23]Anshu Khanna, *supra* note 19, at 107.
[24]*Supra* note 4.
[25]AnshuKhanna, *supra* note 19, at 107.
[26]*Supra* note 4.

of interested jurisdictions to avoid any conflict later. Unilateral APA is usually practiced across jurisdictions which have just entered the arena of the APA. Countries like China, Australia initially[27] adopted the unilateral model of APA and then graduated to more complex forms like bilateral and multilateral.

The Chinese TP Regulations Act, 1998 introduced APA into the country. The SAT Rules[28], 2009 later added bilateral agreements within the ambit of the Chinese APA. The Chinese regime does not provide for a roll back and APA is not applicable in cases of intangibles.

The HMRC scheme of APA in UK has operated since 1991. They implement these AP Aeven in cases of thin capitalization[29] agreements which is essentially required in cases of financial services offered by MNC's across the globe to adjust their inter country debts. However the 'complexity threshold' in the HMRC induces vagueness[30] in interpreting the same because these tax regimes consider a transaction to be complex when ALP cannot be applied to the same. And this threshold which decides which transaction would be decided according to ALP or not, is never truly clear.

The Australian Regime[31] oversimplifies this framework by dividing the APA's further into three sub categories of Simple, Standard and Complex depending upon their complexity and the risk factors associated with them. The level of compliances varies accordingly.

Honk Kong has successfully initiated its APA regime through Internal Department revenue in 2012 with a very stringent time cap of eighteen to twenty-four months stipulated for completion of APA's.

While China offers complementary legal basis[32] for implementation of APA's, countries like Japan and Canada implement it without any legislative measure. The eligibility criterion for a likely candidate for APA's varies from one country to another. Countries like Canada have a list of ineligible persons for APA like the trust of companies operating from tax havens, in UK only certain types of businesses are allowed to enter into such agreements. Taiwan prefers applications only from persons who have good taxing histories. Further nine countries out of

[27]AnshuKhanna, *supra* note 19, at 107.
[28]KPMG, State Administration of Tax Rules, 2009(September 6, 2013), http://www.kpmg.com/cn/en/IssuesAndInsights/ArticlesPublications/Documents/Global-Transfer-Pricing-Review-O-201103-China.pdf
[29]AnshuKhanna, *supra* note 19, at 107.
[30]AnshuKhanna, *supra* note 19, at 107.
[31]AnshuKhanna, *supra* note 19, at 107.
[32]Xinkui Fan, *Difficulties in Pressing Forward Advance Pricing Agreement (APA) in China*, Vol 4 No 11, Asian Social Science J. 53-8, 53 (November, 2008).

thirty-six charge a fee for this process.[33] Japan and UK do not charge fee. In UK application beyond the requisite consultation or pre-filing period can be accepted.

Mature jurisdictions like Japan, Australia and USA encourage public reporting of the APA in order to ensure transparency and accountability. Majoritarian jurisdictions specify the time frame for completion of APA to be between three to five years, usually all the three kinds of APA are allowed.[34]

THE INDIAN SCENARIO (92CC AND 92CD/RULES) AMPLIFIED

The idea of APA was continually mooted in the Indian Scenario[35] and finally being incorporated in the Income Tax Act, 1961 in the year 2012.[36]

As has already been mentioned above, TP refers to the price charged by one segment of an organization for a product or service supplied to another segment of the same organization; esp., the charge assigned to an exchange of goods or services between a corporation's organizational units.[37] Corporations/Entities tend to manipulate this price and use it as a tool to avoid high taxation in certain countries.

Hence, Indian legislators put into place TP provisions to combat these problems.[38] They borrowed from the International front the concept of the ALP. It is the price which is applied or proposed to be applied in a transaction between persons other than associated enterprises[39], in uncontrolled conditions.[40]

The Indian Law provides different methods for determination of the ALP.[41] Even though the first opportunity for determination of ALP is given to the assesse, the Assessing Officer has the power to make adjustments to the ALP if he is of the opinion that all the required conditions under Section 92C have not been fulfilled such as failure to determine price according to the

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[33]Karishma R Phatarphekar, *Indian Advance TP regime: A Game Changer*, Grant Thornton, 2012, 34-35 (2012) , *Recommendations for a model Advance Pricing regime in India*, White Paper, Deloitte, 67 (June 2011), available at www.deloitte.com/in, (last accessed on September 6, 2013)

[34] Scheme of Countries with the maximum number of comparables available in which Advance TP Agreements have been implemented, Karishma R Phatarphekar, *Indian Advance TP regime: A Game Changer*, Grant Thornton, 2012, 34-35 (2012) , *Recommendations for a model Advance Pricing regime in India*, White Paper, Deloitte, 67 (June 2011), available at <www.deloitte.com/in>, (last accessed on September 6, 2013)

[35] APA had been proposed to be introduced as a part of the Direct Tax Code in 2009 and was again mentioned in the DTC, 2010. The idea has been repeatedly mooted in the amendments.

[36] APA under Sections 92CC and 92CD of the Income Tax Act, 1961 and under Rules 10G to 10T of the Income Tax Rules, 1962. (Introduced through Income Tax Amendment Rules, 2012).

[37]Bryan A. Garner., Black's Law Dictionary, (Thomson Reuters West Publishing Co., Minnesota) (2009) p. 1309.

[38] § 92 to 92F of the ITA, 1961.

[39]§ 92A, ITA, 1961.

[40] § 92F(ii), ITA, 1961.

[41] § 92C(1), ITA, 1961.

methods and procedure prescribed[42] or failure to maintain the documents relating to the international transaction[43].

As a result of the aforementioned powers conferred on the Assessing Officer, several disputes with regard to TP arose in India. Many MNC's like IBM, Capgemini and Accenture came under the scanner due to their questionable TP practices.[44]

The past few years have witnessed ever increasing TP adjustments. The TP adjustments in the recent sixth audit cycle in India alone amounted to INR 44,000 crore.[45]of approximately 3,200 cases considered for TP auditing in 2012-13, there was an adjustment of Rs 70,000 crore for 1,600 cases, according to preliminary estimates by the IT department. Nearly 6300 cases have been under the scanner of the tax authorities for 3 years alone from 2005-2008. Out of this tax adjustments have been made in 50% of the cases. The cases mainly involve dispute over the choice of method adopted. Some examples include companies like Skoda India Auto Ltd., IL Jin Electronics, Cheminova, Fiat India and others.[46]APA will emerge as a relief for both taxpayers and taxing authorities as it will eliminate disputes with regard to ALP by determining in advance the ALP or the method of determination of ALP.

An APA is defined as an agreement between the Central Board of Direct Taxes (CBDT) and any person, which determines, *in advance*, the ALP with respect to the international transaction for the period specified by the APA.[47]All persons entering into an international transaction or contemplating on entering into an international transaction can apply for an APA in India.[48] APA's are considered more suitable for high value/complex transactions. The application fee has been set at Rs 10 lacs where the value of transaction is not exceeding Rs 100 crore, Rs 15 lacs where value of transaction is not exceeding Rs 200 crores and where the value is greater than Rs 200 crores, the fee has been set at Rs 20 lacs.[49]APA's in India are generally for a period of 3-5

[42] § 92C(1), 92C(2), ITA, 1961.
[43] § 92C(3)(b), ITA, 1961.
[44] John Samuel Rajad, *MNCs finding it hard to avoid Taxman's glare*, The Economic Times, September 1, 2011.
[45]Vrishti Beniwal, *IT looks at Global Practices on TP* , May 11, 2013, available at http://www.business-standard.com/article/economy-policy/i-t-looks-at-global-practices-on-transfer-pricing-113051000528_1.html, (last accessed on September 6, 2013)
[46]Haskin and Sells, *TP Litigation in India*, (Delloite), available at http://www.puneicai.org/%28S%285aihxnmxbecm33550tsq3k55%29%29/material/CA-Pramod-Joshi.pdf, , (last accessed on September 6, 2013)
[47] CBDT, *APAs Guidance with FAQs*, (Central Board of Direct Tax Release) (August 2012).
[48] Rule 10G, ITR, 1962(Introduced through Income Tax Amendment Rules, 2012).
[49]Rule 10I (5), ITR, 1962.

years, however such period should not exceed five consecutive years.[50] Indian law allows three kinds of APAs. There are some procedural differences in these APAs.

Unilateral - It is a one-sided APA between the CBDT and the applicant.[51]The tax administration of the country of the associated enterprise is not involved here. The taxpayer is required to cite reason in writing if it wishes to opt for a unilateral APA instead of a bilateral one.

Bilateral– It is an agreement between the CBDT and the applicant subsequent to, an agreement entered between the Competent Authority (hereinafter referred to as 'CA') in India with the CA in the other country regarding the most appropriate TP method or the ALP.[52]This APA is generally preferred over unilateral APAs as it reduces the risk of double taxation. However a drawback of this APA is that it involves more time and cost as negotiations with a third party are also required.

Multilateral – It is an Agreement between the CBDT and the applicant, subsequent to any agreement between the competent authority in India with the competent authorities in the other countries regarding the most appropriate TPM or the ALP.[53]

The stages in the procedure of an APA can be better understood with the help of an illustration. Company X, which is involved in the business of distribution of TV sets with base in India for which it earns commission from its TV sets manufacturing-parent company in Australia. It wishes to enter into an APA for this international transaction. X has been instructed by its lawyers that the procedure for APA in India includes 5 steps –

1. *Pre-Filing Consultations:* The first step is the pre-filing consultation wherein X is required to make a request for pre-filing consultations to the Director General of Income-Tax (DGIT). These consultations will help determine the scope of the agreement, identify TP issues, determine the suitability of the international transaction for the agreement and discuss the broad terms of the agreement. However, initiation of these consultations will not indicate that X is entering into an agreement nor will it be binding on either of the parties'.[54] Another unique feature is that pre-filing consultations in India can also be entered into on an anonymous basis.[55]

[50]§ 92CC (4), ITA, 1961.
[51] Rule 10F(k) of ITR, 1962.
[52]Rule 10F(c) of ITR, 1962.
[53] Rule 10F(h) of ITR, 1962.
[54] § 10H(6), ITR, 1962.
[55] Income Tax Rules, 1962 , Pg 16, available at http://www.itatonline.org/info/index.php/cbdt-releases-transfer-pricing-advance-pricing-agreement-scheme-apa/, , (last accessed on September 6, 2013)

Bilateral/Multilateral Agreement – For this X must state in its application whether India has an existing comprehensive Double Taxation Avoidance Agreement (DTAA) with the other country/countries. It may also be verified whether such country/countries has APA program in place.

Documentation – The request for pre-filing consultation should be made in Form No. 3CEC.[56]

Time Period – No time period specified.

2. *APA Application*: Once, consultations are conducted, if X wishes to go ahead with the agreement, it will next have to file an application along with the requisite fee.[57]The APA application should be filed before the first day of the previous year relevant to the first assessment year for which the application is made, in respect of transactions which are of a continuing nature from dealings that are already occurring; or before undertaking the transaction in respect of remaining transactions.[58]

   Unilateral agreement – Application filed with the DGIT

   Bilateral or Multilateral Agreement – Application filed with the Competent Authority (CA)[59]

   Documentation – The application should be filed in Form No. 3CED.[60] The other required documents include Proof of payment of fee, copies of all relevant inter-corporate agreements, corporate annual reports & financial statement for the prior five years and other financial documents, litigation related documents.

   Time period **–** No time period specified.

3. *Preliminary Screening of Application* - Such application shall be screened by the authorities and in case any defect is found in the application; such as any document is not attached or the application is not according to the understanding reached in the pre-filing consultations, a deficiency letter shall be served to Company X.[61]

   Documentation– The authorities may ask for additional documents if they so needed.[62]

   Time Period– The deficiency letter should be served within the expiry of 1 month from the date of receipt of application.[63]

[56] § 10H(1), ITR, 1962.
[57] § 10I(1), ITR, 1962.
[58] § 10I(3), ITR, 1962.
[59] § 10I(2), ITR, 1962.
[60] § 10I(1), ITR, 1962.
[61] 10K (2), ITR, 1962.
[62] § 10K (2), ITR, 1962.

Required modifications have to be made within a period of 15 days from date of service of deficiency letter.[64]If the DGIT or CA is then satisfied with the modifications, X can move ahead to the next step of the procedure which involves negotiations.

4. *Negotiations* - This stage will involve negotiation meetings between the tax administration and X.

   Unilateral APAs - The DGIT appoints a team that enters into negotiations and discussions with X.[65]The Team here will consist of experts from fields of economics, statistics, law and others.

   Bilateral APAs – It is important for a bilateral APA that the associated enterprise in the country where it is situated has initiated the APA process there.[66]The CA will first ensure that the CA in the other country or countries is willing to enter into negotiations for an APA.[67] In case of willingness, the CA in India will enter into negotiations with the CA in the other country and try to reach mutually agreeable terms.[68] These negotiations will then be formalized in the form of a mutual agreement procedure arrangement.[69] The conclusion of the mutual agreement shall be intimated to X who should within a period of 30 days convey its acceptance of the agreement.[70] Once this is done, CA will send the application to the DGIT, who will then appoint a team to enter into negotiations with X.[71] This Team, will then prepare a draft report which will then be sent to DGIT, who in turn will forward it to the CA.[72]

   In the negotiation phase the tax administration and the taxpayer mutually reach to a conclusion on the TP of the covered transactions. In complex transactions, the negotiation meetings could be more than one meeting.[73] While the process of negotiations is on, the tax administration can call for additional documents or information, visit the applicant's business premises or make any other enquiries.

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[63]§ 10L (2) (ii), ITR, 1962.
[64] § 10K (3), ITR, 1962.
[65]§ 10L (1), ITR, 1962.
[66]Rule 44GA (2), ITR, 1962.
[67] Rule 44GA(3), ITR, 1962.
[68] Rule 44GA(4), ITR, 1962.
[69] Rule 44GA(5), ITR, 1962.
[70] Rule 44GA(8), ITR, 1962.
[71] Rule 10L(4), ITR, 1962.
[72] Rule 10L(5), ITR, 1962.
[73]Karishma R Phatarphekar, *Indian Advance TP regime: A Game Changer*, Grant Thornton, 2012, 30 (2012).

5. *Drafting* - The final stage includes drafting of APA. It should include the international transactions covered by the agreement, the agreed TPM, determined arm's length price, definition of any relevant term to be used in ALP, critical assumptions, and the conditions if any other than provided in the Act or these rules.[74] The APA shall then be entered into by Board with the applicant after its approval by the Central Government.[75]

Also, an Annual Compliance Report is required to be submitted to the DGIT for each year covered in the agreement in Form 3CEF. The annual compliance report should be furnished within thirty days of the due date of filing the income tax return for that year, or within ninety days of entering into an APA, whichever is later. Further, the TPO has the power to carry out compliance audit of the agreement for each of the year covered in the Agreement.[76]
The returns for the present assessment year are assessed/ reassessed according to the terms of the APA, even if the APA is pending or the assessment has already been done. In case the returns are filed before the date of entering into an APA, within three months of having entered into an APA, modified returns have to be filed which would be accessed/reassessed accordingly.

An APA can be revised if there is a change in any of the critical assumptions or the law. It can also be cancelled in cases of fraud or misrepresentation, faulty compliances by the tax payer, negative findings by the audit officer or disagreement of the taxpayer over the proposed findings. The option of revision affords flexibility and the prospect of cancellation ensures that due compliance is done by the taxpayers.

MERITS

One of the biggest advantages of APAs is that they are preventive[77] in nature, such that they provide for a solution before the dispute can arise. They lend some flexibility in the manner of determination of ALP, with the possibility of using methods also that may be beneficial to the assesse. They act as an audit settlement tool reducing litigation pertaining to contentious audits.

There exists no element of control on behest of taxpayers in TP while APA's offers them that element of control. APA's prevent the incidence of double taxation, (except for in case of

[74] Rule 10M(1), ITR, 1962.
[75] Rule 10I(8), ITR, 1962.
[76] Rule 10(O), ITR, 1962.
[77] Samir Gandhi, *Important TP Provisions-Finance Bill 2012*, Vol 6 International Taxation, 61-62, 61, (April 2012).

unilateral APAs) and hence provide more incentive to comply since regulated by more than one taxing authorities.

APA's require fewer documentations and increase predictability in cases of tax assessments. They are beneficial in cases where a business is newly set up wherein a Term Test[78] can be included in an APA which would ensure that tax assessments are done only after a certain period to avoid unnecessary assessments which may be practically unviable in the face low profits of the newly set up entity.

One of the basic tenets of an argument advocating for implementation of APA's would be the one highlighting the flaws that exist in the TP regime. Current TP provisions use current year data and arithmetic mean instead of inter-quartile range which may be more beneficial in certain cases. There is an ineffective implementation of the Dispute Resolution Panel provisions. TP may possibly entail the use of unapproved methods like excess earning methods, global formulatory apportionment, and global profits or split methods or the making detrimental adjustments to the taxpayers in high value transaction.[79]APAs enable the taxpayer to enter into a mutual agreement with the tax authorities to choose the method most suited to his situation. APA regime ensures risk assessment even in cases when there is no comparable available.[80]

The below table would be an adequate example to illustrate the contemporary issues that flood the litigation and which otherwise could be easily handled by entering into a negotiation through APA and mutually agreeing on terms that may be a cause of conflict, in advance.

NAME OF THE CASE	PROBLEM WITH THE PRESENT TP SYSTEM
1. CIT v Stratex Net Works(India) P. Ltd IT Appeal No. 353 of 2011	In this case assessee was a wholly owned subsidiary of a Mauritian Company and dispute was regarding whether the transaction pertaining to maintenance services would also fall within the category of international transaction just like the transaction pertaining to installation and commissioning. All these questions can be effectively settled by negotiating an APA.

[78]Karishma R Phatarphekar, *supra* note 77, at 31.
[79] Freddy R Daruwala, APAs, Vol. 6 International Taxation, 111-16, 113 (April 2012).
[80] Freddy R Daruwala, *supra* note 86, at 114.

2. Ay. CIT v Isagro (Asia) Agrochemical (P) Ltd [2013 31taxmann.com 388(Mumbai Tribunal)]	Assessee used the CUP method which was rejected by the TPO. The court later ruled that the method adopted by the assessee was correct and there was no rational behind the assessee having rejected that method. This unnecessary round of litigation could be avoided if the APA and its terms would itself mention the method of TP to be used.

The definition of international transactions has been expanded to cover 'nature of tangibles and intangible property'. It would include transfer or use of rights regarding land use, copy right, patent, trademark, license, franchises, and also marketing related intangible and technology, capital financing and business restructuring and others. Thus from now on increased set of transactions would fall within the ambit of TP regulations. Considering the materiality[81] of the transactions non conformity would now entail significant TP adjustments which could be avoided by entering into an APA.

Further, changes made in the TP regime have now widened the ambit of authorities. 92CA[82] empowers[83] the TPO now to determine the ALP of international transaction noticed by him in course of proceedings even if the said transaction was not referred to him by the AO. Section 147 has been amended to provide that where it is found that the international transaction has not been reported either by non-filing of accountant report or otherwise then such non- reporting would be considered as escaping of income.[84] Also, Central government from now on would fix the upper ceiling of adjustments (currently 3%), which is contrary to the principle that TP is not 'exact science'.[85] This tolerance band related to adjustments has always been an area of heavy litigation.

The recent amendments in the TP framework which simplify the system have not been implemented properly. For instance, the safe harbor provisions had been proposed with the intent to enact rules which would provide taxpayers with a minimum standard to comply with save

[81] Samir Gandhi, *supra* note 83, at 62.
[82]ITA, 1961.
[83]Manoj Pardasani, *TP – What's Next*, Vol 6 INTERNATIONAL TAXATION, 64-69, 68 (April 2012).
[84]Manoj Pardasani, *supra* note 90, at 69
[85] TP New Path Charted, Vol 6 INTERNATIONAL TAXATION, 59-60, 59 (April 2012).

which they would be relieved. DRP[86]was also an outcome of the asymmetry that exists in the TP outcome because there may be instances when there may be more than one result for the arm's length. However, neither was successful in addressing the issue. APA regime effectively addresses this concern; by providing the parties an option to determine what would be reasonable to them out of the possible outcomes.

One of the repeated concerns raised as an objection to APAs is the fact that they pose confidentiality threats as the companies face the risk of an information leak, which they have shared in stages of negotiation. However, there exist adequate safety provisions given under Section 138 of the IT act, 1961 which address these concerns. Also, parliamentarians are free to align any other measures which could safely restrict such leaks. Lastly, the APA's provide an environment conducive enough for the parties to share information in order to facilitate an agreement.

DEMERITS

APAs promise to act as a fix to the current faulty TP regime. However, the same is not a foolproof scenario free from any problems. In cases of unilateral APA's the parties may have a fixed settlement regarding tax payment with the local authorities, however they still face the risk of audits regarding the same transaction from the other authorities outside the jurisdiction.

One of the inherent systemic weaknesses embedded in the very nature of APA, especially highlighted in cases of bilateral APA's is the 'Prisoners Dilemma Syndrome'.[87] Prisoners Dilemma syndrome essentially means that sometimes interactions between two taxing authorities may bring forth strategic considerations as part of negotiating tactics that may result in a '*no agreement*' between the two authorities even when the agreement would be better for the two countries involved.

For example,[88] if the negotiations between USA and India were to be considered a zero sum game, then if India agrees that a portion of profits be taxable in India then the rest of the profits would be taxable in the US. In this environment, the Indian and U.S tax authorities will be driven by the strategic aspect of negotiation, wherein each will try to argue for a larger share of income to be taxed in their respective hands. So both the authorities would have two choices, either to

[86]Shanto Ghosh, *supra* note 12, at 93.
[87]Shanto Ghosh, *supra* note 12, at 92.
[88]Shanto Ghosh, *supra* note 12, at 92.

agree to a bilateral outcome or disagree and choose to litigate. Now the following matrix[89] below would illustrate the payoff associated with both the choices:

PRISONERS'S DILEMMA	(USA) AGREE ON METHODS	(USA) CHOSE TO LITIGATE
(INDIA) AGREE ON METHODS	(2, 2)	(-1,3)
(INDIA) CHOSE TO LITIGATE	(3,-1)	(0,0)

In such a set up in all likelihood the authorities will end up choosing to litigate, which would not be beneficial to either of them. This is the classic drawback in strategic interactions that the bilateral APA regime in India may face.

However this desire to litigate can be reduced if such agreements are entered onto on a regular basis by the authorities, which in turn would depend upon the APA team's ability to conduct interactions in a smooth and consultative manner keeping larger interests of taxpayer in mind.

The current APA regime allows the revenue to obtain third party [90]nonpublic information in certain cases. In the light of the confidentiality concerns that have been raised, this provision seems a bit unwarranted.

Also the provision for multilateral agreements will always face an increased uncertainty in terms of the outcome of the negotiations considering multiple tax regimes always have disparate objectives and principles and the reconciliation of the same in Toto is always not possible.

Further, the element of predictability and certainty that is promised by these advance agreements comes with a drawback. In certain situations the taxpayers inevitably trade off flexibility against certainty, which may not be beneficial to him. For example[91] if the calculation of profits to be taxed is fixed by the margin method in an APA, it would continue to remain so even if profits of the company erode during the tenure of the APA, which would be detrimental to the company.

[89]Shanto Ghosh, *supra* note 12, at 92.
[90] Sanjay Tolia, Darpan Mehta, Poonam Rao, TP Proposals: Navigating the challenges, Vol 6 International Taxation, 71-74, 72(April 2012).
[91] Freddy R Daruwala, *supra* note 86, at 115.

