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## ARTICLES



## BOOK REVIEW

# Tax Avoidance Jurisprudence In India: Questioning the Traditional Narrative

*Khagesh Gautam*[*]



## Introduction

The debate between tax avoidance and tax evasion is as old as taxation itself.[1] This debate is extremely complicated with different people using different terms to describe different things.[2] While some scholars insist on authority of canons of statutory interpretation[3] to assert that tax avoidance

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1 *See* also Walter J. Blum, "Knetsch v. United States: A Pronouncement on Tax Avoidance" (1961) Sup. Ct. Rev. 135, 135-36.

2 *See* also James T. Carter, "Tax Saving versus Tax Evasion" 20 Va. L. Rev. 307 (1934); Montgomery B. Angell, "Tax Evasion and Tax Avoidance" (1938) 38 Colum. L. Rev. 80; Anil Kumar Jain, "Tax Avoidance and Tax Evasion – The Indian Case" (1987) 21 Modern Asian Studies 233, Zoe Prebble and John Prebble, "The Morality of Tax Avoidance" (2009) 43 Creighton L. Rev. 693.

3 The most important judicial authority on the point that is repeatedly cited by all scholars – legal, moral or economic – is the famous US opinion by Judge Learned Hand, the of the Second Circuit, in *Helvering* v. *Gregory*, 69 F 2d 809 (2nd Cir 1934), later affirmed by the US Supreme Court in *Gregory* v. *Helvering*, 1935 SCC OnLine US SC 6 : 79 L Ed 596 : 293 US 465 (1935), where Justice Sutherland (for the Court) held, (at 469), "*The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether*

is legally permissible and it is tax evasion which is illegal[4], others insist that there is no difference between the tax avoidance and tax evasion since both involve taxpayer behavior which is factually similar.[5] The global complexity of this debate can also be gauged by running a simple Westlaw search and going through the facts of some of the western judicial precedents on this point.[6] Similarly, in India as well, the kind of transactions that the courts have to understand are getting increasingly complex.[7] Under pressure to respond adequately to this growing challenge, the legislatures in turn have responded with extremely complex taxation.[8] Any attempt to find a quick fix solution to this problem is bound to result in confusion and failure – may it be on the part of the legislator, the judge, the lawyer or, and most importantly, the scholar.[9]

There is a legal angle (since we are, after all, talking about tax 'laws') to this debate according to which tax avoidance is legal as long as it stays on the right side of the law.[10] There is also an economic angle, where scholars have tried to find and study the economic links between tax laws and taxpayer behavior.[11] There is a moral-philosophical angle that engages with the

*avoid them, by means which the law permits, cannot be doubted*." (emphasis added). The most famous English opinion, again repeatedly cited by scholars, is the one delivered by the House of Lords in *Commrs. of Inland Revenue* v. *Duke of Westminster*, 1936 AC 1 (HL).

4 James T. Carter, "Tax Saving versus Tax Evasion" (1934) 20 Va. L. Rev. 307, Montgomery B. Angell, "Tax Evasion and Tax Avoidance" (1938) 38 Colum. L. Rev. 80.

5 Zoe Prebble and John Prebble, "The Morality of Tax Avoidance" (2009) 43 Creighton L. Rev. 693, 702.

6 *See* also the incredibly complex transaction that was called into question in *ACM Partnership* v. *Commr. of Internal Revenue*, 157 F 3d 231 (3rd Cir 1998); Marvin A. Chirelstein and Lawrence A. Zelnak, "Tax Shelters and the Search for a Silver Bullet" (2005)105 Colum. L. Rev. 1939, 1944. The transaction designed solely for tax avoidance purposes was so complex that even these two learned professors had to omit the full discussion of facts so that the readers can easily understand what was being done. See also *Inland Revenue Commrs.* v. *Burmah Oil Co. Ltd.*, 1982 SC (HL) 114 and more recently.

7 See *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613 at 634-35. On these two pages the lead opinion by Chief Justice Kapadia reproduces the cross-holdings chart submitted to the court by the appellant taxpayer. A cursory look at this chart will baffle the minds of the most senior of tax practitioners, and it will take careful study to find out which company owns which.

8 David A. Weisbach, "Formalism in the Tax Law" (1999)66 U. Chi. L. Rev. 860.

9 *See* also Marvin A. Chirelstein and Lawrence A. Zelnak, "Tax Shelters and the Search for a Silver Bullet" (2005) 105 Colum. L. Rev. 1939; *see also* David A. Weisbach, "Formalism in the Tax Law" (1999) 66 U. Chi. L. Rev. 860.

10 This body of literature argues that the Courts only interpret the law and a transaction falls into the category that is permitted by the law then the matter ends there and it is for the Legislature to make the law so that certain transactions on which they would like to see the tax law applied are covered within the ambit of the law. For those who subscribe to this school of thought disregard any argument made by the revenue authorities on the grounds of the transaction being against "*The Spirit of The Law*". *See* Carter (n 2) at 82, 83 and 89.

11 *See* also Steven Klepper and Daniel Nagin, "The Anatomy of Tax Evasion" (1989) 5 J. L. Econ. & Org. 1.

question as to whether tax avoidance is morally permissible, notwithstanding legality of the taxpayer behavior.[12] The hidden premise in the work of scholars that examine the legality of tax avoidance is that in this domain of the law, legal standards and moral standards are one and the same. Thus, so long as the tax avoidance activity stays on the right side of the law no moral objection can be raised. Relying on judicial authority, some legal scholars also argue that there is a moral entitlement to legally avoiding taxes.[13] The moral scholars, naturally, don't agree with this proposition and maintain that the standards by which morality of tax avoidance is to be judged exist independent of the legal standards.[14] The legal question is limited to figuring out a workable legal method, judicial or statutory, that can be used to draw a line between tax avoidance and tax evasion.[15] For the economist, there is no real difference between tax avoidance and tax evasion since in both cases the state exchequer does not get the tax revenues,[16] but the moralist calls everything into question and changes the nature of the issue completely.[17] For instance, if there is no moral obligation to pay any taxes at all in the first place, why does it matter whether non-payment of taxation is a result of tax avoidance or tax evasion?[18] The moralist engages with several other complicated questions in that.

A few years back, thiseternal, and now increasingly global, debate between tax avoidance and tax evasion came up for judicial consideration before the Supreme Court of India in the well-known *Vodafone International Holdings BV* v. *Union of India* ('*Vodafone case*').[19] In *Vodafone case*, it was unanimously held that the Indian income tax authorities cannot, under section 9 of the Indian Income Tax Act, 1961 impose income tax on indirect transfers of capital assets situated in India.[20] *Vodafone case* was a special case in the sense that it was a foreign investor who had acquired an Indian company without directly acquiring the shares of that company. However, we may spin the facts of the case, in reality Vodafone Int'l had ended up acquiring

12 Zoe Prebble and John Prebble, "The Morality of Tax Avoidance" (2009) 43 Creighton L. Rev. 693, 720. *See* also Robert W. McGee, "Three Views on the Ethics of Tax Evasion" (2006) 67 Journal of Business Ethics 15.

13 Zoe Prebble and John Prebble, "The Morality of Tax Avoidance" (2009)43 Creighton L. Rev. 693, 700.

14 *Ibid.*, at 716.

15 James T. Carter, "Tax Saving versus Tax Evasion" (1934) 20 Va. L. Rev. 307, Montgomery B. Angell, "Tax Evasion and Tax Avoidance" (1938) 38 Colum. L. Rev. 80.

16 Zoe Prebble and John Prebble, "The Morality of Tax Avoidance" (2009) 43 Creighton L. Rev. 693, 715.

17 Robert W. McGee, "Three Views on the Ethics of Tax Evasion" (2006) 67 Journal of Business Ethics 15.

18 *Ibid.*

19 *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613.

20 *Ibid.*, at 673.

Hutch India albeit indirectly. Could they have acquired Hutch India by directly purchasing the shares of the Indian company? Of course. But there was no law that prohibited what they did and in the process they ended up saving a whole lot of cash in taxes. Was there a business purpose to this whole arrangement? Certainly. Cross border corporate acquisitions of this kind are usually not the kind of transactions that are entered into only to stick your thumb in the nose of revenue authorities.[21] There was a clear incentive of avoiding tax avoidance behind structuring the transaction the way it was structured.It is highly improbable that the transaction would have been structured the way it was structured, if there were no such incentive. This is what makes this case particularly special to study.

Public and scholarly discussion on this matter had actually started before the appeals were even filed before the Supreme Court in this case,[22] went on as the matter was being argued, and continued long after the unanimous decision of the three judge bench was delivered.[23] To overcome *Vodafone case* effect, the Parliament responded by bringing in a retrospective amendment to the Income Tax Act, 1961.[24] As one would expect this amendment attracted a lot of criticism,[25] but retrospective amendments in tax law in order to overcome judicial decisions given in favour of the taxpayers have

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[21] *See* also Omri Marian, "Home-Country Effects of Corporate Investors" (Unpublished Manuscript dated September 9, 2014 presented at the International Business Law Scholar's Roundtable organized at the Dennis J. Block Center for the Study of International Business Law, Brooklyn Law School, New York City, NY on October 10, 2014 on the panel on "Tax"; on file with author).

[22] Anisha Keyal and Pritika Rai Advani, "The Vodafone Judgment–Wider Concerns of Withholding Tax under Income Tax Act" (2010) 3 NUJS L. Rev. 511; *See also* T.P. Ostwal and Vikram Vijayaraghavan, "Anti-Avoidance Measures" (2010)22 Nat'l L. Sch. India Rev. 59.

[23] *See* also Prashant Bhushan, "Capital Gains, Everyone Else Loses" *The Hindu* (23 February, 2012) <http://www.thehindu.com/opinion/lead/article2920912.ece>, where, as the title would suggest, he criticizes the decision as causing massive loss to the public exchequer and Arvind P. Datar, "Vodafone is a Misunderstood Case" (March 2, 2012) <http://www.thehindu.com/opinion/op-ed/vodafone-is-a-misunderstood-case/article2951103.ece>, where Datar responds to Bhushan's misreading of the decision and explains why the no income tax could possibly be imposed on this transaction by the Indian Revenue authorities. *See also* Prashant Bhushan, "Legitimising Tax Avoidance" *Economic and Political Weekly* XLVII(9) 37.)

[24] Finance Act, 2012 (India), S. 4. This provision amends Income Tax Act, 1961, S. 9 with retrospective effect from April 1, 1962. The relevant part of the Income Tax Act, S. 9, *before* the amendment, provided—

> Income deemed to accrue or arise in India.—(1) The following incomes shall be deemed to accrue or arise in India— (i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of Income in India or through the transfer of capital asset situate in India.

This provision has been reproduced in *Vodafone*, Blum, *supra* note 1 at 672.

[25] G. Mahadevan, "Vodafone International Holdings BV – A Critical Review of Pre- and Post- Ruling Impact and Future Course of Action" Business Law International 13 (2)

been heavily criticized in past as well.[26] Serious doubts have been expressed over the constitutional validity of certain crucial clauses of this amendment[27] and whether the Indian Parliament has legislative competence under the Constitution of India to levy capital gains tax on indirect share transfer transactions.[28] In fact, the *Vodafone case* itself ended up becoming an electoral issue in the Parliamentary elections of 2014[29] with a special focus onresolving the international arbitration disputes that arose as a consequence of the retrospective amendment.[30] After taking charge a former Law Minister made public statements to resolve this issue.[31] In all this debate, everything centered more around the retrospective amendment and the consequent loss of investor confidence and foreign direct investment. Though much has been written about *Vodafone case* in India and outside, no attention has been paid either by the legal academia in India, or outside or members of the Bar in India to the question of tax avoidancethat the Supreme Court grappled with in that case.[32] Tax avoidance jurisprudence in India is anyway an area

223-234; Matthew Gilleard, "Retrospective Amendments: The Worrying Trend Which Has Taxpayers Looking over Their Shoulders" International Tax Review 23(8) 30.

26 *See* also Nani A. Palkhivala, *We, The People* (2009) 150-51. Speaking specifically in the context of the right to appeal, Palkhivala observed that retrospective amendments make the right to appeal "illusory". Whereas in India the Parliament plays, and has always played, an interventionist role with respect to tax avoidance disputes, in United States and England, this role has traditionally been left to the judiciary; Jain (*supra* note 2) at 248 noting the fact that, "At times the amendments are made merely to get round an adverse decision of the Supreme Court or a High Court.... The amendments are so frequent that, many a time, the assessing officers themselves are not aware of the latest provisions"; David Dunbar, "Tax Avoidance: A Judicial or Legislative Solution; Lessons for the United States from the British Commonwealth" (2001) 12 Corp. Bus. Tax'n. Monthly 21.

27 V. Niranjan, "Defective Validation Clause: The Impact of the Finance Act, 2012 on Vodafone and Other Assessees" (2012) 5 SCC J-25.

28 Khagesh Gautam, "Taxing Offshore Transactions in India and the Territoriality Clause – The Case for Substantial Constitutional Limitations on Indian Parliament's Power to Retrospectively Amend the Income Tax Act" (2014) 40 International Tax Journal 19.

29 *See* also Gireesh Chandra Prasad, "Will Narendra Modi Make it Less Taxing for Investors, Officials?" *Financial Express* (19 May, 2014) <https://www.financialexpress.com/archive/will-narendra-modi-make-it-less-taxing-for-investors-officials/1252235/>; Uttara Choudhury, "What US Investors Want from Modi: To Kickstart India's Economy" Firstpost (17 May, 2014) <http://www.firstpost.com/world/what-us-investors-want-from-modi-to-kickstart-indias-economy-1529075.html>.

30 Asit Ranjan Mishra and Remya Nair, "The Economic Mess That Narendra Modi Will Have to Unravel" *Livemint* (26 May, 2014) <https://www.livemint.com/Politics/3e4dqcszr0pXsREcKgtl9J/The-economic-mess-that-Modi-will-have-to-unravel.html>; James Crabtree, "Modi Faces Dilemma over Ending India's Tax Fight with Vodafone" *Financial Times* (June 10, 2014) <https://www.ft.com/content/d1eaa8ac-f063-11e3-b112-00144feabdc0>.

31 *See* also "Retrospective Taxes Should be Avoided: Ravi Shankar Prasad" *The Economic Times* (28 May, 2014) https://economictimes.indiatimes.com/news/economy/policy/retrospective-taxes-should-be-avoided-ravi-shankar-prasad/articleshow/35646526.cms?from=mdr.

32 G. Mahadevan, "Vodafone International Holdings BV – A Critical Review of Pre- and Post-Ruling Impact and Future Course of Action" Business Law International 13(2) 223-234;

that has not received any academic attention and very little and only patchy attention by members of the Bar. The objective of this articleis to fill this crucial gap.

This article is divided into two parts.Part 1 addresses itself to one of two gapsidentified above i.e. the lack of academic attention given to tax avoidance jurisprudence in India. The popular narrative in India in this regard is the one that may be deduced from short articles that appear in press and news magazines and on occasion in legal journals. This article contends that the popular narrative presents an inaccurate picture of the tax avoidance jurisprudence in India. Part 1 reconstructs the 'Popular Narrative' and points out its deficiencies. To remedy this in Part 2 examines the 'Actual Position'. The Popular Narrative gives undue weightage to a few Supreme Court opinions, most notably *McDowell & Co. Ltd.* v. *CTO ('McDowell')*[33] consequently creating a biased and incorrect understanding of the law. The only way to remedy this is to study how the understanding of this area of law has evolved in India. The Supreme Court of India was established in 1950. *McDowell* was delivered in 1985. Thus Part 2 divides this 64-year timeline into three zones – the pre *McDowell* era (1950-1984), *McDowell* (1985) and the post *McDowell* era (1985-2014).

An examination of the pre *McDowell* cases discloses two distinct methods of judicial decision making.The first, designated as the 'Interpretational Approach', is the traditional approach where the judges invoke traditional and well accepted principles of statutory interpretation to resolve tax avoidance disputes.[34] These interpretational principles are well accepted canons of statutory construction in Britain and the United States. The second, designated the 'Judicial Test Approach', is where the judges would articulate a judicial test to resolve similar disputes. A judicial test would be articulated in one case that would subsequently be applied in another case without invoking any principles of statutory interpretation. The Judicial Test Approach heavily resembles the judicial decision making methodology of the United States Supreme Court. The predominant method used in the pre *McDowell* era was the Interpretational Approach and it was effectively used to deal

Prashant Bhushan, "Legitimising Tax Avoidance" *Economic and Political Weekly* XLVII (9) 37. *See also* Geoffrey T. Loomer, "The Vodafone Essar Dispute: Inadequate Tax Principles Create Difficult Choices for India" (2009) 21 Nat'l L. Sch. India Rev. 89.

33 *McDowell & Co. Ltd.* v. *CTO*, (1985) 3 SCC 230.

34 As a footnote, we may note here that the Interpretational Approach heavily resembles the judicial decision-making methodology of the British Courts. A comparative examination of the Indian and British judicial decision making method is beyond the stated scope of this article but wherever necessary equivalents and divergences in the British and the United States judicial decision-making methods have been pointed out either briefly in the text of the paper or by the way of footnotes.

with and satisfactorily decide cases involving a tax avoidance question. Even though growing factual complexity of the cases involving a tax avoidance questions slowly lead the judges of the Supreme Court of India to realize that the Interpretational Approach might not always be the most effective method of resolving tax avoidance disputes, they were always very reluctant to use the Judicial Test Approach. In *McDowell* – a case incorrectly considered in the Popular Narrative as the most important tax avoidance case in India – Justice Reddy wrote a concurring opinion that was completely unaware of the pre *McDowell* position and thus, far satisfactorily used Interpretational Approach. The post *McDowell* period has been living under the shadow of *McDowell* where the primary emphasis has been to dilute the effect of Justice Reddy's concurrence in *McDowell*, which has finally been achieved in *Vodafone Case*, but again in complete ignorance of well-established pre *McDowell* tax avoidance jurisprudence. By examining the legal position in these three time periodsand by comparing and critiquing them on occasion by using foreign cases, Part 1 attempts to discredit the Popular Narrative by presenting the Actual Position that discloses two distinct decision making methodologies that the Supreme Court of India has used while engaging with tax avoidance cases.

Before moving forward, an important procedural point must be highlighted for the reader not familiar with the inner workings on the Supreme Court of India.The Supreme Court of India ordinarily sits in divisions of two judges that under article 145 of the Constitution is called a 'Division Court' but is popularly known as a 'Division Bench'.[35] If in the course of the hearing of any matter before a Division Bench it is felt that the matter must be dealt with by a larger bench, the matter is referred to the Chief Justice who accordingly constitutes a bigger bench, usually consisting of three judges.[36] But, whenever a case involving a substantial question of law as to the interpretation of the Constitution is involved a bench of 5 judges, or more if

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[35] Constitution of India, Art. 145– "Subject to the provision of clause (3), rules made under this article may fix the minimum number of Judges who are to sit for any purpose, and may provide for the powers of single Judges and Division Courts". Accordingly, the Supreme Court Rules, 1966, Or. VII R. 1 (relevant part) provides – "... every cause, appeal or matter shall be heard by a Bench consisting of not less than two Judges nominated by the Chief Justice...". The title of Or. VII reads "Constitution of Division Courts and Powers of a Single Judge". There is a list of eight kind of matters, in Or. VII R. 1 that a Single Judge of the Supreme Court can hear and dispose of, an examination of which is not relevant for this article.

[36] Supreme Court Rules, 1966, Or. VII R. 2 – "Where in the course of the hearing of any cause, appeal or other proceedings, the Bench considers that the matter should be dealt with by a larger Bench, it shall refer the matter to the Chief Justice, who shall thereupon constitute such a bench for the hearing of it."

necessary, must necessarily be constituted.[37] Such a bench is popularly called a 'Constitution Bench'. The bigger the bench of the Supreme Court that decides the case, the greater the doctrinal value attached to it.[38] Wherever an Indian Supreme Court decision is discussed in this article, the number of judges that comprised of the bench, and how many concurred and dissented, has been mentioned. If no judge dissented, the bench (after mentioning the number of judges comprising the bench) is referred to as a unanimous bench.

## Part 1 – The Popular Narrative

The narrative that is popular in India with regards to tax avoidance versus tax evasion debate is the one that has *McDowell* at its center. As per this narrative, before *McDowell* came and caused substantial turbulence, the position of law was settled in India whereby tax planning was a legitimate activity.[39] The Courts would look at the taxation statutes strictly notwithstanding how much hardship it may cause to the taxpayer or the revenue authorities. The authority cited to support this seemingly settled pre *McDowell* position was *CIT* v. *A. Raman & Co.*[40] Along with it comes

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37 Constitution of India, Art. 145(3) – "The minimum number of Judges who are to sit for the purpose of deciding any case involving a substantial question of law as to the interpretation of this Constitution ... shall be five:

Provided that, where the Court hearing an appeal under any of the provisions of this Chapter other than Article 132 consists of less than five Judges and in the course of the hearing the appeal the Court is satisfied that the appeal involves a substantial question of law as to the interpretation of this Constitution the determination of which is necessary for the disposal of the appeal, such Court shall refer the question for opinion to a Court constituted as required by this clause for the purpose of deciding any case involving such a question and shall on receipt of the opinion dispose of the appeal in conformity with such opinion."