Eroding of profits cannot trigger the critical assumptions or conditions which vitiate the APA as the Indian context does not recognize change in business condition to be a critical assumption.

APA, as a solution would fail, if it fails to address the immense litigation woes and itself becomes a cause of heavy litigation due to disagreements over data used as comparables[92] or the time frame of APA etc.

Also the bilateral agreements would only be possible under the current framework if a treaty exist with the corresponding country. Since the bilateral agreements will be conducted via the Mutual Agreement Procedure, it would suffer from the set of flaws that exist in the Indian MAP process like increased mark ups[93] sought by the taxing authorities and also the inability of the taxing authorities in certain cases to inform the taxpayer of the ongoing negotiations which may hamper the trust coefficient.

APA relies on the arm's length principle to engage in these present arrangements. One of the basic criticisms thus would be the flaws encompassed in the ALP itself. A part of the taxing community believes that '*formulatory apportionment*' would produce fairer results in terms of fair distribution of cross border inter company profits. This method is now increasingly being used in many states of USA.[94] However members of OECD still continually support the cause of application of arm's length principle.

SUGGESTIONS

One of the most upfront accusations on the validity of the APA regime in India is the risk of confidentiality breaches. And even though section 138 of the IT act sufficiently addresses such concerns, the legislature in all its wisdom will have to come up with a set of rules and regulations outlining the conduct of the APA teams to protect the information sharing during the stages of the APA application being negotiated. Currently the information shared by the parties during an APA process can be shared with the on field audit officers.[95]

The APA framework would deliver excellent results if adopted in the areas[96] involving intangibles, IT and ITES related sectors to capture the correct cost plus margin or on interest in

[92]Karishma R Phatarphekar, *supra* note 77, at 32.
[93] Recent Developments in TP, Vol. 3 International Taxation, 40-50, 45 (December 2010).
[94] Roger D Wheeler, World Tax Review, Vol 2 International Taxation, 72-75, 73 (August 2010).
[95]*Supra* note 53.
[96] Freddy R Daruwala, *supra* note 86, at 113.

thin capitalization transactions, guarantees and letter of comforts of Associated Enterprises, while assessing the risk component of the transaction etc., the OTC derivative arrangement pricing between Associated Enterprises along with captive unique high value services. These are the areas of application in which APA's have been successfully implemented in other countries. APA's have been a huge success in case of tangibles as was witnessed in countries like USA. Although jurisdictions across the globe have been a little reluctant to adopt APA in cases of intangibles,[97] such as China, India should follow USA's example.

The need of APA in case of intangibles can be illustrated through royalty payments transactions. The concept of Royalty in the Indian context implies that, "Owner of intangible property possessing domain knowledge continues to retain intangible property and only permits or allows the use of such property".[98] Pricing of these transactions is determined at arm's length. OECD guidelines provide that factors which are to be applied while determining ALP of these royalty payments require special considerations. These factors often suffer from limitations like that of determining the differences posed by the geographical differences, the possibility of sub licensing and the willingness and right of participation in further development of the licensor.[99]

All these considerations can be best determined through mutually determinate negotiation agreements by the parties themselves.

APA's can be cancelled or revoked in case where a critical assumption is triggered. Critical Assumptions are factors which would render the proposed TPM inconsistent with ALP.[100]USA APA program defines critical assumptions to be '*certain business activities, functions performed, risks assumed, assets employed and financial and tax accounting methods and classifications of taxpayers in relation to covered transactions*'. A mere change in business conditions however do not amount to critical assumptions in Indian context. These assumptions should be customized according to the needs of both the parties. They should include factors which would fundamentally effect the continuation of the APA and not minor fluctuations which need not go to the root of the matter and can be tackled otherwise. These factors can include 'currency

[97] Definition of intangible property includes "marketing intangibles, human assets, technology related intangibles, location related intangibles, customer related intangibles, data processing, engineering, customer contracts, goodwill etc", Manoj Pardasani, TP: Whats Next, Vol. 6 International Taxation, 64-69, 67 (April 2012).
[98] *CIT* v. *Davy Ashmore India Ltd.*, (1991) 190 ITR 626 Cal.
[99] V S Wahi, Royalty at Arm's Length , Vol. 8 INTERNATIONAL TAXATION, 77-82, 78 (March 2013).
[100] Alpena Saksena, *supra* note 96, at 101.

fluctuation, input prices, capacity utilization, sales volume, oil price, capacity utilization, labor unrest, lockout or bankruptcy.'[101]

APA's presently do not provide for roll backs in so much so that they are prospective in nature. Roll Backs are not allowed by a lot of provisions and probably should be allowed after acquiring a considerable experience in the field of APA.

Further, India has proposed to include domestic related party transaction within the umbrella of TP regulations from the financial year 2012-2013.This change is in consonance with the dictum of the Supreme Court in the case of *CIT v. GlaxoSmithkline Asia (P) Ltd*[102], which suggested the "application of the same compliance standards as are applicable to international transactions between associated enterprises."[103] However it may in some situations not be possible to easily benchmark these transactions. For example[104] remuneration and commission paid to the director of the company would be something specific and unique to the company and it would not be easy to benchmark it using any of the methods prescribed under 92C of the IT Act without requiring special considerations. Also there is some confusion regarding the nature of the transactions that need to be reported and analyzed.[105]

Indian jurisdiction does not yet offer APA for the Specified Domestic transactions. This would not necessarily mean that the same is a drawback in the context of the APA regime in India. India is taking baby steps to slowly regulate domestic transfer pricing through TP regulations. And eventually if it hopes to tackle the problems associated with subjective interpretations and difficulties in benchmarking, it should gradually make efforts to trickle down the framework of APA from international transactions to domestic transactions.

[101] Alpena Saksena, *supra* note 96, at 98.
[102](2010) 195 TAXMAN 35.
[103] Vijay Iyer and Atul Jain, TP Applications to Domestic Transactions and its impact, Vol 6 International Taxation, 75-79, 78 (April 2012).
[104]*Supra* note 119.
[105] § 92, ITA, 1961 prescribes that two entities would be deemed as Associated Enterprise if 26% of the voting power is held by one entity in another. A similar definition under section 40A(2), Income Tax Act, 1961 of 'substantial interest' defines beneficial owners of shares to include those owners which carry 20% of the voting power in case of company assessee. There is an absence of any definition of the term 'close connection' as used in section 80-IA(10) IT, 1961 which leaves it open for subjective interpretation.

APA's in India do not[106] apply to thin capitalization agreements. All across the globe corporations enter into well-structured intra group arrangements to judiciously use excess cash. In the wake of large scale takeovers and acquisitions in India, intra group financial arrangements have become a surging reality. Jurisdictions, which have large scale financial service transactions like USA and UK have witnessed maximum application of APA's in this segment of commerce.[107]It's important to regulate these through APA so that the issues relating to financial services TP can be effectively addressed.

Further, the procedure of negotiating an APA should be made time-bound. Currently India is one of the few jurisdictions which do not have a time cap on completion of APA. Honk Kong on the other hand which implemented APA's in 2012 just like India imposes a time cap of 18-24 months.

Also the renewal of APA's in India entails the process of fresh application. This process itself is time consuming. And hence a minimum threshold should be carved out such that APA's which are not very high risk should not have to go through the entire process of fresh application in order to obtain renewal.

India could also adopt the Australian model of dividing the APA's into three sub categories of Simple, Standard and Complex depending upon the risk associated with them. The burden and obligations of compliances and documentations could vary according to the risk associated with them with simple APA's requiring the least compliance and being the fastest.

The current APA regime does not address the inherent contradictions that exist in the TP regulations, Custom and Vat regime. The contradiction here exists as while the TPO[108]would test the ALP with the view of lowering the transfer price of imports, with a view of increasing taxable income in the country of importation. But the customs officer would test the ALP of the income with a view to increase value of imports to increase custom duties applicable on them. Hence, the APA scheme can be extended to cover the Custom or Vat calculations also so that the

[106] Deloitte, India Highlights 2013, International Tax, (September 6 2013), http://www.deloitte.com/assets/Dcom-Global/Local%20Assets/Documents/Tax/Taxation%20and%20Investment%20Guides/2013/dttl_tax_highlight_2013_India.pdf

[107]*Recommendations for a model Advance Pricing regime in India*, White Paper, Deloitte, 42 (June 2011) (September 6, 2013) , www.deloitte.com/in

[108]*Supra*note 104.

ALP is calculated in a manner that is in tandem with both the Custom and the TP regime. Or since the APA Rules require the mandatory approval of the Central Government, (Central Government governs both the Income Tax and Customs Department), the approval given by the central government on APA could be presumed to operate on all the bodies.[109]

In China all states and local tax bureaus accept and implement as matter of rule the terms of the APA. This could be a possibility even for the Indian scenario.[110]

WILL THEY WORK: THE INDIAN CONTEXT

The effectiveness of APA in resolving TP related disputes is visible from the published statistics of several tax authorities that show record levels of APA application. The level of satisfaction of users with APA process is high, with 90% indicating that they will implement an APA in the future. In light of the absence of AP program up until now, India remains the only jurisdiction with significant litigation activity with 50% of the respondents relying on litigation for resolution of TP disputes.[111]

TP regulations in India are infested with the problems of unwarranted litigation, onerous compliances and unpredictable audits. The various amendments made in the TP regime like the Dispute resolution Panel have not been able to achieve the desired outcome. Maybe, it's time to adopt a different approach. Not only have the amendments failed in achieving the desired objective but some of them like increasing the power of authorities or bringing more transactions under audit, will increase the likelihood of more litigations.

Several jurisdictions which have successfully implemented APA consider lack of resources, lack of a holistic approach to TP, case overload and backlog, unbalanced treaty relationships and contradictions between tax goals and country policies as some of the major challenges faced in implementing APA. Thus the predictions regarding implementation of APA should not be unnecessarily speculated. The challenges that we may face, are out there in black and white. If the tax authorities and policy makers can overcome these roadblocks, then there is no reason why APA's should not work. Plus, most of the jurisdictions have been able to successfully implement APA's with these challenges. APA is not a failed concept.

[109]Alpena Saksena, *supra* note 96, at 98.
[110]KPMG, Implementation Measures of Special Tax Adjustments (Trial Version), No 2 GuoShui, (2009)(Translated by KPMG China).
[111] *Managing Global TP Issues APAs, Ernst &Young , (2012).*

Ultimately if the conforming taxpayer derives more benefits out of the long term certainty offered by these agreements as compared to the costs related to the uncertainty in the outcome of the APA or the initial investment associated with it, he will continue to make that choice in favor of an APA and it would be a success.

ANALYSING ESCALATION CLAUSES IN INTERNATIONAL ARBITRATION: ISSUES RELATING TO ENFORCEMENT

Anand Deshpande and Anu Shrivastava*

ABSTRACT

Arbitration has proved to be a convenient Alternative Dispute Resolution mechanism which seeks to cut down the expense of time and money associated with litigation and courts. However, even arbitration is not devoid of disadvantages. For increasingly complex contracts such as those of construction contracts, arbitration is being seen as an arduous task by contracting parties. There may be disputes of a trifling nature which could very well be resolved through the process of mediation or conciliation.

To facilitate the resolution of such disputes, the parties adopt an escalation clause which provides for mediation, conciliation or expert determination on the failure of which, arbitration would be resorted to for the final adjudication of the disputes.

The insertion of an escalation clause, however, does not come without problems and issues. The first and the foremost question which arises is regarding the binding value of the clauses upon the parties and the consequences of not complying with the initial stages, by-passing them to directly jump to arbitration. Furthermore, to what extent can the escalation clause be enforced upon the parties – whether it can be construed as an arbitration agreement or not.

The article aims at analyzing the issues related to Multi-Tier Dispute Resolution also known as escalation clauses or step-up arbitration clauses. The authors compare the approaches taken by Courts in various countries of both Common Law and Civil Law jurisdictions as well as decisions given by international bodies. The last part of the article deals with the suggestions on the essentials of drafting an escalation clause.

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INTRODUCTION

Alternative Dispute Resolution (hereinafter referred to as 'ADR') clauses have widely gained recognition in commercial contracts due to the various advantages associated with them such as speedy and inexpensive adjudication of disputes. However, among the various ADR mechanisms such as negotiation, expert determination, mediation, settlement and arbitration, arbitration is still considered to be comparatively costly and time-consuming. The recent trend therefore, is to try for the resolution of disputes through other ADR mechanisms before jumping to arbitration. Such ADR clauses are referred to as multi-tiered dispute resolution (hereinafter referred to as 'MTDR') clauses or step clause arbitration clauses.

Multi-tier dispute resolution is a clause in a contract which provides for distinct stages, involving separate procedures, for dealing with and seeking to resolve disputes.[1]ADR clauses are mostly concerned with future disputes which are varied in nature. These disputes may be concerned with multifarious issues, claims and monetary values and arbitration may not always be the best way to resolve all such kinds of disputes. Therefore, it is considered more convenient for the parties to adopt other ADR mechanisms leaving arbitration as the last resort if any of the ADR mechanisms results in a failure.

The most typical of all problems associated with such MTDR clauses (hereinafter 'MTDRC) is to decide what happens in case of non-compliance with the earlier steps and directly invoking arbitration. Another issue is whether the agreement to negotiate or mediate is an agreement of a procedural nature, in which case it would constitute a condition precedent to arbitration and to the procedural admissibility of the claim, or whether it is an agreement of a substantive nature.[2]Moreover, the question of enforceability also arises. Since mediation and negotiation are voluntary in nature, whether non-compliance with these steps in a MTDR can be enforced, that is to say, whether an agreement to negotiate or mediate is enforceable. Also, can MTDRC which provide for arbitration only in the last step can be construed as arbitration clauses under the international conventions. All these problems have been analysed by considering the approach taken by various Courts in countries such as England, Australia, India, Switzerland, Germany etc.

[1]Michael Pryles, *Multi-Tiered Dispute Resolution Clauses,*18 (2) JOURNAL OF INTERNATIONAL ARBITRATION159(2001).; paper delivered at *ICCA Conference, New Delhi*, March 2000 and published in Journal of International Arbitration, 2001.

[2]Alexander Jolles, *Consequences of Multi-tier Arbitration Clauses: Issues of Enforcement*, 72 (4) THEJOURNAL OF THE CHARTERED INSTITUTE OF ARBITRATORS329 (2006).

COMMON LAW JURISDICTIONS

A. ENGLAND

There seem to be two diverging streams in English Case Laws, one against and one in favour of enforcement of an MTDR clause.[3] The first case is classified as against enforcement because the court did not order that ADR be followed. However, the court was able to enforce the ADR provision indirectly by staying the court proceedings.

1. CHANNEL TUNNEL GROUP LTD V *BALFOUR BEATTY CONSTRUCTION LTD.*[4]

In this case, the appellants were the concessionaires under a concession and granted the English Government and the Government of the French Republic for the construction and operation of the Channel Tunnel. Under an agreement dated 13 August, 1986 (hereinafter 'the construction contract') the appellants employed the respondents to design and commission the Tunnel. The appellants issued a variation order for the constructing of a cooling system and a dispute arose in connection with the price for this variation. As per the contract between the two, all disputes were to be settled in accordance with Clause 67 of the contract which was a lengthy MTDR clause.[5]

The respondents wanted the dispute to be settled in accordance with this clause 67 of the contract which provided for settlement by a panel of three experts within 90 days followed by arbitration under the Rules of Conciliation and Arbitration of the ICC. The contention of the respondents was that clause 67 was an arbitration clause and thus proceedings should be stayed before the Court. Secondly, the Courts should invoke its inherent powers to grant a stay. This was equated by the Court with it's the undoubted power to stay proceedings when an action was brought in breach of an agreement to submit disputes to the adjudication of a foreign court.

The question then arose as to whether clause 67 could have been considered to be an arbitration agreement and a stay be granted under Section 1 of the Arbitration Act.[6] The court looked at Section 1[7] and compared it with the wording of Article II (3) of the New York

[3]WianErlank, *Enforcement of Multi-Tier Dispute Resolution Clauses*, (September 2002), DOI: 10.2139/ssrn.1491027, http://ssrn.com/abstract=1491027(Last updated 1st December 2013) ["ERLANK W."]
[4]1993 AC 334.
[5] *Id.*
[6]United Kingdom Arbitration Act of 1975.
[7] "If any party to an arbitration agreement commences any legal proceedings in respect of any matter agreed to be referred the court shall make an order staying the proceedings"

Convention.[8]On a comparison between the two and taking note of the difference in wording of Section 1 of the UK Arbitration Act and Article II (3) of the New York Convention, the court came to the conclusion that as per the UK Arbitration Act, Clause 67 did amount to an arbitration agreement. The court noted that even an "agreement to refer" a dispute to arbitration would amount to an arbitration agreement under Section 1 but such "reference to arbitration" would not have amounted to a binding arbitration agreement as per Article II (3) of the New York Convention. Consequently, the Court held that a stay could be granted under Section 1.

According to the court, Clause 67 required the court to refer the dispute to a panel of experts in the first instance and arbitration should have been the second stage if the experts were unable to settle the dispute. If the UK Arbitration Act had followed the exact wording of the convention, the court would have concluded that the duty to stay does not extend to the situation where a referral to arbitration would occur at a secondary stage on the failure of resolution of the dispute by expert determination.[9]A mere reference to arbitration could not be considered as an arbitration agreement under Article II (3) of the New York Convention. Thus, the court granted a stay under Section 1 of the Arbitration Act and also held that a stay might as well have been granted by invoking inherent powers of the Court. However, such a stay would not have been mandatory but discretionary.

In this case, the parties were large commercial enterprises who were used to having commercial transactions between them. As such, they would be considered as negotiating at arms' length. They would have given abundant thought to the dispute resolution clause and considered its pros and cons in detail. In a situation like this, the Court should be able to enforce an ADR mechanism which is an almost effective agreement to arbitrate even though it may not be exactly the same.

2. CABLE & WIRELESS PLC V IBM UNITED KINGDOM LTD.[10]

The dispute arose from a contract between IBM and Cable & Wireless (hereinafter 'C&W') for provision of certain services in the Information Technology Industry by IBM. According to the Clause 40 of the contract, disputes were to be resolved by negotiations by referring it to escalating levels of management set out in the clause. On the failure of this, clause 41.2 could be invoked wherein the parties would go for arbitration on the failure of which, ultimately,

[8] The court of a contracting state, when seized of an action in a matter in respect of which the parties have made an agreement within the meaning of this article, shall, at the request of one of the parties, refer the parties to arbitration, unless it finds that the said agreement is null and void, inoperative or incapable of being performed.
[9]PRYLES M., *supra*note1.
[10][2002] EWHC 2059.

the parties would resort to litigation. C&W had started proceedings in the court and declined to refer the matter to arbitration and IBM applied for a stay. The final stage of the MTDR clause was litigation, not arbitration so there was no scope of using the arbitration legislation to enforce the clause indirectly.

The Court observed that,[11]

> *"The dispute resolution structure to be found in clauses 40 and 41 of the GFA leaves no doubt that when the parties negotiated that agreement it was the mutual intention that litigation was to be resorted to as a last resort in the event that negotiation by means of the escalation process so specifically set out in clause 40 or, failing that, ADR under clause 41 were unproductive."*

C&W in this matter had put up three contentions before the court. First, the arbitration clause was unenforceable because it was an agreement to agree as decided in *Courtney & Fairbairn Ltd.* v *Tolaini Brothers.*[12] The Court rejected this argument by holding that there was a difference between an agreement to negotiate, which is unenforceable for uncertainty because the outcome of the negotiations is unknown, and an agreement to follow a particular dispute resolution procedure. In the latter instance, what the parties are agreeing is not what the outcome of their negotiations will be, but rather that they will engage in a process which may or may not bring about a resolution to their differences. The second type of agreement is not void for uncertainty because the parties' obligations from the contract could be found from the Model Mediation Procedure of the Centre for Dispute Resolution (CEDR).

Second contention raised by C&W was that the wording of Clause 41 provided for commencing litigation even when the arbitration proceedings were being followed this meant that the ultimate aim was not to fetter the parties' right to start litigation. The Court held that it was evident that the parties were trying to keep themselves out of litigation and to resort to it only when the ADR mechanisms would fail.

According to the third contention, imposing a stay would amount to forcing C&W to participate in the ADR proceedings, so a stay should only be granted where it would be equitable to do so. C&W maintained its position that imposing a stay would be inconsistent with the other aspects of the conduct of IBM. The Court rejected this by holding that there

[11] *Id.*
[12] [1975] 1 WLR 297.

was a clear agreement between the parties for following the ADR mechanism. The court finally ordered that the parties first exhaust their ADR remedies before returning to court with the hope that the ADR will be successful. By this decision the court emphasises the importance that it attaches to mediation.[13]

3. *SULAMERICA CIA NACIONAL DE SEUGROS S.A. V ENESA ENENHARIA S.A.*[14]

The matter came before the English Court of Appeal against the order of Cooke J. continuing an anti-suit injunction restraining the appellants, Enesa Engenharia S.A. and other insured ('the insured'), from pursuing proceedings against the respondents, Sulamérica Cia Nacional de Seguros S.A. and other insurers ('the insurers'), in the courts of Brazil. The Contract was that of insurance and provided for a mediation procedure under Clause 11 which preceded arbitration as covered under Clause 12. The insurer had initiated the arbitration proceedings without going through mediation and the insured contended that mediation and arbitration were part of a single dispute resolution regime and that mediation would form a precondition to arbitration in the absence of which the arbitration proceedings could not be commenced.

The Court upheld the decision of the trial court given by Cooke J. by holding that Clause 11 did not create a binding obligation for the parties to mediate as it was not specific and certain enough. The clause did not lay down the procedure to be followed for mediation nor did it provide for referring the parties to any specific mediation provider.

The Court distinguished the present case from that of *Cable & Wireless* v *IBM*, and held that[15]

> *"condition 11 does not set out any defined mediation process, nor does it refer to the procedure of a specific mediation provider. The first paragraph contains merely an undertaking to seek to have the dispute resolved amicably by mediation. No provision is made for the process by which that is to be undertaken and none of the succeeding paragraphs touches on that question."*

Such an unqualified reference to mediation was not held to be sufficient enough to be treated as a pre-condition for arbitration. The Court declined to lay down the requirements for a

[13]TanyaMelnyk,*Enforcement of ADR procedures*,14, IBA SECTION ON BUSINESS LAW, COMMITTEE D NEWS, SEPTEMBER 2003.
[14][2012] EWCA Civ 638.
[15] *Id.*, ¶ 36

mediation clause which could be considered as being specific enough to be treated as a pre-condition and said that every case would have to be considered on its own terms.

B. AUSTRALIA

1. HOOPER BAILIE ASSOCIATION LTD. V. *NATCOM GROUP PTY LTD.*[16]

In this case, the parties had decided that some of the disputes would be resolved by the process of conciliation and that the decision of the conciliator would be final and binding upon the parties. NATCOM wanted to refer the matter to arbitration whereas the other party stated that a legally binding contract to conciliate had come into existence and arbitration could not be resorted to. They then applied to the Supreme Court for staying the proceedings.

The Court went on to decide whether the agreement was legally binding. The opponents of enforceability argued that the process requires consent and cooperation by the parties and it would be of no use to anyone if a party was forced to participate without consent. Those in favour of enforceability contend that cooperation and consent are not enforced, but rather participation is from which cooperation and consent might arise.[17] The Court analysed English precedents[18] and observed that an agreement to refer the disputes to conciliation was not enforceable distinguishing the position in New South Wales by saying that an agreement to mediate or conciliate is not the same as an agreement to agree or negotiate in good faith. If terms of the agreement to conciliate or mediate were sufficiently certain the Court could force the parties to participate in the process. The Court found the ADR clause for mediation to be sufficiently certain in the present matter and granted the stay under its inherent jurisdiction to prevent abuse of the Court process.

This benchmark of sufficient certainty for an MTDR clause rendering mediation or conciliation was again taken up in *Elizabeth Bay Developments Pty Ltd v. Boral Building Services Pty Ltd*.[19] The contract contained an MTDR clause referring the disputes to the Australian Commercial Disputes Centre (ACDC) which had guidelines for resolution of disputes through mediation. On the facts the court found that the mediation provisions in the MTDR clause were too uncertain to be enforceable according to the sufficient certainty standards set in *Hooper Bailie*.[20]

[16][1992] 28 NSWLR194.
[17]ERLANK W.,*supra* note3.
[18]Paul Smith Ltd v H&S International Holding Inc., [1991] 2 Lloyd's Rep 127.
[19][1995] 36 NSWLR 709.
[20] *Id.*

2. AITON v. *TRANSFIELD*[21]

The defendants in this case had requested for a stay of proceedings on the ground that the contract contained express ADR mechanisms before litigation. Clause 28 of the contract provided for express terms and conditions and long provisions in the nature of a MTDR clause. It was found that the procedure laid down in Clause 28 was not complied with.

The Court compared the cases of *Hooper Bailie*[22], *Racecourse Betting Control Board* v *Secretary for Air,*[23] *AWA Ltd* v *Daniels*[24] and *Allco (Steel) Queensland Pty Ltd* v *Torres Strait Pty Ltd.*[25] and found that the Court makes people abide by their contracts and prevents a party from commencing proceedings contrary to the agreement entered between them for the resolution of disputes. The Court stated that "it is trite to observe that parties ought to be bound by their freely negotiated contracts" and referred to *Trawl Industries*[26]case as well as *Meehan* v *Jones*[27] which in essence held that courts should uphold the construction and validity of commercial contracts.

Aiton raised three contentions before the Court. Firstly, that the Clause 28.1 was not mandatory due to various constructions to which the Court said that it was not up to the parties to elect whether to comply or not comply with the procedure.[28] Secondly, it was argued that the clause did not apply to all of the claims put forth by the Plaintiff. The Court rejected this by observing that all the claims were inextricably linked with the contractual claims. Finally, it was contended that the reference to "good faith" in clause 28 did not mean that the parties would submit to ADR because of an imprecise concept of "good faith". To this, the Court first examined if an ADR clause is a precondition to litigation. The Court again noted the difference between an 'agreement to negotiate' and an 'agreement to agree.'

The Court however, upheld the contention of the plaintiff that Clause 28.1 was unenforceable due to lack of certainty. It was observed that firstly there were no provisions dealing with the remuneration to be paid to the mediators and secondly there were no provisions dealing with what should happen if one or both parties were unable to agree on the appointment of the

[21] [1999] NSWSC 996.
[22] (1992) 28 NSWLR 194.
[23][1944] Ch 114.
[24][1995] 37 NSWLR 438.
[25]Unreported, SC of Queensland, No. 2742 of 1989, 12 March 1990.
[26](1992) 27 NSWLR 326.
[27](1982) 149 CLR 571.
[28] Clause 28.1 requires that the parties "shall" make good faith efforts to comply with stage one "before" either party commences mediation, legal action or expert resolution. If that stage one fails, then stage two commences, namely 28.2 which provides for mediation and uses the mandatory language of "shall" in addition to expressly stating that stage two is a compulsory precondition to the right to further proceedings. See Erlank

mediators and further what should happen if the mediator declines the appointment.[29] The Court held the mediation clause being inseparable from the negotiation clause as unenforceable.

C. INDIA

In India, there have not been many cases before the Courts regarding MTDRC or escalation clauses. In a recent judgment, the question regarding the validity of such MTDRC came up before the Delhi High Court.

HAVELS INDIA LTD. V. ELECTRIUM SALES LTD.[30]

The Plaintiff (Havels) and Electrium had entered into a Supply Agreement. The defendant, a subsidiary of Electrium had filed a request for arbitration before the International Chamber of Commerce (ICC) and the plaintiff had approached the Court for a declaration that there was no arbitration agreement between the plaintiff and the defendant.

The Defendant in this matter had filed an application under Section 8[31] of the Arbitration Act, 1996 and under Order VII, Rule 11[32] of the Code of Civil Procedure, 1908(hereinafter referred to as C.P.C). The plaintiff contended before the Court that existence of an arbitration agreement does not come within the domain of Order VII, Rule 11 of C.P.C application and that the considerations for applicability of Order VII, Rule 11 of C.P.C are confined to the averments in the plaint along with the supporting documents of the plaintiff, and not beyond that. In light of Section 5[33] of the Arbitration Act, 1996, judicial intervention should be limited only to those cases as have been envisaged by the Act. The Court regarding this contention analysed Section 8, Section 11,[34]Section 16[35] and Section5 of the Arbitration Act and relying on judicial precedents held that upon being satisfied of a prima facie existence of an arbitration agreement, it is imperative for a court to refer the parties to arbitration. However, itis not reason enough to hold that a suit for the declaration of the same relief would also be maintainable. There is no provision in the Act enabling the filing of such a suit. It also cannot be lost sight of that an application under Section 8 is filed in a case where a suit

[29]ERLANK W. at *supra* note3.
[30]2013 (2) ARBLR 117 (Del).
[31]§8: Power to refer parties to arbitration where there is an arbitration agreement. (1) A judicial authority before which an action is brought in a matter which is the subject of an arbitration agreement shall, if a party so applies not later than when submitting his first statement on the substance of the dispute, refer the parties to arbitration.
[32]Grounds for Rejection of Plaint.
[33]Extent of judicial intervention: Notwithstanding anything contained in any other law for the time being in force, in matters governed by this Part, no judicial authority shall intervene except where so provided in this Part.
[34]Appointment of Arbitrators.
[35]Competence of Arbitral Tribunal to rule on its jurisdiction.

is already before the Court; while an application under Section 11 is envisaged by the Act merely for the reference of the disputes to arbitration by appointment of the Arbitrator.[36] Since a prima facie arbitration agreement between parties existed, suit was apparently barred under Section 5[37] read with Section 16 of Act. The Court finally held that the plaint was liable to be rejected under Order 7 Rule 11 of the C.P.C.

The second contention of the plaintiff was that there was an apparent inconsistency between clause 23 of the Purchase Order and clause 14 & 15 of the Supply Agreement. The Supply Agreement envisaged disputes to be resolved by an arbitration proceeding under the ICC Rules. On the contrary, as per Clause 23 of the Purchase Orders, parties had agreed to submit to the exclusive jurisdiction of the English Courts. Therefore, even if it was held that the Plaintiff was privy to the Supply Agreement, clause 23 vitiated the arbitration clause contained under clause 15 of the Purchase Order. The court regarding this contention held that clause 23 was merely a Forum Selection Clause[38] and there was no inconsistency between the clauses. It cannot be said that by merely agreeing to the exclusive jurisdiction of the English Courts the parties have waived the dispute resolution mechanism as laid out in the Supply Agreement.

The plaintiff further contended that the correspondence and the communication regarding the submission of the plaintiff to the dispute resolution mechanism of mediation and arbitration which was sought to be relied upon by the defendant, was 'without prejudice' and further that the submission of the plaintiff to the dispute resolution mechanism of medication and arbitration was also 'without prejudice'. The Court rejected this contention and held that the 'without prejudice' statement could not be extended to dispute resolution mechanism or regarding the invocation of the arbitrator.

The question of validity and enforcement of a MTDR clause was not before the court in this case. However, the Court accorded recognition to MTDRC known as escalation clauses by holding that the 'without prejudice' statement could not be used to frustrate the objective of MTDRC by any party by claiming that its participation in the preceding mediation proceedings cannot be used to trigger the arbitration clause, merely because it used the term 'without prejudice' in the communications. In future, if a question of validity/enforceability

[36]The Handicrafts and Handlooms Exports Corporation of India Ltd. v Ashok Metal Corporation &Anr., (2010) ILR 6 Del 295.
[37]Bhushan Steel Ltd. v Singapore International Arbitration Centre &Anr., (2010) ILR 6 Del 295.
[38]Rajasthan State Electricity Board v M/s. Universal Petro Chemical Ltd., (2009) 3 SCC 107.

of MTDRC arises before the Courts in India, the Courts, in light of Section 5 of the Arbitration Act, 1996, should accord due recognition to it and avoid court interference.

CIVIL LAW JURISDICTIONS

In Switzerland, ADR is being increasingly used especially in matters relating to family law.[39] There is however, a long standing tradition in Swiss Courts to conduct negotiations themselves.[40] Further the pre-trial discovery procedures typical in common law countries do not exist and there is minimal cost of inflation.[41] Hence, the practical importance of mediation by independent parties seems to be an uncertainty.[42]

In a decision by the Court of Cassation of the canton of Zurich,[43] the court dismissed the defendant's claim and held that a mediation clause was an issue about the material admissibility of the claim and not of a jurisdictional nature.[44] However, in an *obiter* in a later case the Court adopted a different approach.[45] The case dealt with a challenge to an appointment of an arbitrator based on the argument that the mandatory conciliation procedure was not followed by one of the parties. The Court did not reject the argument and instead chose to leave the issue open for the Tribunal to decide.[46]

According to the 1999 decision, the clause is purely substantive and as such ordinary courts will open a judicial procedure even in the violation of such a clause by one party. In essence the only remedy available to the claimant for enforcement of the clause is a claim for damages caused by the violation of the clause.[47] This approach defeats the purpose of the clause as damages caused are very difficult to prove. It is thus suggested by the authors that the approach taken by the Court of Cassation in the 1999 decision is incorrect and must therefore, be discarded.[48]

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[39]Nathalie Voser,*Enforcement of Multi-Tier Dispute Resolution Clauses by National Courts and Arbitral Tribunals – the Civil Law Approach*,IBA CONFERENCE DURBAN 2002: COMMITTEE D SESSION ON MULTI-TIERED DISPUTE RESOLUTION CLAUSES AND THEIR ENFORCEMENT ["VOSER"].

[40] Historically approximately 80% of pending commercial court cases in Zurich are terminated via a settlement agreement between the parties, usually because of the judge's efforts.

[41]For more information on the use of ADR in Swiss Law see HEINEREYHOLZER, DIE STREITBEILEGUNGSABREDE, (Fribourg, 1998).

[42]ERLANK W. at *supra* note 3, See also NATHALIE VOSER,*supra*note 39.

[43]*Id.*

[44] Cassation Court of the canton of Zurich ("Kassationsgericht Zürich"), Decision dated 15 März 1999, published in ZR 99 (2000) Nr. 29.

[45] ZR 101 (2002), Nr.21, 77-81.

[46] *Id.*

[47]Voserrecommends that in order to guard against such a situation, certain penalties for non-fulfilment should be stipulated in the contract itself.

[48] The French Courts in general seem to prefer this solution.

A. FRANCE

The French Cour de Cassation (2nd Civil Chamber) took a contrary approach to that of Cassation Court of the Canto of Zurich when it confirmed the decision of a lower court to start proceedings when one of the parties had failed to comply with a conciliation clause.[49]

On the other hand two more recent decisions by the first civil chamber of the Cour de Cassation found that a mandatory conciliation clause in a contract would not be enforceable.[50] These have been criticized as violating the fundamental principle of *pacta sunt servanda*.[51]

One of the arguments in favour of the latter approach is that mediation by its very nature should be voluntary and a forced mediation cannot lead to a satisfactory result as mediation is a procedure based on the willingness of the parties to come to a mutual understanding.[52]However, this argument may also be refuted on the basis that dispute resolution measures would only be resorted to when a dispute arises, which would mean that parties would usually be unwilling to come to any 'understanding'. However, as studies have shown, the intervention by a third neutral party improves the chances of parties being able to reach an agreement.[53]

Voser points out that care must however be taken that the remedy of refusal to commence judicial proceedings on procedural as opposed to substantive grounds does not lead to inappropriate solutions when the commencement of the proceedings is needed by one of the parties in order to interrupt the period of limitation under certain applicable laws. This should be addressed by adapting the municipal law to such a degree that the institution of ADR proceedings as such (which could culminate in arbitration or litigation) should act as a stay of the period of limitation.[54]

Another issue that must be considered is that parties may implicitly waive the enforcement of the conciliation clause by deciding not to invoke it.[55] However, sufficient flexibility may be given to the courts to allow them to take into account the will of parties while examining, *ex officio,* the conditions precedent to the proceedings. It should also be possible for the court

[49]Polyclinique des Fleurs-the French Cour de Cassation (2nd civil Chamber)2 July 2000 – *Cf.* Revue de l"arbitrage 4/2001, 749.
[50]Charles Jarrosson,*Observations on Poiré v. Tripier*,19 ARBITRATION INTERNATIONAL, NO.3.LCIA,364 (2003) ["JARROSSON"].
[51]*Id.*
[52]VOSER, *supra* note 39.
[53]JARROSSON,*supra* note 50.
[54]*Id.* See also, ERLANK W., *supra* note 3.
[55]VOSER,*supra* note 39.

when staying the judicial procedure to also invite the parties to comply with the mediation clause within a certain time frame.[56] However, the one disadvantage with this approach is that it gives excessive discretion to the court.[57]

In February 2003, the Cour de Cassation ruled that an action could be dismissed even without looking at the merits of the case.[58] The contract in the case contained a compulsory clause for conciliation. The parties had made no attempt at conciliation and one of the parties was willing to pursue conciliation as provided in the clause. The Court held that such a party could challenge an action before the courts by raising a plea to the existence of such a clause and that such a plea would be peremptory in nature.[59]

This settles the conflicting views of the various Sections of the Court of Cassation on this subject since it was jointly rendered by the different Sections in order to unify their position.[60] The Court of Cassation even specified that the effect of the applicable statute of limitations is suspended by submitting the dispute to conciliation or arbitration.

However, this leaves open the questions as to whether this plea may be taken up by the Court *meromoto* and the stage up to which the plea may be raised.[61] This decision however gives certainty to the fact that French Courts give effect to arbitration and conciliation clauses and ensures enforceability.

A party seeking an injunction or any other interim relief will however be able to approach the Court. The Court of Appeal in Paris has held that an injunction could be ordered despite a mediation clause. This decision is also consistent with Article 13 of the UNCITRAL Model Law of International Commercial Conciliation.[62]

[56]JARROSSON, *supra* note 50.
[57]VOSER,*supra* note 39.
[58]Poiré v Tripier, Cour de Cassation, 14 February 2003.
[59] The court based its decision on article 122 of the French New Code of Civil Procedure.
[60] McDougall A & Borg G, Court of Cassation Decision Enforces a Conciliation Clause, IBA SECTION ON BUSINESS LAW, COMMITTEE D NEWS,(September 2003) ["McDougall A & Borg G"].
[61]*Id.*, Cf. JARROSSON,*supra* note 50.
[62]"Where the parties have agreed to conciliate and have expressly undertaken not to initiate during a specific period of time or until a specific event has occurred arbitral or judicial proceedings with respect to an existing or future dispute, such an undertaking shall be given effect by the arbitral tribunal or the court until the terms of the undertaking have been complied with, except to the extent necessary for a party, in its opinion, to preserve its rights. Initiation of such proceedings is not of itself to be regarded as a waiver of the agreement to conciliate or as a termination of the conciliation proceedings."

B. GERMANY

The German Bundesgerichtsh of also examined the enforcement of a mediation clause in a decision of 1998[63] and also came to a different conclusion to that of the Cassation Court of the canton of Zurich in 1999.

The facts concerned a seller who agreed to the sale and transfer of his tax consultant's bureau. The contract provided for a mandatory pre-arbitration mediation clause, with the Chamber of Tax Consultants acting as a mediator.[64]

When a dispute arose the matter was accordingly submitted by the seller to the Chamber. The Chamber requested the payment of its fee from the parties in equal amounts. The buyer refused to pay his share and the Chamber refused to commence mediation. The other party attempted to resolve the dispute through negotiation and when it failed, approached the Courts. Before the Court, the buyer contended that the seller could not initiate judicial proceedings as the procedure for mediation was never resorted to and this constituted a mandatory breach of contract. The Court held that if a contract contains a mediation clause, the clause would exclude a reference to judicial proceedings until the parties sincerely attempt to reach an agreement through conciliation. The reference to the court is therefore made temporarily inadmissible.

The court presumed that the clause would be treated as an arbitration clause with respect to its procedural effects and giving regard to its objectives.[65] The Court also assumes that the compliance with such a clause is not a condition precedent to judicial recourse to be examined *ex officio* by Courts. It would be taken into account only if it was invoked by one of the parties.[66] This is contrary to the position discussed in *Polyclinique des Fleurs*[67]and *Poire v Tripier*[68]discussed above.

In the particular facts however, the Court did not allow the buyer to invoke the clause as the party itself had been responsible for impeding the process of mediation by not paying fees due to it. Therefore, the buyer could not rely on a pre-litigation clause because of estoppels as his behaviour was contrary to good faith.

[63]November 18, 1998 (VIII ZR 344/97), cons. 3a).
[64]See VOSER,*supra* note 39.
[65] *Id.*
[66]*supra* note 49.
[67]Poiré v TripierCour de Cassation, 14 February 2003.
[68]November 18, 1998 (VIII ZR 344/97), cons. 3b).

Some jurists believe that this solution gives the best balance between the two views of looking at the clause – as a condition precedent in contrast to viewing it as a substantive clause.[69] This view appears to respect the hybrid nature of the clause. However, another solution could have been to refer the parties to mediation and compel the buyer to pay the costs of the Chamber which would have given greater regard to the aim of the procedure stipulated by the clause.

In conclusion, we see that courts in civil countries seem willing enough to enforce such clauses. However it is suggested that the best solution to the conflicting decisions is that a specific provision of law be introduced into the procedural law for the state courts as well as the *lex arbitri* of the Tribunal, that would require the court or tribunal to stay the proceedings unless the lower tiers have been complied with.[70]

ARBITRAL TRIBUNALS

In case of arbitration by tribunals two questions arise:

1) Who decides the dispute in cases where one of the parties fails to comply with the clause?

2) What decision will the Tribunal take in case of such non-compliance?

Voser opines that the Tribunal should be the one to decide the jurisdiction based on the doctrine of *Kompetenz-Kompetenz.*[71]The answer to the second question would vary with the facts and circumstances of each case.

In case where the parties have autonomously agreed that the first tier should be a condition precedent to the jurisdiction of the Tribunal, the Tribunal should decline its jurisdiction on the matter.[72] The issue now arises as to whether this rejection of jurisdiction is temporary or permanent. In case it is temporary, the parties may approach the Tribunal after attempts have been made to satisfy the lower tiers. This is usually done in cases when the parties wish to avoid the intrusion of the Tribunal in a lower tier, which may consist of expert determination for example.[73] However, if the jurisdiction of the Tribunal is rejected *in toto* then the dispute is open to the jurisdiction of the ordinary civil courts.[74] The problem that arises with the second approach is that the parties would have entered into the complicated tiered clause only with a wish to avoid ordinary litigation and this approach would force them to resort to a

[69]This view is given by VOSER which is acknowledged by ERLANK W. in his article.
[70]ERLANK W., *supra* note 3. See also JARROSSON, *supra* note 50.
[71]VOSER,*supra* note 39.
[72]PRYLES M,*supra*note1.
[73]VOSER,*supra* note 39.
[74]ERLANK W.,*supra* note 3.

system to which the parties actively wished to evade. On the other hand, the adoption of the first approach of a temporary denial diffuses the authority of lower tiers and increases chances of interference by the arbitral tribunal. A party may also attempt to circumvent the lower tiers of the clause in case too lenient an approach is adopted.

Another factor which must be considered by the tribunal is the reason for non-fulfilment. These must be analysed with reference to the principle of good faith as discussed in the preceding Bundesgerichtshof decision.[75]

In an analysis of nine cases that was heard by the ICC[76] which contained mandatory MTDRC Jiménez[77] discusses the views taken by the arbitral tribunals about the enforcement of these clauses. The failure of resolving lower stages of MTDRC has led the respondents to object to the admissibility of the claim.

In such cases, the ICC International Court of Arbitration may allow the case to proceed and leave it for the arbitration tribunal to decide once it has been constituted.[78] Jiménez found that the tribunals in the nine cases showed remarkable consistency in their reasoning.[79] The Tribunals adopted two-pronged approach. Firstly, they consider whether the parties had undertaken an obligation to attempt to resolve the dispute through amicable resolution before approaching the tribunal. If the first condition is satisfied then they will look at whether this obligation has been fulfilled.[80]

The Tribunal has held that if the wording of the clause appears to make the use of ADR optional, a party may directly approach the tribunal and if it has clearly expressed the intention that it is a mandatory clause then it would be binding on the parties.[81]

[75]November 18, 1998 (VIII ZR 344/97), cons. 3a).
[76]International Chamber of Commerce. The ICC has amongst other things an International Court of Arbitration. The court was created in 1923 and since then has handled over 13,000 cases. The ICC has also developed a range of other dispute resolution rules in addition to arbitration and offers a comprehensive package of dispute resolution services.
[77]Dyalá Jiménez Figueres,*Multi-Tiered Dispute Resolution Clauses in ICC Arbitration*, ICC INTERNATIONAL COURT OF ARBITRATION BULLETIN VOL.14/NO. 1– SPRING 2003.
[78] See ICC Rules article 52 – which states that decisions on jurisdiction may be taken by the tribunal if the ICC court is prima facie satisfied that an arbitration agreement under the Rules may exist.
[79] Jiménez,*supra* note 77.
[80]ERLANK W.,*supra* note 3.
[81] Jiménez,*supra* note 77.

PRACTICAL SOLUTIONS

General Drafting Methods: Given that the arbitration clause is often relegated to the status of boiler-plate during contractual negotiations, it will come as no surprise that arbitration clauses may be inadequately drafted.

Duprey opines that the reason for introducing arbitration clauses is to lay down a suitable procedure before a dispute actually arises and to minimize the risk of disagreement on procedural grounds.[82] Sometimes parties may prefer to use an even faster method of resolving disputes before resorting to arbitration. There is a chance that such a method may not give a satisfactory conclusion and hence the need was felt to introduce the concept of multi-tiered dispute resolution clauses from the beginning.[83]

As has been analysed above, these MTDRC are not free from disputes and confusions of their own and have given rise to a variety of conflicting jurisprudence and legal viewpoint while evaluating their enforceability. The drafting of the MTDRC therefore assumes an even greater importance as being a clear indicator of the parties' will. There are several factors that must be looked at while drafting these clauses including *inter alia* which of the ADR techniques to use; in what order to use them; over what period of time they will be used; the precise form of each particular technique to use and lastly whether there is a need for "separate" dispute resolution paths[84], or an integrated multi-tiered process.[85]

Pryles recommends[86] that for the MTDRC to be effective, the clause should be contractually sound and suggests that the procedures to be used before resorting to arbitration should be clearly stipulated. He also suggests that one should not use subjective criteria to determine when one tier should come to an end and when the next should begin.[87] One should therefore implement a set time period for each tier and if no resolution is reached within the time, the parties should move on to the next tier.[88]

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[82]Duprey, Pierre,*Practical Considerations in the drafting and use of a multi-tiered dispute resolution clause*,IBA-CONFERENCE DURBAN 2002: COMMITTEE D SESSION ON MULTI-TIERED DISPUTE RESOLUTION CLAUSES AND THEIR ENFORCEMENT ["DUPREY"].