38 *See generally* A. Lakshminath, *Precedent in Indian Law: Judicial Process* (2009)

39 *See e.g.* K. Vijay Kumar, "Tax Avoidance vs. Tax Evasion", TaxOnlineIndia, <https://taxindiaonline.com/RC2/inside2.php3?filename=bnews_detail.php3&newsid=605>; C.P. Ramaswamy, "Tax Planning: Does Westminster's Prevail over McDowell's?", Bombay Chartered Accountants' Society, (April, 2004), <https://www.bcasonline.org/articles/artin.asp?368>.

40 *CIT* v. *A. Raman & Co.*, AIR 1968 SC 49; *see also* Indraneel R. Chaudhury, "From McDowell to Vodafone", *The Hindu BusinessLine* (March 11, 2012), <http://www.thehindubusinessline.com/features/taxation-and-accounts/from-mcdowell-to-vodafone/article2984857.ece>. Chaudhury's piece is perhaps the most clear example of the point being made here where he cites *McDowell* as, "The foremost decision in India on the matter..."; Suresh Surana, "Know the Difference between Tax Planning & Tax Avoidance", *The Economic Times* (September 13, 2011), <https://economictimes.indiatimes.com/wealth/personal-finance-news/know-the-difference-between-tax-planning-tax-avoidance/articleshow/9962651.cms>. Surana's short piece also pays the same adulation to *McDowell* as other pieces cited here; S. Muralidharan, "Now, A Tax Avoidance Threshold", *The Hindu BusinessLine* (July 3, 2010), <http://www.thehindubusinessline.com/todays-paper/tp-opinion/now-a-tax-avoidance-threshold/article997480.ece>; Dipanshu Singhal,

Justice Reddy with his extreme views in the concurring opinion, he delivered, in *McDowell* on the authority of which the Revenue authorities started questioning all legitimate cases of tax planning.[41] Thus, revenue authorities started abusing *McDowell*, while the poor taxpayer got reeled under excessive tax rates, highhandedness and arbitrariness of revenue officials.The Bar, and in some immediate post *McDowell* opinions the Bench, criticized Justice Reddy's extreme views in *McDowell.* Thus, Justice Reddy's extreme views were never considered correct and never totally accepted by the Bar, the Bench and the taxpayers.Relief ultimately came in the *Indo-Mauritius DTAA Case*,[42] and then *Vodafone case*, that struck a decisive death blow to Justice Reddy's extreme views or, to ironically use Justice Reddy's own phrase, finally 'exorcised the ghost' of *McDowell* from the face of Indian tax avoidance jurisprudence.[43]

This narrative is based on an incomplete understanding of the way in which law has evolved in the pre *McDowell* era. In my view, this is a time period which has not been carefully studied within or outside India.Most writings on Indian tax avoidance jurisprudence usually begin with *McDowell.* This is not a sound approach. In order to truly and properly understand what the Supreme Court did right or wrong in *Vodafone* or in *McDowell*, it is necessary tofirst understand how the Court arrived at the decision.[44] *Vodafone* itself seems to have become a particularly important point of contest between tax payers especially multinational corporations, and the Indian income tax

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"Indian GAAR Story", Money Control (November 20, 2012), <http://thefirm.moneycontrol.com/story_page.php?autono=784709>.

41 K. Vijay Kumar, "Tax Avoidance vs. Tax Evasion", TaxOnlineIndia, <https://taxindiaonline.com/RC2/inside2.php3?filename=bnews_detail.php3&newsid=605>. The author of this short internet article, a retired Superintendent of Central Excise, maintains that *McDowell*, especially Justice Reddy's opinion, is a case that, "Any student of taxation should read…" The author takes a mildly critical view of Justice Reddy's opinion though. Most of the short pieces on tax evasion in India are very similar in the narrative they construct to this short piece. They, like this article, begin with *McDowell.*

42 *Union of India* v. *Azadi Bachao Andolan*, (2004) 10 SCC 1.

43 *See also* Indraneel R. Chaudhury, "From McDowell to Vodafone", *The Hindu BusinessLine* (March 11, 2012), <http://www.thehindubusinessline.com/features/taxation-and-accounts/from-mcdowell-to-vodafone/article2984857.ece>. By the end of his short piece Chaudhury observes that the Supreme Court reinstated, "… the Westminster principle [as] the cornerstone of law [such that now] every taxpayer is entitled to arrange his affairs so as to reduce the tax liability."

44 This becomes additionally important in light of the post *Vodafone* tax disputes where the Indian Income Tax authorities have focused their attention on several multi-national corporations and have initiated income tax proceedings against them on the grounds of tax evasion. *See e.g.* Utpal Bhaskar, Remya Nair and Amrit Raj, "Shell India Accused of Tax Evasion", *Livemint* (February 1, 2013), <http://www.livemint.com/Companies/VzRIkNIEGaV3Gbd5MdhdNL/IT-department-alleges-under-pricing-of-15000-cr-by-Shell.html>.

authorities.[45] Filling this gap provides important lessons in understanding how the Court used to deal with tax avoidance issues, where the important lessons of the past were forgotten and how they can be now revived or revisited to deal with these perplexing questions today.[46] With the pressing need to raise more tax revenues the tax authorities are under a consistent pressure to recover more taxes. In situations like this it is seemingly convenient for the tax authorities to slap tax demands on tax payers on the grounds of tax evasion.[47] In these circumstances, it becomes even more important to resuscitate the forgotten lessons. A comparative analysis of these lessons also provides important lessons to foreign jurisdictions, most importantly the United States and Britain, to have a closer look at their own tax avoidance jurisprudence. The Popular Narrative also unfairly chastises revenue authorities for being highhanded and arbitrary in the post *McDowell* period, though in my experienceIndian revenue authorities do sometimes times, or as the Popular Narrative would have it most of the times, act unfairly and uncharitably towards the taxpayers.

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[45] *See e.g.* Gangadhar Patil, "DNA Exclusive: Tax Evasion – IBM India told to cough up Rs 5,357 cr", *DNA India* (November 1, 2013), <https://www.dnaindia.com/business/report-dna-exclusive-tax-evasion-ibm-india-told-to-cough-up-rs5357cr-1912053>. This news article reports that IBM India was served an income tax notice on the grounds that, "... IBM India had suppressed revenue to evade tax under the export promotion scheme of the Software Technology Park of India (STPI)."

[46] Utpal Bhaskar, Remya Nair and Amrit Raj, "Shell India Accused of Tax Evasion", *Livemint* (February 1, 2013), <http://www.livemint.com/Companies/VzRIkNIEGaV3Gbd5MdhdNL/IT-department-alleges-under-pricing-of-15000-cr-by-Shell.html>. This article in a leading financial newspaper reports that the income tax proceedings against Shell India were initiated, "... in the backdrop of the $ 2 billion tax dispute between Vodafone Group Plc and the Indian tax authorities, though the transactions are of a different nature." That the transactions are of a different nature is an extremely important point to note as demonstrated throughout Part 2 of this article.

[47] *See e.g.* Reuters, "Probe into Cadbury India's Rs 200 cr Tax Evasion Case", *Business Standard* (November 23, 2013), <http://www.business-standard.com/article/companies/probe-into-cadbury-india-s-rs-200-cr-tax-evasion-case-112112300080_1.html>, Press Trust of India, "Govt. Initiates Probe into Kraft's Cadbury Takeover", *Business Standard* (January 4, 2011), <http://www.business-standard.com/article/companies/govt-initiates-probe-into-kraft-s-cadbury-takeover-111010400101_1.html>. This probe into the Kraft-Cadbury takeover was, "... for alleged tax evasion and flouting of buyout norms." The probe was clearly motivated by the, "... UK-based Vodafone's arm [that was] asked to pay over Rs 11,000 crore as taxes for buying Hong Kong based Hutchison's telecom company." The Kraft-Cadbury probe interestingly came about as the result of a public interest litigation filed in the Delhi High Court on the ground that, "... while acquiring the shares and assets of Cadbury, Kraft Food Inc. was under an obligation to pay tax on the acquisition of the Indian business." *See also* Bureau, "2 Tax Evasion Cases by Cadbury India Detected: Govt.", *The Hindu BusinessLine*, (November 22, 2012), <http://www.thehindubusinessline.com/companies/2-tax-evasion-cases-by-cadbury-india-detected-govt/article4123721.ece> and Rajesh Kumar Singh, "Govt. Investigating Cadbury India in Tax Evasion Case", Reuters (November 22, 2012), <http://in.reuters.com/article/2012/11/22/cadbury-india-investigation-idINDEE8AL03U20121122>.

The manifest incorrectness of the Popular Narrative is demonstrable. Two identical views expressed by respected members of the Bar may be examined to prove this point. The first of these two was expressed by the legendary tax and constitutional lawyer Nani A. Palkhivala, while critiquing the 1968-69 budget,and the second was by another distinguished member of the Indian Bar, S.P. Gupta, while critiquing the abuse of *McDowell* by revenue authorities in 2003.Criticizing the Revenue authorities' arbitrariness Palkhivala said that, 'The environment and setup are highly conducive to the general tendency to record conclusions adverse to the assessee and let the law take its course – its painfully prolonged and tiring course. The prick of the official conscience is assuaged by the knowledge that the wronged assessee has the right of appeal and reference'.[48] Gupta wrote that as a result of *McDowell*, '… several innocent commercial and financial acts and transactions of the [taxpayers] which were till then neither treated nor supposed to be treated as taxable suddenly found themselves threatened with being dragged within the pale of taxability and even penalization. The observations in [*McDowell*] against tax avoidance have so emboldened the assessing and taxing authorities that it results in a lot of unreasonableness and high-handedness towards the [taxpayers]'.[49] These identical observations made decades apart establish that revenue authorities' highhandedness and arbitrariness was a constant before and after *McDowell*.Therefore, *McDowell* cannot be legitimately invoked to ascribe to the revenue authorities'mischievous conduct which they are being charged with after *McDowell* was delivered in 1985, something that the Popular Narrative strongly, but clearly incorrectly, insists. In fact, Palkhivala, while delivering a memorial lecture in 1965, strongly criticized the tax laws and tax administration in India as 'arbitrary provisions which stem from individual whims' and 'an administration marked by petrification of discretion and paralysis of the will to do justice'.[50] Revenue authorities have been, therefore, doing the same thing before and after *McDowell*. Thus, it makes *McDowell* an extremely insufficient explanation of revenue authorities'alleged mischievous behavior. Thus, thereis need to revisit the original sources, and relevant judicial opinions on the point, in order to create an accurate historical timeline since 1950 so that we may objectively examine what changed and what remained constant in pre and post *McDowell* periods.

48 Nani A. Palkhivala, *We, The People* 132-33 (2009).

49 S.P. Gupta, "The McDowell Dictum – Vanishing Line between Tax Avoidance and Tax Evasion", (2003) 5 SCC J-15.

50 Nani A. Palkhivala, *We, The People* 97 (2009).

## Part 2 – The Actual Position

### A. Pre McDowell Position (1950-1984)

In the pre *McDowell* period, as disclosed by a review of the law reports, there are several cases where issues of tax avoidance and tax evasion were raised but not all those cases are important for the purpose of this article.[51] One obvious example is the set of cases that involve outright tax evasion by the reason of fraud.[52] Therefore, only two types of cases were selected for a closer inspection. First is the kind where the true character of the transaction was not disputed. In cases falling in this category, the taxpayer was

[51] See e.g. *A. Thangal Kunju Musaliar* v. *M. Venkatachalam Potti*, AIR 1956 SC 246. This was a unanimous five judge constitution bench opinion where certain references made by the State Government in respect of evasion of taxes where challenged on the ground that the government had no jurisdiction to make those references beyond the specific time periods for which it was empowered under the law. The question of law eventually came down to understanding whether the government had the requisite jurisdiction and to what extent can the High Court go, under Art. 226 of the Constitution, to judicially review such executive actions. The actual transaction by the taxpayer was not something that the Court was concerned with. There are a few other cases like these where certain laws of executive notifications have been challenged as unconstitutional. Cases such as these have been omitted from the discussion because these cases throw no light on what sort of transaction was undertaken by the taxpayer and why the Revenue was characterizing that transaction as tax evasive. In other words, there was no substantial tax evasion question involved in these cases. *See also M. Ct. Muthiah* v. *CIT*, AIR 1956 SC 269, where Taxation on Income (Investigation Commission) Act of 1947 was challenged on the ground that it violated the Equality Clause (Art. 14) of the Constitution. This law provided that the cases of "substantial evaders" of income tax were to be treated by a drastic and summary procedure whereby they could not exercise certain procedural rights like the right to inspect documents and the right to question finding of facts made by the Income Tax Officer in appeal, a right that other persons not falling within that class could enjoy, only because the government was of the view that a certain class of taxpayers fell into the category of "substantial evaders". The unanimous five judge constitution bench ultimately held that the classification was violative of the Equality Clause. But for reasons articulated in context of the previously noted case in this footnote, the case even though touching on the topic of tax evasions is essentially a constitutional matter where the validity of the legislation is in question and not a case where the characterization of a transaction is disputed. Thus this case cannot be included in our discussion of pre *McDowell* cases. See also *CIT* v. *Shanti K. Maheshwari*, 1957 SCC OnLine Bom 116 : AIR 1958 Bom 478 (Bombay High Court), where the question before a division bench of two judges of the Bombay High Court was about interpretation of certain articles of an Indo-Pak Double Taxation Avoidance Agreement; *Baldev Singh* v. *CIT*, AIR 1961 SC 736; *Ghanshyamdas* v. *CST*, AIR 1964 SC 766, for other example of cases that even though touch upon the subject of tax evasion or income/turnover escaping assessment do not qualify to be discussed for the purposes of the current discussion. Other cases that do not quality despite having a discussion on tax evasion in them are noted as and when required during the course of this article.

[52] See e.g. *Jagannath Prasad* v. *State of U.P.*, AIR 1963 SC 416 for cases that fall into this category. This is a case where forged documents and invoices were submitted along with sales tax returns in order to avoid application of sales tax laws. The taxpayer was prosecuted and convicted for tax fraud. The Court speaks about the importance of preventing tax evasion but the context is completely different and thus not relevant for this article.

attempting to obtain the tax benefits that would arise if the transaction was held to be covered by a certain provision of a statute, taxation or otherwise. Second is the kind where true character of the transaction was itself disputed. Here a deduction or an exemption was claimed by the taxpayer while computinghis tax liability that was denied by the revenue authorities on the groundsthat the deduction or the exemption was not genuine, but result of a colorable device.

In the first category, the judges would examine the text of the statute and invoke the aid of the long established principles of statutory interpretation to resolve the dispute. Since the facts of the cases (i.e. the true nature of the transaction) before the Court were not disputed, the question perforce was strictly legal restricted only to an examination of the applicable statute. The traditional judicial way of resolving this dispute, not just in India but in almost all common law jurisdictions, has been to 'interpret' the law for that is a functioneminently within, and has always understood to be within, the domain of the judiciary. In the first category five distinct principles of statutory interpretation stand out clearly in the Indian tax avoidance jurisprudence. These are – (1) The Legislative Intent Rule, (2) The Textual Rule, (3) The Minimum Liability Rule, (4) The Strict Interpretation Rule, and (5) The Restrictive Strict Interpretation Rule. These rules are not mentioned in any order of preference.

In the second category, the true nature of the transaction is itself disputed, thus, making the judicial function a bit more complex. Determination of the true nature of the transaction is necessarily a factual question. This determination cannot be successfully obtained by the application of principles of statutory interpretation, for these principles are rules of constructing a legal text and not of determining facts.[53] Thus, the need to articulate a judicial test, as has been done in other contexts by almost all common law courts, to determine the true nature of the transaction. Once this determination is obtained, there is no restriction for the revenue authorities to raise a question of law i.e. even though true nature of the transaction is now determined (thus, there being no dispute as to the facts), the law is not applicable to this transaction. At this state we find ourselves facing a question that falls in the first category where the question is not of facts but of law. This is where the judge sometimes carries on with the judicial test previously articulated. But,

[53] *See e.g.* Martin A. Chirelstein, "Learned Hand's Contribution to the Law of Tax Avoidance", 77 Yale. L. J. 440, 441 (1968) where, speaking in context of Justice Hand's contribution, Chirelstein makes a distinction between permissible and impermissible tax avoidance that he says is the basis on which it is to be decided whether a "literal construction" of the statute is appropriate or not. For Chirelstein therefore the invocation of a particular statutory interpretational rule is based on first examining the true nature of the transaction.

it stands to reason that since the traditional method of using statutory interpretation has worked well in the past, the judge ought to continue with that method unless there is a strong reason to do otherwise. In the second category, four distinct judicial tests seem to have been articulated by the Court, but they operate in very narrow areas. These are – (1) The Test of Ordinary Course of Business, (2) The Prudent Businessman Yardstick, (3) The Test of Bonafide Commercial Transaction, and (4) The Test of Commercial Expediency.

## I. The Legislative Intent Rule

One of the earliest cases on point is 1957 3-judge bench opinion delivered in *CIT* v. *Sodra Devi* ('*Sodra Devi*').[54] In this case,this rule was invoked by the Court to interpret the Income Tax Act of 1922 to resolve a tax avoidance dispute.The taxpayers, in these bunch of tax-appeals before the Supreme Court, had admitted to the benefits of their partnership firm obtained with the help of their minor sons and wives.[55] Businessmen had been regularly resorting to this arrangement in British India[56] because there was no provision in the Income Tax Act of 1922 to include the income of wife or a minor child in the computation of the total income of 'any individual' for the purpose of assessment.[57] The absence of any such provision in the Act resulted in a lot of income that escaped assessment.[58] Note here that the Court characterized this arrangement as tax-evasive[59] even though there was no positive provision of law that was being violated. The phrase was used to denote an 'evil' that 'was so rampant' that a positive provision of law was required to remedy it.[60] There was a gap in the law that was being exploited by the taxpayers to bring their taxable income down – a perfectly acceptable legal strategy not just in India but also in other common law jurisdictions. To remedy this problem, in 1937 section 16(3)[61]

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54 *CIT* v. *Sodra Devi*, AIR 1957 SC 832.
55 *Ibid.* at 833, 834.
56 This was a point that was noted by the Income Tax Enquiry Report of 1936. The relevant passages from the Report are quoted *ibid.* at 838.
57 *CIT* v. *Sodra Devi*, AIR 1957 SC 832, 838.
58 *Ibid.*
59 *Ibid.* Justice Bhagwati (for himself and Justice Kapoor) observing that, "There were also cases where husbands and fathers provided shares for their wives and minor sons and thus evaded payment of income tax in regard to their shares in the profits of such partnerships."
60 *Ibid.* Justice Bhagwati refers to the Income Tax Inquiry Report of 1936 that recommended the insertion of S. 16(3) in order to make taxable the income that was distributed by husbands and fathers to their wives and minor children by entering into nominal partnerships by admitting the same to the benefits of the partnership.
61 Income Tax Act, 1922, S. 16(3) (relevant part) provided that – "In computing the total income of any individual for the purpose of assessment, there shall be included – (a) so much of the income of a wife or minor child of such individual as arises directly or indirectly: (i)

was inserted into the Act in 1937.[62] But, after insertion of section 16(3) a new problem arose. In this bunch of tax-appeals before the Court, in one of the cases the partner in the firm had admitted his wife and two minor sons to the benefits of the partnership but had subsequently died.[63] As per section 16(3), the partnership income that went to the share of the minor sons was to be included in the income of their father, also a partner in the firm, for computation of income tax. But since he was now dead, section 16(3) could not be used to tax the income that went to the minor sons. So the revenue added the income of the minor sons to the income of their mother who was also a partner in the firm by interpreting the word 'individual' in section 16(3)(a) as including a male as well as a female.[64] Thus, the income distributed to the minors was not allowed to escape assessment, which gave rise to the question as to whether the word 'individual' in section 16(3)(a) was used to mean 'a male of the species' or 'both a male as well as a female of the species'.[65]

Justice Bhagwati found that the use of the word 'individual' in section 16(3)(a) was ambiguous[66] and aid of the Income Tax Enquiry Committee Report of 1936[67] as well as the Statement of Object and Reasons behind the 1937 amendment inserting section 16(3)[68] may validly be taken to interpret the ambiguous word 'individual'.[69] Having examined the background context in which the legislature had chosen the word 'individual' Justice Bhagwati concluded that the word 'individual' was restricted to only to mean 'the male of the species' and not the female[70] even though divorced

from the membership of the wife in a firm or which her husband is a partner; (ii) from the admission of the minor to the benefits of the partnership in a firm of which such individual in is a partner; ..." Another important case that does not qualify for a detailed discussion is the unanimous five judge constitution bench opinion delivered in *Balaji* v. *ITO*, AIR 1962 SC 123 where S. 16(3)(a)(i) was challenged as unconstitutional. The constitutional challenge failed and in that context Justice Subba Rao (for the Court) observed that (at 129), "The object sought to be achieved [by Section 16(3)(a)] was to prevent the prevalent abuse, namely, evasion of tax by an individual doing business under a partnership nominally entered with his wife or minor children.... The mode of taxation may be a little hard on a husband or a father in the case of genuine partnership with wife or minor children, but that is offset, to a large extent, by the beneficent results that flow therefrom to the public, namely, the prevention of evasion of income tax...."