[83] Mackie K, *The Future for ADR Clauses After Cable & Wireless v. IBM*" 19 ARBITRATION INTERNATIONAL345(2003).

[84] "Separate" means that a casuistic approach is followed in determining which form of ADR will be used. For example, the contract can state that in all matters relating to the quality of the material used mediation must be used, but where a dispute arises about the price of material it must go to expert determination. This is different from the integrated process where each and every dispute must follow the same process.

[85]DUPREY, *supra* note 82.

[86]PRYLES M,*supra* note1.

[87] *Id.*

[88]PRYLES appears to be of the view that the most challenging problem with MTDRC concerns their enforceability.

After the *Aiton*[89]decision contracting parties must make doubly sure that there is no indistinctness or ambiguity in the clause that can make it sufficiently uncertain. With regards to the decision in the *Aiton* and *Sulamerica*[90]cases, it would appear that the best approach would be to be as specific as possible while drafting the clause and clearly stipulating all possible issues that may cause uncertainty.

It is also opined by Melnyk[91] that great care must be taken to ensure that the procedures are clear and certain. By using simple, straightforward language and carefully constructing the clause, many disagreements about the clauses themselves may be avoided saving money and time spent on litigation.

The 'IBA Guidelines for Drafting International Arbitration Clauses'[92], recently published in draft form by the International Bar Association also lay down certain guidelines to be followed while drafting multi-tier dispute resolution clauses. These are:

1) The clause should specify a period of time for negotiation or mediation, triggered by a defined and indisputable event (i.e., a written request), after which either party can resort to arbitration.
2) The clause should avoid the trap of rendering arbitration permissive, not mandatory.
3) The clause should define the disputes to be submitted to negotiation or mediation and to arbitration in identical terms.

These guidelines along with the opinions of the authors given above form a useful basis on which to draft the MTDRC and to ensure their enforceability in judicial proceedings.

CONCLUSION

We see from the above discussion that the mechanism of Multi-Tier Dispute Resolution Clauses has given a new perspective to the jurisprudence in Arbitration Law. In attempting to resolve the time consuming and expensive procedures the disputes surrounding enforceability of these clauses have themselves given rise to whole nest of protracted litigation.

We have also examined the differing approaches adopted by various countries to deal with MTDRC. From treating a conciliation clause as a substantive contractual term to regarding it

[89]Aiton v. Transfield, Supreme Court of New South Wales, Einstein J., 1999 [1999] NSWSC 996 Unreported, Supreme Court of New South Wales, Einstein J., October 1999.
[90][2012] EWCA Civ 638.
[91]MELNYK, *supra* note 13.
[92]'IBA GUIDELINES FOR DRAFTING INTERNATIONAL ARBITRATION CLAUSES' adopted by a resolution of the IBA Council on the 7th of October 2010, International Bar Association.

as a procedural requirement precedent to litigation, each country has adopted a different stance regarding its interpretation and enforceability.

However, both common law as well as civil law systems have begun to recognize the importance of supporting alternative methods of resolution in the interest of economy and the overburdened legal systems on the whole. Given the difference in the approaches and the requirement in different national laws, parties who wish to subscribe to an MTDRC should ensure that their clause meets the requirements of the legal system where it would be enforced.

In conclusion one can predict that with the increasing court support for ADR or MTDRC and with careful drafting of contracts to cover all the requirements of enforcement, the outcome of enforceability proceedings in a court or before an arbitral tribunal will become much more certain than is currently the case. This will promote the use of ADR in general and help parties avoid the delay and high cost connected with most litigation and arbitrations.

ROLE OF JUDICIARY IN ADR

Jenny Thomas and Nilika Kumar[*]

ABSTRACT

Alternative Dispute Resolution (hereinafter referred to as 'ADR') refers to method of resolving a dispute, which is alternative to litigation in a court. The primary objective of ADR system is to minimize the supervisory role of the courts in the arbitration process. ADR system furnishes speedy and accessible justice. This paper elaborates the suo moto recognition of arbitration in ADR throughout the Courts of India. Although the courts' involvement is limited, intervention by courts is inevitable as no single process can by itself banish the darkness of injustice. The judicial process is meant to provide an effective and impartial mechanism for redressal of grievances. Moreover intervention by courts becomes necessary in the cases of bias by arbitrators, misconduct of proceedings etc. Arbitration and Conciliation Act, 1996 is based on the UNCITRAL model. Section 5 of the Act mentions that the Judiciary shall not intervene in the agreement between the parties in dispute except as provided under the Act. The Act provides for judicial intervention only in sections 8, 9, 11, 13(4), 13(5), 14(2), 16(6), 27, 34, 37, 39(2) and (4), 43(3). The other area where ADR is recognized in India is in Family Law. Sections 6 and 9 of the Family Court Act, 1984 provides for judicial intervention by courts. The Code of Civil Procedure, 1908 elaborated in section 89 of the Act giving importance to mediation, conciliation and arbitration. The Legal Services Authority Act, 1985 has also given emphasis on ADR which the authors shall deal subsequently. The New York Convention, 1958 is referred by courts for arbitration. It places strict limitations on the reasons for an acceding nation to refuse to enforce a qualified arbitral award [Art. I (3) and Art. VII (1)]. The authors will conclude by the detailed analysis of the Role of Judiciary and try to suggest a direction for the road ahead.

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"It is the spirit and not the form of law that keeps the justice alive."

■ ***LJ Earl Warren***

INTRODUCTION

Dispute arises when the parties are unable to agree on some issue or matter. The parties can resolve the dispute either through litigation or through Alternative Dispute Resolution (hereinafter referred to as 'ADR'). ADR means encompassing all legally permitted processes of dispute resolution other than litigation.[1]Although the settlement of a dispute is certainly not the first thing that parties have in mind, yet when entering into a contract they should be aware that differences, grievances and dispute can arise at any time. For the purpose of settling a dispute the first step to be taken in this regard is the identification of the potential areas of dispute and formulation of a productive method for its prevention.[2]Under ADR parties can resolve through Arbitration, Mediation, Conciliation, Negotiation etc. ADR is favored because it encourages the parties to deal with the cardinal issues for a good value of money. It gives the parties a leverage to reduce opposition, restore alliance, earn acceptance of result, retrieve control, resolve dispute in an amicable manner, and aims to accomplish justice in each individual case. The dispute is resolved in a confidential manner making it more practical, economical and effective. The primary objective of ADR system is to minimize the supervisory role of the courts in the arbitration process. It is not possible to completely exclude the court from the ADR proceedings. The judicial process is meant to provide an effective and impartial mechanism for redressal of grievances. Moreover intervention by courts becomes necessary in the cases of bias by arbitrators, misconduct of proceedings etc. ADR is not intended to replace altogether the traditional means of resolving disputes by means of litigation.[3]

ROLE OF JUDICIARY- 1940

The first Indian Arbitration Act was enacted in 1899 which was largely based on the English Arbitration Act, 1889. The scope of this Act was confined to arbitration by agreement without the intervention of the court. The Second Schedule of the Code of Civil Procedure, 1908 dealt with arbitrations outside the operation and scope of the 1899 Act. This Schedule, by and large, related to arbitration in suits while briefly providing arbitration without intervention of the court.

[1] BRYAN A. GARNER, BLACK'S LAW DICTIONARY (9thed.).
[2]G.K. KWATRA, ARBITRATION AND ALTERNATIVE DISPUTE RESOLUTION (2008).
[3]P.C.RAO & WILLIAM SHEFFIELD, ALTERNATIVE DISPUTE RESOLUTION 25 (1sted.).

It also provided alternative methodology whereby the parties to a dispute or any one of them could file their arbitration agreement before a court for reference to arbitration after compliance with the prescribed procedure.[4]

The year 1940 is an important year in the history of law of arbitration in British India. The 1940 Act basically advocated and intended to incorporate and amend the laws relating to arbitration as embraced in 1899 and the Second Schedule of the Code of Civil Procedure, 1908. It was based on the English Arbitration Act 1934. The Act dealt with broadly three kinds of arbitration. Firstly, arbitration without intervention of the court, secondly, arbitration with intervention of court where there is no suit pending, and thirdly, arbitration in suits.[5]

The Arbitration Act, 1940, dealt with only domestic arbitration. As per 1940 Act, Court was requisitioned to interpose in all the three stages that is prior to referring of a dispute before arbitral tribunal, and during the continuance of the proceeding before arbitral tribunal and after the award has been made by arbitral tribunal. Before an arbitral tribunal took cognizance of a dispute, court intervention was required to set the arbitration proceedings in motion. For the purpose of extension of time and passing of an award, the court was required to intervene. Before the award could be finally enforced it had to be made the rule of the court.[6] The 1940 Act was comprehended as a good piece of legislation although when it came to its actual execution it proved to be unproductive and had become outdated in its operations. Reason being, all the three stages of arbitration contained intervention of the court which made the arbitration proceeding more complex and time consuming. Supreme Court also observed that:[7]

> *"We should make the law of arbitration simple, less technical and more responsible to the actual realities of the situations but must be responsive to the canons of justice and fair play and make the arbitrator adhere to such process and norms which will create confidence, not only by doing justice between the parties, but by creating sense that justice appear to have been done..*

[4]OP MALHOTRA & INDU MALHOTRA, THE LAW AND PRACTISE OF ARBITRATION AND CONCILIATION 10 (2nd ed., 2006).
[5]*Supra* note 3, at 34.
[6]Krishna Sharma, *Development and Practice of Arbitration in India- has it evolved as an effective legal institution*, http://iis-db.stanford.edu/pubs/22693/No_103_Sarma_India_Arbitration_India_509.pdf, (last visited November 24, 2013).
[7]Food Corporation of India v. Joginderpal Mohinder Lal, (1989) AIR SC 126.

ARBITRATION AND CONCILIATION ACT, 1996

Failure of 1940 Act accentuated the urgency of an Act which could cater the needs of both domestic and international arbitration. The worldwide recognition of 'conciliation' as an instrument of dispute resolution also called for legislative recognition. The Arbitration and Conciliation Act was enacted in 1996 and applies to both domestic and international arbitration. The Act is cast in terms of the UNCITRAL[8] Model Law on International Commercial Arbitration and seeks to break away from the regulated and supervised forms of ADR as have been in existence in India. It is an attempt by Parliament to take a holistic approach to alternative dispute resolution in India. In the past, domestic and international arbitrations were dealt with separately under different legislations; the Arbitration Act, 1940 dealt only with domestic arbitrations.[9]

The 1996 Act has two significant parts – Part I of the Act provides for any arbitration conducted in India and enforcement of awards there under. Part II of the Act provides for enforcement of foreign awards. Any arbitration which is conducted in India or enforcement of award either domestic or international is governed by Part I of the Act, while enforcement of any foreign award to which the New York Convention or the Geneva Convention applies, is governed by Part II of the 1996 Act. The 1996 Act contains two unusual features that differed from the UNCITRAL Model Law. First, while the UNICITRAL Model Law was designed to apply only to international commercial arbitrations, the 1996 Act applies both to international and domestic arbitrations. Second, the 1996 Act goes beyond the UNICITRAL Model Law in the area of minimizing judicial intervention.[10]

In Arbitration and Conciliation Act 1996, the legislature has incorporated two provisions:
(i) Conferring finality to the arbitral award under Section 35.
(ii) Enforcement of awards in the same manner as if it were a decree of the court under Section 36.

Section 35 states that in order to give recognition to the awards made by the tribunal as final and binding, the grounds stipulated under section 34 should not be indicted. In the 1940 Act it was

[8]United Nations Commission on International Trade Law.
[9]Murali Neelakantan, Conciliation *and ADR in India*, available at http://www.nishithdesai.com/Research-Papers/adr.pdf, (last accessed on November 25, 2013).
[10]*Supra* note 6.

prescribed as an implied condition, in the First Schedule, that the award is final and binding on the parties and persons claiming under them respectively. Yet there was confusion on the point of recognition of award unless and until decreed.

Under the Arbitration Act 1940, once the award is published by the arbitrator it is only the end of one round of litigation for commencement of another round, which at times becomes more difficult and time consuming because under Section 14 of that Act, the arbitrator has to file the award before the court, either on request of the interested party or on direction of the court, the affected or defeated party can, seek to modify the award under Section 15, Section 16 deals with remission of the award or even seek to set aside the award under Section 33 for the grounds set out in Section 30. Under the new Act of 1996, the second round of litigation to confirm the award into a decree has been taken away, of course, subject to the power of the court to have the final word on the award, because the award is still subject to scrutiny under Section 34 for impeachment which however gives only a narrow scope for interference by the court compared to the grounds under 1940 Act[11].

THE EXTENT TO WHICH JUDICIAL INTERVENTION IS JUSTIFIED

The purpose of Section 5 of the 1996 Act is to 'exclude any general or residual powers given to the courts in a domestic system which are not listed in this Act'[12]. It prohibits the unwanted legal interference. It also functions to accelerate the arbitral process in allowing less of a chance of a delay caused by intentional and dilatory court proceedings. However, judicial intervention is provided in the following sections:-

- *Section 8* of the Act authorizes the judicial authority to refer the matter to the arbitration if the particular matter is subject to an arbitration agreement. In other words, if an action is brought before the judicial authority in breach of an arbitration agreement, a party to that arbitration agreement may apply to that judicial authority having jurisdiction to refer the parties to arbitration. Such application should be made not later than when submitting his first statement on the substance of the dispute and must be accompanied by the

[11]India Juris, *Arbitration Laws in India*, http://www.indiajuris.com/pdf/Arbitration%20Laws%20in%20India.pdf(last visited November 26, 2013).
[12] Arbitration and Conciliation Act 1996, § 5.

original arbitration agreement. The court must be satisfied that a valid arbitration clause exists and the subject matter of action is within that clause[13].

- *Section 9* of this Act is inspired by Article 9 of UNCITRAL Model law which contents itself by stating that an application to the Court for an interim measure of protection is not in conflict with the arbitration agreement regardless of when such application is made. This section details out the nature of interim measures of protection that can be ordered by the Court. These orders are aimed at preserving assets, protecting the position of the parties, maintaining status quo, and procuring evidence. If the interim measure of protection ordered purports to give the same relief as the arbitral tribunal will finally award, it will defeat the entire purpose of arbitral proceedings. In such a situation, the Court should not snatch the decision making power out of the hands of the arbitral tribunal.
- *Section 11*deals with the appointment of arbitrators. The Parties to arbitration are free to agree on the procedure for appointment of arbitrators.[14] The situations suitable for intervention of the Chief Justice or his designate naming an arbitrator are:
    - The procedure agreed is not followed;
    - There is no agreement on procedure.

In above stated situations, the interventions of the Chief Justice or his designate are mandatory. In the first situation, a party may request the Chief Justice or his designate to take necessary measure if it fails to act as per the procedure, or the parties are unable to reach an agreement, or a third party (including an institution) fails to perform any function entrusted to it as per such procedure.[15]

- *Section 13(4) and (5)* deals with the situation where a party's challenge is rejected by the arbitral tribunal or other body agreed on by the parties, and allows the challenging parties to address the Court under Section 34(2) for a final decision on a challenge. It constitutes a party's last resort if all else fails, and, therefore, has to be secured accordingly.

[13]*Supra* note 4, at 347.
[1414] Arbitration and Conciliation Act 1996, § 11(2).
[15] Arbitration and Conciliation Act 1996, § 11(6).

- *Section 14(2)* enumerates that, the mandate of an arbitrator shall terminate if he becomes legally incapable to perform his functions for instances like incapacity, bankruptcy, conviction for criminal offence etc. or if he is physically prevented from fulfilling his functions for instances like serious illness, other physical disability or death. The party may apply to the Court to decide on the termination of the mandate.
- *Section 16(6)* reads that a party which is aggrieved by an arbitral award may make an application for setting it aside in accordance with section 34 of the Act. Section 34 regulates not only the means of recourse to the court for setting aside the award on the ground set forth in, but also contains the procedural provisions in connection with setting aside an award[16].

Thus under Section 34, Courts had no power to get into the merits of an arbitral dispute. In *Narayan Prasad Lohia v. Nikunj Kumar Lohia*[17] it was held that if an award was in accordance with the agreement of the parties, it may not be set aside by the court. As per *ONGC* case, the primary question considered by the court was the scope and ambit of the courts powers vis-a-vis section 34. The award must be in accordance with the agreement of the parties and the agreement of the parties must lie within the parameters prescribed by the provisions of Part I.

In the case of *ONGC* vs. *Saw Pipes,*[18] the Hon'ble Supreme Court held that an award shown to be suffering from 'patent error of law' could be challenged under the head "award being in conflict with public policy of India". Breach of public policy shall be interpreted in a restricted sense as its dissension is graver than mere violation of law. Court in this case, interpreted 'public policy' in the widest terms possible. The Court held that any arbitral award which is violative of Indian statutory provisions is "patently illegal" and contrary to the "public policy". The court bypassed the precedent set forth in the *Renusagar* case[19] which had restrictively defined "public policy", by stating that an award is premeditated as final only when it serves the grounds plugged in section 34 of the Act as the award does not become final the moment it is made by the arbitrator and once an award is notified as final, the grounds to promulgate it as null gets tapered.

[16]*Id*. at 1080.
[17](2002) 3 SCC 572.
[18]2003 (2) Arb.LR 5 (SC).
[19](1994) Suppl. (1) SCC 644.

It can be invoked only by making an application to the court for setting aside the award in accordance with the provisions of sub-section (2) and (3) of section 34, which postulates:-
The Court can set aside the arbitral award under Section 34(2) of the Act if the party making the application furnishes proof that:-

(i) A party was under some incapacity,

(ii) The arbitration agreement is not valid under the law to which the parties have subjected it or, failing under the law for the time being in force,

(iii) The party making the application was not given proper notice of the appointment of an arbitrator or of the arbitral proceedings or was otherwise unable to present his case,

(iv) It contains decisions on matters beyond the scope of the submission to arbitration,

(v) If the composition of the arbitral tribunal was not in accordance with the agreement of the parties,

(vi) Failing such agreement, the composition or arbitral procedure of the arbitral tribunal was not in accordance with Part-I of the Act.

(2) The award could be set aside if it is against the public policy of India, i.e. if it is contrary to:-

- Fundamental policy of Indian law,
- The interest of India,
- Justice or morality,
- If it is patently illegal.

(3) It could be challenged: - (a) as provided under Section 13(5) and Section 16(6) of the Act.[20]

- *Section 27* mentions about the Court's assistance in taking the evidence. The arbitral tribunal has no judicial powers except where specifically conferred by the Act. It has no power to compel the attendance of witnesses who refuses to attend and give evidence. Similarly it lacks power to order production of documents, particularly in possession of

[20]*Supra* note 16.

third party, even when such documents may be relevant to the matters in issue. Therefore, the arbitral tribunal is dependent on the assistance of the local Court in taking evidence particularly by compelling appearance of witnesses, production of documents, or access to property for inspection.[21]

- *Section 37* deals with Appealable orders. Section 37(1) provides appeals against certain orders of the Court. Section 37(2) provides appeal against certain orders of arbitral tribunal. Section 37(3) prohibits a second appeal against appellate orders under Section 37(1) and (2).
- *Section 39* says that arbitral tribunal has a mandatory lien on the arbitral award for unpaid costs of arbitration. The tribunal may refuse to deliver the award to the parties unless the payment of the costs of arbitration demanded by it is paid by the parties. If the parties feel that the cost of arbitration is unreasonably exorbitant then it may file an application to the court. The court will order to deposit the entire sum demanded by the tribunal, make an inquiry, and order to pay such amount as it may deem fit and refund rest of the amount.
- *Section 43 (3)* says that it is in the discretion of the court to extend the time for such period as it thinks proper, but the court must be of the opinion that, in the circumstances of the case, if the time limit is not extended, a party would suffer undue hardship. The decision of Supreme Court in *Asia Resorts Ltd. v. Usha Breco Ltd.*[22] illustrates this point. On facts, the court condoned the delay in filing the application by the appellants on the condition that they deposited a certain sum of money by way of costs and it was shown that the delay was not willful[23].

The Court may however refuse to enforce a foreign award if it finds:-

a) Non-arbitrability- i.e., that the award is in respect of the matter which is not capable of being settled by arbitration under the laws of India.[24]

[21] *Supra* note 4, at 873.
[22] (2001) 8 SCC 710.
[23] *Supra* note 4, at 1314.
[24] *Supra* note 12, at § 48 (2) (a).

b) Contrary to public policy- i.e., that the enforcement of the foreign award would be contrary to public policy of India.[25]

The issue that cropped up was *whether Part I of Arbitration and Conciliation Act, 1996 includes Part II also i.e. international commercial arbitration?*

Supreme Court replying the issue in *Bhatia International v. Bulk Trading S.A. & Anr.*[26] held that:[27]

> *"the provisions of Part I would apply to all arbitrations and to all proceedings relating thereto. Where such arbitration is held in India the provisions of Part I would compulsory apply and parties are free to deviate only to the extent permitted by the derogable provisions of Part I. In cases of international commercial arbitrations held out of India provisions of Part I would apply unless the parties by agreement express or implied, exclude all or any of its provisions. In that case the laws or rules chosen by the parties would prevail. Any provision, in Part I, which is contrary to or excluded by that law or rules will not apply."*

Supreme Court reiterated the decision of *Bhatia International v. Bulk Trading S.A. & Anr.*[28]in *Venture Global Engineering v. Satyam Computer Services Ltd. & Anr*[29], and concluded that Part it would apply even for foreign awards.

NEW YORK CONVENTION 1958

The enforcement of the arbitration agreement is provided for in Article II (3), which states that "*A Court of a contracting state, when seized of an action in a matter in respect of which the parties have made an agreement within the meaning of Article II, shall, at the request of one of the parties, refer the parties to arbitration."* There is a general agreement between the Courts that the Court does not have any discretion for referring the parties to arbitration. This provision supersedes domestic law which may provide that the Court has a discretionary power in deciding whether or not to stay a Court action brought in violation of an arbitration agreement. However if

[25]*Id*. at§ 48(2) (b).
[26](2004) 2SCC 105.
[27]*Id.* at ¶ 32.
[28]*Supra* note 26.
[29](2008) (4) SCC 190.

the court discovers that the arbitration agreement is invalid and is incapable of being performed with due recourse, it can then refer the parties to arbitration. Article VII (1) says that the right of the party to avail itself on an arbitral award in a manner and to an extent allowed by its law is extended to the right that a party may have in respect of a domestic award. It also states that this convention does not affect the validity of other treaties in the field of arbitration.[30]

OTHER STATUTORY RECOGNITIONS

Family Court Act, 1984 is established with a view to promote conciliation and secure speedy settlements of disputes relating to marriage and family affairs. Sections 6 and 9 of this Act provides for judicial intervention by the Court. Section 6 of the Act says that the State Government shall consult the High Court regarding the number and categories of counselors, officers and other employees to assist the Family Court in discharge of its functions and also provide with such counselors, officers and other employees. The High Court will decide and also provide number of counselors, officers and other employees to the Family Court. Section 9 of the Act enumerates that the Family Courts are obliged to induce the parties to settle disputes at the first instance contingent to the rules made by the High Court.[31]

Section 89 of Code of Civil Procedure, 1908 says that if the Court feels that the dispute can be resolved through settlement which may be acceptable to the parties, the Court shall formulate the terms of settlement and give to the parties for their observations and on receiving the response from the parties the Court may formulate the terms of settlement and refer it to either Arbitration, Conciliation, Judicial Settlement including settlement through Lok Adalats, or Mediation. According to Section 89(2) of the Act, it reads that on referring a dispute to arbitration by the Court, provisions of the Arbitration and Conciliation Act, 1996 will be adhered to and when the Court forwards or refers the dispute to Lok Adalats for conclusion, the Legal Services Authorities Act, 1987 will apply.[32]

[30]Albert Jan van den Berg, *The New York Convention 1958: An Overview*, http://www.arbitration-icca.org/media/0/12125884227980/new_york_convention_of_1958_overview.pdf, (last visited November 30, 2013).
[31]K.A. Abdul Jalees v. T.A.Sahida, (2003) 4 SCC 166.
[32]Hon'ble Justice S.B. Sinha, *ADR and Access to Justice: Issues and Perspectives*, available at http://www.hcmadras.tn.nic.in/jacademy/articles/ADR-%20Justice%20SB%20Sinha.pdf, (last accessed on November 30,2013).

In *Legal Service Authority Act 1987,*a settlement arrived at in the Lok Adalats has been given the force of a decree which can be executed through Court as if it is a decree passed by a Competent Court.[33] Further provision has been made in the Act for settling pre-litigation cases through such Adalats. Power has been given to the Lok Adalats, to decide the dispute referred to them, to effect settlement by mediation and if settlement is arrived at between parties to draw a decree on the basis of compromise and the same will be signed by the members of the Adalat. Lok Adalats have been quite popular amongst the public due to providing speedy results, it being cost effective and its award being non appealable.

JUDICIAL RECOGNITION

The new Arbitration and Conciliation Act, 1996 acted as the major force to reduce excessive judicial intervention due to which the earlier Arbitration Act, 1940 suffered serious problems. Section 8(1) of the 1996 Act, therefore, makes it a mandatory duty for the judicial authority to refer the subject matter to the arbitral tribunal. Similar provisions are made in connection with the New York and Geneva Convention[34]. The enactment of the 1996 Act was initially met with approbation by the Court in cases like *Konkan Case,*[35] which stated clearly that the provisions of the 1996 Act unequivocally indicate that the Act limits intervention of the Court with an arbitral process to the minimum.

In *ONGC v. Collector of Central Excise,*[36] dispute was between government department and PSU. It was held that public sector undertaking decided to resolve the disputes by mutual consultation in or through good offices empowered agencies of government or arbitration avoiding litigation.

In *Chief Conservator of Forests v. Collector,*[37]it was said that state/union government must evolve a mechanism for resolving interdepartmental controversies- disputes between departments of Government cannot be contested in court.

[33]Legal Service Authorities Act 1987, § 21(1).
[34]*Challenges in Introducing ADR System in India,* http://www.scribd.com/doc/37702564/CHALLENGES-IN-INTRODUCING-ADR-SYSTEM-IN-INDIA, (last visited November 29, 2013).
[35]Konkan Railway Corporation v. Mehul Construction Co., 2000 (7) SCC 201.
[36] [1995 Supp4 SCC 541] (ONGC II).
[37](2003) 3 SCC 472.

In *Punjab & Sind Bank v. Allahabad Bank,*[38] it was held that the government was required to set up committee to monitor disputes between government departments and public sector undertakings make it clear that the machinery contemplated is only to ensure that no litigation comes to court without the parties having had an opportunity of conciliation before an in-house committee.

CONCLUSION

With the increase in disputes the numbers of cases are also increasing. The numbers of cases are likely to increase by 10 to 12 percent every year. There are too few judges per citizen in India, which is why there are delays in decision. In US the number of judges quoted at 150 per million people, while in India the same number is 12 judges per million people.[39] There is an urgent need for ADR in India. The key purpose of ADR is to avoid litigation and settling the dispute between the parties. Although the courts' involvement is limited, intervention by courts is inevitable as no single process can by itself banish the darkness of injustice. ADR can be used as an alternative to time consuming adversarial process of Court litigation. The settlement of disputes through ADR has acquired good popularity among public and this will no doubt reduce the pendency of cases in the Court. ADR provides an opportunity to the people to get involved in settling their grievances which is not possible in formal and adversarial justice system which is usually dominated by lengthy procedure. It offers choice of method, of procedure, of cost etc[40]. The role of judiciary in ADR is not an intervention but it's rather an assistance provided by the Court so that justice is not denied. The Court's involvement is limited to support assistance in giving effect to arbitration process aggrieved by the party. It is evident that the Courts' have accepted and endorsed these two primary objectives of the Act, i.e. upholding party autonomy and ensuring and exclusively supporting role for the Courts.[41]

[38] 2006(3) SCALE 557.
[39] K.G. Balakrishnan, available at http://zeenews.india.com/news/nation/more-judges-in-india-s-sc-as-compared-to-other-countries_618086.html, (last accessed on November 30, 2013).
[40] *Supra* note 25.
[41] *Supra* note 4, at 232.

COMPETITION ISSUES IN THE INDIAN FILM INDUSTRY: AN ANALYSIS OF THE MARKET STRATEGIES

Rupkatha Basu & Arkadeep Sarkar[*]

ABSTRACT

The colossal Indian Film Industry is seeing a constant increase in its massive turnover each year. This is because diverse visions are being captured on reels which find their way to the viewers in the relevant market, fostered by competition. The Competition Commission of India, the watchdog of competition law in India is playing an important role since its inception in the year 2009. Its jurisdiction over the film industry has been challenged but was held to be an invalid contention. The different marketing strategies adopted by associations of producers, distributors or exhibitors between themselves or among different levels can be termed to be forming cartels and hence per se anti-competitive. But being a major player in the market does not necessarily lead to abuse of dominant position. Market share of the enterprise, size and position of the competitors, market structure etc. are the determining factors. Competition law does not only provide an exception to an agreement made in accord with any intellectual property right viz. copyright in case of films, but also in a way fosters competition by protecting the copyright owners right to sale, broadcast, give rent etc. his films according to his own will. There needs to be a balance between healthy competition and interests of the regional players who often lose work while fostering the notion of competition.

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"Anyone who imagines they can work alone winds up surrounded by nothing but rivals, without companions. The fact is, no one ascends alone."[1]

— Lance Armstrong, 'It's Not About the Bike: My Journey Back to Life'

INTRODUCTION

The centenary year is definitely proving to be the prime one till date for the Indian film industry with as many as 1602 films being produced throughout the country in 2012.[2]The Indian Film Industry consists not only of 'Bollywood' as we know it, but also innumerable films made in regional languages. The year saw a diverse range of movies, made on big or small budgets, in different languages, some even multilingual. It is beyond any deliberation that the film industry is enhancing at a never seen before express speed. The trends in film production are even more cutting-edge. The old concept of a single producer has given way to corporatization with big players like Eros International, Reliance Entertainment, UTV and Yash-Raj Films. Foreign production houses like Warner Bros, Viacom18, Sony Pictures etc. are investing increasingly in the Indian market.[3] Not only Bollywood, these production houses finance the regional film industries too, especially through remakes of popular Bollywood movies. But only the big sharks in the sea survive with only 10% of them having generated revenue while the others sank without a trace.[4] Many have been shelved and never had a theatrical release.

As any other industry, competition is the driving factor in the cine business. But the issues and challenges are unique to this *sui generis* industry. Film industry, in order to have discipline, has formed self-regulatory bodies which impose certain rules and regulations on its members and even non-members. This is mostly related to the exhibition and distribution of the films, show timings, number of shows etc. This has a huge impact on the competitiveness of the market. The basic objective of competition law (or anti-trust law) of any country is to provide a law that will ensure that competition among enterprises will be free without the stronger trading entities

[1]http://www.goodreads.com/quotes/tag/competition?page=1(last accessed on November 28,2013).
[2]Sushil Rao, *India surges ahead in film production, Tamil films on top*, Times News Network, August 20,2013, http://articles.timesofindia.indiatimes.com/2013-08-20/news-interviews/41428396_1_tamil-films-producers-malayalam(last accessed on November 28, 2013).
[3]*Roadmap For Single Window Clearance for Film Production in India: A Prelude*, available at http://www.laindiafilmcouncil.org/reports/eny_report4.pdf(last accessed on November 28, 2013).
[4]*Supra* note 2.

manipulating the market, thereby putting the consumers at a loss. Thus, a prominent issue arises: are the activities of these film associations anti-competitive?

Another significant problem is in the arena of revenue sharing ratio. As a practice, it is decided by an agreement between the producer and the distributor. With the venturing of the film producers into distribution as well and the advent of the multiplexes, the single screen movie hall owners and small distributors are losing out.[5] Their concerns have led to forming anti-competitive agreements among themselves in order to avert the businesses of the multiplexes. Further, the question of abuse of dominant position in the film industry has extended to the Competition Commission's doorsteps a number of times.

Another emerging debate which ensues is the dichotomy between the intellectual property rights involved in films and the anti-competition laws. Competition law and Intellectual Property Law, both have evolved as two separate systems of law but there are significant overlapping. While IP laws restrict access, competition law has the objective to enhance access. IPRs by designating boundaries, within which the competitors can exercise their dominance over their property, appear to be against the competition law.[6] This is infact even more evident in the film industry where the producer in spite of having exclusive IP rights over his film, falls prey to the anti-competitive strategies indulged in by the other market players. Needless to say, these issues need to be acknowledged and addressed to find a scheme to put to rest all these warring issues so that the rights of all can be balanced.

This article aims at identifying such issues allied to the film industry in India and the prevalent strategies therein. It will further analyze the various judgments given by the Competition Commission of India and the recent controversies in the field related to anti-competitive practices. The researchers shall limit their analysis only to strategies adopted for release and

[5]Paras Savla, *Disputes in the Film Industry and role of Competition Commission, available at* http://parassavla.blogspot.in/2012/07/disputes-in-film-industry-and-role-of.html(last accessed on November 29, 2013).

[6]Atul Patel, Aurobindo Panda et.al. *Intellectual Property Law and Competition Law*, Journal of International Commercial Law and Technology, 6(2), (2011), available athttp://www.jiclt.com/index.php/jiclt/article/viewFile/132/130(lastaccessed on November 29, 2013).

broadcasting of movies and not products of the television industry. Therefore, only the first- run films are deliberated and not old films.

THE INDIAN FILM INDUSTRY: A MAMMOTH

Starting from *Raja Harish chandra* in 1913 by Dada Shaheb Phalke, and super success of ArdeshirIrani's *Alam Ara* (1931),[7] Indian cinema was battered by the Great Depression, World War II, the Indian independence movement, and the vehemence of the Partition.[8] Following India's independence, the period from the late 1940s to the 1960s is regarded by film historians as the "*Golden Age*" of Hindi cinema. Some of the most critically acclaimed Hindi films ever were produced during this period. The 1950s saw the advent of the '*Parallel Cinema*'. Though the movement was mainly led by Bengali cinema, it also began achieving eminence in Hindi cinema.[9]

The 1970s saw the decline of on-screen romance and gritty, violent movies about dacoits gained prominence. During the late 1980s and early 1990s, the pendulum oscillated towards family drama and romantic musicals.[10]The 2000s saw a tremendous advance in Bollywood's attractiveness in the world. Indian filmmaking reached new heights in terms of innovative story line, quality, cinematography and technological developments.[11] The turnover of the Indian film industry is around 1.8 billion dollars and it is expected to grow by 56% to Rs. 12,800 crore by 2015, from Rs 8,190 crore last year due to increasing digitalization of the sector.[12]

From 7th to 12th December, 2012, World Intellectual Property Organization (WIPO) organized a Festival of Indian Film to commemorate 100 years of Indian cinema with a variety of films ranging from the silent film *Raja Harishchandra* to the very recent 100 crore grosser 3 idiots. India is the world's largest producer of feature films with more than 1200 films produced

[7]Gulzar; Nihalani, Govind; Chatterji, Saibal (2003).*Encyclopaedia of Hindi Cinema*. Encyclopaedia Britannica (India) Pvt Ltd. pp. 136–137. ISBN 81-7991-066-0.
[8]*Supra* note 1.
[9]K. MotiGokulsing, K. Gokulsing, WimalDissanayake (2004);*Indian Popular Cinema: A Narrative of Cultural Change*, Trentham Books, p. 18, ISBN 1-85856-329-1
[10]http://atyourlibrary.org/culture/bollywood-films-influence-such-movies-moulin-rouge(last accessed on December 7, 2013).
[11] Anita N. Wadhwani. *"Bollywood Mania" Rising in United States*, US State Department. (9 August 2006) available at athttp://iipdigital.usembassy.gov/#axzz2nLiCQutO (retrieved on 30.11.2013).
[12]"*Indian cinema revenue no match to Hollywood"*,available at http://www.newindianexpress.com/entertainment/tamil/Indian-cinema-revenue-no-match-to-Hollywood/2013/11/13/article1887061.ece(lastaccessed on November 30, 2013).

annually in over 25 languages.[13]In 2011, the size of the Indian film industry was estimated to be over Rs.90 billion with an estimated compound annual growth rate (CAGR) of 10.2 percent. It is expected to reach Rs.150 billion by 2016.About 1.83 million people are employed in the film industry in the country.[14]

With the growth of multiplexes, the film industry is growing at a rapid pace like never before. The number of market players in the fields of making, producing, distributing, screening and broadcasting have increased manifold and thus has the importance of maintaining healthy competition in the market for the interest of the players as well as the end consumers' i.e. the audience.

JURISDICTION OF THE COMPETITION COMMISSION OF INDIA RELATED TO THE FILM INDUSTRY

During the case of *FICCI- Multiplex Association of India v. United Producers/ Distributors Forum*[15]*sub judice* before the Competition Commission of India, the UPDF filed a writ petition before the Hon'ble Bombay High Court through the case of *Amir Khan Productions Pvt. Ltd. v. Competition Commission of India*[16] , challenging the jurisdiction of the Competition Commission in matters related to the film industry since films are subject to the copyright law, which is in turn an exception under Section 3(5) of The Competition Act, 2002. The petitioners further contended that sub-section (1) of Section 3 of the Competition Act,2002 prohibits an anti-competitive agreement in respect of *"production, supply, distribution, storage, acquisition or control of goods or provision of services, which causes or is likely to cause an appreciable adverse effect on competition within India"*. The right to release a film can never be considered to be related to any goods or services. Thus, the Competition Act, 2002 has no application in the distribution of films released in India. In addition to this, Section 13(1) (b) of the Copyright Act, 1956 confers copyright in cinematograph films. Section 14(d)(ii) further states that in case of a

[13] February 2013, WIPO Magazine, available at http://www.wipo.int/wipo_magazine/en/2013/01/article_0001.html(last accessed on December 2, 2013).
[14]*Id*.
[15]FICCI- Multiplex Association of India v. United Producers/ Distributors Forum, CASE No. 01/2009 before the Competition Commission of India.
[16]Amir Khan Productions Pvt. Ltd. V. Competition Commission of India, 2010 Comp LR 105 (Bombay).

cinematograph film, copyright means the exclusive right *"to sell or give on hire or hire for sale or hire, any copy of the film, regardless of whether such copy has been sold or given on hire on earlier occasions"* Sub-section (iii) confers on the owner of the copyright, the right to communicate the film to the public. Most importantly, in case of a cinematograph film, the person who has *"contributed any valuable consideration"*[17] towards the making of the film, shall be the first owner of the copyright. This clearly means that the producer is the owner of copyright in a cinematograph film and thus, he has the sole right to decide on the distributive channels of the film. If any other person wishes to acquire any right related to this his copyright on the film, he can only get it by applying to the Copyright Board under section 31 of the Act. But this is only permissible when he has been refused a license from the owner of the copyright and he has fulfilled the conditions[18] mentioned u/s 31. The Competition Commission has no jurisdiction, whatsoever, over the matter. But the Hon'ble court dismissed the petition on the ground that the Competition Commission of India would definitely address the issue of jurisdiction in the case before it.

Thus, in *FICCI- Multiplex Association of India v. United Producers/ Distributors Forum*[19], the Competition Commission of India held that the informants do not want to infringe the copyright of the films. There is no question of exercise of copyright in this case. Therefore, exemption under section 3(5) shall not be available. CCI referred to foreign cases of similar issues. Citing *United States v. Microsoft,*[20]the Commission observed that copyright does not provide immunity from general law including anti-trust law.

Most importantly, as per section 60 of the Competition Act, 2002, the Act shall have overriding effect on any law inconsistent with the Act. Further, section 62 states that the Act shall be in addition to the other laws in force in India. This makes it clear that the CCI shall have

[17]§ 17(b) of The Copyright Act, 1956.
[18] The conditions are:(i) the owner of the copyright has refused to republish or allow the republication of the copyrighted work; (ii) the owner has refused to permit communication of such work via broadcast to the public; (iii)the Copyright Board shall have to consider the grounds of refusal by the copyright owner unreasonable after proper hearing of the matter.
[19]*supra*note9.
[20]United States v. Microsoft [38 1998 WL 614485].

jurisdiction on all matters related to cinematograph films, unless they are expressly excluded under the Act.

SELF-REGULATORY ASSOCIATIONS IN THE INDIAN FILM INDUSTRY: ANTI-COMPETITIVE?

The object of the Competition Act, 2002 has been laid down in the Preamble and it is articulate with the economic scenario in India. It reads as, *"to prevent practices having adverse effect on competition, to promote and sustain competition in markets, to protect the interests of consumers and to ensure freedom of trade carried on by other participants in markets, in India, and for matters connected therewith or incidental thereto"*. This indicates that the principal objective of the Act is to ensure that the market is designed in a way that defends the interest of the smaller players without influencing the interest of the big players within the same market.

The Film Federation of India (FFI) is the apex body of film industry in India. It is basically a company and federating body of several associations from different States, such as Producers Councils, Distributors Councils etc.[21]But the film industry is still a very less regulated market laden with different producers' guilds calling the cards in true sense.

Barriers to entry

Barriers to entry in the relevant market can be in the form of regulatory bodies imposing restrictions on the film releasing and distributing platforms. For instance, it is a common practice that films are to be released in theatres before being broadcasted on the television. A classic example can be the case of Kamal Hassan's movie '*Vishwaroopam*', which is analyzed in the later part of this article. Further, the emergent dominance of large cinema circuits may operate to squash cinemas which do not belong to a circuit out of the schedule of film releases.[22]

[21] Film Federation of India website,available at http://filmfed.org/index2.html(lastaccessed on December 4, 2013).
[22]Tulika Singh, *Competition Concerns in Film Industry*, Competition Commission of India, http://cci.gov.in/images/media/ResearchReports/COMPETITION%20CONCERNS%20IN%20FILM%20INDUSTRY.pdf(lastaccessed on onDecember 5, 2013).

Cartel

In 1998, OECD[23] adopted a *Recommendation of Council Concerning Effective Action Against Hard Core Cartels.*[24]Cartel has been defined under section 2(c) of the Competition Act, 2002 as *"Cartel" includes an association of producers, sellers, distributors, traders or service providers who, by agreement amongst themselves, limit, control or attempt to control the production, distribution, sale or price of, or, trade in goods or provision of services;'*. In *UTV Software Communications Limited, Mumbai v. Motion Pictures Association, Delhi,*[25]the informant was the producers of the movie *'Saat Khoon Maf'*. The Opposite party was an association of producers and distributors who imposed restrictions on producers of cinematograph films amongst which were restrictions on not releasing a film of non-members, imposition of sanctions for releasing a non-registered film, premature satellite broadcast etc. The CCI found the opposite party to be forming a cartel and thus violating sections 3(3)(b) and 3(1) of The Competition Act since the opposite party was an association of enterprise which *"limits or controls production, supply, markets, technical development, investment or provision of services"* i.e. the movies made. The opposite party was also found to forma cartel in *FICCI-Multiplex Association of India v. United Producers/Distributors Forum (UPDF).*[26]

Horizontal concentration and Vertical Integration

Cartelization is one of the horizontal agreements that shall be assumed to have appreciable adverse effect on competition under Section 3 of The Competition Act, 2002. The Associations formed amongst themselves by the producers, distributors and theatre owners are nothing but horizontal agreements.[27]

The imposing of unwanted burdens by the economically stronger market players leads to vertical restraints when that is practiced in the different stages of the production chain.[28]In the film industry, vertical integration is not a new phenomenon and is formed by co-ordination of

[23]Organization of Economic Cooperation and Development. India is a member.
[24]Whish Richard and Bailey David, *Competition Law*, 512 (7th ed., Oxford University Press, New Delhi 2012).
[25] UTV Software Communications Limited, Mumbai v. Motion Pictures Association, Delhi Case Number 9 of 2011 before the CCI.
[26]*Supra* note 9.
[27]http://www.cci.gov.in/menu/cartels.pdf(last visited December 7, 2013).
[28]Ramappa T., *Competition Laws in India*,99 (2nded.,Oxford University Press, New Delhi 2009).

production, distribution and exhibition decisions. By controlling the distribution of their films, the producers ensure that their films are shown but when a circuit is formed, prejudices proliferate against outsiders. The independent producers have to bear the loss thus created against them. The CCI in *Eros International Media Limited v. Central Circuit Cine Association, Indore and ors.*[29]held that these associations of film producers, distributors and exhibitors are not merely there to foster development and cooperation in the film industry but also form cartels which are anti-competitive and impose unfair restrictions. It gave several directives to these associations viz. removing the requirement of compulsory registration, restriction on the number of theatres, discrimination on the basis of language and region etc.

INTERFACE OF COPYRIGHT AND COMPETITION LAWS

The Indian Supreme Court has held that, *"An artistic, literary or musical work is the brain-child of an author, the fruit of his labour and, so, considered to be his property. So highly is it prized by all civilized nations that it is thought worthy of protection by national laws and international conventions relating to copyright"*.[30] Further, it was also held that *"It is considered a social requirement in the public interest that authors and other rights owners should be encouraged to publish their work so as to permit the widest possible dissemination of works to the public at large."*[31] At a glance, it might seem that competition law has no role to play in matters related to copyright. Typically, copyright law is one arena where the legislature intends to ensure no competition during the term of the copyright, it guarantees monopoly. As already stated, section 3(5) of The Competition Act, 2002, thus, provides an exception to the otherwise anti-competitive agreements.[32] The exception is provided for copyright holders who frequently impose certain

[29]Eros International Media Limited v. Central Circuit Cine Association, Indore and ors. Case No. 52 and 56 of 2010 before the CCI.
[30]M/s Entertainment India Network Ltd. v. M/s Super Cassette Ltd.,2008(9)SCR165;Gramophone Company of India Ltd. v. D.B. Pandey, (1984) 2 SCC 534 at 549.
[31]*Id.*
[32] The rights guaranteed under The Copyright Act, The Patents Act, The Trademark Act, the Geographical Indications of Goods (Registration and Protection) Act, the Designs Act and the Semi- conductor Integrated Circuits Layout- Design Act are protected u/ § 3(5).

restrictions over their licensees through the licensing agreements which go beyond the rights guaranteed to them.[33]

In the case of *Amir Khan Productions Pvt. Ltd. V. Competition Commission of India*[34] the court had to find answers to a couple of questions; whether UPDF is a cartel or not and does Sec 3(5)(i) of the Competition Act, 2002 provides for blanket exception to feature film. The court opined that cartel is a horizontal activity. The fact that the definition of cartel is inclusive in nature illustrates the fact that the legislature wanted to give a broader meaning.[35] UPDF is an association of producers and distributors who are basically the market players. Producers are recognized for making of the film and on the other hand the distributors are known to circulate films to multiplexes and single screen theatre. The question then arises that whether this vertical integration between producers and distributors makes UPDF a horizontal agreement? Horizontal agreement is dealt in Sec 3(3) of the Competition Act, 2002. It is to be noted that no explanation on reasonableness is given under Section 3(5) of the Act and judicial precedent is absent regarding this aspect. Thus CCI pointed out two factor test to analyze whether this situation will fall under the exemption or not. First, whether the activity is to restrain infringement. Second, whether the activity in question is a reasonable condition imposed under IP laws. There is no right which the copyright law expressly creates.[36] An evaluation of the Copyright law makes it evident that the legislature intended to give more protection to pure artistic works than to works commercial in nature like cinematograph films. CCI further said that the UPDF has not been able to prove that they foster efficiency in the relevant market. Moreover, Joint Ventures do not have blanket exemption under proviso to Section 3(3) of Competition Act, 2002. Only that Joint venture will get an exemption which surges efficiency in the market.