62 *CIT* v. *Sodra Devi*, AIR 1957 SC 832, 838.

63 *Ibid*. at 834.

64 *Ibid*.

65 *Ibid*. at 836.

66 *Ibid*. at 837. Justice Das delivered a dissenting opinion (*ibid*. at 840-846) and held that (*ibid*. at 845), "My conclusion therefore is that there is nothing in the policy of the legislation and the scope and object of the statute which compels one to cut down the natural meaning of the word "individual" used in sub-section (3) of Section 16 of the Act so as to confine it to a male individual alone."

67 *Ibid*. at 838.

68 *Ibid*. at 839.

69 *Ibid*. at 835.

70 *Ibid*. at 839, 840.

from that context it could be interpreted to include both male and female.[71] Consequently it was held, '... it was not the intention of the Legislature to impose additional tax on a mother taxpayer by including in her income the income of her minor children arising from the benefits of partnership of a firm in which the mother and the minors were partners'.[72]

The Court in *Sodra Devi* did not articulate any judicial test to examine the validity of the transaction even though there were some observations regarding the tax evasive nature of the same. This was because the genuineness of the partnership agreement was not disputed by the revenue authorities. This is an important point to note. For a judicial test to be articulated to examine the true nature of the transaction a dispute as to the true nature of the transaction must first exist.If the question is only whether a transaction is being covered by a certain legal provision or not, the nature of the transaction being undisputed, a judicial test is not really required to answer this question because principles of statutory interpretation are sufficient to resolve this dispute.A bare examination of the widely cited US Supreme Court case *Gregory* v. *Helvering*[73] is sufficient to demonstrate this point. This is an important distinction that has not been understood by courts across common law jurisdictions while dealing with tax avoidance disputes. As we will see, the failure to realize this distinction results in courts articulating judicial tests that create more problems than they could solve. These judicial tests, articulated,in fact,to review the true nature of the transaction are subsequently invoked as principles of interpretation to interpret taxation statutes – a purpose for which these tests were neither created nor can legitimately be used. This problem is further compounded by the failure to properly distinguish between a judicial test is to be used and a principle of statutory interpretation. On top of that there is also afurther failure to realize what specific principles of interpretation are to be used on what occasions.

One principle of interpretation that the judgesfeel bound by while interpreting taxation statues is that the terms of a taxing statute cannot be stretched in order to improve upon the efforts of the legislature and to fill gaps left open by the statute.[74] This principle of interpretation has been understood by some judges to mean that a taxation statute in its entirety must be subjected to a strict interpretation, thus, leading to the conclusion that a taxation statute cannot be interpreted by taking assistance of any external aids and must

[71] *Ibid*. at 839.

[72] *Ibid*. at 840.

[73] *Gregory* v. *Helvering*, 1935 SCC OnLine US SC 6 : 79 L Ed 596 : 293 US 465 (1935).

[74] See e.g. *Vestey's Executors* v. *Inland Revenue Commrs*., (1949) 1 All ER 1108 (HL) and *CIT* v. *S. Teja Singh*, AIR 1959 SC 352 (in principle accepting the rule of interpretation laid down in *Vestey's Executors* that the language of the taxing statute cannot be stretched and concluding that on facts it was not applicable).

be interpreted on its text and that too strictly. *Sodra Devi* is an example of (but not the only one)that there is no reason why a taxation statute should not be interpreted using the general principles of statutory interpretation that are available for non-taxation or non-fiscal statues.This is not to mean that all provisions of a taxation statutes can be interpreted using the general principles.But if some parts of a taxation statue can be interpreted using general principles while certain others must be interpreted strictly, the question naturally arises – how are we to separate the provisions of a tax law that can be interpreted using general principles from those that must be interpreted strictly? This question has been answered authoritatively by the Supreme Court as we will later see. Note here that in *Sodra Devi*, the Court not only used the statutory interpretation method to answer the legal question before it, but because the aid of external sources was taken, this case is an authority for the proposition that there is no reason why a taxation statute cannot be interpreted by invoking general principles of statutory interpretation. This rule of interpretation is designated the 'Legislative Intent Rule'.[75] We may caution ourselves by noting that it is not made clear in this case, under what circumstances, and to what parts of a taxation statute isthe Legislative Intent Rule applicable. We may further note that the rule was applied to a machinery provision of the Income Tax Act i.e. a provision pertaining to the computation of the tax liability. A machinery provision may be distinguished from a charging provision i.e. the provision that imposes the charge of the tax or lays down who has to pay the tax and on what basis.

## II. THE TEXTUAL RULE

Decided in 1958 by a unanimous bench of 3-judges, *Mazagaon Dock Ltd.* v. *CIT*[76] is the next case that qualifies for a closer inspection.This is a very interesting case on its facts. The taxpayer, a private limited company, incorporated under the Indian Companies Act, was engaged in the business of marine engineers and ship repairers.[77] Its office was in Bombay and for the purpose of the Income-tax Act, 1922, it was ordinarily residing in India.[78] The entire share capital of the appellant was owned by two British companies which were in the business of plying ships for hire.[79] The British companies,

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75 Even in the English common law, it is now well established that the Parliament cannot be expected to anticipate and legislate on every possible method of carrying out a transaction thus the next best solution is to allow the Courts to make assumptions about the legislative intent in certain situations. *See* David Dunbar, "Tax Avoidance: A Judicial or Legislative Solution; Lessons for the United States from the British Commonwealth", 12 CORP. BUS. TAX'N. MONTHLY 21, 24 (2011).

76 *Mazagaon Dock Ltd.* v. *CIT*, AIR 1958 SC 861.

77 *Ibid.* at 863.

78 *Ibid.*

79 *Ibid.*

non-resident in India for tax purposes, had an agreement with the appellant under which their ships were repaired by the appellant at an 'on-cost' basis without charging any profits.[80] The question before the Court was whether the appellant would be chargeable to tax under section 42(2) of the Income-tax Act, 1922?[81] Section 42(1) imposed a charge on income, profits or gains accruing to a non-resident through any *business connection* in the taxable territories.[82]

The appellant made two arguments. The first was that section 42(2) imposed a charge only on a business carried on by a non-resident, and therefore, no tax could be imposed under section 42(2) on the business of the appellant who is a resident.[83] This argument was based on the idea that the true intention behind section 42(2) was to tax the profits of the non-resident but the burden fell on the resident because of its close connection of the non-resident.[84] Rejecting this view it was held, 'The language of the section is clear beyond all reasonable doubt as to what it is that is sought to be taxed under this section. That is only the business of the resident and not that of the non-resident'.[85] The second was that a condition precedent for levy of a charge under section 42(2) was that the non-resident must carry on a business with the resident – a requirement that was not satisfied in this case.[86] This was based on the fact that the business of the non-resident companies was to ply ships for hire with which the appellant has no concern and that of the appellant was to repair ships with which the non-resident companies had no concern.[87] Although smartly crafted, the argument also could not withstand the judicial scrutiny. Rejecting this argument, it was held,

The non-resident Companies send their ships for repair to the appellant, not as they might to any other repairer but under a special agreement that repairs should be done at cost. And further unlike customers who purchased

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80 *Ibid.*

81 *Ibid.* Income Tax Act, 1922, S. 42(2) provided – "Where a person not resident or not ordinarily resident in the taxable territories carries on business with a person resident in the taxable territories, and it appears to the Income Tax Officer that owing to the close connection between such persons the course of business is so arranged that the business done by the resident person with the person not resident or not ordinarily resident produces to the resident either no profits or less than ordinary profits which might be expected to arise in that business, the profits derived therefrom, or which may reasonably be deemed to have been derived therefrom, shall be chargeable to income tax in the name of the resident person who shall be deemed to be, for all the purposes of this Act, the taxpayer in respect of such income tax."

82 *Mazagaon Dock Ltd.* v. *CIT*, AIR 1958 SC 861, 867.

83 *Ibid.* at 864.

84 *Ibid.*

85 *Ibid.* at 865.

86 *Ibid.* at 864.

87 *Ibid.* at 866.

goods for their own consumption or use, the non-resident Companies get their ships repaired for use in what is admittedly their business. These are clearly trading activities, organized and continuous in their character and it will be difficult to escape the conclusion that they constitute business.[88]

But most notable is the observation of the Court on section 42(1).[89] In *Anglo-French Textile Co. Ltd.* v. *CIT*[90] the Court, interpreting section 42(2), had held, '...where there is continuity of business relationship between the person in British India who helps to make the profits and the person outside British India who receives or realizes his profits, such relationship constitute a business connection'.[91] Relying on this authority, the Court held that the phrase "where a person not resident in the taxable territories carries on business with a person resident" in section 42(2) should be similarly interpreted.[92]

Note here that the Court did analyze the true nature of the transaction. Now, there was every reason for the Court to lay this down as a judicial test to be applied to similar cases in future. But they didn't because the question before the Court essentially was a legal one – is this transaction covered by section 42(1) or not? Both arguments made by the taxpayer were based on interpretation of section 42(1). Thus, the Court, true to its tradition, followed the statutory interpretation method. We may designate this as the 'Textual Rule'.

As per this rule, the Court examined only the text of the statutory provision to see if the transaction comes within the purview of the same or not. This rule may be distinguished from the Legislative Intent Rule in a very important way. Section 42(1) imposed a charge of income tax on certain types of income and was not concerned with actual computation of the income tax once the income chargeable to tax is determined. Whereas in *Sodra Devi*, the statutory provision was not about determining the charge of the income but about computation of income by adding income of the father and the income of the minor sons who were partners in the same partnership firm. This distinction is crucial to understand where the Legislative Intent Rule is to be invoked and where the Textual Rule is to be invoked. Though *Mazagaon Dock* does not clearly articulate this distinction, it would be made abundantly clear by the Court in a later case when the 'Restrictive Strict Interpretation Rule' would be laid down.

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88 *Ibid.*
89 *Ibid.*
90 *Anglo-French Textile Co. Ltd.* v. *CIT*, AIR 1953 SC 105.
91 Cited with approval at *Mazagaon Dock Ltd.* v. *CIT*, AIR 1958 SC 861, 867.
92 *Mazagaon Dock Ltd.* v. *CIT*, AIR 1958 SC 861, 867.

## III. The Minimum Liability Rule

This is the second most important pre *McDowell* rule. It is my view that not just the Supreme Court of India, but all common law courts would be well assisted to keep this rule in their sights anytime they engage with a tax avoidance dispute. This is an established and long accepted ruleof Indian tax avoidance jurisprudence. The rule, the origins whereof can be traced to the British common law, is a well-accepted and long established common law rule of statutory interpretation of taxation and fiscal statutes.[93]

The 1964 case of *CIT* v. *Sivakasi Match Exporting Co.* ('*Sivakasi*')[94] is the first case in point. In this case,there were five firms (one sole proprietorship and four partnership firms) that were engaged in the business of manufacturing matches in *Sivakasi* and the total number of partners in these five firms was 'ten or eleven'.[95] Later, one person from each of these five firms in their representative capacity formed a new partnership to carry on the business of banking and commission-agents for the principal business of marketing the products of different match factories in *Sivakasi*.[96] The new partnership's application for registration with the Income Tax Department as a taxpayer was denied on the ground that different firms could not constitute a valid partnership.[97] After this denial, the partners from these four firms and the sole proprietor came together in their individual capacities, entered into a new partnership for the same purpose and executed a partnership deed.[98] This new partnership was accepted and given a registration certificate as a taxpayer by the Income Tax Officer but the Commissioner of Income Tax, by an order, cancelled the same and directed that the firm be assessed to income tax as an unregistered firm, on the ground that the partnership deed was not genuine and was only to reduce the tax liability of the partners.[99] Before the Supreme Court, it was not disputed that the partnership deed conformed to the legal requirements under the Income Tax Act

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93 *See* David Dunbar, "Tax Avoidance: A Judicial or Legislative Solution; Lessons for the United States from the British Commonwealth", 12 Corp. Bus. Tax'n. Monthly 21, 24 (2011). As per the English common law, "… taxpayers must not be taxed unless they come within the letter of the law. Accordingly, it is the right of all taxpayers to arrange their affairs so as to pay as little as is legally possible…". Though this rule must be read with the cautionary note stuck by the 7th Circuit in *Saviano* v. *Commr. of Internal Revenue*, 765 F 2d 643 (7th Cir 1985) where it was held that a taxpayers in the guise of this principle cannot involve in "financial fantasies" and expect the Revenue to "play along".

94 *CIT* v. *Sivakasi Match Exporting Co.*, AIR 1964 SC 1813.

95 *Ibid.* at 1814.

96 *Ibid.*

97 *Ibid.* at 1814-15.

98 *Ibid.* at 1815.

99 *Ibid.*

as well as the Indian Partnership Act.[100] As it happened, under the Indian Partnership Act there was no legal prohibition against the partners in one firm combining together to form another partnership for carrying on a separate business.[101] The partnership deed therefore was held to be embodying a valid partnership.[102] The objection of the revenue was that if the new partnership is accepted as valid then the profits from the businesses would be split between the new partnership and the already existing previous partnership firms (i.e. between the firms manufacturing the matches and the firms marketing them).[103] The legality of this partnership as permitted by the Indian Partnership Act was not questioned by the revenue authorities. It was the effect of this new partnership that was being questioned and consequently the partnership arrangement was being re-characterized by the revenue as a tax evasive arrangement, even though legally permissible. But the Supreme Court was not impressed and Justice Subba Rao held that, '…the mere fact that one of [the partners] borrowed the capital from a parent firm… or some of [the partners] surrendered their profits to the parent firm cannot make it any the less a genuine firm.'[104] The legal principle at the heart of tax avoidance versus tax evasion debate was noted by Justice Subba Rao as –

> [The partnership agreement] is a genuine document and it complies with the requirements of the law. *It is not an attempt to evade tax, but a legal device to reduce its tax liability.*[105]

Justice Shah in his dissenting opinion also noted this principle (and did not express any disagreement with it) as–

> *It is always open to a person, consistently with the law, to so arrange his affairs that he may reduce his tax liability to the minimum permissible under the law.* The fact that the liability to tax may be reduced by the adoption of an expedient which law permits, is wholly irrelevant in considering the validity of the expedient. But where the law prescribes conditions for obtaining the benefit of reduced liability

[100] *Ibid.* at 1816.

[101] *Ibid.*

[102] *Ibid.*

[103] *Ibid.* The Income Tax Appellate Tribunal had noted that as per the new partnership deed the newly created firm had the right to collect the commission of the entire match production of the larger partnerships whether they effect their sales through the firm or not. Also the fact that most of the capital for the new firm had been contributed by only one member in his individual capacity.

[104] *Ibid.* at 1817. Justice Subba Rao (for himself and Justice Sikri) noted that securing capital from another from or surrendering the profits to any other person would not convert a valid partnership into a bogus one. Justice Shah delivered a dissenting opinion (*ibid.* at 1817-21) where he took the view that it was open to the Income Tax Officer to decline to register a partnership firm even if the firm conformed to the provisions of the Indian Partnership Act.

[105] *Ibid.* (emphasis added).

> to taxation, those conditions, unless otherwise provided, must be strictly complied with, and if they are not so complied with, the taxing authorities would be bound to refuse to give the taxpayer the benefit claimed.[106]

Both judges did not cite a single judicial precedent in support of the above quoted observations, perhaps because both judges took this principle to be so widely accepted so as to not require any reference to an authority. We may designate this rule as the 'Minimum Liability Rule' whereby if the taxpayer engages in a genuine transaction the consequence of which is the reduction of his tax liability, the Court will not concern itself with the effect of the transaction so long as the transaction is genuine. The 'genuineness' of the transaction is to be judged by testing whether the transaction strictly complies with the relevant law applicable to such transaction. This rule of interpretation is based on the judicial policy that every taxpayer is allowed to so arrange his affairs so as to bring his liability to the minimum permissible under the law.

We began with a distinction between two types of tax avoidance cases. One is where the facts are admitted and only the application of law is contested and second is where the facts are also disputed in addition to the application of law that may or may not be contested. In the first category, the judges have used the principles of statutory interpretation to resolve the legal question and in the second, they use a judicial test to resolve the factual question and then may or may not use principles of statutory interpretation to resolve the factual question. Since *Sivakasi Match Exporting* is a case where the transaction was being re-characterized, it is a factual dispute. A question may fairly be asked – why did the judges not articulate a judicial test in this case? The Court could have articulated a test akin to the 'Business Purpose Test'. The facts were ripe for such an articulation. If the partnership was created only to split the profits thus reducing the taxable income without any business or commercial reason for the firm to exist, revenue authorities would be well within their jurisdiction to say that the firm is nothing but a colorable device to avoid taxes. So why didn't they? Because if we look closely, the facts of this case were not in dispute even though on a first reading it might appear to be so. The Commissioner never argued that the partnership firm as constituted was a device that was not permissible by the law. Lack of business purpose was a plea that the Commissioner never took in this case. Instead the argument was that the net taxable income would be reduced. That, the Court rightly held, is no ground to deny a legally constituted partnership a tax registration certificate. This was because there is no

[106] *Ibid.* at 1820. (emphasis added)

legal obligation to pay maximum tax that may be levied by the law. There was, therefore, no occasion for the Court to articulate a judicial test and the Court correctly did not venture on to that exercise.

In 1968, a unanimous 3-judge bench of the Court delivered its opinion in *CIT* v. *A. Raman & Co.* ('*Raman*')[107] and re-exposited this principle. *Raman* is the case that, in the Popular Narrative, is understood to be the most important pre *McDowell* case on the point. As is demonstrably the case, it is not the accurate position. *Raman* is also a rather ordinary case. on its facts, that further challenges its position in the Popular Narrative as a case of such high significance as it is made out to be. In this case, the assessment officer had issued notices for reopening assessments for previous three financial years (viz. 1959-60, 1960-61 and 1961-62) to the taxpayer on the ground that an attempt to divert profits to another entity and consequently evade taxation had been made by the partners of the taxpayer.[108] In response the taxpayer raised a plea the assessment officer had no jurisdiction to reopen assessments[109] and in the alternative that correct and proper returns supported by books of accounts for each assessment year had been submitted.[110] After this reply was rejected by the assessment officer, the taxpayer was able to successfully challenge the notices before the Gujarat High Court under article 226 of the Constitution.[111] The Supreme Court granted special leave to the Commissioner of Income Tax,[112] affirmed the High Court's order and dismissed the Commissioner's appeal.[113] The notice for reassessment was issued under section 147(1)(b) of the Income Tax Act, 1961[114] and the 'reason to believe' that income had escaped assessment was a condition precedent to exercise of jurisdiction under section 147(1)(b)[115] failing which the notice of reopening assessment could be quashed.[116] The question before the Supreme Court was, in fact, very narrow – was the exercise of jurisdiction under section 147(1)(b) on assessment officer's part valid in this case?[117] It was in

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107 *CIT* v. *A. Raman & Co.*, AIR 1968 SC 49.
108 *Ibid.* at 50-51.
109 *Ibid.* at 51.
110 *Ibid.*
111 *Ibid.*
112 *Ibid.*
113 *Ibid.* at 53.
114 *Ibid.* at 51, relevant part of the Income Tax Act, 1961, S. 147(1)(b) provided – "notwithstanding that there has been no omission or failure as mentioned in Cl. (a) on the part of the taxpayer, the Income Tax Officer has in consequence of information in his possession reason to believe that income chargeable to tax has escaped assessment for any assessment year, he may, subject to the provisions of Sections 148 to 153, assess or re-assess such income or recomputed the loss or the depreciation allowance as the case may be, for the assessment year concerned."
115 *Ibid.*
116 *Ibid.*, see also *Calcutta Discount Co. Ltd.* v. *ITO*, AIR 1961 SC 372.
117 *CIT* v. *A. Raman & Co.*, AIR 1968 SC 49, 52

response to this narrow question that the unanimous three judge bench in this case had made an observation that would subsequently be cited in the Popular Narrative as an authoritative pronouncement on the point.