The informant argued that any dispute arising in this scenario shall be dealt under the Copyright Act only. In reply CCI stated that multiplexes do not want to infringe the Copyright of films of

[33]*Supra* note27, at 109.
[34]*Supra* note 15.
[35]*Id.* The Court observed that *"Cartel includes an association of producers, sellers, distributors, traders or service providers who, by agreement amongst themselves, limit, control or attempt to control the production, distribution, sale or price of, or, trade in goods or provision of services"*. Basically § 2(c) of The Competition Act, 2002.
[36]*Understanding Copyright and Related Rights, available at* http://www.wipo.int/freepublications/en/intproperty/909/wipo_pub_909.html, (last accessed on December 2, 2013).

UPDF members. They want to get license which is essential and sole input of their business. So there is no question restraining the infringement by restricting the supply of feature film in the present case.

Regarding the reasonable use of IPRs CCI said that there is no question of exercise of Copyright under the present case. So exemption under Section 3(5)(i) is not available under this case. The CCI referred to *United States v. Microsoft*[37] and said that copyright does not provide immunity from general law including anti-trust law. In this case feature films are an essential facility to multiplexes. If the act of the copyright owner is in lieu of the rights vested on him for his IP, it will be exempted under Section 3(5)(i) of Competition Act, 2002. Otherwise there is no exemption to IPRs. Exemption provision in its present form does not provide clearly about relation between competition law and IPRs[38]. If this provision would not have been there CCI could have passed the similar order in this case. CCI rightly pointed the need to include explanation to reasonableness under Section 3(5)(i). Not only explanation to provision but there is a need of comprehensive guidelines to deal with patent pooling, standard setting, grant back, cross licensing etc. CCI held that it is an anti-competitive activity. UPDF was refrained from indulging in anti-competitive activity and penalty of one lakh each was imposed on 27 UPDF members.

Producers being at the dominant position in the film industry and the sole owner of the copyright over the film, often used to get copyright even on subject-matters which are capable of getting copyright separately, viz. music, lyrics etc. But the producers through the contracts between them and the lyricists and the music directors used to secure royalties over these. To curb this practice and to foster more competition, The Copyright Amendment Act, 2012 inserted provisions to safeguard the interests of the lyricists, musicians etc.[39] It is now mandatory that royalties for the performance of any song or music shall be shared equally with the lyricists and music directors as well when that song is being performed publicly, other than as a part of that

[37]*Supra* note19.
[38]*The Relationship between the Intellectual Property Rights and Competition Law*, available at http://bookshop.blackwell.co.uk/extracts/9780199289387_whish.pdf (last accessed on December 3, 2013).
[39]§18 and 19 of *The Copyright Act*, amended through the Copyright Amendment Act, 2012.

cinematograph film. Thus, now it can safely be inferred that competition is endorsed between the producers and the music directors in event of a song being performed in the public.

RECENT CONTROVERSIES: ROLE PLAYED BY THE COMPETITION COMMISSION

One significant case before the Competition Commission in 2012 was *Ajay Devgan v Yash Raj Films Pvt. Ltd*[40]. The opposite party entered into a tie-in arrangement with a number of single screen theatres. License was given for the rights of their movie 'Ek Tha Tiger' on the condition that the screen owners would also release their forthcoming movie 'Jab Tak Hain Jaan'. This was possible because the opposite party was the sole copyright owners of its movies. The informant alleged that this was violation of Section 4 of the Competition Act, 2002 as the opposite party was abusing its dominant position in the market. Further, the agreement formed between the distributors and the opposite party was barred under Section 3(4). Rejecting this contention, the CCI held that the impugned agreement was purely commercial in nature between parties promoting their economic interests. There was no appreciable adverse effect on competition. The CCI further held that no case could be made under Section 4. No enterprise can be considered to be in a dominant position simply because it is a big player. It can be determined taking into consideration the factors mentioned under section 19 of the Competition Act, 2002.[41]

The most recent controversy involved the Kamal Hassan movie 'Vishwaroopam'. In the case of *Raj Kamal Film International v. M/s Tamil Nadu Theatre Owners Association*[42], the producers of the movie intended to release their movie not only in theatres but also through DTH. But the opposite party passed a resolution *'not to lend co-operation for screening of any film that is released even before it comes to the theatre, through DTH or any other technology.'* The informant's contention is that this abovementioned resolution was in blatant contravention to the provisions of Section 3(1) read with Section 3(3)(b) of the Competition Act, 2002.

[40]Ajay Devgan v. Yash Raj Films Pvt. Ltd, Case Number 66 of 2012 before the CCI.
[41]Includes factors as market share of the enterprise, size and resources of the enterprise, size and importance of the competitors, counterveiling buying power, market structure and size of market, social obligations and social costs etc.
[42]Raj Kamal Film International v. M/s Tamil Nadu Theatre Owners Association, Case Number 01 of 2013 before the CCI.

The CCI observed that *"Technological innovations or utilization of existing technology in a more novel manner is the right of every entrepreneur. Such ventures usually have an effect of enhancing competition and promoting consumer welfare"* which is the primary objective of the Competition law. The CCI held this arrangement to be anti-competitive, limiting the market of exhibition of films in the territory under the jurisdiction of the opposite party.

A recent hue and cry has been raised by the technicians of Bengali feature film as the Bollywood movie '*Gunday*' is being dubbed and is set to release in Bengali. There is no legal hassle in doing this now as the restrictions on dubbing a movie has been done away with. The CCI has asked the Federation of Cine Technicians and Workers of Eastern India not to impose any restriction[43]. But this is indeed not a welcome change for the technicians of Bengali cinema as they are facing tough times and this means loss of work for them.

CONCLUSION

The extravagant Indian Film Industry is no exception to other markets which thrives on competition. Competition brings out the best of anything and thus needs to be ensured for a flexible and dynamic market economy. The Competition law in India would eventually play a major role in the growth and development of the rich Indian Film Industry. Although the Competition Act, 2002 provides exemption to an agreement made under the IP laws from the thwart of section 3, by declaring the arrangements and unreasonable restrictions posed by the different associations in the name of advancement of the film business, eventually endorse the rights guaranteed under the Copyright law in India. The producers can exercise their copyright to the greatest extent as they are made free from all burdens, restrictions and rules of such associations. A balance needs to be maintained in the rules made by these associations. They should not restrict competition but also must warrant the interests of the film fraternity in general and their peer group in particular. Freedom of speech and expression is guaranteed by our Constitution. Cinema being a very strong form of expression should be given the required protection. Diversified views in the form of diversified movies might one day bring us the much awaited Oscar in the Best Foreign Film category.

[43]KhannaRohit and SenZinia, TNN Nov 30, 2013, available at http://articles.timesofindia.indiatimes.com/2013-11-30/kolkata/44595399_1_gunday-bengali-films-ranveer-singh-arjun-kapoor(last accessed on December 8, 2013).

TAX AVOIDANCE IN INDIA: CONFLICT AND CHAOS BETWEEN THE LEGISLATIVE, EXECUTIVE AND JUDICIARY

Neeraj Singh and Ayush Verma[*]

ABSTRACT

Tax avoidance is a very big problem being faced by most of the nations in the present times. While tax avoidance can be described as reducing the burden of tax cast over an entity by using the provisions within the law to one's advantage, it affects revenue generation of the country in a big way. Tax is one of the very important sources of earning for any state throughout the world. The income generated through tax is spent by the states for various purposes like development works, welfare measures for the people, defence of the state and for security of its citizens. Thus as a result of tax avoidance, the income from taxes gets reduced and the above activities get affected.

Tax avoidance generally takes place due to lack of foresightedness of the legislature while framing the laws. Some transactions are kept out of ambit of tax laws and taking benefit of such provisions various entities try to show their income in such a way that taxable income is brought to a minimum level. But it has raised eyebrows of the countrymen as to the tax avoidance in the country and has brought forward the helplessness of the economy and the democracy that India is in securing its own interests at the altars of the foreign investments. To address such problem, tax laws need to be updated and anti-avoidance provisions needs to be incorporated. The laws need to address the problem by looking into the intentions behind the transactions rather than looking at the transaction at its face. Through this paper an attempt is being made to bring out the problem in a comprehensive manner, discuss its various aspects and the possible solutions for the same. Further the various relevant case laws have also been highlighted and the provisions of Special Anti Avoidance Rules and General Anti Avoidance Rules have been mentioned.

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INTRODUCTION

Tax is an obligation which each and every person is bound to pay it to its Government in return for the facilities which are provided by the Government, for example, electricity tax for electricity, water tax for supply of clean water. The term 'Tax' is defined in Black's Law Dictionary as—[1]

> *"A tax is a pecuniary burden laid upon individuals or property owners to support the government, a payment exacted by legislative authority. It is not a voluntary payment or donation, but an enforced contribution, exacted pursuant to legislative authority and is any contribution imposed by government whether under the name of toll, tribute, tallage, gabel, impost, duty, custom, excise, subsidy, aid, supply, or other name".*

In modern times, the entire system is growing rapidly and with the betterment of society this development is also creating some chaos because of which the laws of any country are restricted to the its own jurisdiction and becomes ineffective to deal with those transactions in which parties from different countries are involved. Such causes have led to an increase in the rate of tax avoidance through taking out the transactions from the ambit of the respective laws of the country which results into less collection of taxes.

Indian tax laws have provisions for tax planning; people also go for tax avoidance by using the loopholes and the open doors in the statute itself. Tax evasion is not at all allowed and is strictly punishable with hefty penalty and prosecution with imprisonment and fine.

When cost of tax compliance was a problem, it was tax evasion which ruled the roost. But with the subsequent developments and improvements in the statute which resulted into a decreased cost of compliance, tax avoidance became a problem and huge companies and Multi National

[1] *Black's Law Dictionary* 1628 (4th ed. 1968).

Companies[2] started taking undue advantage of the provisions which provided them routes to do away with taxes.

With the advent of the concept of Double Tax Avoidance Agreement[3], the violation became more brazen and rampant. DTAA could be signed by India with any country as given under section 90 of the Act. It led to treaty shopping and round tripping as many big investing firms opened their offices in the country of benefit, for example, Mauritius to take advantage of the convention[4] and many Indian companies and individuals too started sending their money to such tax havens through complex routes just to invest back to India and take advantage of the treaty provisions.

CHAOS AND CONFLICT IN THE POSITION OF THE GOVERNMENT

The position of the three organs of the Government have further added to the problem as they have themselves got entangled into chaos by taking conflicting opinions amongst themselves and within themselves.

It is a classic case of chaos and conflict among the three instruments of the state viz. legislature, executive and the judiciary, whereby all have shown state of confusion and have confronted each other on regular intervals giving divergent and mutually exclusive views and modicum of thinking on the same. Within the executive itself the confusion and the conflict is more prolonged when the income tax department doesn't want to let go off such huge tax funds out of its hand but the finance ministry and the government as a whole keeps international ties on the priority list and is more than willing to give away huge swathes of fund just to maintain good mutual relations. However what it has always failed to see and appreciate is that the very intention for which tax avoidance treaties were entered into have become frustrated as many MNCs are calling their shots by establishing offices in the benefit country and investing from there, giving tax nowhere and taking all money back to their coffers. At times it has resulted into farce as well.

[2] Hereinafter referred to as MNCs.
[3] Hereinafter referred as DTAA.
[4] *Convention between the Government of Mauritius and the Government of Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains and for the Encouragement of Mutual Trade and Investment*, available at , http://mra.gov.mu/download/Mtius_India.pdf, (last accessed on November 30, 2013)

THE CONFUSION OF THE EXECUTIVE

We saw in the recent past that an egregious Pranab Mukherjee, the then Finance Minister during 2012 Vodafone upheaval and upsetting the mood of the tax collectors by the Supreme Court decision, tried reversing the currents by retrospectively applying the General Anti-Avoidance Rules[5] to make it applicable even on the Vodafone, doing what the Honorable Supreme Court had undone. He showed strong sentiments not to let go off the fund during the troubled times for the economy but twists and turns are bound to happen in a melodrama. God knows what happened behind the closed doors and how in no time the Finance Minister got a more awe striking posting in the awe striking President house at Raisina Hills and the Ministry of Finance went to the Prime Minister, leading to reconsideration of the application of the GAAR (General Anti-Avoidance Rules). A Committee headed by Parthsarthee Shome was appointed which of course, for obvious reasons mooted for postponing GAAR until 2016. The new Finance Minister, Mr. P. Chidambaram, who is known for his investment and development friendly approach, shared the same sentiments and so was the fire evoked by Shri Mukherjee, doused. GAAR has been put to rest in peace until 2016 but who knows what happens then.[6]

It can and should startle people of the country and inquisitive minds as to how there is such a broad conflicting specter within the same ministry led by the same party and able leaders of the same caliber.

Nevertheless, the chaos and conflict at the top echelons has confirmed and raised eyebrows of the countrymen as to the tax avoidance in the country and has brought forward the helplessness of the economy and the democracy that India is in securing its own interests at the altars of the foreign investments.

THE DILEMMA OF THE JUDICIARY

The chaos becomes more pronounced when the stand of the executive is juxtaposed with that of the judiciary. From time to time the stand of judiciary has gone steps further than the executive when it comes to showing conflict of thoughts, opinions, preaching and priorities. Not only has it

[5] Hereinafter referred as GAAR.
[6] http://businesstoday.intoday.in/story/gaar-pranab-mukherjee-amends-rules-investment-avoid-tax/1/24635.html, (last accessed on December 01, 2013)

stood in reverse gear mode *vis-à-vis* the executive, it has run against its own senses and established principles. Sometimes it preached something, in other cases it affirmed its preaching, and in many other cases, it stood to say in complete contradistinction to itself.

The journey can be traced from the famous case of *The Commissioners of Inland Revenue (IRC) v. His Grace the Duke of Westminster*[7], where the Privy Council said that tax planning could be done to reduce ones tax burdens. The payments were not remuneration for services. Three of the five Lords concluded that the letter was not a contract, only an expression of hope or anticipation and four of the five Lords concluded that, even if it was a contract, it was nothing more than a contract that the person's remuneration for future services will not be full remuneration but only the additional sum referred to in the letter. The fifth Lord, in dissent, concluded that the deed and letter should be viewed together as a simply maintaining the existing contract of service rather than radically altering it.

All of the Lords rejected the proposition that in revenue cases there is a doctrine that the court may ignore the legal position and regard the substance of the matter. The substance is that which results from the legal rights and obligations of the parties ascertained upon ordinary legal principles.

In *Jiyajeerao Cotton Mills Ltd. v. Commissioner of Income Tax and Excess Profits Tax, Bombay*[8], it clarified its position by adding a rider that though one could plan his taxes, it could be so done only within the legitimate four walls of the law and held, that every person is entitled to so arrange his affairs as to avoid taxation but the arrangement should be real and genuine and not a sham or make-believe.

Then came the landmark case of the *McDowell and Co. Ltd. v. Commercial Tax Officer*[9], where the Supreme Court of India laid down the Look through test and showed seriousness on the front of tax avoidance. It established the 'look through rule' and differentiated it with the 'look at rule' and said that it will look through the transaction to ascertain its true motive and if the motive was

[7] The Commissioners of Inland Revenue (I.R.C.) v. His Grace the Duke of Westminster, [1936] A.C. 1
[8] Jiyajeerao Cotton Mills Ltd. v. Commissioner of Income Tax and Excess Profits Tax, Bombay, A.I.R.1959 S.C. 270
[9] McDowell and Co. Ltd. v. Commercial Tax Officer, 1986 A.I.R. 649 S.C.

to avoid taxes, it would tax such transactions. O. Chinnappa Reddy, J., Supreme Court of India stated in the present case that—

> *"We now live in a welfare state whose financial needs, if backed by the law, have to be respected and met. We must recognize that there is behind taxation laws as much moral sanction as behind any other welfare legislation and it is a pretence to say that avoidance of taxation is not unethical and that it stands on no less moral plane than honest payment of taxation.... It is neither fair nor desirable to expect the legislature to intervene and take care of every device and scheme to avoid taxation. It is up to the court to take stock to determine the nature of the new and sophisticated legal devices to avoid tax and... to avoid the devices for what they really are and to refuse to give judicial benediction."*

But upsettingly came a case that almost killed the beautiful and visionary approach of McDowell which was of far reaching significance and in the interests of the revenue. The case was that of *Union of India & Anr. v. Azadi Bachao Andolan & Anr.*[10], where the supreme court contradicted its own stands and laid down that if the avoidance of taxes was taking place within the limits of tax avoidance treaties, it would not look through the transaction to ascertain the true motive. This was a myopic vision as it opened clandestine doors for the fund swindlers across the world that had once been forcefully shut upon them. It meant that the Court would not look through the transaction even it meant huge tax avoidance which had nothing to do with the enhancement of the mutual relationships between the treaty countries. Treaty shopping was given a thumps up by the decision of the court. The Court held Treaty Shopping valid as—

> *"There is elaborate discussion in Baker's treatise on the anti abuse provisions in the Organization for Economic Co-Operation Development* [11] *model and the approach of different countries to the issue of 'treaty shopping'. True that several countries like the USA, Germany, Netherlands, Switzerland and United Kingdom have taken suitable steps, either by way of incorporation of appropriate provisions in the*

[10] [2003] 263 I.T.R. 706 S.C.
[11] Hereinafter referred as OECD.

> *international conventions as to double taxation avoidance, or by domestic legislation, to ensure that the benefits of a treaty/convention are not available to residents of a third State. Doubtless, the treatise by Philip Baker is an excellent guide as to how a State should modulate its laws or incorporate suitable terms in tax conventions to which it is party so that the possibility of a resident of a third State deriving benefits thereunder is totally eliminated. That may be an academic approach to the problem to say how the law should be. The maxim judicisest jus dicere, non dare pithily expounds the duty of the court. It is to decide what the law is, and apply it; not to make it."*[12]

Then came the landmark case of *Vodafone International Holdings B.V. v. Union of India (UOI) & Anr.*[13], which reaffirmed the stand of the judiciary taken in the Azadi Bachao Andolan Case and applying the same principle, it said that Vodafone could not be taxed by the Indian authorities.

The IT department had considered that the transfer of capital assets by the Hutch to the Vodafone, both foreign companies, and the transfer itself took place outside India, had its effect in India and hence the income could be deemed to accrue or arise in India under section 9(1)(i) of the Income Tax Act, 1961. And that it was the responsibility of the Vodafone to deduct TDS under section 195 of the Act while making the payment to the Hutch. Since Vodafone had not done so, it was an assessee in default and hence it was now its liability to pay the tax under section 201 of the Act.

However Supreme Court didn't agree to its arguments and said that the IT department could not tax a foreign transaction. It was also held that-

> *"Situs of shares situates at the place where the company is incorporated and/or the place where the share can be dealt with by way of transfer. CGP share is registered in Cayman Island and materials placed before us would indicate that*

[12] Union of India &Anr. v. Azadi Bachao Andolan & Anr., [2003] 263 I.T.R. 706
[13]Vodafone International Holdings B.V. v. Union of India & Anr., [2012] 1 J.T. 410

Cayman Island law, unlike other laws does not recognize the multiplicity of registers. Section 184 of the Cayman Island Act provides that the company may be exempt if it gives to the Registrar, a declaration that "operation of an exempted company will be conducted mainly outside the Island". Section 193 of the Cayman Island Act expressly recognizes that even exempted companies may, to a limited extent trade within the Islands. Section 193 permits activities by way of trading which are incidental of off shore operations also all rights to enter into the contract etc. The facts in this case as well as the provisions of the Caymen Island Act would clearly indicate that the CGP (CI) share situates in Caymen Island. The legal principle on which situs of an asset, such as share of the company is determined, is well settled. "

CRITICISM

I stand critically opposed to the view taken by the Apex court as it has taken a myopic view on the point. It would have been more ideal for it to remain stuck to its core principles it preached in the earlier cases. When in an earlier case it had taken the noble mission to look through transactions to detect sham and in genuine transactions and showed impatience and strictly rejected as well the idea of tax avoidance, it shows no line of logic to prevent oneself from piercing the veil and looking through to maintain the correct practices of the business and impart holistic propriety.

The court would have only helped maintain and propagate the ethics had it carried forward its pious stand and would have served the nobler objectives of the preamble of the constitution, of which it is the guardian and the protector as the preamble itself celebrates and behold the idea of justice in its highest regard of which social and economic justice are the main components. It does no good to the cause of the economic justice where an outside player takes away the money in huge margins without paying legitimate taxes, which otherwise could have been used for the upliftment of the masses in need. Thus, it is wrong on part of the executive as well as the courts to neglect and encourage such tax avoidance practices. They should be checked and effective and uniform system of regulation and management should be brought in place so that this rampant misuse doesn't take place putting the revenue interests of the country at stake.

SOLUTIONS TO THE PROBLEM

One of the best solutions would be to bring GAAR as soon as possible. It will effectively check such avoidance practices. The Direct Tax Code (DTC) which is on anvil right now and is expected to simplify the taxation structure like never before shall incorporate such GAAR provisions and they must be made complementary to each other so that both could be harmoniously interpreted and be used effectively to look through transactions in order to save the revenue from being avoided by companies guided by the ulterior motives of profit and saving taxes by hook or by crook, more so by using the loopholes of the law to their advantage. DTAA will have the investors claiming treaty benefits under the DTAA to a commercial substance and bona fide business purpose test. Under GAAR, Indian tax authorities will be empowered to declare any "arrangement" as an "impermissible avoidance arrangement" if an ownership or investment structure has been implemented that, in whole or in part, has the main purpose of obtaining a "tax benefit". The burden of proof will be on the investor whenever an investment structure is challenged under GAAR, as an "arrangement" will be presumed to be for obtaining tax benefits unless the investor demonstrates that obtaining a "tax benefit" was not the main objective.

It will effectively curb the practice of treaty shopping which is now so common in Mauritius where the companies of all hues have opened offices, in fact brazenly in small dingy rooms and invest in India from there in order to take benefit of the treaty between India and Mauritius which says that Any Capital Gains Tax arising out of capital asset transfer in India will not be taxed in India. The reality is that the capital gain is not taxable in India. Hence treaty shopping takes place.

Limitation on benefit (LOB) clause will be one more effective tool in combating such practices. We have such clauses entered into DTAAs with various countries like Singapore.

CONCLUSION

With about 2,976 bilateral tax treaties concluded by the end of 2010 (UNCTAD, 2011), these treaties represent the immense majority of all international tax arrangements. Countries in Asia and the Pacific intensified their tax treaty activity in the 1980s. During the 1960s, they had

signed only 29 tax treaties and hence had a very low average number of treaties per country in the region. By the end of 2002, countries in the Asia and Pacific region were party to 842 bilateral tax treaties (an average of 15 treaties per country) – more than any other developing region (UNCTAD, 2003, p. 48). The propensity to sign such treaties varies greatly. Among developing countries and economies in transition, India was the leader for Double Taxation Avoidance Agreements in 2002.[14] This very fact is sufficient enough to understand that there is a telling and compelling urgent need to have such Clauses inserted in the DTAAs otherwise the level of huge swindling of funds in from of tax avoidance will severely prejudice the interests of the revenue of the country and lead to an unmitigated challenge to the sovereignty of the state as the investment companies could keep creating pressures for advantages and would in fact dare to hijack the policy making of the country.