One of the arguments that the revenue made in order to defend the issuance of notice of reopening assessment was that there was some income that could have been earned by the taxpayer but, in fact, it (owing to the arrangements made by the taxpayer) was not and was instead earned by some other entity.[118] If this arrangement would not have existed, then the income of the taxpayer would have been higher.[119] The arrangement made by the taxpayer was a 'subterfuge' or a 'contrivance' and for this arrangement the income would 'normally' have been earned by the taxpayer.[120] The argument was rejected and it was in this context that the following observation, which is cited in the Popular Narrative, was made –

> *But the law does not oblige a trader to make the maximum profit that he can out of this trading transactions.* Income which accrues to a trader is taxable in his hands: income which he could have, but has not earned is not made taxable as income accrued to him. By adopting a device, if it is made to appear that income which belonged to the taxpayer had been earned by some other person, that income may be brought to tax in the hands in the hands of the taxpayer… *Avoidance of tax liability by so arranging commercial affairs that charge of tax is distributed is not prohibited. A taxpayer may resort to a device to divert the income before it accrues or arises to him. Effectiveness of the device depends not upon considerations of morality, but on the operation of the Income-tax Act. Legislative injunction in taxing statutes may not, except on peril of penalty, be violated, but it may lawfully be circumvented.*[121]

It takes only a moment's reflection and comparison of this view with the view taken in *Sivakasi Match Exporting* Co. in 1964 to see that the principle of law being laid down is exactly similar. *Raman* was subsequently cited with approval by a unanimous 3-judge bench in 1972 in *Lachminarayan Madan Lal* v. *CIT*[122] and in 1973 by a division bench in *CIT* v. *Calcutta Discount Co. Ltd.*[123] Thus, it made the "well-accepted proposition that the

118 *Ibid.*

119 *Ibid.*

120 *Ibid.* at 52-53.

121 *Ibid.* at 53. (emphasis added)

122 *Lachminarayan Madan Lal* v. *CIT*, (1973) 3 SCC 76.

123 *CIT* v. *Calcutta Discount Co. Ltd.*, (1974) 3 SCC 260. In this case the taxpayer company floated a subsidiary company and transferred to that various shares held by it. In return the subsidiary transferred to the taxpayer company its shares amounting to INR

law does not oblige a trader to make the maximum profit that he can out of his trading transactions" and that "an assessee can so arrange his affairs as to minimize his tax burden" a part of Indian tax avoidance jurisprudence. The observations of the bench, in *Madan Lal*, are worth noting in full –

> Avoidance of tax liability by so arranging commercial affairs that *charge of tax* is distributed is not prohibited. A tax-payer may resort to a device to diver the income before it accrues or arises to him. Effectiveness of the device depends not upon considerations of morality but on the operation of the Income Tax Act. But… if it is made to appear that the income which belonged to the assessee had been earned by some other person, that income may be brought to tax in the hands of the assessee.[124]

## IV. The Strict Interpretation Rule

This rule in India has been taken directly from the 1920 British opinion delivered in *Cape Brandy Syndicate* v. *Inland Revenue Commrs.* ('*Cape Brandy*').[125] The following quote from *Cape Brandy* has been cited with approval in several Indian Supreme Court opinions –

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13,881,173. The book value of these shares of the subsidiary was INR 16,669.391. The taxpayer company thus suffered a loss of INR 27,02,389 on the transaction but never claimed that loss on its tax returns. However the income tax officer valued these subsidiary shares at their market value and concluded that in fact the taxpayer has made a profit of INR 10,240,546 on the transaction and accordingly imposed income tax on the same. The income tax officer's order was reversed by the Appellate Commissioner; the Appellate Commissioner's order was upheld in appeal by the Income Tax Appellate Tribunal, then by the Calcutta High Court and finally by the Supreme Court. The Calcutta High Court held that in absence of any evidence to show that this was a sham transaction the income tax officer's order cannot be sustained. Relying on *Raman* the Revenue's appeal was dismissed by the Supreme Court and High Court's reasoning was upheld.

124 *Lachminarayan Madan Lal* v. *CIT*, (1973) 3 SCC 76, 81. Though it would be profitable to note that on the facts the taxpayer lost this case. The taxpayer in this case was a firm of three brother partners. Their business was that of manufacture and sale of aluminium utensils. Till a given assessment year, the firm was making sales directly to customers but in the next year the firm claimed that a commission was paid to another firm and claimed deduction in its tax returns. This selling agency, it turned out, was nothing but a "manifestation" of the taxpayer firm created only to minimize taxable income by claimed a "make-believe" deduction. Out of the five members in this selling agency, one partner was also a partner in the taxpayer firm. The other two partners were wives of the partners in the taxpayer firm, two minor sons of the fellow who was partner in both firms and his major son. Besides, and most importantly, the selling firm had not even come into existence on the date on account of the sales for which it had received the commission for which the taxpayer firm had claimed deductions.

125 *Cape Brandy Syndicate* v. *Inland Revenue Commrs.*, (1921) 1 KB 64 .

> In a Taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.[126]

Unfortunately in an overwhelmingly large number of these Indian opinions, *Cape Brandy* is indiscriminately used and cited without any attempt by the judges to establish why *Cape Brandy* in that case can be legitimately cited.[127] There are also other opinions, the facts of which need not detain us, where this principle has been recognized by the Court without direct reference to *Cape Brandy*.[128] It is not being suggested that the above quoted principle is not a sound principle of interpretation but a blind reliance on this principle is neither an advisable practice nor a wise one.

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[126] *Ibid*. at 71.

[127] See e.g. *CTO* v. *Binani Cements Ltd*., (2014) 8 SCC 319 : (2014) 68 VST 459, where the issue was the grant of an eligibility certificate for exemption from payment of sales tax; *CIT* v. *Shahzada Nand & Sons*, AIR 1966 SC 1342, where the dispute was regarding issuance of a reassessment notice; *Baidyanath Ayurved Bhawan (P) Ltd*. v. *Excise Commr*., (1971) 1 SCC 4 at 7 where the dispute was regarding levy of excise duties on certain medicinal substances on the ground that they contained alcohol; *ITO* v. *T.S. Devinath Nadar*, AIR 1968 SC 623, where the dispute was regarding the scope of rectification powers given under the Income Tax Act of 1922, speaking for the unanimous 5-judge constitution bench Justice Mitter observed, "[The *Cape Brandy* principle has] been accepted as correct both by the English courts and the superior courts in this country. It is now well established that if the interpretation of a fiscal enactment is in doubt … the subject cannot be taxed unless he comes within the letter of the law and the argument that he falls within the spirit of the law cannot avail the department." These authorities have been cited by way of illustration. It is completely beyond the scope of the stated objective of this paper to venture into a detailed examination of this particular principle of statutory interpretation thought the author feels obliged to report that a survey of the Indian cases on the point disclose that there are two sides to this principle – (1) a general rule that a charging provision must be strictly interpreted that sometimes is misunderstood by some judges to mean that the entire taxation statute must be strictly interpreted and (2) a specific rule that if any ambiguity remains in the taxation statute an interpretation favoring the taxpayer must be adopted. This second side of this principle provides considerable support to the Minimum Liability Rule according to which the taxpayer has a legal right to legally minimize its tax liability. Both these read together go a long way in establishing that morality of tax avoidance notwithstanding, it has always been accepted in the common law courts that the taxpayer has a right to pay the legal minimum by way of taxes to the State. For a discussion on the morality of tax evasion, *see* Richard J. Kovach, "Taxes, Loopholes and Morals Revisited: A 1963 Perspective on the Tax Gap", 30 Whittier L. Rev. 247, 277 (2009).

[128] See e.g. *CIT* v. *Mir Barkat Ali Khan Bahadur*, (1975) 4 SCC 360; *Lakshmi Kant Jha* v. *CWT*, (1974) 3 SCC 126, 132, Justice Khanna for the Court observing that, "It, no doubt, appears to be somewhat harsh that in computing the value of an asset only the price it would fetch if sold in the open markets has to be taken into account and the expenses which would have to borne in making the sale have to be excluded from consideration. This, however, is a matter essentially for the legislature. No resort can be made to an equitable principle for there is no equity about a tax." The caveat mentioned in *supra* note 127 is applicable here as well. These cases are cited by way of illustration for a more detailed examination of this rule is beyond the stated objective of this article.

It is necessary first therefore to examine the context in which *Cape Brandy* was decided. Three gentlemen, who were members of different firms, came together and formed the Cape Brandy Syndicate.[129] They purchased 3100 casks of brandy from Cape Government[130] and shipped some of this brandy to London where it was blended with French brandy and subsequently sold, for profit, between July 1, 1916 and September 17, 1917.[131] Resisting the application of the excess profits duty, the taxpayers argued that the profits they had earned were the realization of a speculative investment and not profits arising from a trade or business carried on by the appellants.[132] In any case the business did not commence until 1916 and excess profits duty could not be charged on a business commencing after August, 1914.[133] Justice Rowlatt found that the charge of tax was created on, '...the amount by which profits made since the outbreak of war have exceeded what is called the pre-war standard of profits'.[134] But if company had commenced business, "... after the outbreak of war there has, of course, been no pre-war trade year".[135] Describing the revenue authorities' attempts to levy the pre-war standards on the business of the taxpayers that was commenced after the war as 'extremely artificial' and 'too wide and fanciful' he held,

> ... in a taxing Act one has to look merely at what is clearly said. There is no room for intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.[136]

This was, thus, in the context of a charging provision that Justice Rowlatt made these observations.

Now, note what happened afterwards. The British Parliament had enacted another statute by which the excess profits duty was extended to a post-war period,[137] thus, imposing 'not in direct words but by necessity, this tax on trade and businesses commencing after August 4, 1914'.[138] Staying true to the principle of strict interpretation he held,

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[129] *Cape Brandy Syndicate* v. *Inland Revenue Commrs*., (1921) 1 KB 64.
[130] *Ibid*.
[131] *Ibid*. at 65.
[132] *Ibid*.
[133] *Ibid*. at 65, 66.
[134] *Ibid*. at 69.
[135] *Ibid*. at 70.
[136] *Ibid*. at 71. On this basis it was held that by Justice Rowlatt that, "I find it quite impossible to hold that this tax has been imposed by the Finance (No. 2) Act, 1915, upon a person who had no pre-war trade or business."
[137] *Ibid*.
[138] *Ibid*. at 72.

> I have come to the conclusion that s. 45, sub-s. (2), of the Act of 1916 extends the scope of the Act of 1915. I must treat this exposition in the Act of 1916 in the same way as if it had been given by a Court binding upon me, compelling me to construe the Act of 1915 in a way that I could not otherwise have done... the only effect I can give to the legislation is to say that the interpretation of the Act of 1915 given by the Act of 1916 must ensure for the purposes of construing similar Acts, although not containing the same words as the Act of 1916.[139]

What the judge had held in context of the charging provision of the 1915 Act, because of the charge being extended by the 1916 Act, by the application of the same principle the judge had to hold all over again. In other words, upon a strict interpretation of the charging provision of the 1915 Act the taxpayers were not liable but since the charge was extended to post-war years by the 1916 Act, by the application of the exact same principle the taxpayers were liable and were held to be so. The taxpayers argued that the 1916 Act only laid down a rate of tax and not a charge but this argument was summarily rejected by the judge.[140] A careful observer will instantly note that *Cape Brandy* was a case that was not even close to either a tax evasion or a tax avoidance case. There was nothing of the sort even remotely hinted in this case. This was a case that involved a purely technical question of law and other than an ardent student or a practitioner of taxation laws, or perhaps a brandy connoisseur, the case would hardly interest the general public.

The rule is also stated in *Tarulata Shyam* v. *CIT*[141] (and affirmed by a unanimous 5-judge constitution bench in *Janapada Sabha, Chhindwara* v. *Central Provinces Syndicate Ltd.*[142]) where the unanimous three judge bench, speaking in context of sections 2(6A)(e), 12(1B) and 23A of the Income Tax Act of 1922, the interpretational principle was stated as follows –

> ... in a taxing act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used. Once it is shown that the assessee comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be.[143]

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139 *Ibid.*

140 *Ibid.*

141 *Tarulata Shyam* v. *CIT*, (1977) 3 SCC 305.

142 *Janapada Sabha, Chhindwara* v. *Central Provinces Syndicate Ltd.*, (1970) 1 SCC 509, 514.

143 *Ibid.* at 316 (internal citations omitted). See also *CIT* v. *Central India Industries Ltd.*, (1972) 3 SCC 311, where a division bench of the Supreme Court, in context of the provisions in the Income Tax Act of 1922 that were inserted in order to check evasion of income

## V. The Restrictive Strict Interpretation Rule

This is the most important rule of interpretation articulated by the Supreme Court that goes a long way in resolving tax avoidance disputes. Looked at in isolation, one cannot help but wonder that at the marvelous genius of this seemingly uncomplicated rule that opens up the paths considered heretofore closed primarily because of a misunderstanding of the scope of the Strict Interpretation Rule. But looked on a broader timeline, one realizes that this rule is nothing but a refined and more evolved version of the Legislative Intent Rule and the Minimum Liability Rule read together. This rule also gives a deep insight into resolving tax avoidance disputes to all members of the legal profession across common law jurisdictions. This rule seems to have been completely forgotten in India and the sooner this rule is revived the better.

This rule was first laid down in, what I considerthe most important pre *McDowell* opinion,by a 3-judge bench in *Murarilal Mahabir Prasad* v. *B.R. Vad*.[144] Despite this decision being of such great significance, it has not been cited in either *McDowell* or any of the post *McDowell* opinions. In this case, a partnership firm, doing business in Bombay, was registered as a 'dealer' under the Bombay Sales Tax Act of 1953 and then the Bombay Sales Tax Act of 1959.[145] A 'dealer' is a taxpayer under the Indian sales tax statues. For certain assessment years (1957-58), the sales tax officer assessed that the taxpayer firm had suppressed sales worth INR 41,47,090 that had escaped assessment.[146] During the period in which the assessment proceedings were pending, it was brought to the attention of the sales tax officer that the firm was actually dissolved in 1962.[147] This raised a question that had a jurisprudential angle to it as well. The question was that whether the sales tax officer had the authority to reassess a taxpayer firm that had ceased to exist prior to the date the assessment order was passed.[148] The reason behind the

tax by dividends being distributed in form of equity, observed that, "Equitable considerations are not relevant in interpreting the provisions of a taxing statute...". The Court was not impressed with the taxpayer invoking equity in case where factually it was clear that a clear attempt to evade payment of income tax by circumventing the law was being made. The Income Tax Appellate Tribunal had held that distribution of shares was not a distribution of profits and thus their value cannot be considered as divided. On appeal, the Supreme Court reversed and held when dividend in received in kind (in this case in form of shares), the market value of those shares can be added to the income of the taxpayer on which income tax can be levied for otherwise, "... companies may distribute their dividends in kind and under-value the goods distributed and thereby facilitate evasion of tax by their share-holders."

144 *Murarilal Mahabir Prasad* v. *B.R. Vad*, (1975) 2 SCC 736.

145 *Ibid*. at 739.

146 *Ibid*. at 740.

147 *Ibid*. at 741.

148 *Ibid*.

question being that was nothing in the law that expressly authorized the revenue authorities to assess a dissolved firm, therefore, making everything done by the sales tax officer without the authority of law.[149] Also, if there was no firm that survived, to whom would assessment notices be served?[150] The, now dissolved, taxpayer firm naturally invoked the interpretational principle that while interpreting fiscal statutes one must have regard only to the letter of the law and not the spirit of the law.[151] If accepted, this would allow the taxpayers firms to evade their tax liability by dissolving their firms before the assessment orders were passed.[152] Justice Chandrachud, speaking for the majority, resolved this question in a way that is a great example of judicial craftsmanship[153] and his words are worth reproduction in full and a very careful study –

> The true implication of the principle that a taxing statute must be construed strictly is often misunderstood and the principle is unjustifiably extended beyond the legitimate field of its operation. Indeed, the more well-expressed the principle in *Cape Brandy case*... the greater the reluctance to see its limitations... **There is no equity about a tax in the sense that a provision by which a tax is imposed has to be construed strictly, regardless of the hardship that such a construction may cause either to the treasury or the taxpayer.** If the subject falls squarely within the letter of law he must be taxed, howsoever inequitable the consequences may appear to the judicial mind. If the revenue authorities seeking to tax cannot bring the subject within the letter of law, the subject is free no matter that such a construction may cause serious prejudice to the revenue authorities. **In other words, though what is called equitable construction may be admissible in relation to other statutes or other provisions of a taxing statute, such a construction is not admissible in the interpretation of a charging or taxing provision of a taxing statute... To put in other words, the subject is not to be taxed unless the charging provision clearly imposes the obligation.**[154]

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149 *Ibid*. at 742.

150 *Ibid*. at 747.

151 *Ibid*. at 748. The Court also noted that the principle, coming from the English opinion *Cape Brandy Syndicate* v. *Inland Revenue Commrs*., (1921) 2 KB 403 that "In a taxing statute one has to look at what is clearly said. There is no room for intendment. There is no equity about a tax." was a part of Indian tax jurisprudence as well.

152 *Ibid*. at 745, 746.

153 The dissenting opinion was delivered by Justice Gupta that, in the opinion of this author, failed to realize the distinction between a "charging provision" and a "machinery provision" as correctly made by Justice Chandrachud. The distinction, it is submitted, is based on sound jurisprudential foundations and on a true reading of the observations as made by Justice Rowlatt in *Cape Brandy*.

154 *Murarilal Mahabir Prasad* v. *B.R. Vad*, (1975) 2 SCC 736, 749. The English common law equivalent of this rule has been described, in David Dunbar, "Tax Avoidance: A Judicial

Thus, by clarifying the scope of the Strict Interpretation Rule, Justice Chandrachud cleared the way for using ordinary principles of interpretation, one of which is the Legislative Intent Rule, to interpret the non-charging provisions of a taxing statute. It would be noted that not one of the cases discussed in this paper raised a dispute about whether or not the taxpayer was covered by the charging provision. In other words, in not one case was the taxpayer's stand that the charging provision is not applicable to it. The disputes are mostly centering around the question as to whether the taxpayer, by particular transaction, is permitted to take the tax benefits. Or whether a particular deducting or exemption claimed by the taxpayer on his returns may legitimately be claimed under the taxing statute. The provisions of the taxing statute, thus, subjected to interpretation were not charging provisions – these provisions did not *impose* the tax. They were machinery provision – pertaining to the calculation of tax liability.

Another rule that might offer valuable assistance to the Restrictive Strict Interpretation Rule is stated, for instance, in *State of T.N.* v. *M.K. Kandaswami*.[155] In this case, dealing with a question arising out of a provision of the Madras General Sales Tax Act of 1959, a unanimous three judge bench stated the interpretational principle as follows –

> In interpreting [a provision whose main object is to prevent evasion of tax] a construction which would defeat its purpose and, in effect, obliterate it from the statute book should be eschewed. If more than one construction is possible, that which preserves its workability, and efficacy is to be preferred to the one which would render it otiose or sterile. The view taken by the High Court is repugnant to this cardinal cannon of interpretation.[156]

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or Legislative Solution; Lessons for the United States from the British Commonwealth", 12 CORP. BUS. TAX'N. MONTHLY 21, 27 (2011), as the rule on "purposive construction". The rule is distinguished from the United States Economic Substance Doctrine, first laid down in *Gregory* v. *Helvering*, 1935 SCC OnLine US SC 6 : 79 L Ed 596 : 293 US 465 (1935), to the extent that, "A U.K. court would look at the purpose of the exemption from tax and not assume that it is to allow shareholders to adjust their shareholding without triggering a tax liability whenever it is commercially expedient to do so." Dunbar, after reviewing the views of four commonwealth superior courts viz. United Kingdom, Canada, New Zealand and Australia, concluded that, "The single greatest lesson that Congress and the Supreme Court could take from the British Commonwealth experience is that **all four superior courts have reached the position of accepting that revenue statutes are just like any other statute and should be consistently interpreted in a purpose fashion, having regard to the statutory language and also the intended legislative effect.**" (emphasis added). To these four superior courts, we may now confidently add the Supreme Court of India.

155 *State of T.N.* v. *M.K. Kandaswami*, (1975) 4 SCC 745.

156 *Ibid*. at 751.

It may be noted that this interpretational principle is a derivative of constitutional law. In constitutional interpretation, the rule that 'if two constructions of a law are equally possible and of them leads to the law being constitutionally invalid, while the other one upholds its validity, the law should be read in the manner that upholds its validity' is well recognized and established. The above quoted interpretational principle is a derivate of this general rule for the only thing that is different between the above quoted rule of interpreting a taxation statute and the above cited general principle of constitutional interpretation is the phrase 'tax law' against 'a law'.

## VI. The Test of Ordinary Course of Business

Contrary to the impression given by the Popular Narrative, *McDowell* is not the only 5-judge constitution bench opinion that dealt with the question of tax evasion, though it should be fairly stated that *McDowell* is the one that factually comes closest to the issue and, most importantly, is the only one in which direct and pointed observations of the sort made in that case. There are two pre *McDowell* 5-judge constitution bench opinions that partly dealt with the question of tax evasion by use of colorable devices by the taxpayers and the attempts made by the Parliament to arrest this problem.

The first was delivered in 1964 in *Navnit Lal C. Javeri* v. *K.K. Sen* ('*Javeri*').[157] In *Javeri*, constitutional validity of section 12(1B) and section 2(6A)(e) of the Income Tax Act of 1922 was challenged.[158] The combined effect of these two provisions was that three types of payments made by a company to its shareholders were treated as dividends to the extent of the accumulated profits held by that company. These three were – (i) payments made to the shareholder by way of advance or loan, (ii) payments made on his behalf, and (iii) payments made for his individual benefit. These legal provisions were enacted because the Parliament had realized that 'though enough money was reasonably available with the company in the form of profits, those in charge of the company deliberately refused to distribute it as dividends to the shareholders, but *adopted the device of advancing the said*

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[157] *Navnit Lal C. Javeri* v. *K.K. Sen*, AIR 1965 SC 1375.

[158] *Ibid.*, at 1378. Income Tax Act, 1922, S. 12(1-B) (relevant part) provided that – "any payment by a company to a shareholder by way of advance or loan which would have been treated as a dividend within the meaning of cl. (*e*) of sub-s. (6-A) of S. 2 in any previous year relevant to any assessment year prior to the assessment year ending on the 31st day of March, 1956, had that clause been in force that year, shall be treated as a dividend received by him in the previous year relevant to the assessment year ending on the 31st day of March, 1956, if such loan or advance remained outstanding on the first day of such previous year."

*accumulated profits by way of loan or advance* to one of its shareholders' with the objective of evading payment of taxes on accumulated profits.[159] The Court was also aware that such colourable devices are employed not just in India but worldwide.[160] However, the government had also realized that these legal provisions would also end up causing genuine hardship for all the genuine transactions of loans.[161] In fact, this was one of the primary grounds on which the constitutional validity of these provisions was assailed.[162] But the Central Board of Revenue issued a circular pointing out to the assessment officers that these provisions should not be applied to genuine transactions and directing them to 'intimate to all companies that if loans were repaid before June 30, 1956 in a genuine manner, they would not be taken into account in determining the tax liability of the shareholders' to whom the loans were advanced.[163] One of the five conditions that must be satisfied for these provisions to apply, as laid down by the majority opinion delivered by Chief Justice Gajendragadkar[164], was that, "...the loan must not have been advanced by the company in the *ordinary course of its business*."[165] In the Chief Justice's view, since the objective behind these provisions was to arrest the evasion of income tax by giving the dividend to the shareholders in the *disguised* form of loan, such a transaction would be covered by these provisions only when it is clear that the company 'does not *normally* deal in money lending'.[166] In so interpreting section 12(1B), he upheld its constitutional validity.[167] The sole dissenting judge, Justice Dayal, however, was not

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159 *Ibid.*, at 1381.

160 *Ibid.*, at 1382.

161 *Ibid.*, at 1379.

162 *Ibid.*, at 1382. The counsel for the petitioner-appellant had argued that the, "... omission of Parliament to exclude from the operation of S. 12(1-B) genuine loans and advances made as device shows, that it has acted blindly and must, therefore, be held to have exceeded its legislative power..." This argument was obviously rejected.

163 *Ibid.*

164 *Ibid.*, at 1377-83, Chief Justice Ganjendragadkar (for himself, Justices Wanchoo, Hidayatullah and Mudhholkar).

165 *Ibid.*, at 1379. (emphasis added). The other four conditions were – (*i*) the company in question must be one in which the public are not sufficiently interested; (*ii*) the borrower must be a shareholder at the date when the loan was advanced, the extent of his shareholding being irrelevant,; (*iii*) the loan advanced could be deemed to a dividend only to the extent to which it is shown that the company possessed accumulated profits; and (*iv*) the loan must have remained outstanding at the commencement of the shareholder's previous year in relation to the Assessment Year 1955-56.

166 *Ibid.*, at 1381, Chief Justice Ganjendragadkar (for himself, Justices Wanchoo, Hidayatullah and Mudhholkar) observing that, "It will be remembered that an advance or loan made by a company which falls within the mischief of the impugned section is advance or loan made by a company which does not normally deal in money lending, and it is made in full knowledge of the provisions contained in the impugned section."

167 *Ibid.*, at 1382-83, Chief Justice Ganjendragadkar (for himself, Justices Wanchoo, Hidayatullah and Mudhholkar) holding that, "If the legislature thinks that the advances or loans are in almost every case the result of a device, it would be competent to it to prescribe

impressed by these arguments[168] and declared these provisions unconstitutional[169] on the ground, *inter alia*, that these provisions imposed unreasonable restrictions on the fundamental right to hold property.[170] The second was delivered, in 1965, in *Punjab Distilling Industries Ltd.* v. *CIT*[171]. The same arrangement made by the Income Tax Act of 1922 to arrest the evasion of income tax by distributing accumulated profits and loans and not dividend was challenged once again in this case except this time the focus was on section 2(6A)(d).[172] The validity of this provision was unanimously upheld[173] and the use of colourable devices to evade payment of income tax and the efforts on the part of the Parliament to arrest this problem were noted once again.[174]

Chief Justice Gajendragadkar's opinion in *Javeri* gives the first but only slight indication of the use of a judicial test in place of a principles of statutory interpretation. Since loans given by the companies to its own shareholders was a disguised form of distributing dividends to avoid income tax, such a practice was to be discouraged. But again, what if the loans were genuine? To overcome this approach, the judge could have invoked the 'Legislative Intent Rule' that was a part of the Indian tax avoidance jurisprudence. It would have been a perfectly acceptable solution on the part of the judge to say that since only the abusive sort of loans were hit by the law, genuine

a fiction and hold that in cases of such advances or loans, tax should be recovered, from the shareholder on the basis that he has received the dividend."

168 *Ibid.*, at 1383-87.

169 *Ibid.*, at 1387.

170 *Ibid.*, at 1385, Justice Dayal (dissenting) holding that, "It appears to me unreasonable that a particular shareholder who receives a loan or advance from a company be deemed to have received that entire amount as dividend when his proportionate share be much less. I would, for this reason also, consider the provisions of the impugned sections to amount to imposing unreasonable restrictions on the fundamental right to hold property under Art. 19(1)(*f*)." Art. 19(1)(*f*) was repealed by the 44th Amendment in 1978 and now exists not as a fundamental right but only a constitution right under Art. 300-A of the Indian Constitution.

171 *Punjab Distilling Industries Ltd.* v. *CIT*, AIR 1965 SC 1862.

172 *Ibid.*, at 1864. Income Tax Act, 1922, S. 2(6-A)(*d*) provided that, " 'Dividend' includes any distribution by a company on the reduction of its capital to the extent to which the company possesses accumulated profits which arose after the end of the previous year ending next before the 1st day of April, 1933, whether such accumulated profits have been capitalised or not."

173 *Ibid.*, at 1868.

174 *Ibid.*, at 1866, Justice Subba Rao (for himself, Justice Mudholkar and Justice Ramaswami, Justice Dayal and Bachawat concurring) observed that, "... a company may, on the pretext of reducing its capital, utilise its accumulated profits to pay back to the shareholders the whole or part of the paid up amounts on the shares. A shareholder though in form gets back the whole or a part of the capital contributed to him, in effect get gets a share of the accumulated profits which, if a straightforward course was followed, he should have received as dividend. This is a division of profits under the guise of division of capital; a distribution of profits under the colour of reduction of capital."

loans were not to be governed by the same. But the next obvious question is – how do we distinguish between genuine loans from the fake ones? One would realize, as is being argued, that principles of statutory construction are not really very helpful to answer this question because of the inherent factual nature of the question. This is perhaps why the judge articulated the test of 'Ordinary Course of Business' whereby if the company that advanced the load was in the business of giving loans to people, and there being no principle that a loan cannot be advanced to its own shareholders, a straight forward application of the anti-tax-avoidance rule in the Income Tax Act would end up causing considerable hardship for genuine debtors of the company for now they not only have to pay the interest on the loan to the company but also pay income tax on the loan that has been deemed to be their income. The shareholders could now continue to get loans from the corporations in which they were shareholders except now they would not be able to get away with abusing anti-avoidance methods i.e. distribution of dividends disguised as loans. However, the Court's use of the phrase 'tax evasion' in this context must be understood as 'tax avoidance' for there is no possible way in which these transactions of loan could be said to be violative of the law.[175]

## VII. The Prudent Businessman Yardstick

Perhaps the most important case arising out of the Parliament's efforts to catch the evasion of taxes by use of colourable devices is a 1965 unanimous three Judge bench opinion delivered in *CIT* v. *Gangadhar Banerjee and Co. (P) Ltd.* ("*Banerjee*").[176] This is the second case, that a review of the law reports disclosed, where the Court seems to have diverged, though again only very slightly, from its traditional practice of using principles of statutory interpretation when tax evasion questions are raised. The question that arose in this case was in context of section 23A of the Income Tax Act of 1922[177] that was also introduced to prevent the use of corporations by their members

[175] The confusion here again stems out of the use of the terms "tax evasion" and "tax avoidance" and post McDowell the phrase "tax planning" to mean different things. Different parties use these phrases to denote different things but there is no single universally accepted definition. *See e.g.*, David Dunbar, "Tax Avoidance: A Judicial or Legislative Solution; Lessons for the United States from the British Commonwealth", 12 Corp. Bus. Tax'n. Monthly 21, 22 (2011) where he defined "tax evasion" as, "... [involving] wilful or intentional fraudulent conduct and is a criminal offence. The conduct that gives rise to tax evasion is inherently illegal. That is the main distinguishing feature between tax evasion and tax avoidance that can be defined as involving a legal activity, but one that is not effective for tax purposes. In case of tax avoidance there is no suggestion of fraudulent or deceptive behaviour."

[176] *CIT* v. *Gangadhar Banerjee and Co. (P) Ltd.*, AIR 1965 SC 1977.

[177] *Ibid.*, at 1978-79.

to 'evade higher taxation'.[178] As per this provision, the assessment officer had to first see whether the dividends distributed by the corporation during the prescribed period was less than the statutory percentage (which was fixed at 60% of the assessable income of the corporation minus the amount of income-tax and super-tax payable by such corporation in respect thereof). If such were the case, the officer was empowered to make an order declaring that the undistributed portion of the assessable income minus the taxes be deemed to have been distributed to the shareholders. But before making this order, the officer was also required to satisfy himself about the reasonability of a larger declared dividend after considering the losses incurred by the corporation in previous years. In other words, just because the declared dividend was small, itis not enough to pass the order. The smallness of the dividend could have been the result of losses incurred in previous years. So before an order under section 23A could be made, previous year losses were also required to be considered. Now the question was that how should the order passed by assessment officer be judicially reviewed?[179]

Clearly this is a question that could be answered in two ways. The Court could either lay down a judicial test to which all the orders should conform and on the basis of which the legality of an order could be tested.Else, the Court could review the order by invoking the 'Legislative Intent Rule', except in the second case. Clarity will emerge only slowly after a few cases have been decided and a judicial trend can be deduced from those cases. There are clear costs and benefits to either of these approaches. In *Banerjee*, the Court decided to adopt the first method that resulted in the 'prudent businessman yardstick'[180] by which section 23A orders were to be reviewed. As per this judicial test, 'The reasonability or the unreasonability of the amount distributed as dividends in judged by business considerations, such as previous losses, the present profits, the availability of surplus money and the reasonable requirements of the future and similar others'.[181] The officer was required to put himself in the shoes of a 'prudent businessman' or the 'director of the company' before he makes an order under section 23A. But, the Court also said that it was 'neither possible nor advisable' to lay down any decisive tests for the guidance of the officer.[182]

*Javeri* and *Banerjee* show that the traditional method of using the principles of statutory interpretation has its limits. There arise certain situations, as disclosed by the facts of these two cases, where the only way to answer the

178 *Ibid.*, at 1979.
179 *Ibid.*, at 1979-80.
180 *Ibid.*, at 1980.
181 *Ibid.*
182 *Ibid.*

legal question is to lay down a judicial test. The risk of course is that the test might work fine for the case at hand but might not for the next case. This is perhaps why the Court in *Banerjee* left some elbow room for the officer by laying down only general guidelines that he must follow while applying the 'Prudent Businessman Yardstick'.

## VIII. The Test of Bonafide Commercial Transaction

In 1966, a dispute similar to *Sivakasi Match Exporting Co.* arose in *M.C.T.M. Chidambaram Chettiar* v. *CIT*[183] that was decided by a unanimous bench of three judges. The facts of this case are very interesting. A Hindu Undivided Family (HUF) was carrying on the business of money lending in British India, Burma and elsewhere.[184] Till assessment year 1927-28, the entity was assessed to tax as a HUF. But in 1928-29, a partition had taken place and the father, with his two sons, constituted a duly registered partnership 'Firm' which was being assessed to tax.[185] In 1929, the father died and was replaced by his wife but the Firm continued.[186] In June 1929, the Firm started a new money lending business at Kuala Lumpur in the Federated Malaya States the capital for which, it was transferred from its business in Burma.[187] In March 1934, 'M. Ct. M. Banking Corporation' ('the Corporation') was launched, which was incorporated in India in a place called Pudukkotai.[188] One of the purposes of the Corporation was to acquire and carry on the Kuala Lumpur money lending business that was previously being carried on by the Firm.[189] The head office of the Firm was in Madras.[190] Therefore, in September 1933, a branch of the Company was opened in Kuala Lumpur and in November 1933, assets of the Firm (net value INR 1,200,000) were transferred to the Company, which in turn allotted to the partners of the Firm 1,200 shares of face-value INR 1,000 each.[191] Despite its incorporation in 1932, the Corporation never declared any dividends.[192] Till December 1937, a profit of INR 504,084 had accumulated to the Corporation and in 1938, it distributed bonus shares of value INR 500,000. On December 31, 1938, out of total of 2,271 shares, the two sons and their mother held 1,944 shares.[193] For assessment year 1938-39, the Firm was treated as the agent of

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[183] *M.C.T.M. Chidambaram Chettiar* v. *CIT*, AIR 1966 SC 1453.
[184] *Ibid.*, at 1454.
[185] *Ibid.*
[186] *Ibid.*
[187] *Ibid.*
[188] *Ibid.*
[189] *Ibid.*
[190] *Ibid.*, at 1455.
[191] *Ibid.*, at 1454.
[192] *Ibid.*
[193] *Ibid.*

the Corporation and its income arising and accruing in British India was assessed at the hands of the Firm.[194] For assessment-years 1939-40, 1940-41 and 1941-42, the partners of the Firm were also assessed separately under section 44D of the Income-tax Act, 1922.[195]

The purpose of section 44D was to prevent the residents of India from evading the payment of income tax by transferring their assets to non-residents while enjoying the income by adopting devious methods.[196] Therefore, under section 44D, if a resident had the power to enjoy the income accruing or arising out of the assets transferred to a non-resident, he would be deemed to have received that income and, therefore, would be liable to be assessed under the Income-tax Act.[197]

Resisting the application of section 44D, the taxpayers argued that the phrase 'by means of a transfer' in that section means a transfer by the taxpayer.[198] In this case, the income of the Corporation could not be taxed at their hands because the Firm as a juristic entity was separate from the individual assesses.[199] But the unanimous three judge bench rejected this argument and held that the phrase 'by means of a transfer' means 'as a result or by virtue or in consequence of the transfer'.[200] The Court also observed that that facts, in this case, overwhelmingly established that the individual assesses has a controlling interest in the Corporation.[201] The taxpayer argued that the transfer of assets of the Firm to the Corporation was not for a tax avoidance purpose but rather was a *bona fide commercial transaction*.[202] Though the Court was not completely impressed by this new approach, this argument was not totally rejected either as the Court held that burden of proof to establish the same was on the individual taxpayers and in which they had failed.[203] Thus,

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[194] *Ibid.*, at 1455.

[195] Income Tax Act, 1922 (India), S. 44-D provided: — "Where any person has, by any means of a transfer of assets, by virtue or in consequence whereof, either alone or in conjunction with associated operations, any income which if it were the income of such person would be chargeable to income tax becomes payable to a person not resident or to a person resident but not ordinarily resident in the taxable territories, acquired any rights by virtue or in consequences of which he has within the meaning of this section power to enjoy such income, whether forthwith or in the future, that income shall, whether it would or would not have been chargeable to income tax apart from provisions of this section, be deemed to be income of such first mentioned person for all purposes of this Act."

[196] *M.C.T.M. Chidambaram Chettiar* v. *CIT*, AIR 1966 SC 1453, 1455.

[197] *Ibid.*

[198] *Ibid.*

[199] *Ibid.*

[200] *Ibid.*, at 1456.

[201] *Ibid.*, at 1457.

[202] *Ibid.*

[203] *Ibid.*

by saying that burden to establish the *bona fides* of the commercial transaction was on the taxpayer the judicial test option was kept open by the Court.

Next year in 1967, a similar dispute was decided by a unanimous three judge bench of the Court in *CIT* v. *Sri Meenakshi Mills Ltd.*.[204] This case gives a hint of a judicial test akin to the Economic Substance Test as well as a new dimension to the tax evasion cases now coming to the Court. This case is an instance of tax havens that existed in British India, how they were put to good use to evade taxes by businessmen of those days and how the revenue authorities battled with the use of colourable devices to evade taxes. Factually, the nature of this case could be said to be closest to the dispute in *Vodafone case*. In this case, there were three respondent-taxpayers all of which were public limited companies engaged in manufacture and sale of yarn.[205] They all also had branches at a place called Pudukottai.[206] They all used to deposit their sale proceeds at the Pudukottai branch of the Madurai Bank ('the Bank').[207] As it happened, all three of these companies had also borrowed money from the Madurai branch of the Bank on the security of the fixed deposits that were made at the Pudukottai branch and the loans that were granted were far in excess of the available profits at Pudukottai.[208] The interesting thing to note is that out of a total of its 15,000 shares, the bank had issued 14,766 out of which the first respondent Meenakshi Mills held 5,972 shares, the second respondent Rajendra Mills held 3,009 shares and the third respondent Saroja Mills held 4,177 shares.[209] The Income-tax Officer in charge of assessing the tax concluded that, '…the borrowings in British India on the security of the fixed deposits made at Pudukottai amounted to constructive remittances of the profits by the branches of the taxpayer-companies to their Head Offices in India…'[210] and went on to include the entire profits of the taxpayer-companies including the interest receipts from the Pudukottai branches in the assessment of the taxpayer-companies on the ground that overdrafts availed of by the taxpayer-companies far exceeded the available profits.[211]Against this, taxpayers filed an appeal before the appellate Assistant Commissioner, who dismissed the appeal and took the view, '…the Pudukottai branch of the Bank had transmitted the funds so

[204] *CIT* v. *Sri Meenakshi Mills Ltd.*, AIR 1967 SC 819.

[205] *Ibid.*

[206] *Ibid.*, We many profitably note here that Pudukottai is the same geographical location that was the Corporation in *Chettiar* was located. The extent to which Pudukottai contributed as a tax haven in British India is an extremely interesting historical question that needs to be examined but doing so is beyond the stated brief of this paper.

[207] *Ibid.*, 819-20.

[208] *Ibid.*, at 820.