[14]World Investment Report 2011, *Non-Equity Modes of International Production and Development*, UNCTAD available at http://unctad.org/en/docs/wir2011_embargoed_en.pdf., (last accessed on December 01, 2013)

CORPORATE GOVERNANCE (2011 – SIXTH EDITION). BY DR. H.R. MACHIRAJU

HIMALAYA PUBLISHING HOUSE PVT. LTD., "RAMDOOT", DR. BHALERAO MARG, GOREGAON, MUMBAI – 400004

Pratiti Nayak[*]

The Author of the book is a financial economist. The book under review is a simple and crisp presentation of the subject-matter that is Corporate Governance. The book in essence deals with the corporate form of organization, nature & systems of corporate governance, role of corporate boards, board committees, and shareholders in corporate governance, corporate social responsibility and other aspects as well. The author explains the different aspects of Corporate Governance in a very lucid and friendly manner. The book in short gives us an idea about the varied intricacies of the concept of corporate governance.

Corporate governance deals with relations between board, management and shareholders of a corporate body. This book attempts to establish the relationship between the three anchors of corporate governance and rates the present system of governance in practice. It also suggests certain governance reforms in India as well as U.S. The author tries to throw some light on each of the aspect of corporate governance.

The book is divided into 11 chapters dealing with the various aspects of corporate governance. Equal importance has been given to each of the chapters. The author has beautifully dealt with the different attributes of corporate governance in each chapter in brief.

Chapter first titled as, "Market Economy and Corporate Form of Organization" discusses the laissez-faire principle of economics by Adam Smith which holds that individuals in the selfish pursuit of their own personal good are led by an indivisible hand to achieve the best good for all. The author talks about benefit of free trade & private enterprise in the sense that economic liberalism functions best with checks and balances but it also needs regulation & oversight. The expansion of political & civil liberty has led to the growth of economic liberty. But the results of such economic & financial boom in U.S. has produced extreme results of pile of corporate scandals which severely diminished the retirement savings of millions of ordinary people and led to the loss of billions of shareholder dollars. The author further describes the

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business corporation as an integral part of capitalism providing the nature of corporate firm from several perspectives: the contract view, transaction cost approach, corporate control and evolutionary view. He further discusses governance issues of corporate in the context of principal agent model, mediating hierarchy approach, managerial capitalism & financial market dominance to ensure efficient use of resources. The author has managed to give a fair explanation of the link between the growing market economy & the growth of corporate firms and the requirement of governance techniques in such firms in the wake of growing capitalism. But at the same time the author has failed to provide a clear idea about the various aspects of market economy & capitalism which makes it difficult for the readers having no background knowledge of economics.

Chapter second captioned as, "Nature & Systems of Corporate Governance" discusses the definition & scope of corporate governance. The author describes corporate governance as a mixture of systems and processes which ensure the efficient functioning of the companies in a transparent manner for the benefit of all the stakeholders with focus on relationship between owners & board in directing & controlling companies as perpetual legal entities. He further discusses the normative theory of corporate governance in the light of morality, competition, shareholder democracy & participation of stakeholders. However, the author is of the view that corporate governance must be based on a genuine respect for business ethics & values. He also throws some light on the OECD principles of corporate governance[1], certain aspects of the report of Cadbury Committee, 1991 in U.S.[2], the importance of the recommendations of Committee on Corporate Governance (under the Chairmanship of Kumar Mangalam Birla) 1999[3] & other committee reports also.

Chapter three very aptly uses the caption "The Three Anchors of Corporate Governance" to describe the relationship between the three critically important organs of a corporate, that is, the board of directors, the management & the shareholders to achieve an effective corporate governance model. He points out some of the transparency, accountability & disclosure requirements of each of the anchors. But the author fails to provide to the readers a proper & clear understanding of the relationship between the three with respect to corporate governance mechanism.

[1] H.R. Machiraju, Corporate Governance, 19 (6th ed., Himalaya Publishing House, 2011).
[2] *Id*., at 26.
[3] *Id.*, at 31.

The Author very lucidly explains the importance & functioning of the corporate board and its various committees like the audit committee and the remuneration & nomination committees in ensuring effective and efficient corporate governance in a company in its Chapters on "Central Role of Board in Corporate Governance" & "Board Committees". He also discusses some statutory guidelines with respect to the same, like SEBI Guidelines, SEBI Committee Report on Corporate Governance (2003)[4], The Conference Board CPTPE (2002) Responsibilities[5], etc.

Chapter on "Management" provides an insight to the readers regarding nature of Board & Management, Disclosures relating to management and many other aspects. Shareholders being the creditors & owners of the company have not been given proper importance by the author with respect to their role in the context of corporate governance. However, the author has thrown some light on democracy, grievances & transparency requirements of the shareholders.

Corporate Social Responsibility being one of the important aspects of an effective corporate governance model has been given a little importance by the author under a separate chapter quoting that "value based management holds that the social mission of corporation is to make as much money as possible for its owners while conforming to the rules of society."[6]

Chapter 10 titled "Rating Corporate Governance" provides an idea to the readers regarding the unique model launched by two credit rating agencies of SEBI for rating the level of corporate governance in an enterprise.

The author in his concluding chapter on "Reform of Corporate Governance" enumerates certain governance reforms in India & U.S. in the wake of growing number of corporate scandals. Further he suggests for a separation of board & management and other reforms in corporate board & its performance for a more strong, efficient and effective corporate governance system.

The Author has made a good attempt to look at the concept of Corporate Governance from a student's perspective in a very simple manner. The book makes us to understand the relationship between the economy, corporate firm, its different organs and the necessity of an effective corporate governance model for the development of the corporate world in its truest sense. The book amongst many other aspects also talks about models & systems of corporate

[4] Naresh Chandra Committee Report, 2003.
[5] *supra* note 1 at 87.
[6] *Id*., at 110.

governance and the attempts at reform in UK & USA which have market driven systems. However, a limitation to the book is that it is not self-sufficient. It is very difficult for a student with no economics or financial knowledge background to understand the context of the book. It has to be read with other books on Corporate Governance so as to have a clear understanding of the theoretical as well as practical aspects of the subject. The relevant law on the subject has not been given due space. If the relevant law is analyzed together with the practicalities of the subject along with some case studies, the book will prove immensely useful to law students, management students and other readers as well.

The book has a good get up. It is almost free from spelling mistakes. It is nicely printed & reasonably priced.

BHARAT ALUMINIUM CASE:

PROSPECTIVE DEBACLE OF DOMESTIC ARBITRATIONS

Anamika and Nikhil Varshney[*]

ABSTRACT

The year 2012 began with high expectations from the Indian judiciary when the five judges Bench of Apex Court sat to meticulously revisit its 2002 ruling in Bhatia International v. Bulk Trading SA case which had created lot many hassles in international commercial arbitrations. The international commercial community around the globe since then had tried to dodge India as a destination for arbitration because of the law laid down in Bhatia International judgment. The Supreme Court which embarked upon a journey in the nick of time to look thoroughly into the major problems surrounding international arbitrations in India overruled Bhatia International judgment and categorically held that Part I and Part II of Arbitration & Conciliation Act, 1996 are mutually exclusive. This article broaches how far the Supreme Court has been able to mend the situation both at domestic and international arena. In its endeavour to make India an arbitration-friendly country internationally, the Court seems to have tinkered with the firmly established position regarding domestic arbitrations. The Apex Court has wobbled the entire jurisprudence on the issue of triggering of jurisdiction of a court. This article rakes up the issue of 2012 judgment being fatal to domestic arbitrations and gauges what ramifications the present ruling is going to have on domestic arbitrations. With one stroke of the pen, on one hand where Apex Court seems to propel India to be an arbitration-friendly nation regarding international commercial arbitrations while on the other has ruffled the hair of settled position on domestic arbitrations.

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INTRODUCTION

The international commercial community closely looked at the legal happenings in the Supreme Court of India when the proceedings in *Bharat Aluminum* case were going on in the court as the five judges Bench was anticipated to exorcize the effect of *Bhatia International* ruling. And the anticipation turned to reality when on 6th September 2012, the Supreme Court pronounced its judgment in *Bharat Aluminium Company &Ors. v. Kaiser Aluminium Technical Service, Inc. &Ors.*[1] penned down by Justice S.S. Nijjar on behalf of five judges Constitutional Bench overruled *Bhatia International* judgment and categorically held that Part I of Arbitration and Conciliation Act, 1996 is inapplicable to international commercial arbitrations and the Supreme Court conclusively dispelled the ambiguity on 'the extent to which the judiciary can intervene in the enforcement of foreign arbitral awards in India'. India had endured a gruelling ordeal since the passing of *Bhatia International* judgment. The *Bharat Aluminium* judgment was lauded for the Supreme Court in its stride to make India an arbitration-friendly nation succeeded to a certain extent and with this decision, the hassles that parties used to have because of the *Bhatia International v. Bulk Trading SA*[2]judgment would get away. With the new judgment, India is poised to be on an arbitration spree and this 2012 judgment is expected to boost foreign investment flowing into India and has hit the nail on the head according to legal fraternity.

But everything is not well with the judgment as it seems so at a *prima facie* glance. The *Bharat Aluminium* ruling, which was the need of the hour considering the nature of commercial transactions at international level, has fiddled with the position of law regarding the triggering of jurisdiction of a particular court of law which was developed eons ago. The settled position of law that a court will have jurisdiction to entertain a particular case if the *cause of action* arises in that court's territorial limits has been toppled by the *Bharat Aluminium* ruling and this is evident from the paragraphs 96, 97 and 98 of the judgment. The much touted judgment is going to draw flak as in an attempt to mend the position with regard to international commercial arbitrations, the Apex Court has perturbed the settled principles of domestic cases (arbitrations). The judgment needs to be criticized as it has shaken the enduring principle of law on the jurisdiction of a court of law and more trouble seems to be in the offing which can peter out the impact of *Bharat Aluminum* ruling.

[1]2012 (8) SCALE 333.
[2]AIR 2002 SC 1432.

BALCO JUDGMENT ON DOMESTIC ARBITRATIONS

The judgment truly can cure all the ills related to international commercial arbitrations and in legal terminology, arbitrations that fall under Part II of the Indian Arbitration & Conciliation Act, 1996. The economically beneficial judgment is destined to boost commercial transactions of Indians with persons across the globe and will rope in foreign investment according to prophecy made by legal pundits. *So far so good*; but the judgment has thwarted the legal principles on which the jurisdiction of a court of law rests. The Apex Court in paragraph 96, 97 and 98 seems to have upset the entire jurisprudence that goes behind vesting the jurisdiction in a court of law. The judgment appears to place a jinx on the domestic arbitrations. The Apex Court's attention needs to be driven towards this aspect so as to eschew the domestic arbitrations' fiasco. The law so laid down in *Bharat Aluminium* can run the entire place into a quagmire and domestic arbitrations in India could enter into an unending morass.

According to the Hon'ble Supreme Court, s. 2(e) of the Arbitration & Conciliation Act, 1996 has to be construed keeping in view the provisions in s. 20 of the 1996 Act which give recognition to *'party autonomy'*. The Apex Court held that the parties may choose a neutral place as place of arbitration unrelated to the entire contract between the parties and the courts where the arbitration takes place will have jurisdiction to exercise supervisory control over the arbitral process. The Supreme Court further goes on to give an illustration, which if brought into practice, will throng the courts with multiple applications under Arbitration and Conciliation Act, 1996; more particularly with courts in metropolis where one finds courts with better infrastructure and courts being tech-savvy enables the presiding officer of the court to pass the judgment in no time. The illustration given by Supreme Court in para. 96 goes like this:

> *If the arbitration is held in Delhi, where neither of the parties are from Delhi, (Delhi having been chosen as a neutral place as between a party from Mumbai and the other from Kolkata) and the tribunal sitting in Delhi passes an interim order Under s. 17 of the Arbitration Act, 1996, the appeal against such an interim order under s. 37 must lie to the Courts of Delhi being the Courts having supervisory jurisdiction over the arbitration proceedings and the tribunal. This would be irrespective of the fact that the obligations to be performed under the contract were to be performed either at Mumbai or at Kolkata, and only*

> *arbitration is to take place in Delhi. In such circumstances, both the Courts would have jurisdiction, i.e., the Court within whose jurisdiction the subject matter of the suit is situated and the courts within the jurisdiction of which the dispute resolution, i.e., arbitration is located.*

If one goes by the illustration, it leads to a grim conclusion in one's mind that even by the mutual consent, parties can vest jurisdiction with a court of law which has not even a miniature role to play in the entire contract that was signed between the parties. The interpretation, so given by the Hon'ble Apex Court only confounds the existing perplex situation. Going by the view of the Court, parties can now move to a court of law where neither the cause of action arose, nor the parties reside; but only the arbitration proceedings were conducted. The judgment is unfathomable considering the well settled position of law in the extant cases and statutes in this regard. The rhetoric of Supreme Court if turned into action would attract lots of ramifications, more particularly for the courts in metropolitan cities. What will follow is 'n' number of applications being filed under Arbitration and Conciliation Act, 1996 in the courts in metro cities. The parties in their contract would prefer and would thus mutually agree to have the arbitration proceedings in Delhi or Mumbai or any other metro city in case of dispute between them for the very reason that the courts situated in big cities have better infrastructure and are quite technology friendly. Thus, it is possible to get an order from those courts at quicker rate when compared to courts in other places. Also, by virtue of the present ruling, it is immaterial if the court which has been approached actually has the jurisdiction to entertain the application under Arbitration & Conciliation Act, 1996 i.e. it is now insignificant if really the pre-requisites of triggering of the jurisdiction of a court have been fulfilled. The requirement of arising of cause of action in the approached court's jurisdiction or residence of any of the parties in that place whose court's jurisdiction is being triggered need not now be looked into. If the position as laid down in *Bharat Aluminium* case is not nipped in the bud, then the BALCO ruling, *in effect*, would go astray and its impact would fizzle out in domestic domain.

It is palpable from the data available at the Delhi courts website that the courts have been engulfed in dealing with arbitration matters as a whopping *5,655* number of cases

(applications) are pending in courts in Delhi[3] under Arbitration and Conciliation Act, 1996 as on July 1, 2012.

GENERAL UNDERSTANDING OF CAUSE OF ACTION

It may be defined as the fact or facts which entitles a party to seek redressal in a court of law. The term connotes every fact which if traversed, it would be necessary for the plaintiff to prove in order to support his right to the judgment of the court.[4]

The expression 'cause of action' has acquired a judicially settled meaning. In the restricted sense, 'cause of action' means the circumstances forming the infraction of the right or the immediate occasion for the action. In the wider sense, it means necessary conditions for the maintenance of suit, including not only the infraction of right, but the infraction coupled with the right itself. Compendiously, the expression means every effect which it would be necessary for the plaintiff to prove, if traversed, in order to support his right to the judgment of the Court. Ever fact which needs to be proved, as distinguished from every piece of evidence which is necessary to prove each fact, comprises 'cause of action'. It is to be left to be determined in each individual case as to where the cause of action arises.[5]

The well-established principle of law that jurisdiction is conferred upon courts by the legislature only and the consent of parties cannot therefore confer jurisdiction upon a Court when it does not possess is thus tumbled by the 2012 ruling and the ruling is fraught with repercussions.

SETTLED LAW ON CONFERRING JURISDICTION UPON COURT OF LAW

The present judgment flouts the ensconced law on the point of conferring jurisdiction on a court of law which had been time and again re-affirmed by the various courts across India. The pertinent judgments on this point are herein below discussed.

[3]Available at http://delhicourts.nic.in/Stats_01072012.htm as last accessed on 04/11/2013.
[4]Ram Awalamb v. Shankar, AIR 1969 All 426, Ujjal Taluqdar v. Netichand, AIR 1969 Cal 224.
[5]Rajasthan High Court Advocates Association v. Union of India, (2001) 2 SCC 294.

In the case of *Harshad Chiman Lal Modi v. DLF Universal and Anr.*,[6]Hon'ble Supreme Court while upholding the jurisdiction vested with the Delhi courts as per the contract between the parties as part of cause of action arose in Delhi; succinctly affirmed the settled position that *if a particular Court does not have any jurisdiction to deal with the matter and no part of cause of action has arisen within the jurisdiction of that Court, the parties by their consent and mutual agreement cannot vest jurisdiction in the said Court.* Thus, a clause vesting jurisdiction on a Court which otherwise does not have jurisdiction to decide the matter, would be void as being against the public policy.

It is apt to mention here the in the case of *Rites Ltd. v. Ramjee Power Construction Ltd.*,[7]Hon'ble Delhi High Court succinctly held that;

> *"parties by a consent cannot confer jurisdiction by way of an agreement on a Court which otherwise does not possess such jurisdiction under the 1996 Act. Parties to arbitration agreement, therefore by consent cannot confer jurisdiction on a Court where no part of cause of action accrued. It is to be seen, if any part of cause of action arose so as to vest jurisdiction in that Court.*"

The case of *State of Orissa v. DurgaCharanRoutray*[8] is noteworthy at this juncture wherein Hon'ble Orissa High Court did not admit the arbitration petition u/s 34 of the 1996 Act for the reason of lack of territorial jurisdiction. The Hon'ble High Court held that;

> "*it is well settled in law that the concerned Court, gets its jurisdiction to deal with only those disputes which arise within its territorial jurisdiction*".

In the case of *Rajasthan State Electricity Board v. Universal Petrol Chemicals Ltd.*, [9] Hon'ble Apex Court held that an analytical look at the provisions of Arbitration Act make it explicitly clear that any application in any reference, which thus includes an application under s. 20 of the Act could or should be filed in a court competent to entertain such proceeding and *having jurisdiction to decide the subject* of the reference. The Supreme Court further held that the jurisdiction cannot be given to a court which does not have jurisdiction otherwise on the subject matter as per the provisions of Code of Civil Procedure, 1908.

[6](2005) 7 SCC 791.
[7]High Court of Delhi at New Delhi, OMP No.116/2006, decided on 21st August, 2009.
[8]AIR 2010 Ori 89.
[9](2009) 3 SCC 107.

In *Pacific Greens InfraconPvt. Ltd. v. Senior Builders Ltd.* case,[10] Hon'ble Delhi High Court dealt with an application under s. 9 of Arbitration & Conciliation Act, 1996 which was filed to restrain Respondent from selling, transferring, disposing of or alienating or creating any third party interest with respect of property in dispute. Respondents raised issue of jurisdiction of Court to entertain petition. Petitioner averred that Court would have jurisdiction in view of arbitration clause entered into between parties and fact that contract between parties was signed within jurisdiction of Court and also that both parties are having their offices and business within jurisdiction of Court. Hon'ble Delhi High Court while dismissing the petition held that merely because parties have chosen place of arbitration which is within jurisdiction of Court would not mean that Courts at such place will have jurisdiction in respect of application filed under s. 9. The Court stated that s. 2(1)(e) read with s. 9 makes it clear that in order to have jurisdiction to decide application under s. 9, the*Court entertaining application should be the Court which has power to entertain suit on facts* as mentioned in application under s. 9, and Court is competent to give relief in suit Court would have no territorial jurisdiction since subject matter of the suit is immovable property and property is situated outside jurisdiction of Court.

In the case of *Executive Engineer &Ors. v. YoginderSarin,*[11]Hon'ble Punjab & Haryana High Court while dealing with a revision petition against award passed by arbitrator held that Court will have jurisdiction where even fraction of cause of action has arisen; thus the Hon'ble court made it clear that the principles of cause of action entailed in Code of Civil Procedure, 1908 are very well applicable to arbitration cases. *Furthermore*, the Court also categorically stated that s. 20(c) C.P.C, 1908 is based on broad principle so as to avoid inconvenience to the parties.

The bonhomie between arbitration and subject matter of suit can be gauged from the fact that under the Arbitration Act, 1940, the definition of 'Court' as provided in s. 2(1)(c) of then Act was a Civil Court having jurisdiction to decide the questions forming the subject- matter of the reference if the same had been the *subject- matter of a suit*, but does not, except for the purpose of arbitration proceedings under s. 21, include a Small Cause Court. Thus, it is manifest that jurisdiction of a court of law in an arbitration application rests on the question of

[10]159 (2009) DLT 130.
[11] (2000) 126 PLR 813.

subject matter of suit. This logically leads to a conclusion that cause of action is not a bizarre element for arbitration cases.

Case of *M/s Elder Telecom Ltd. v. Union of India*[12]is notable here wherein Hon'ble Punjab & Haryana High Court held that "*where no part of cause of action has accrued within the territorial jurisdiction by a particular court, that Court would not have jurisdiction.*" On the similar lines in *M/s Belliss India Ltd. v. U.P. State Sugar Corporation Ltd.,*[13]Hon'ble Delhi High Court gave effect to the exclusion clause in the contract as per which only the High Court at Allahabad had jurisdiction with exclusion of all other Courts because of the very reason that part of cause of action arose in Uttar Pradesh.

The case of *JatinderNath v.Chopra Land Developers Pvt. Ltd. and Anr.*[14]is of much significance. The Supreme Court addressed itself on the question of lack of territorial jurisdiction in the context of an agreement between the owner of a plot of land and the developer. The plot of land was situated within the territorial jurisdiction of Delhi, whereas the agreement was executed between the parties at Faridabad, Haryana. The appeal was brought before the Supreme Court against the judgment of the High Court of Punjab & Haryana, whereby it upset the judgment passed by the Additional Civil Judge, Faridabad by which an application filed by the developers, under s. 14 of the Arbitration Act, 1940 for seeking enforcement of an award rendered by the Arbitrator, was dismissed for 'want of jurisdiction'. The Supreme Court held that the agreement in question was purely a development agreement, thus it was observed that it cannot be stated that the Courts at Faridabad had no jurisdiction to make the award rendered by the Arbitrator . It is noteworthy that though the Apex Court stated that Faridabad court had jurisdiction, it was only on the basis of the special kind of contract (development contract) that was entered into by the parties. As development contract encapsulates issues like rendition of accounts in it; which is why Faridabad court was vested with the jurisdiction by Hon'ble Apex court. The Court in the instant case too did not do away with the C.P.C mandate as part of cause of action (issue of rendition of accounts which are imbibed in development contracts) arose in Faridabad, thus Faridabad court was granted jurisdiction. Relying on the *Jatinder Nath*case, Hon'ble Delhi High Court in the case of *Suresh Jain v. Dinesh Kumar*[15]held that the Delhi court has jurisdiction as part of cause of action arose within local limits of Delhi court. These raft of cases makes the fact

[12]1993 (1) C.L.J. 762.
[13] 159(2009)DLT 595.
[14]AIR 2007 SC 1401.
[15]AIR 2008 Del 127.

palpable how important is the issue of cause of action even in arbitration matters and this established principle cannot be shattered, which has been so done by *Bharat Aluminium* ruling and thus requires reconsideration.

It is worthwhile to mention here the case of *Pratap Electrical & Co. v. Asea Brawn Boveri*,[16] wherein the court held that the deeming clause contained in the agreement ousting the jurisdiction of Jharkhand Court and conferring the jurisdiction to the Court at Bangalore cannot override the provision of s. 42 of the Act of 1996. The Hon'ble court further held that *"A conjoint reading of the definition of Court as given in s. 2(e) and s. 42 of the Act, leaves no mind of doubt that only one Court, namely, the Civil Court of original jurisdiction or the High Court in exercise of its ordinary original jurisdiction shall have the jurisdiction to entertain application in respect of disputes and differences forming subject matter of the arbitration."*

Likewise, in the case of *Shaw Wallace and Co. Ltd. v. M.P. Beer Products Pvt. Ltd.*[17] wherein Hon'ble Delhi High Court emphatically stated that when a Court had no jurisdiction at all in the matter, by consent the parties cannot confer jurisdiction. Only that Court would have jurisdiction which according to law has jurisdiction.