[209] *Ibid.*

[210] *Ibid.*

[211] *Ibid.*

deposited for enabling the Madurai branch to advance loans at interest to the taxpayer-companies and that the transmissions of funds were made with the knowledge of the taxpayer-companies who were major share-holders of the Bank'.[212] From this, a further appeal was taken to the Income Tax Appellate Tribunal (ITAT), which the taxpayers lost, with ITAT making scathing remarks against the taxpayer. The ITAT observed, '…Pudukottai is neither a cotton producing area not has a market for cotton; except that it was a non-taxable territory, there was nothing else to recommend the carrying on of the business in cotton spinning and weaving there… being a non-taxable area, there were many very rich men there with an influx of funds to invest in banks and industries… the bank itself was started at Madurai and a branch of it was opened at Pudukottai only with a view to help the financial operations [of the three respondents]'.[213] The taxpayers then took the matter to the High Court of Madras on reference where they won for the first time.[214] The High Court held that it was not established that there was any arrangement between the taxpayer-companies and the Bank whether at Pudukottai or at Madurai for transference of money from Pudukottai branch to Madurai.[215] In other words, the High Court held that no collusion to evade taxes by use of a colourable device was proved. The Commissioner, on appeal, took the matter to the Supreme Court where a unanimous three judge bench of the Supreme Court reversed the High Court.[216]

Before the Supreme Court, the Commissioner invoked section 42 of the Income-tax Act, 1922.[217] As per this provision, if any money was lent at interest outside the taxable territory, any income, profit or gain had arisen or accrued as a result of such being lend at interest and the money was brought back into the taxable territory in cash or kind, then such income was deemed to income arising or accruing within taxable territory. The validity of section 42 on the grounds of it having extra-territorial operation had previously been upheld by the Federal Court of India (the predecessor to the Supreme Court of India) in *A.H. Wadia* v. *CIT* ("*Wadia*")[218] on the ground that the nexus between the income and the authority to tax the same was created by the knowledge, attributed to the lender, that the borrower had borrowed money for the purpose of taking it to British India and earning money on

212 *Ibid*.

213 *Ibid*., at 820-21.

214 *Ibid*., at 821.

215 *Ibid*.

216 *Ibid*., at 823.

217 Income Tax Act, 1922 (India), S. 42 provided (relevant part only) —"All income, profits or gains accruing or arising whether directly or indirectly … through or from any money lent at interest and brought into the taxable territories in cash or in kind … shall be deemed to be income accruing or arising within the taxable territories…."

218 *A.H. Wadia* v. *CIT*, 1948 SCC OnLine FC 8 : AIR 1949 FC 18.

that income.[219] It was held that the *Wadia* test was satisfied in this case.[220] Expanding on the *Wadia* test it was held in this case that –

> *It is well established that in a matter of this description the Income-tax authorities are entitled to pierce the veil of corporate entity and to look at the reality of the transaction.* It is true that from the juristic point of view the company is a legal personality entirely distinct from its members and the company is capable of enjoying rights and being subjected to duties which are not the same as those enjoyed or borne by its members. *But in certain exceptional circumstances the Court is entitled to lift the veil of corporate entity and to pay regard to the economic realities behind the legal facade.*[221]

## IX. THE TEST OF 'COMMERCIAL EXPEDIENCY'

In a distinctly identifiable line of pre *McDowell* cases, the Court started with the judicial test approach and laid down 'Test of Commercial Expediency' that was consistently used in subsequent cases of similar nature. This line of cases gives considerable weight to the point that there are, in fact, certain categories of tax avoidance cases where the principles of statutory interpretation are not really helpful and that the Court is well aware of this phenomenon. All these cases are factually similar in that a particular transaction is being characterized by the revenue authorities as bogus (and thus, tax-evasive) and by the taxpayer as genuine (and thus, only tax-avoiding). These transactions are those in which a particular expense incurred by the taxpayer is being disallowed by the revenue authorities which the tax-payer

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219 *CIT* v. *Sri Meenakshi Mills Ltd.*, AIR 1967 SC 819, 821.

220 *Ibid.*, at 822.

221 *Ibid.* (emphasis added). Two English cases were cited to support this proposition of law. First was *Apthorpe* v. *Peter Schoenhofen Brewing Co. Ltd.*, (1899) 4 TC 41 (Court of Appeal) (*ibid.*, at 822-23) where it was found that all property of a New York company, except its land, was transferred to an English company. The only reason why the New York company was kept because aliens were not allowed to hold land under New York law. All but three shares of the New York company were held by the English company. Commissioner concluded that the New York company was merely the agent of the English company. The Court of Appeal held that New York business was in fact of the English company and the same was liable for English income tax. The other was *Firestone Tyre and Rubber Co.* v. *Llewellin*, (1957) 1 WLR 464 (*ibid.*, at 823) where an American company had an arrangement with its distributors in Europe whereby they obtained their supplies from the English manufacturer (which was a wholly owned subsidiary of the American company). It was held in this case that in substance the English company was nothing but a means for the American company to carry on its European business (through the agency of its English subsidiary). See also *Kamalpat* v. *CIT*, AIR 1969 SC 932, where a unanimous three-Judge Bench held that lifting of corporate veil is permissible if the corporation is being used for tax evasion or circumventing tax obligation or perpetuating a fraud.

is legally entitled to claim under the Income Tax Act. But even in this category of cases, not all are relevant for this article.[222] The test was laid down, as disclosed by a review of the law reports, for the first time in 1967 by a unanimous three judge bench in *CIT* v. *Walchand & Co. (P) Ltd.*[223] In this case, the taxpayer was a private corporation that had increased the remuneration of its directors and the assessment officer had decided to disallow the increased remuneration of the directors in the computation of income that was filed along with the returns[224] on the grounds that the increase in remuneration was not necessary for the purpose of the sort of business the corporation was in.[225] The Supreme Court allowed the expenses.[226] It was in this context the following test was laid down –

> ... it is not the function of the [assessment officer] to determine the remuneration which in their view should be paid to an employee of the assessee. When a claim for allowance is made... the Income-tax authorities have to decide whether the expenditure claimed as an allowance was incurred voluntarily and on grounds of commercial expediency. In applying the test of commercial expediency for determining whether the expenditure was *wholly and exclusively laid out for the purpose of business*, reasonableness of the expenditure has to be adjudged from the point of view of the businessman and not of the Revenue.[227]

The Commercial Expediency Test was followed by another unanimous three judge bench in 1968 in *J.K. Woolen Manufacturers* v. *CIT*[228] where certain benefits-in-kind and parts of remuneration given to its General Manager

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[222] See e.g., *Shew Kissan Bhattar* v. *CIT*, (1973) 4 SCC 115, where the individual taxpayer had claimed certain interest payments as deductions. The interest payments were compounded because the taxpayer had failed to pay interest on time thus attracting a clause in his loan agreement that compounded the interest in case of failure to pay on time. The compounded interest payments were disallowed and only it was held that the taxpayer is entitled to deduct only the simple interest that he would have originally ended up paying and not the compounded interest the he actually ended up paying. The Court expressed its concerns that if they hold otherwise, "... then to door will be open for evasion of tax. All that the debtor need do is not to pay interest regularly but utilise that amount for other purposes and make the Revenue pay compound interest payable by him and thus derive advantage out of his own omission."

[223] *CIT* v. *Walchand & Co. (P) Ltd.*, AIR 1967 SC 1435.

[224] *Ibid.*, at 1436.

[225] *Ibid.*, at 1436-37.

[226] *Ibid.*, at 1437.

[227] *Ibid.* (emphasis added). The assessment officer had disallowed the increased remuneration because there was no corresponding increase in the profits of the taxpayer corporation. Applying the Test of Commercial Expediency, the Court held that, "The rule that increased remuneration can only be justified if there be corresponding increase in the profits of the employer is, in our judgment, erroneous."

[228] *J.K. Woolen Manufacturers* v. *CIT*, AIR 1969 SC 609.

by the taxpayer corporation were disallowed by the assessment officer on the ground that they were "excessive and quite unreasonable".[229] Applying the Commercial Expediency Test,[230] the Court allowed the expenses as the Court found that the remuneration paid to the General Manager was "... an amount laid out or expended *wholly and exclusively for the purpose of business* of the assessee".[231] It was followed once again in 1972 by another unanimous three judge bench in *Aluminium Corpn. of India Ltd.* v. *CIT*,[232] where certain commissions paid by the taxpayer corporation and claimed as expenditure were found to be *wholly or exclusively for the purpose of the business* of the assessee.[233]

## A. McDowell (1985)

*McDowell* was a short opinion taking only 25 pages in the law report Supreme Court Cases.[234] The reason why the five judge bench was assembled in *McDowell* was to answer a question of law that wasn't all that extraordinary, unless of course you are an ardent student of the law of excise taxes. We'll have to go through the majority opinion by Justice Ranganath Misra that dealt with the legal question that arose on facts on the case, and took 12 pages to answer, to understand this point.[235] The short question before the five judge bench was on a very technical point of excise duty that would hardly interest the general public

> ...whether excise duty paid directly to the excise authorities or deposited directly in the State Exchequer, in respect of Indian liquor, by the buyers before removing the same from the distillery could be said to form part of the taxable turnover of the appellant distillery.[236]

In the end, the question was answered in favour of the revenue authorities but that entire discussion is not relevant to this article. After having clearly answered this question of law in favour of revenue,[237] and having overruled its previous applicable holding on the point (with which Justice Chinnappa

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229 *Ibid.*, at 610.
230 *Ibid.*, at 612. *Walchand* is the only cases cited in support of the Commercial Expediency Test.
231 *Ibid.*
232 *Aluminium Corpn. of India Ltd.* v. *CIT*, (1972) 4 SCC 37.
233 *Ibid.*, at 42.
234 *McDowell* v. *CTO*, (1985) 3 SCC 230-255.
235 *Ibid.*, at 243-255.
236 *Ibid.*, at 244.
237 *Ibid.*, at 250. Justice Misra (for the Chief Justice, Justices Desai, Venkataramiah and himself) holding that, "We are, therefore, clearly of the opinion that excise duty though paid by the purchaser to meet the liability of the appellant, is a part of the consideration for the sale and is includible in the turnover of the appellant.")

Reddy concurred 'entirely'[238]),[239] there was nothing else left to decide in the case. It was, at this point of time, in his opinion that Justice Misra then went on to note the last argument made by the taxpayer, which was – '...*it is open to everyone to so arrange his affairs as to reduce the brunt of taxation of to the minimum and such a process does not constitute tax evasion; nor does it carry any ignominy*'.[240] After discussing four precedents of its own,[241] and one of Gujarat High Court's[242] (that was subsequently affirmed by the Supreme Court[243]) and two English precedents,[244] Justice Misra held as follows –

> Tax planning may be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges.[245]

After having held so, he observed that, "*On this aspect* one of us, Chinnappa Reddy, J., has proposed a separate and detailed opinion, *with which we agree*".[246] Thereafter, Justice Misra proceeded to dispose of the petition and grant the relief that was prayed for.

Justice Reddy, opened his concurring opinion by stating that he 'entirely agreed' with Justice Misra, but wished to add a few paragraphs on the topic of tax avoidance.[247] Relying on *Fisher's Executors* and *Westminster* he stated the principles of law that have been demonstrated before as rules of

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238 *Ibid.*, at 233 (emphasis added). In the very first sentence of his concurring opinion, Justice Reddy said that he "entirely agreed" with Justice Misra's opinion.

239 *Ibid.*, at 252. Justice Misra (for the Chief Justice, Justices Desai, Venkataramiah and himself) holding that, "We are of the view that the conclusion reached in the appellant's case in *McDowell & Co. Ltd. case* on the second aspect of the matter, namely, when the excise duty does not go into the common till of the taxpayer and it does not become a part of the circulating capital, it does not become a part of the circulating capital, it does not constitute turnover, is not the decisive test for determining whether such duty would constitute turnover." (Internal citations omitted). The previous decision that was overruled had, as we have seen, the same title as the current case but it was delivered by a Bench of two Judges. *See McDowell & Co. Ltd.* v. *CTO*, (1977) 1 SCC 441.

240 *Ibid.*, at 253.

241 *CIT* v. *A. Raman & Co.*, AIR 1968 SC 49, *CIT* v. *B.M. Kharwar*, AIR 1969 SC 812, *Jiyajeerao Cotton Mills Ltd.* v. *CIT*, AIR 1959 SC 270.

242 *CIT* v. *Sakarlal Balabhai*, 1968 SCC OnLine Guj 62 : (1968) 69 ITR 186.

243 *CIT* v. *Vadilal Lallubhai*, (1973) 3 SCC 17.

244 *Bank of Chettinad Ltd.* v. *CIT*, 1940 SCC OnLine PC 29 : (1940) 8 ITR 522, *Latilla* v. *Inland Revenue Commr.*, 1943 AC 377 : (1941-43) 25 TC 107.

245 *McDowell and Co. Ltd.* v. *CTO*, (1985) 3 SCC 230, 254-55.

246 *Ibid.* (emphasis added)

247 *Ibid.*, at 233.

statutory interpretation namely the Strict Interpretation Textualism Ruleand the Minimum Liability Rule.[248] After discussing several British cases on the point, he concluded that *Westminster* rule i.e. the 'Minimum Liability Rule' is no longer good law in Britain itself.[249] Citing *Raman* as the case that institutionalized the *Westminster* rule in India, he argued that since *Westminster* has been abandoned in Britain, it is time for the rule to be abandoned in India as well.[250]After making some *obiter* observations about the 'evil consequences of tax avoidance',[251] Justice Reddy did nothing more than laying down a principle of statutory interpretation for taxing statutes in following words –

> In our view, the proper way to construe a taxing statute, while considering a device to avoid tax, is not to ask whether the provisions should be construed literally or liberally, nor whether the transaction is not unreal and not prohibited by the statute, but *whether the transaction is a device to avoid tax*, and whether the transaction is such that the judicial process may accord its approval to it… 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 consider whether the situation created by the devices could be related to the existing legislation with the aid of 'emerging' techniques of interpretation…* and to expose the devices for what they really are and to refuse to give judicial benediction.[252]

The above quoted passage will subsequently be cited by revenue authorities to say that all kinds of tax avoidance have been held in *McDowell* to be impermissible. In other words, the 'Minimum Liability Rule' is no longer a part of Indian tax avoidance jurisprudence. Though if we read this passage carefully, we can deduce that Justice Reddy is clearly not talking about all kinds of tax avoidance schemes but only those *devices* that cannot be judicially approved. The idea behind Justice Reddy's views were perhaps best expressed by a United States court (7th Circuit) opinion delivered ironically in the same year (1985). In *Saviano* v. *Commr. of Internal Revenue*,[253] the 7th Circuit observed that the freedom to the taxpayer to arrange their affairs so as to minimize their tax liability does not include the right to engage in

[248] *Ibid.*, at 233-34.

[249] *Ibid.*, at 234-41.

[250] *Ibid.*, at 241-43. He cites *Raman* and *CIT* v. *B.M. Kharwar*, AIR 1969 SC 812, as the two cases where the "Minimum Liability Rule" was institutionalised relying primarily on *Westminster*.

[251] *Ibid.*, at 242-43.

[252] *Ibid.*, at 243. (emphasis added).

[253] *Saviano* v. *Commr. of Internal Revenue*, 765 F 2d 643 (7th Cir 1985).

'financial fantasies' and to expect that the government will 'play along'.[254] In such cases, the Courts will look beyond the contrived forms of transactions. Whereas tax evasion has been defined by several commentators to be restricted to only illegal and/or fraudulent conduct, tax avoidance has been defined to 'involve arrangements that seek to take advantage of the absence of any such evident intention in the words used in the statute'.[255] If this is the case, then the Restrictive Strict Interpretation Rule read with the Legislative Intent Rule is perfectly legitimate guide for interpreting taxation statutes.

One can only speculate what the *McDowell* bench might have done, if the existence of these rules were brought to their attention. Though it is one of the viable conclusions that Justice Reddy might not have taken the extreme view that he took wherein he ended up equating legitimate tax planning, which is a part of Indian tax avoidance jurisprudence as per the Minimum Liability Rule, with abusive tax avoidance that but for the presence of a positive legal provision would have been an illegal/fraudulent, thus, punishable activity. But this italicized bit read with the *obiter* observations of the judge on morality of tax avoidance in a welfare state, does tend to give the impression that all tax avoidance schemes have been declared illegal. This confusion, as we will see will be taken care of the in post *McDowell* opinions.But it was the needless moral sermon delivered by Justice Reddy that will be questioned immediately.

## B. Post McDowell Position (1986-2014)

The decision in *McDowell* did not get a warm welcome from the Bar and was criticized almost instantly. Describing *McDowell* as a case of 'great public importance', Palkhivala criticized the decision as 'blurring the distinction between tax avoidance which is legitimate and tax evasion which is not'.[256] Palkhivala's critique was broadly based on three points – (i) the English opinions were read out of context, (ii) the House of Lords had actually 'expressly reaffirmed' the basic principle that a taxpayer was entitled to arrange his affairs so as to reduce his tax liability, and (iii) *Westminster* was never

[254] *Ibid.*, at 654.

[255] David Dunbar, "Tax Avoidance: A Judicial or Legislative Solution; Lessons for the United States from the British Commonwealth", 12 Corp. Bus. Tax'n. Monthly 21, 23 (2011).

[256] Nani A. Palkhivala, *We, the Nation: The Lost Decades* 131 (2010). But *see* Richard J. Kovach, "Taxes, Loopholes and Morals Revisited: A 1963 Perspective on the Tax Gap", 30 Whittier L. Rev. 247, 277 (2009), where it is pointed out that as a result of increasing tax shelter activity, this line, on facts is also getting increasingly blurred. This is also demonstrably true if one examines the factual nature of the cases that is getting increasingly complex. *See also* Brea E. L'Heureux, "Why Common Law Calculus Failed: An Analysis of the Economic Substance" Doctrine in *Klamath Strategic Investment Fund* v. *United States*, 64 Tax Law 471, 473 (2011).

overruled by House of Lords.[257] After criticizing *McDowell* as an opinion as based on a misinterpretation and indiscriminate and thoughtless application of the English cases cited therein, he felt 'reassured' that in *CWT* v. *Arvind Narottam*,[258] the Court had not gone the *McDowell* path.[259]

An examination of the post *McDowell* opinions on the point shows that the *McDowell* principle was never quite accepted by the subsequent benches of the Supreme Court. On every occasion where the holdings of Justice Reddy could have been followed, distinctions were made to justify that the law as laid down in *McDowell* was not really applicable to the facts of the particular case under consideration. Take, for instance, the division bench opinion delivered in the 1988 case of *CWT* v. *Arvind Narottam*. The taxpayer had created two trusts, identical in terms except in regards to the minimum amount payable to the beneficiaries, for the benefit of himself, his wife, children and grandchildren.[260] The wealth tax officer imposed wealth tax on the entire value of the assets held by the trusts, which, on appeal, were reduced to the capitalized value of the minimum amounts payable under the trust deeds by the Appellate Commissioner.[261] The Appellate Tribunal upheld Commissioner's view but the High Court reversed both the Commissioner and the wealth tax officer.[262] Before the Supreme Court, the revenue authorities, relying on *McDowell*,[263] took the stand that 'in the case of a discretionary trust the interest of the beneficiary extends not only to the actual share paid to him but to his right to be considered as a potential recipient of the net income remaining after defraying the management expenses and paying the taxes'.[264] The argument was rejected by Chief Justice Pathak and he held that only the amount to which the taxpayer was entitled to could he claim as his property and, thus, on that alone could the tax be imposed.[265] The concurring judge, Justice Mukharji (later Chief Justice) questioned whether Justice Reddy in *McDowell* laid down a practical principle and observed that –

> One would wish, as noted by Reddy, J that one could get the enthusiasm of Justice Holmes that taxes are the price of civilization and one would like to pay that price to buy civilization. But the question which many ordinary tax payers very often in a country of shortages with ostentatious consumption and deprivation for the large masses ask is

[257] Nani A. Palkhivala, *We, the Nation: The Lost Decades* 131-32 (2010).
[258] *CWT* v. *Arvind Narottam*, (1988) 4 SCC 113.
[259] *Ibid*., at 132, 133.
[260] *Ibid*., at 115.
[261] *Ibid*., at 117.
[262] *Ibid*.
[263] *Ibid*., at 120.
[264] *Ibid*., at 118.
[265] *Ibid*., at 119.

> does he facilitate the wastes and ostentatiousness of the few. Unless wastes and ostentatiousness in government's spending are avoided or eschewed no amount of moral sermons would change people's attitude to tax avoidance.[266]

Talking about the morality of tax evasion and expressing a sentiment similar to these, Palkhivala wrote that people generally fell into three categories – those who would honestly pay taxes, no matter how heavy the burden; those would be dishonest and never pay taxes, no matter how light the burden and those that basically honest but 'the nature of whose response to the law is conditioned by the quality of the law'.[267] Tax laws in India, Palkhivala observed, 'ignores the first, is preoccupied with the second, and alienates the third'.[268] Exposing the deep divide between the morality of tax evasion and the reality of tax avoidance, Palkhivala observed that while 'ideologues and academics spend hours' convincing themselves that high rates of personal taxation are essential in a socialist economy, the people 'persistent in their obstinate belief that the State is not entitled to take more than half of their income… are prepared to resort to various devices, even at the risk of being prosecuted, to keep a fair share of their own earnings.'[269]

Speaking again for the Court, through a division bench, in 1989, Justice Mukharji again questioned the *McDowell* holding, in *Union of India* v. *Playworld Electronics (P) Ltd*.[270] This case involved the dispute over evasion of payment of excise duty. If a taxpayer sold the goods he manufactured to a 'related person' or a 'favoured buyer', the concessional rate of duty that was applicable to certain goods (in this case wireless receiving sets, tape recorders and tape payers) could be denied to the taxpayer.[271] A related person was defined to be 'a person who is so associated with the assessee that they have interest, directly or indirectly, in the business of each other.[272] If such was the case, then excise duty was to be imposed on the 'price at which such goods

[266] *Ibid*., at 121.
[267] Nani A. Palkhivala, *We, The People* 120 (2009).
[268] *Ibid*., *See also* Richard J. Kovach, "Taxes, Loopholes and Morals Revisited: A 1963 Perspective on the Tax Gap", 30 Whittier L. Rev. 247, 264 (2009). Kovach brings about another angle to this morality debate by pointing out that, "… the moral underpinnings of a tax system based on voluntary compliance would weaken when groups of taxpayers, because of their unique circumstances, gain access to tax shelters not generally available to the entire population of taxpayers".
[269] *Ibid*., at 157. *See also* Brea E. L'Heureux, "Why Common Law Calculus Failed: An Analysis of the Economic Substance Doctrine" in *Klamath Strategic Investment Fund* v. *United States*, 64 Tax Law 471, 472 (2011). The note argues that, "A high-rate tax regime gives clever individuals a powerful incentive to game the system."
[270] *Union of India* v. *Playworld Electronics (P) Ltd*., (1989) 3 SCC 181.
[271] *Ibid*., at 183.
[272] *Ibid*., at 185.

were ordinarily sold by the assessee to a buyer'.[273] Naturally, the dispute arose as the sale transactions by the taxpayer were contended by the revenue, *inter alia* relying on *McDowell*[274], to be made to a 'related person' while the purchaser was denied to be a 'related person' by the taxpayer. It would be profitable to keep in mind here that *McDowell* was a case in which, on facts, the dispute was about imposition of excise duty on liquor. Justice Mukharji, citing the view he had taken in *Narottam*,[275] held that the Court needed to examine 'the true nature of the transaction' in order to resolve alleged tax evasion disputes.[276] Clearly, being of the view that *McDowell* was perhaps not correctly decided, he observed that it is unsafe to make bad laws out of hard facts.[277]

A strong blow was struck to *McDowell* in 2004 by a division bench of the Court in *Indo-Mauritius DTAA case*.[278] Perhaps the most comprehensive opinion on the point, this case cites/discusses a total of 62 judicial opinions including amongst them several key pre *McDowell* opinions, several leading English and United States opinions including the famous *Gregory* v. *Helvering*. The legal dispute, in this case, arose out of a Circular issued by the Central Board of Direct Taxes with regard to the assessment of cases in which the Indo-Mauritius Double Taxation Avoidance Convention of 1983 was applied.[279] The purpose of the 1983 Convention was to avoid double taxation, encourage mutual trade and investment, and 'bring an environment of certainty in matters of tax affairs in both countries'.[280] As per the impugned Circular, directions were given that capital gains of any resident of Mauritius by way of sales of shares on an Indian corporation were to be taxable in Mauritius only and not in India.[281] Consequently several Foreign Institutional Investors (FIIs) in Mauritius invested money in India by purchasing shares of Indian corporations.[282] All these FIIs were then issued notices by Revenue as to why they should not be taxed in India on the profits and dividends accrued to them in India on the ground that they were 'shell companies' created only to invest funds in India.[283] A civil society activist group challenged the validity of this Circular[284], relying 'heavily' on the

[273] *Ibid*., at 184.
[274] *Ibid*., at 190.
[275] *Ibid*., at 19.
[276] *Ibid*., at 190-91.
[277] *Ibid*., at 191.
[278] *Union of India* v. *Azadi Bachao Andolan*, (2004) 10 SCC 1.
[279] *Ibid*., at 16.
[280] *Ibid*.
[281] *Ibid*., at 18-19.
[282] *Ibid*., at 19.
[283] *Ibid*., at 19, 48.
[284] *Ibid*., at 20.

authority of *McDowell* characterized these shell companies as 'sham' and a mere 'device actuated by improper motives'[285] and argued that 'any tax planning which is intended to and results in avoidance of tax must be struck down' by the Supreme Court.[286] The view that all tax planning is illegitimate, based on Justice Reddy's views in *McDowell* was totally rejected by the Court.[287] The mode of judicial reasoning that was adopted here will be later affirmed, and more elaborately, employed in *Vodafone* except this time by a unanimous three judge bench. Justice Srikrishna read the views of Justice Reddy in *McDowell* and believes that they were controlled and delimited by the majority view expressed by Justice Mishra (later Chief Justice).[288] It was also held, on the authority of subsequent English decisions that far from having been exorcised *Westminster* actually 'continues to be alive and kicking in England'.[289] *McDowell*, therefore, was only a 'temporary turbulence' in India.[290] The position in United States was also considered but only very briefly and *Gregory* v. *Helvering* was cited only by way of a footnote though some other U.S. opinions were quoted from, again briefly.[291]

The decisive blow that was dealt to *McDowell*, in 2012, in *Vodafone case*. But before we examine *Vodafone case*, we may quickly note two division bench opinions delivered in 2010. The first one, *CIT* v. *Ashini Lease Finance (P) Ltd.*[292] is a very short one, which may fairly be described as a text-book case of use of colourable tax avoidance. The taxpayer corporation loaned money to its subsidiary corporation so that the subsidiary could acquire controlling shares in another corporation; the subsidiary paid interest on that loan to the taxpayer corporation and later claimed interest expenses in its income tax returns.[293] Describing this transaction as a 'circular transaction', Justice Kapadia (later Chief Justice) dismissed the taxpayer's appeal.[294] In the second, the Supreme Court was presented with another transaction, which would be described as a 'dividend stripping' transaction, in a batch of income tax appeals in *CIT* v. *Walfort Share and Stock Brokers (P) Ltd.*[295]

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[285] *Ibid.*, at 54, 55.

[286] *Ibid.*, at 54-55.

[287] *Ibid.*, at 56. Justice Srikrishna (for the Court) holding that, "We are afraid we are unable to read or comprehend the majority judgment in *McDowell* as having endorsed this extreme view of Chinnappa Reddy, J., which in our considered opinion, actually militates against the observations of the majority of the Judges we have just extracted from the leading judgment of Ranganath Mishra, J. (as he then was)." (Internal Citations Omitted)

[288] *Ibid.*, at 55-56.

[289] *Ibid.*, at 55, 56, 5.

[290] *Ibid.*, at 61.

[291] *Ibid.*, at 61-62.

[292] *CIT* v. *Ashini Lease Finance (P) Ltd.*, (2010) 14 SCC 795.

[293] *Ibid.*, at 796.

[294] *Ibid.*

[295] *CIT* v. *Walfort Share and Stock Brokers (P) Ltd.*, (2010) 8 SCC 137.

where a different view was taken. In this case, the taxpayer purchased a security, on which he earned tax-free dividend but later the price of the security dropped and he sold the security incurring a loss, the amount of the loss and the tax-free dividend being identical.[296] The loss was claimed by the taxpayer on the income-tax returns that resulted in the net taxable income going down and was rejected by the income tax officer.[297] The income tax officer's view was upheld by the Appellate Commissioner but was rejected in the ITAT. ITAT's order was upheld by the High Court.[298] We should note here that the dividend that was earned by the taxpayer was tax-free in the first place. The problem for the revenue authorities was that the loss could not be claimed only against the tax-free dividend but could also be claimed against the entire income, thus, reducing the entire taxable income.[299]The revenue authorities, before the Supreme Court, tried to create a distinction between a 'tax loss' and a 'commercial loss' and characterized this 'dividend-stripping transaction' as a 'tax loss' that was contrived without suffering any corresponding 'commercial loss'.[300]

The first question before the Court was whether the loss as claimed by the taxpayer could be allowed being considered as expenditure in relation to earning of dividend income that was exempt from income tax anyway?[301] This question was answered against the taxpayer.[302] The second question was whether this loss could be disallowed on the ground this was a dividend-stripping transaction i.e. a premeditated transaction calculated to create a deliberate loss?[303] The loss was disallowed by the income tax officer on the ground that the transaction was entered into by the taxpayer 'with full knowledge about the guaranteed fall in the market value of the units'[304] But, because the revenue authorities were not able to produce any evidence of this 'full knowledge' it was held that there was 'nothing to impeach the

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296 *Ibid.*, at 142.
297 *Ibid.*, at 142-43.
298 *Ibid.*, at 143.
299 *Ibid.*, at 153. The revenue's "real objection" as recorded in the opinion was in fact framed pretty much in these exact words.
300 *Ibid.*, at 144. An argument strikingly similar was made in the US Supreme Court by the IRS in *Gitlitz* v. *Commr. of Internal Revenue*, 2001 SCC OnLine US SC 2 : 148 L Ed 2d 613 : 531 US 206 (2001) where a transaction had produced a tax loss without the taxpayer incurring an accompanying economic loss. IRS lost as the Court took the view that since the text of the statute permitted the taxpayers to receive this benefit there was no ground to intervene. *See also* David Dunbar, "Tax Avoidance: A Judicial or Legislative Solution; Lessons for the United States from the British Commonwealth", 12 Corp. Bus. Tax'n. Monthly 21, 28 (2011).
301 *Ibid.*, at 150.
302 *Ibid.*, at 152.
303 *Ibid.*
304 *Ibid.*, at 152-53.

genuineness of the transaction'.[305] It was in the context of the second question that it was held by Chief Justice Kapadia that –

> With regard to the ruling in [*McDowell*], it may be stated that in the later decision of this Court in [*Indo-Mauritius DTAA case*] it has been held that a citizen is free to carry on its business within the four corners of the law. That, mere tax planning, without any motive to evade taxes through colourable devices is not frowned upon even by the judgment of this Court in [*McDowell*].[306]

*Vodafone case* is a long decision to study. Two concurring opinions delivered in this case span a total of 103 pages (excluding case-notes) in the law report Supreme Court Cases.[307] The opinion delivered by Chief Justice Kapadia (for himself and Justice Swatanter Kumar) is 39 pages long ('the Lead Opinion')[308] and Justice Radhakrishnan's concurring opinion is 64 pages long ('the Concurring Opinion').[309] Facts of the case, for the purpose of our analysis, are taken from the Lead Opinion. Briefly, they are as follows. A Dutch company 'Vodafone Int'l Holdings' ('Vodafone Int'l') acquired the entire share capital of a Cayman Islands company 'CGP Investments' ('CGP').[310] CGP, in turn, though indirectly, held 52% shareholding interest, with an option to acquire further 15% shareholding, in an Indian company 'Hutchison Essar Ltd.' ('Hutch India').[311] As a result of this transaction, Vodafone Int'l ended up acquiring 67% controlling interest in Hutch India.[312] Indian revenue authorities were of the view that capital gains tax was capable of being levied on the transaction between Vodafone Int'l and CGP on the ground that CGP, even though not resident in India, held underlying Indian assets.[313] The complex nature of this transaction can gauged by examining the detailed ownership structure chart reproduced in the Lead Opinion.[314] After narrating the facts of the case,[315] the Lead Opinion goes directly to the 'tax avoidance versus tax evasion' issue.[316]

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305 *Ibid*., at 153.

306 *Ibid*.

307 *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, 654-757.

308 *Ibid*., at 654-693.

309 *Ibid*., at 693-757.

310 *Ibid*., at 654.

311 *Ibid*., at 654, 666. Chief Justice Kapadia (majority opinion) found, "To sum up, CGP held 42.34% in [Hutch India] through 100% wholly owned subsidiaries (Mauritius companies), 9.62% indirectly through TII and Omega (i.e. pro rata route), and 15.03% through GSPL route."

312 *Ibid*.

313 *Ibid*.

314 *Ibid*., at 664-665.

315 *Ibid*., at 654-665.

316 *Ibid*., at 666.

The issue was framed, from the very beginning, as a conflict of judicial opinion between the unanimous five judge bench opinion in *McDowell*[317] and the *Indo-Mauritius DTAA case* with the revenue authoritiesbuilding their argument by questioning the correctness of the latter decision.[318] Relying on *McDowell* and arguing that *Indo-Mauritius DTAA case* had misunderstood the holding in *McDowell*, the revenue authorities'position essentially was that while tax evasion is certainly illegal, in certain circumstances, their legality notwithstanding, even tax avoidance transactions could be brought within the tax ambit since this is what Justice Chinnappa Reddy had held in *McDowell.*[319] Central to this argument raised by the Revenue were two famous English (House of Lords) decisions – *Westminster*[320] and *Ramsay.*[321] *Ramsay* was distinguished by *Westminster* and it was held that –

> *Ramsay* did not discard *Westminster* but read it in the proper context by which a "device" which was colourable in nature had to be ignored as fiscal nullity. *Thus, Ramsay lays down the principle of statutory interpretation rather than an over-arching anti-avoidance doctrine imposed upon tax laws.*[322]

Speaking of the use of colourable devices the Lead Opinion also cited *Dawson*[323] where the 'Step Transaction Doctrine' was put in place.[324] As per this case, if a series of transactions have no business purpose but have been inserted only to avoid taxation, the Courts may disregard such steps. This doctrine is also referred to as 'Wash Transactions Doctrine' and is a judicially recognized doctrine in the United States as well. The subsequent misuse of *Dawson* by revenue authorities was also noted,[325] which resulted in *Craven* v. *White*[326] where the House of Lords reiterated that genuine tax

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317 *McDowell and Co. Ltd.* v. *CTO*, (1985) 3 SCC 230.

318 *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, 666.

319 *Ibid.*

320 *Commrs. of Inland Revenue* v. *Duke of Westminster*, 1936 AC 1 (HL). In this case it was held that if a transaction is genuine, the Courts are not allowed to go behind the supposed underlying substance of the transaction.

321 *W.T. Ramsay Ltd.* v. *Inland Revenue Commrs.*, 1982 AC 300 (HL). The Revenue contented that the *Westminster* principle (i.e. the form over substance test) had been abandoned by the House of Lords in *Ramsay* and therefore *Westminster* principle could not be applied in *Vodafone case.*

322 *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, 667.

323 *Furniss* v. *Dawson*, 1984 AC 474 (HL).

324 *Ibid.*, cited at *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, 667.

325 *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, 667-668. Chief Justice Kapadia noted that, "... the Revenue started rejecting every case of strategic investment/tax planning undertaken years before the event saying that the insertion of the entity was effected with the sole intention of tax avoidance."

326 1989 AC 389 (HL).

planning was not hit by *Dawson*.[327] At this point, Chief Justice Kapadia did something that requires a close reading of *McDowell*. Justice Misra, in *McDowell*, had held as follows –

> Tax planning may be legitimate provided it is within the framework of law. Colourable devices cannot be part of tax planning and it is wrong to encourage or entertain the belief that it is honourable to avoid payment of tax by resorting to dubious methods. It is the obligation of every citizen to pay the taxes honestly without resorting to subterfuges.[328]

After having held so, he observed, "*On this aspect* one of us, Chinnappa Reddy, J., has proposed a separate and detailed opinion, *with which we agree*".[329] Thereafter, Justice Misra proceeded to dispose of the petition and grant the relief that was prayed for. Chief Justice Kapadia, in the Lead Opinion, uses this phrase '*on this aspect*' to narrow down the holding of Justice Reddy.[330] Thus, even though the majority (of 4 judges) in *McDowell* concurred with the separate concurring opinion, the content of what the majority concurred with was narrowed down by giving context of the separate concurring opinion – a context that came out of the majority opinion and a legal position that has been firmly established and followed in India long before Justice Reddy wrote his concurrence in *McDowell* and long after the content of his concurrence was subsequently diluted by post McDowell decisions.

But the Concurring Opinion opens with a steady dose of reality. The very first paragraph notes that foreign investment in India is generally routed through offshore financial centers and through countries with whom India has entered into treaties.[331] Vodafone Int'l argued that complex commercial transactions, such as the one under judicial scrutiny in this case, are designed for good commercial reasons and not just tax avoidance.[332] There was a special international context to this whole case and the Concurring Opinion grasped this very quickly.[333] Justice Radhakrishnan understood that there

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327 *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, 688.

328 *McDowell and Co. Ltd.* v. *CTO*, (1985) 3 SCC 230, 254-55.

329 *Ibid*. (emphasis added).

330 *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, 668.

331 *Ibid*., at 693.

332 *Ibid*., at 704 (Arguments of Vodafone Int'l's counsel, Mr. Harish N. Salve, Senior Advocate).

333 *See e.g.*, *Ibid*., at 711. Justice Radhakrishnan (concurring), "**Tax avoidance is a problem faced by almost all countries following civil and common law systems and all share the common broad aim, that is to combat it.** Many countries are taking various legislative measures to increase the scrutiny of transactions concluded by non-resident enterprises." (emphasis added)

is a difference between a corporate structure that is the result of investment decisions and those that are created only for tax avoidance.[334] Take, for instance, the following observation –

> In transnational investments, the use of tax neutral and investor-friendly countries to establish an [Special Purpose Vehicle] is motivated by the need to create a tax efficient structure to eliminate double taxation wherever possible and also plan their activities attracting no or lesser tax so as to give maximum benefit to the investor.[335]

Justice Radhakrishnan begins his 'tax avoidance versus tax evasion' with the famous *Westminster* citing it as an authority for the proposition that in tax avoidance cases, as per *Westminster*, tax laws are to be strictly interpreted and the legal form of the arrangement is to be examined, notwithstanding its economic or commercial substance.[336] Citing *Ramsay* and *Burmah Oil*[337] as authorities for the next proposition, he observes that it was only during the 1980s that the House of Lords moved towards a more purposive interpretation.Consequently, the Economic Substance Doctrine was put in place[338] but *Westminster* was still good law.[339] But, he carefully notes that *Ramsay* and *Burmah Oil* were the result of readymade transactions, a series of self-cancelling transactions that was designed to create allowable losses with the intent of avoiding capital gains tax.[340] The difficulty arose with *Dawson* where the House of Lords, dealing with a non-self-cancelling transaction, held that, '…steps inserted in a *preordained* series of transactions with no commercial purpose other than tax avoidance should be disregarded for tax purposes, notwithstanding that the inserted step… had a business effect',[341] thus, causing the appearance that the House of Lords had held that all transactions having a tax avoidance purpose were to be disregarded for that reason alone.[342]But later, in *Craven*, the House of Lords clarified,

> …an intermediate transfer which was, at the time when it was effected, so closely interconnected with the ultimate disposition, could properly be described as not, in itself, a real transaction at all, but merely an element in some different and larger whole without independent effect.[343]

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334 *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, 708.
335 *Ibid.*
336 *Ibid.*, at 719-20.
337 *Inland Revenue Commrs.* v. *Burmah Oil Co. Ltd.*, 1982 SC (HL) 114.
338 *Ibid.*, at 720.
339 *Ibid.*
340 *Ibid.*, at 721.
341 *Ibid.*, at 722.
342 *Ibid.*
343 *Ibid.*, at 723.

Note here at this point of time i.e. after discussing *Craven*, the Chief Justice stopped and moved to the conflict between *McDowell* and *Indo-Mauritius DTAA case*. But Justice Radhakrishnan decides to examine more English precedents on the point. After discussing 6 more English cases (5 of them being House of Lords decisions),[344] he concluded–

> The above discussion would indicate *that a clear-cut distinction between tax avoidance and tax evasion is still to emerge in England and in absence of any legislative guidelines there is bound to be uncertainty, but to say that the principle of* [Westminster] *has been exorcised in English is too tall a statement and not seen accepted even in England*.[345]

This observation is interesting to note because in *McDowell* Justice Reddy called for 'exorcising the ghost of Westminster'. This broad survey of English law on the subject was Justice Radhakrishnan's way of saying that perhaps Justice Reddy did not get it right in his concurrent opinion in *McDowell*. After pointing out that Westminster is still good law in the jurisdiction where it originated, he then moves to examining the conflict between *McDowell* and *Indo-Mauritius DTAA case*.[346]

Let us be with Justice Radhakrishnan's conclusion on the point. After discussing *McDowell* and *Indo-Mauritius DTAA case* and some other relevant Indian precedents on the point that we will examine later, he concluded–

> *The Revenue cannot tax a subject without a statute to support and in the course we also acknowledge that every taxpayer is entitled to arrange his affairs so that his taxes shall be as low as possible and that he is not bound to choose that pattern which will replenish the treasury.* The Revenue's stand that the ratio laid down in *McDowell* is contrary to what has been laid down in [*Indo-Mauritius DTAA case*], in our view, unsustainable and, therefore, calls for no reconsideration by a larger Bench.[347]

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[344] *Ensign Tankers (Leasing) Ltd.* v. *Stokes*, (1992) 1 AC 655 (HL), *Floor* v. *Davis*, 1978 Ch 295 : (1978) 3 WLR 360 (CA); *Inland Revenue Commrs.* v. *McGuckian*, (1997) 1 WLR 991 : (1997) 3 All ER 817 (HL); *MacNiven* v. *Westmoreland Investment Ltd.*, (2003) 1 AC 311 (HL); *Barclays Mercantile Business Finance Ltd.* v. *Mawson*, (2005) 1 AC 684 (HL); *Inland Revenue Commrs.* v. *Scottish Provident Institution*, (2005) 1 WLR 3172 : (2005) 1 All ER 325 (HL).