It is humbly submitted that these plethora of judgments hold firm the principle that consent of parties cannot vest jurisdiction with a court which does not have it. The paragraphs 96-98 of *Bharat Aluminium* judgment dazzles to frustrate this principle. It is respectfully submitted that the author flunks to agree with the Hon'ble Supreme Court on this point and cannot connive with the court to annihilate the domestic arbitrations.

CRITICAL APPRAISAL

An agreement between parties is not above the law of the land. Arbitration spawns out of s. 89 of the Code of Civil Procedure and thus rules under C.P.C are very well applicable to arbitration matters though remaining in dormant position. Courts have held in catena of cases that provisions of Arbitration and Conciliation Act, 1996 are to be read in consonance with provisions of Code of Civil Procedure, 1908. This has been recently held again by Hon'ble

[16] AIR 2005 Jhar95.
[17] 149(2008)DLT391.

Bombay High Court in the case of *National Commodity and Derivative Exchange Ltd., Mumbai v. Indian Exchange of Metal Ltd., Ghaziabad*[18] More so, Hon'ble Supreme Court in the case of *Hakam Singh v. Gammon India Limited*[19] even stated that the Code of Civil Procedure in its entirety applies to proceedings under the Arbitration Act. When a civil court is approached for granting relief by a party, it is the C.P.C, 1908 wherefrom the court derives its jurisdiction; so even when a party to arbitration approaches court, it is C.P.C whose rules would determine the court's jurisdiction; considering the fact that arbitration stems out of s. 89 C.P.C which got its Supreme Court's approval in the *Salem Advocate Bar Association v. Union of India*[20]case and C.P.C emphatically in its provisions from s.16-20 states that only those courts can have jurisdiction in a particular matter where the parties reside or the cause of action arise. Now when none of them are the components and the parties consent to vest jurisdiction with 'x' place's court, such contract falls on its face taking into consideration the stern rules of C.P.C in this regard.

It gets important to put forth s. 2(1)(e) of the Arbitration and Conciliation Act, 1996 which the Supreme Court has given a grim dimension.

s. 2(1) (e) - "Court" means the principal Civil Court of original jurisdiction in a district, and includes the High Court in exercise of its ordinary original civil jurisdiction, having jurisdiction to decide the questions forming the subject- matter of the arbitration if the same had been the subject- matter of a suit, but does not- include any civil court of a grade inferior to such principal Civil Court, or any Court of Small Causes.

The Apex Court in paragraph 97 of the judgment relies on the terms "*subject matter of arbitration*" used in s.2(1)(e) of the 1996 Act but it is humbly submitted that court failed to consider wherefrom the entire Arbitration & Conciliation Act, 1996 derives its authority from; it is undoubtedly s. 89 of the Code of Civil Procedure, 1908. Tracing back the history of arbitrations in India; earlier arbitrations were governed by the Indian Arbitration Act, 1859 along with the Second Schedule to the Code of Civil Procedure. It would not be wrong if it is so said that, Arbitration & Conciliation Act, 1996 is a *protege* of Code of Civil Procedure, 1908 and this is evident from *Salem Bar Association* judgment (supra) of the Apex Court. The Court's view that "subject matter of arbitration" stands on a different footing than that of "subject matter of

[18]In The High Court of Judicature at Bombay, Ordinary Original Civil Jurisdiction, Arbitration Petition (L) NO.280 of 2012.
[19]AIR 1971 SC 740.
[20]2003 (1) SCC 49.

suit" is appreciable but is fallacious for the very reason that s. 2(1)(e) pronounces that "'court' means court having jurisdiction to decide the questions forming the subject- matter of the arbitration if the same had been the subject- matter of a suit". Interpreting the words literally, 'court' means that court of law which would be having jurisdiction if the matter is directly brought before the civil court (i.e. if there exists no arbitration agreement between the parties). It is trite to mention here that had there been no agreement between the parties to settle the disputes before the arbitrator/arbitral tribunal, then the aggrieved party would have directly approached civil court of law as per provisions of Code of Civil Procedure which in s.16-20 states that only court in whose jurisdiction the cause of action arose or the parties to the proceedings reside would have the jurisdiction. It can be very safely concluded from s.2(1)(e) that in arbitration petitions, as the matter is first referred to arbitration by the parties and civil court is approached only at later stage for some relief (under s. 9 or 34 or 37 of the Arbitration & Conciliation Act, 1996); thus the term 'court' herein would mean the court where the subject matter of arbitration arose. It goes without saying that had there been no such arbitration agreement between the parties, then aggrieved party would have approached a civil court with proper jurisdiction in the matter (i.e. the court wherein subject matter of suit arose) and rules under s.16-20 C.P.C would have been applicable in those circumstances. Therefore, the subject matter of arbitration is the staple of the definition of "Court" under 1996 Act and the competent court is the one which would have adjudicated the matter, had the matter been a suit. For determination of jurisdiction in a suit, rules of C.P.C. would apply. Thus, rules of C.P.C. are at the fulcrum to determine jurisdiction of the court in arbitration matters too. It is submitted that the wordings of s. 2(1)(e) are not *disjunctive* but *conjunctive* and are to be read together. When read together, it could be only concluded that provisions of C.P.C. are very well applicable in this regard too and then the Supreme Court's opinion in this regard in para 96 and 97 does not hold any water and is erroneous.

Also, this is a basic principle of law that courts should not give such an interpretation to the provisions of a statute that it leads to absurd results[21] which was established as early as in the case of *B. Udeypal Singh v. Lakshmi Chand*[22]by Indian courts. But it is submitted with utmost respect for the Hon'ble Supreme Court that the present judgment does so and would create many hassles, unnecessarily burdening the courts generally in metro cities where a party can get a

[21]Saramma v. State of Kerala; In The High Court Of Kerala At Ernakulam, WP(C).No. 34524 of 2010(M).
[22] AIR 1935 All. 946.

quicker decision when compared to their counterparts in other places because of better technology and infrastructure.

It is respectfully submitted that the paragraphs 96, 97 and 98 of the *Bharat Aluminium* judgment requires serious consideration as otherwise it would beset the domestic arbitrations. If the present judgment has really to stand the test of time for international commercial arbitrations as well as domestic arbitrations, then it would be better that the interpretation so given needs to be made obsolete. A review petition of *Bharat Aluminium* judgment to this extent is called for and the Apex Court should saddle up to give a harmonious interpretation to the provisions of Arbitration & Conciliation Act, 1996 and Code of Civil Procedure, 1908. The judgment penned by S.S. Nijjar J. on behalf of the 5 judges Constitutional Bench (with no dissenting or different opinion) is really commendable one as it was the need of the hour. It is truly a godsend for the harried parties to international commercial arbitration. The only quibble with the judgment is about the views of Apex Court in paragraphs 96, 97 and 98 of the judgment with regard to domestic arbitrations. The author exhorts the Hon'ble Supreme Court to give a second thought to its decision. It is submitted that such interpretation requires to be taken back by the Hon'ble Apex Court and that would be a fitting coda to the remarkable story of arbitrations associated to India.

SHORTCOMINGS IN BALCO

The Hon'ble Court said even interim reliefs could not be granted by Indian courts in cases of foreign-seated international commercial arbitrations. The Court could have referred to s.151 C.P.C., 1908 which gives inherent power to the court. In *Vareed Jacob v. Sosamma Geevarghese*[23] **,** it was held that inherent power u/s 151 is exercised by the court when a given fact situation fell outside the scope of Order 39 C.P.C.

Also, s.94 of C.P.C. read with Order 39 C.P.C. is wide enough to give powers to court to grant interim relief.

Position in England:

The Siskina Doctrine that has been unbendingly followed by the Hon'ble Supreme Court had faced a severe challenge in the *Channel Tunnel case*[24] where House of Lords held that it is not obligatory for the cause of action to fall within the territorial jurisdiction of the court leading to the inference that an interlocutory injunction can be granted by a domestic court.

[23](2004) 6 SCC 378.
[24] [1993] A.C. 334 (H.L.)

In fact, tides began to turn against Siskina Doctrine in *South Carolina Insurance Co. v. Assurantie Maatschappij "De Zeven ProvincienN"*[25]wherein Lord Goff refused to accept the anti-suit injunctions as an exception to the Siskina and pointed out that instead, it unraveled the doctrinaire error of the doctrine.

Moreover, S. 25 of Civil Jurisdiction and Judgments Act, 1982 as extended by Civil Jurisdiction and Judgments Act, 1982 enables English courts to grant interim reliefs in relation to proceedings in foreign state. The observation of the Hon'ble Court that the Indian statute does not have any provision similar to s. 25 as a reason for not granting interim injunction is not justifiable as the South Carolina judgment was passed way before the inclusion of the s. 25 in 1997.

The Indian Courts have also given decisions in this favour. While talking about the protection of constitutionality, Justice Katju in the case *L.M.L. Ltd. and Another vs Union Of India And Others*[26]held that s. 9,though stated in Part I of the Act would be applicable to all the arbitration proceedings even lying in the Part II of the Act otherwise irreparable loss would be caused.

The Supreme Court in *Golaknath&Ors.v. State of Punjab*[27] had explicitly laid down that the doctrine of prospective overruling could be invoked only in Constitutional cases and by the Supreme Court only. The Court very rightly pointed out that the doctrine would be of no aid to the parties where the transactions had already taken place because the law would take effect from the date of the judgment only.

The position regarding the prospective overruling is universal all over the globe. The UK Supreme Court in a very recent case *Spectrum Plus Limited and others and others Vs. National Westminster Bank plc*[28] has cited a plethora of decisions of various countries including the *Golaknath*case holding that the principle of prospective overruling is bad in law as the principle is not capable of deciding the dispute between the parties according to what the court declares is the present state of law.

[25] [1987] A.C. 24 (H.L.)
[26]1998 (4) AWC 659.
[27]1967 AIR 1643,1967 SCR (2) 762.
[28] No. [2004] EWCA Civ 670.

Furthermore, reliance requirement which is a mandate to be fulfilled before applying prospective overruling has failed. It ignores the claim of pre-Bhatia claimants, when generally the position was that the Indian courts had no jurisdiction. Pre-Bhatia claimants have stronger reliance case as they could have easily excluded the Indian courts from jurisdiction but did not do so because mere designation of foreign seat was sufficient for this purpose. The requirement has failed because if appellants sought an order restraining application of this judgment to arbitration agreements to be entered in future, it would be necessary to show that the arbitration agreements were in reliance with *Bhatia International* case or appellants would have done something differently in their arbitration agreements if they had known that the *Bhatia International* case was not good law so as to confer jurisdiction on Indian courts.

A BRIEF ANALYSIS OF THE BANKING LAWS (AMENDMENT) ACT, 2012

Varun Tripathi[*]

BACKGROUND AND SCOPE

Law is dynamic. It is imperative for Law to adapt with the changes and adopt such changes which are beneficial to the public at large. After nearly 60 successful years of implementation of the Banking Regulation Act, 1949, the Banking Laws (Amendment) Act, 2012 (hereinafter referred to as the "Amending Act") aimed at certain changes to the existing law.

The Banking Regulation (Amendment) Bill, 2005 was introduced in the Lok Sabha but ultimately lapsed due to Lok Sabha's dissolution in the year 2009. The Banking Laws (Amendment) Bill, 2011 was introduced with embodiment of certain provisions of the Amendment Bill of 2005. The subsequent bill aimed at certain modifications of the Banking Companies (Acquisition and Transfer of Undertaking) Act of 1970 and 1980 as well. The Lok Sabha passed the bill on December 18, 2012 and the Rajya Sabha approved on December 20, 2012. The Bill was assented by the President Pranab Mukherjee in January 2013 and since then has attained the force of law.

The Act has made certain amendments in the Banking Regulation Act, 1949, the Banking Companies (Acquisition and Transfer of Undertaking) Act, 1970 and 1980 and certain consequential amendments in the Indian Contract Act, 1872 and the Indian Stamp Act, 1899.[1]

SALIENT FEATURES AND IMPLICATIONS OF THE ACT

1. Amendments to Banking Regulation Act, 1949

(i) Definition of "approved securities"

As per the Amendment, **sec. 5(a)** of the Act of 1949 has been substituted to restrict the definition of approved securities to mean securities issued by Central or State Government or specified as such by the Reserve bank of India (RBI)[2]. The prior definition involved securities which the Central Government authorized or in which a trustee could invest in pursuance of the provisions of the Indian Trusts Act.[3]

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[1] Preamble, The Banking Laws (Amendment) Act, 2012.

[2] § 2, The Banking Laws (Amendment) Act, 2012.

[3] § 20(a), (b), (bb), (c), (d) ,(ff), Indian Trusts Act, 1882 (2 of 1882).

(ii) Issuance of preference shares by Banks subject to regulatory RBI guidelines

The amendment of *Sec. 12(1) (ii)* of the 1949 act has empowered the Banking Companies to issue preference shares subject to accordance with the guidelines framed by the RBI.[4] The RBI has been directed to frame guidelines which shall specify (i) class and extent, whether perpetual, redeemable or irredeemable of such preference shares, and (ii) terms and conditions of such issuance. This amendment would enable the private sector banks to access capital for further development of banking business[5] and also enable the nationalized banks to raise capital by issue of preference shares or rights issue or bonus shares.[6] Additionally, a major implication of this would benefit the government as it has majority holding in all the public sector banks. This step will also create a conducive environment for banks to raise fresh capital more easily from the market and thus help in meeting their capital adequacy requirements prescribed under Basel III norms.[7]

Also, the Act makes clear that the holder of such preference shares will not possess voting rights as mentioned under sec. 87(2) (b) of the Companies Act, 1956 for non-payment of dividend by the Company. The intent of the Legislature is simply to clasp instances where such shareholders may raise subsequent demands. This empowers the private banks to gather additional capital without providing any voting rights to such preference shareholders.

(iii) Raising the ceiling value on Voting Rights

The Amending Act also has substituted *Sec. 12(2)* of the 1949 Act and has empowered the RBI to raise the ceiling on voting rights for shareholders of *Private Banks* from the earlier 10% to 26% in a phased manner.[8] Also, the ceiling on voting rights for shareholders of *Public Sector Banks* has been elevated from earlier 1% to 10%.

The fundamental intent and result of this provision is that the investors will be empowered to exercise greater control over the functioning of the banks. This amendment will make the voting rights proportional to the number of shares held by shareholders and will attract foreign institutional investors, who have been sitting on the sidelines as far as investing in

[4] § 3A(i), the Amending Act, 2012.
[5] 43rd Report, The Standing Committee on Finance on the Banking Laws (Amendment) Bill, 2011, p. 14
[6] Press Information Bureau, Ministry of Finance, www.pib.nic.in/new site/erelease.aspx ?relid=91116
[7] Gurpur, *What are its benefits to the banking public?*, www.moneylife.in/ article/banking-amendment-bill-what-are-its-benefits-to-the-banking-public/30304.html last viewed on 21-12-2013 at 9:30 p.m.
[8] § 3B, Amending Act, 2012.

these banks is concerned.[9] On one hand it may boost the growth of the bank empowering the promoters in effective control of the management instead it may also influence the decisions detrimental to the interests of the stakeholders. It is imperative for the RBI to exercise greater caution with this provision.

(iv) Regulation of acquisition of share or voting rights

The Amending Act has inserted[10] *Sec. 12B* to the 1949 Act, the provision simply makes mandatory the procurement of RBI's approval for any direct or indirect acquisition of shares or voting rights in excess of 5% of the paid-up capital of such banking company.

In order to ascertain value of such acquisition, shares held by relatives, associated enterprises or persons 'acting in concert' of the concerned applicant will be consolidated.

Sec. 12B Explanation 1(a) defines associated enterprise to mean a company which is:-

(i) a holding or subsidiary company of the applicant;

(ii) is a joint venture of the applicant;

(iii) has control over the composition of Board of directors or other governing body of the applicant.

(iv) in the opinion of RBI exercises significant influence on the applicant in taking financial or policy decisions

(v) is able to obtain economic benefits from applicant's activities.

The term 'relative' has the same meaning as defined under Sec. 6 of the Companies Act, 1956. As regards to persons 'acting in concert', persons who with a common object of acquiring shares, or voting rights in excess of 5%, by way of an agreement or undertaking, co-operate to acquire such shares or voting rights in the banking company.

Pursuant to such application, the RBI may approve, on being satisfied on grounds of public interest, banking policy, and interests of the banking and financial system in India. The RBI has also been empowered to specify different criteria for such acquisition. The RBI has been vested with great power to monitor and regulate affairs of such banking companies. Further, the RBI may direct a bank to provide information relating to the business or affairs of any Associate Enterprise. The implication of this provision would facilitate licensing for new banks as to be in consonance with the Draft Guidelines for Licensing of New Banks in the

[9] www.albrightstonebridge.com/banking (Last accessed on 02.14.2013)
[10] § 4, Amending Act, 2012.

Private Sector issued by the RBI, which requires new banks to be established by promoter groups through a wholly-owned non-operating holding company ("NOHC") and the RBI should be equipped to obtain such information from the promoter group for effective compliance.

(v) Supersession of the Board of Directors of Banking Company

The Amendment has inserted[11] *Part IIAB* to the Act of 1949, this part empowers the RBI to supersede the Board of Directors of a banking Company, if the RBI, in consultation with the Central Government, considers it necessary in public interest, or for preventing the affairs of any banking company from being conducted in a manner detrimental to the interest of the depositors or any banking company, or for securing the proper management of any banking company. The chairman, managing director and other directors shall vacate their office during the period of supersession.

Such period of supersession cannot exceed 6 months at a time and cannot be extend beyond 12 months in total. The RBI may appoint an administrator having sufficient experience in law, finance, banking, economics or accountancy.[12] The Administrator so appointed will discharge all the functions and possess all the powers as are vested in the chairman, managing director or directors of the bank.[13] The act grants validity to the powers exercised by the Administrator even if they are only exercisable by resolution passed by general meetings of the banking company.[14] The RBI may appoint a committee of 3 or more professionals to assist the Administrator in his discharge of functions.[15]

The Administrator is obligated to call a general meeting for appointment of new directors of the company and reconstitute its Board on or before two months before the expiry of the period of supersession.[16]

The provision implicates greater control of RBI over the banks; the pervasive role of RBI may now assure protection of the interests of the stakeholders and the public at large. This was much needed especially in view of additional relaxation given to the banks on other

[11] § 10, Amending Act, 2012.
[12] § 36ACA(2), Banking Regulation Act, 1949 (as amended).
[13] § 36ACA(4)(b), Banking Regulation Act, 1949 (as amended).
[14] *Id.*
[15] § 36ACA(5), Banking Regulation Act, 1949 (as amended).
[16] § 36ACA(8), Banking Regulation Act, 1949 (as amended).

fronts. As a safety valve against potential misuse of this provision by RBI, the Act mandates consultation with the Central Government.

(vi) Establishment of Depositor Education and Awareness Fund

The RBI has been empowered by insertion[17] of Sec. 26A to transfer money from dormant accounts, which are not operative for more than 10 years to *the 'Depositor Education and Awareness Fund'***.** The fund will be utilized to create awareness amongst customers and will be managed under a committee appointed by the RBI. Provision has also been made that if legitimate claims are made for such transferred amount subsequently, the Bank will repay the same with interest to the claimant.[18] This indeed is a welcome provision channelizing the depositors' unclaimed money for their benefit.

2. Amendments to Banking Companies (Acquisition and Transfer of Undertaking) Act, 1970 and 1980

The Amendment has substituted[19] *Sec. 3(2A)* of the 1970 and 1980 Act and raised the authorized share capital of nationalized banks to Rs. 3000 crores as compared to the previous Rs. 1500 crores. This provision shall serve as impetus to attract investors in such nationalized banks. The Nationalized banks have also been permitted

The Amendment has enabled the nationalized banks to increase or reduce their authorized capital with the permission of the RBI and the Central Government. Also, such banks may increase their authorized share capital through issuance of 'bonus shares' and 'rights issue'. This has enabled the nationalized banks to issue 'bonus shares' which will attract investors.

3. Amendments to Indian Contract Act, 1872 and Indian Stamp Act, 1899

(i) Bank Guarantees vis-à-vis Section 28 of the Indian Contract Act, 1872

Agreements in restraint of legal proceedings are void under s. 28 the Contract Act[20]. The Amendment has carved an exception clause to the said section. Bank guarantees generally contain a clause mentioning a specified period from the date of expiry of the bank guarantee, within which claims or legal proceedings may be brought against the bank by the beneficiary.

[17] § 8, Amending Act, 2012.
[18] Proviso, § 26(A)(2), Amending Act, 2012.
[19] Vide § 15 and § 16 of the Amending Act, 2012.
[20] § 28, Indian Contract Act, 1872 (9 of 1872).

On expiry of the said specified period, guarantee would stand absolved as the beneficiary is deemed to have waived his right. The same was rendered void as contravention of sec. 28 of the Contract Act. But by virtue of the amendment, any bank guarantee (or a similar guarantee agreement), stipulating a term for discharge of a party from any liability on at least expiry of one year shall not be treated as void under S. 28 of the Contract Act. This will allow banks to stipulate conditions for their discharge on or after expiry of one year and the same shall not be rendered void.

(ii) Exemption from Stamp duty

The Amendment has inserted a new provision viz. **sec. 8E** in the Indian Stamp Act[21] which exempts stamp duty when;

(a) A branch is converted into a wholly owned subsidiary of the bank; or transfer of shareholding of a bank to a holding company of the bank in conformity with the scheme or guidelines issued by RBI.

(b) Any instrument which effectuates the abovementioned transfer of shareholdings to the holding banks or such conversion of a branch into a wholly owned subsidiary of the bank is executed.

The fundamental intent and implication behind such exemption is to facilitate the foreign banks to convert their branches in India into wholly owned subsidiaries and expand their operations in India.

CONCLUSION

The Amendment has brought about various measures to attract investments in the banking Sector, the RBI has strengthened its supervisory role to minimize possible risk or prejudice against the investors and the depositors. The amendment came as a much needed impetus to the deteriorating capital investment in banks. With substantial increase in RBI's power, increase in responsibilities is inevitable, which invites RBI to ensure that the banking sector progresses on sound lines. Additional liberalization of banking sector also means that the RBI should observe the functioning of all private banks to avoid circumstances detrimental to interests of shareholders.

The position previously was tough for the banks to open new branches but the Amendment has amicably addressed this problem facilitating in opening of new branches. It is worthy to

[21] Indian Stamps Act, 1899 (2 of 1899).

note that the amendment has also freed up ceiling in voting rights. This may well be compared to the prior curb that was exercised in terms of voting rights, now particularly making the structure and policy implementation more democratic and wider powers to other shareholders. It has also freed up, both the public sector and private sector, banks to materialize additional involvement of the corporate intelligentsia and reduction in political interference.

The Amendment has definite far reaching effects and will surely serve as an impetus to the existing financial and banking element of the country. The proposed ingress of corporate into public sector banks has raised an objection from the Banking Unions and Left parties of a fear of decisions which may prove detrimental to the public interest. Nevertheless, certain untouched instrumental areas like improvement in corporate governance, relieving banks from dual control of finance ministry and RBI, and providing a better customer service necessarily need vehement consideration and should be addressed specifically.

DISCLAIMER