[345] *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, 725. (emphasis provided).

[346] *Ibid.*, at 726.

[347] *Ibid.*, at 733. (emphasis provided).

To support this finding he gave two reasons. First reason was the same as that given by the Chief Justice, which has been discussed previously. The lead opinion in *McDowell* was delivered by Justice Misra and Justice Reddy, per his own opinion, was only writing a supplemental concurrence.[348] Therefore, it was Justice Misra's opinion that should be read and used to provide context and limitations to the opinion of Justice Reddy. The second reason had to do with the 'ghost of Westminster' observation in Justice Reddy's concurrence in *McDowell*, which Justice Radhakrishnan held was merely Justice Reddy's opinion and not good law.[349]

## Conclusion

Supreme Court of India's juristic technique, in cases of tax avoidance disputes, discloses two distinct decision making methods. The traditional approach uses one of several interpretational principles.[350] As per this approach, one of these principles is either invoked and then applied or is invoked and then improved upon. These principles, as identified in Part 2, are the 'Legislative Intent Rule', the 'Textual Rule', the 'Minimum Liability Rule', the 'Strict Interpretation Rule', and the 'Restrictive Strict Interpretation Rule'. We can call this the 'Interpretational Approach'.[351] The other approach, which we can call the 'Judicial Test Approach', begins to appeal where the judges, while following the Interpretational Approach realized that in certain factual scenarios, or even the way the taxation statute was drafted, the interpretation principles because of their inherent limitations cannot be used to resolve the question completely.In this situation, the judges will either respond by creating a new rule of interpretation,[352] and, at other times, judges would articulate a judicial test.[353]

A crucial distinction between these two approaches should be noted. In the Interpretational Approach, the content of the interpretational rule

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[348] *Vodafone International Holdings BV* v. *Union of India*, (2012) 6 SCC 613, 733.

[349] *Ibid.*, at 732.

[350] *Supra* Parts 2.1 (I), (II), (III), (IV).

[351] *See* Brian Galle, "Interpretative Theory and Tax Shelter Regulation", 26 Va. Tax Rev. 357 (2007) at 358. Brian Galle describes, "The practice of tax law is fundamentally the practice of statutory interpretation."

[352] The Strict Interpretation Rule was the result of just such a situation that has been discussed *supra* Part 2.1 (IV).

[353] *Supra* Parts 2.1 (VI), (VII), (VIII), (IX). But *see also* Richard J. Kovach, "Taxes, Loopholes and Morals Revisited: A 1963 Perspective on the Tax Gap", 30 Whittier L. Rev. 247, 264 (2009) for a different take. Kovach says that, "Those taxpayers who [are] not in a position to apply bastardized interpretations of the business deduction rules … would resent their inability to save taxes this way." (Internal citations omitted).

remains constant even though the facts of the next case inevitably would be different from the previous ones. This consistency, in the content of the interpretational principle, is disturbed only when a new rule of interpretation is developed, or perhaps even discovered. But in this case also, the content of the old rules remains the same and a new rule is now added to the judicial tool kit. The content of this new rule also remains constant in future. This consistency in the Interpretational Approach gives a measure of predictability to the judicial decisions. Even though no one can really predict what a court will decide in any given case, by looking at the judicial decision making methodology one can reasonably assess what the decision in a given case is going to be.

In the Judicial Test Approach, however, the content of the judicial test remains subject to constant change depending on the facts of the next case. Since a judicial test has been articulated in the specific factual context of that case, it is inevitably going to be coloured by the legal question(s) raised in that case. Since the facts of no two cases are the same, or at least as the Bar would have it anyway, any judicial test is subject to constant modification and re-articulation depending of the facts of the next case and this cycle continues perpetually. This gives a certain measure of unpredictability to the judicial decisions because there is no way to know what gloss might be put over the judicial test in a given case. But the very existence of the Judicial Test Approach is, in itself, evidence of the fact that the Interpretational Approach has its limitations and the most efficient way to get over its limitations are sometimes to articulate a judicial test.

Following the Judicial Test Approach, the Supreme Court of India has developed some judicial tests *viz*. the 'Ordinary Course of Business' test, the 'Prudent Businessman Yardstick', the 'Bonafide Commercial Transaction' test and the 'Commercial Expediency' test. The problem.However, is that there is no coherent methodology in India whereby either the Bench or the Bar can discern the situations where the Interpretational Approach would be taken and where the Judicial Test Approach would be taken by the Court. Furthermore, the Interpretational Approach is essentially based on a statutory rule and is by definition restricted in its scope because all the judge can do is either expand or contract the competing meanings assigned to the text. [354]For example, it can be said the 'Commercial Expediency Test' has worked very well in its narrow sphere. But that is only because everyone knows how this test is to be applied and the content of the test has remained fairly stable. This demonstrates that for a judicial test to fare well in long term it is not just desirable but necessary for the content of the test to remain stable and

[354] *See e.g.*, David A. Weisbach, "Formalism in the Tax Law", 66 U. Chi. L. Rev. 860 (1999).

for it to be very clear in what situations the test can be invoked.[355] However, the Judicial Test Approach, being a departure from the Interpretational Approach for the reason that principles of interpretation cannot offer full assistance in answering the legal question raised, it must first be seen that this is indeed the case. This is where perhaps the *Vodafone case* bench fell into a classical confusion by failing to realize whether the legal question can be answered using the Interpretational Approach or the need to take the Judicial Test Approach has arisen.

By laying down the several interpretational principles that hold this field in the complex area of tax avoidance jurisprudence, as well as the judicial tests that the Supreme Court has laid down, and by distinguishing when the Interpretational Approach is best suited to resolve the conflict and when the Judicial Test Approach fares better, this article hopes to fill this crucial gap in scholarship. We can conclude by reproducing in full a quote made in 1937 by a highly respected US tax lawyer Randolph E. Paul that perhaps most accurately captures the confusion, and one that this article hopes to have clarified

> Confusion is often introduced or multiplied by a failure to distinguish between questions of fact and questions of law. In the *fact* cases the paramount question is always essentially the same. Has the taxpayer really done what he professes he has done? Has he actually taken the steps on which his attempt at avoidance was based? ... The second type of question, one of *law*, not *fact*, ... is how the law is to be construed in relation to the facts proved. Here, rules of statutory construction are relevant.[356]

[355] *See e.g.*, Martin A. Chirelstein, *supra* note 53. Chirelstein says that, "... the ability to perceive alternatives in great numbers can sometimes by a dangerous intelligence unless it is combined with a power to forecast the likely reaction of the Service and the courts to each of the alternatives in view".

[356] Walter J. Blum, "*Knetsch* v. *United States*: A Pronouncement on Tax Avoidance", 1961 Sup. Ct. Rev. 135, 143 (1961) where he reproduces Paul's observations; the original source cited by Blum is Paul, Studies in Federal Taxation 130 (1937).

# The FDI Conundrum In E-Commerce

*Akshita Pandey &Vernita Jaishal*

**Abstract** *E-commerce has become the cynosure attracting both applause and criticism. It has opened tremendous opportunities for businesses by blurring national boundaries and has provided a whole new universe of options to consumers at a click of the mouse. At the same time it has uprooted the centuries-old established traditional business-to-consumer models and replaced them with a convenient and more affordable mechanism. Regulation of the sector becomes the natural corollary with governments around the world trying to figure out the right mix of laws that ought to be complied by e-commerce entities. The Indian government too, with this objective in mind, is making attempts at governing a sector whose compounded annual growth rate projections are humungous. The following research paper deals with the foreign direct investment laws applicable on e-commerce entities and the impact that the recent amendments will have on the sector.*



## Part I: Introduction

It is no secret that e-commerce is the next big driver of growth and an area of opportunity having the potential to generate huge returns. Whenever the size of aspecific business avenue increases so as to impact a number of persons, the government steps in attempting to regulate them with the utilitarian[1] objective often at the forefront. E-commerce being what it is, a disruptor,

1 Antoinette Baujard, "Utilitarianism and Anti-Utilitarianism" (2013) Gate 2013-32, 2013 <https://halshs.archives-ouvertes.fr/halshs-00906899/document> accessed 1 February, 2019.

it has changed the manner in which sellers used to traditionally sell their merchandise. It has given consumers access to a wide variety of products at competitive prices. On the flipside, it has also had a debilitating effect on the ability of the sellers to price their products and generate the desired profits.

E-commerce entities are at present governed by a potpourri of legislations in India covering a wide gamut of fields such as foreign exchange, company, technology and competition laws, to name a few. Each and every one of these consists of a set of regulations that the e- commerce entities need to comply with, in order to undertake business activities in India. A cursory glance reveals that as a general rule, these laws do not address the e-commerce eco-system directly but are applicable tangentially. The most significant exception to the aforementioned statement, and the crux of this research paper, is the foreign exchange laws along with their attendant amendments in the recent past.

Inflow of foreign exchange has always been highly regulated in India due to its perpetual paucity and the consequent desire on part of the government to have control over it (up to a maddening degree before the liberalisation of the economy).[2] The central government dictates the foreign direct investment (hereinafter, FDI) policy of India.[3] This is done through the Department for Promotion of Industry and Internal Trade (hereinafter, DPIIT), née Department for Industrial Policy and Promotion (hereinafter, DIPP).[4] Prior to this change in nomenclature and the accompanied modifications; matters of internal trade came under the Ministry of Consumer Affairs.[5] With this change, issues concerning promotion of internal trade, including retail trade, welfare of traders and their employees, facilitation of ease of doing business, and start-ups, will be dealt with by the DPIIT.[6] Formerly, it was amongst the roles and functions of DIPP to formulate the FDI Policy and undertake efforts for the promotion, approval, and facilitation of FDI.[7] To this effect,

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2 Montek S. Ahluwalia, "India's Economic Reforms: An Appraisal" <http://planningcommission.nic.in/aboutus/speech/spemsa/msa018.pdf> accessed 2 February, 2019.

3 R. Nagaraj, "Foreign Direct Investment in India in the 1990s: Trends and Issues" (2003) *Economic and Political Weekly* 1701.

4 PTI, 'Govt. Christens DIPP as Department for Promotion of Industry and Internal Trade' *The Economic Times* (New Delhi, 30 January 2019) <https://economictimes.indiatimes.com/news/economy/policy/govt-christens-dipp-as-department-for-promotion-of-industry-and-internal-trade/articleshow/67753585.cms> accessed 2 February, 2019.

5 *Ibid.*

6 PTI, "Now Both External, Internal Trade under Commerce & Industry Ministry", *The Economics Times* (New Delhi, 30 January, 2019) <https://economictimes.indiatimes.com/news/economy/policy/now-both-external-internal-trade-under-commerce-industry-ministry/articleshow/67762390.cms> accessed 1 February, 2019.

7 Department for Promotion of Industry & Internal Trade, "Role & Functions of the Department of Industrial Policy & Promotion" <https://dipp.gov.in/about-us/role-and-functions-department-industrial-policy-promotion> accessed 5 February, 2019.

the department issued the consolidated FDI policy and press notes that have far reaching consequences for foreign businesses operating in India. The poweris obtained from Article 77 of the Constitution of India, 1950, which mandates the President to make rules for more convenient transaction of the business of the Government of India, and for the allocation of the said business, among ministers. In pursuance of the same, the Government of India (Allocation of Business) Rules, 1961 were enacted. The DIPP under the Ministry of Commerce and Industry was conferred with the power to make rules with regards to direct foreign and non-resident investment in industrial and service projects.[8] Inferentially, it can be said that DIPP has the power to regulate the operation of the e-commerce entities that have the backing of a foreign entity whether in the form of an ownership stake or control over the entity.

The research paper is divided into four parts.Beginning with the introduction of the issues faced in e-commerce, *Part I* sets the tone fora comprehensive analysis of the FDI policy governing foreign investment into e-commerce entities operating in India. *Part II* gives a glimpse into the history of FDI laws and how they have evolved in the span of a decade or so. *Part III* of the research paper deals with the changes introduced by the latest press note, i.e., Press Note 2 of 2018 (hereinafter, PN2/18). It delves into the ramifications of the mandate of the DIPP and the resultant effects the policy has on the operations of the e-commerce players in the market. *Part IV* of the paper concludes the discussion on PN2/18 and summarizes the analysis in the foregoing parts.

## Part II: History of FDI Laws in E-Commerce

The regulation of FDI in e-commerce commenced around the same time it was done for physical retail trade. The restrictions in the offline world applied with just as much vigour to the online world, establishing an equivalence that was unwarranted at the time - between the nascent e-commerce industry and the traditional Indian retail.[9] This regulatory hostility did not however deter foreign companies from entering the e-commerce space in India, the primary reason being the market size, which was too big to ignore. Hence, lawyers helped them evolve myriad convoluted corporate structures to ensure that the businesses were complying with the regulations as per their strict and literal interpretation. The next time DIPP decided to take a

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[8] The Government of India (Allocation of Business) Rules, 1961.

[9] Rahul Matthan, "Time to Redo FDI in E-Commerce in India" *Livemint* (Mumbai, 16 January, 2019) <https://www.livemint.com/Opinion/cO0CvCKOwrxUe8usL1QrQO/Opinion--Time-to-redo-FDI-in-ecommerce-in-India.html> accessed 10 February, 2019.

look at the e-commerce regulations was after a long period of timemarked by global recession and the rise of technology-based start-ups. It was only whene-commerce entities operating in India became massive in scale and in operation, that the government sprang into action.

The preceding cause was the constant demands of the small mom-and-pop store owners to control burgeoning e-commerce entities like Amazon and Flipkart that were alleged to be abusing their dominant position.[10] Accordingly, Press Note 3 of 2016 (hereinafter, PN3/16) was passed with the aim of ensuring parity, especially in the pricing power of products on the offline vis-a-vis the online platforms.The concepts ofmarketplace model and inventory-based model of e-commerce were introduced, FDI in the latter being prohibited.[11] In the former, the role of an e-commerce entity is restricted to providing information technology platforms on a digital and electronic network acting as a facilitator between the buyer and the seller.[12] In the latter, the inventory of goods and services is owned by the e-commerce entity and is directly sold to consumers.[13] At the same time, a slew of definitions were added[14] and certain relaxations were given to FDI in Business-to-Consumer (hereinafter, B2C) companies, that were banned till then.[15]

## PART III: CRITICAL ANALYSIS OF PRESS NOTE 2 (2018 SERIES)

### I. B2C: TO BE OR NOT TO BE

The PN2/18 Para 5.2.15.2.1[16] says that e-commerce entities will engage only in Business-to-Business (hereinafter, B2B) e-commerce and not in B2C

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10 "Flipkart, Amazon Not Abusing Market Position: CCI" *The Hindu* (New Delhi, 7 November, 2018) <https://www.thehindubusinessline.com/info-tech/flipkart-amazon-not-abusing-market-position-cci/article25437369.ece> accessed 7 February, 2019.

11 Ministry of Commerce & Industry, Department of Industrial Policy & Promotion, Press Note No. 3 (2016 Series) <https://dipp.gov.in/sites/default/files/pn3_2016_0.pdf> accessed 7 February, 2019.

12 Ministry of Commerce & Industry, Department of Industrial Policy & Promotion, Press Note No. 3 (2016 Series) <https://dipp.gov.in/sites/default/files/pn3_2016_0.pdf> accessed 7 February, 2019.

13 *Ibid.*

14 *Ibid.*, Definitions added include those of e-commerce, e-commerce entities, inventory based model of e-commerce, marketplace based model of e-commerce.

15 *Ibid.*, Foreign companies are now permitted to invest in B2C companies as well in:
(*a*) a manufacturer manufacturing its products in India;
(*b*) a single brand retail trading entity selling its products under a single brand through its brick-and-mortar stores, and;
(*c*) an Indian manufacturer who owns the Indian brand and manufactures 70% of its products in-house and sources, at most, 30% from Indian manufacturers.

16 Ministry of Commerce &Industry, Department of Industrial Policy & Promotion, Press Note No. 2 (2018 Series) <https://dipp.gov.in/sites/default/files/pn2_2018.pdf> accessed 15

e-commerce,[17] except in case of food manufactured or produced in India which get 100% FDI in B2C model under government route.[18] This means that e-commerce entities cannot hold an inventory of goods to sell it directly to end consumers. Earlier PN3/16 allowed FDI in B2C e-commerce under particular conditions[19] but these never featured in the Consolidated FDI Policy of 2017.

When the DIPP was questioned about PN2/18, the press note was said to be just a clarification and therefore, FDI in B2C e-commerce in multi-brand retail through inventory-based model[20] is not allowed in India.[21] Then a question arises as to why DIPP permitted 51% FDI in multi-brand retailing in other sectors.[22] Since B2C e-commerce is not allowed, Amazon, Flipkart, Shopclues, etc., had to change their model to a B2B marketplace model[23] to do business in India.In the authors' opinion, limited FDI should be allowed

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February, 2019.

[17] DIPP, Discussion Paper On E-Commerce – 2013-14 <http://indiafdiwatch.org/wp-content/uploads/2014/01/discussionpaper.pdf> accessed 16 March 2019. Business-to-Business e-commerce means transactions between two enterprise like manufactures and wholesalers, etc. whereas Business-to-Consumer e-commerce is a transaction between enterprise and end consumers.

[18] Make in India, Foreign Direct Investment: Sectors under Automatic Route with Conditions <http://www.makeinindia.com/policy/foreign-direct-investment> accessed 24 February, 2019.

[19] Ministry of Commerce & Industry, Department of Industrial Policy & Promotion, Press Note No. 3 (2016 Series) <https://dipp.gov.in/sites/default/files/pn3_2016_0.pdf> accessed 7 February, 2019. Foreign companies are now permitted to invest in B2C companies as well in:

(*a*) a manufacturer manufacturing its products in India,

(*b*) a single brand retail trading entity selling its products under a single brand through its brick-and-mortar stores, and;

(*c*) an Indian manufacturer who owns the Indian brand and manufactures 70% of its products in-house and sources, at most, 30% from Indian manufacturers.

[20] Ministry of Commerce & Industry, Department of Industrial Policy & Promotion, Consolidated FDI Policy 2017 <http://www.makeinindia.com/documents/10281/0/Consolidated+FDI+Policy+2017.pdf> accessed 13 February, 2019. Inventory-based model of e-commerce means where inventory of goods and services are owned by e-commerce entity and sold to end consumers directly.

[21] Ministry of Commerce & Industry, Department of Industrial Policy & Promotion, Response to Comments Reported in the Media on Press Note 2 (2018) <https://dipp.gov.in/whats-new/response-comments-reported-media-press-note-2-2018> accessed 23 February, 2019.

[22] "E-Commerce Rules Do Not Allow Foreign Investment in Multi-Brand Retail: DIPP" *The Economic Times* (New Delhi, 3 January, 2019) <https://economictimes.indiatimes.com/news/economy/policy/e-commerce-rules-do-not-allow-foreign-investment-in-multi-brand-retail-dipp/articleshow/67366533.cms?from=mdr> accessed 15 February, 2019.

[23] Ministry of Commerce and Industry, Department of Industrial Policy and Promotion, Consolidated FDI Policy 2017 <http://www.makeinindia.com/documents/10281/0/Consolidated+FDI+Policy+2017.pdf> accessed 13 February, 2019. Marketplace based model means e-commerce entity handling the information technology platform on digital and electronic network to act as facilitator between buyer and seller.

in B2C inventory model because otherwise e-commerce entities will devise indirect ways to undertake the very same prohibited activities. It is better to regulate it rather than altogether ban it, as it is a driver of growth in the economy.Trade bodies like NASSCOM and FICCI have also proposed that FDI should be allowed in B2C inventory-based model for the growth of 'Make in India'.[24]

B2C inventory-based model is effective for the manufacturers of India to grow their market. It creates jobs, reducesinventory and labour costs, ensures faster deliveries to customers, etc.[25] The marketplace model as such is not efficient for companies because a lot of money is needed to handle it such as logistical costs, there are supply chain inefficiencies and they lack control over the quality of goods being sold.[26]

There are a lot of downsides tothe marketplace model as well whichwould form part of the many reasons due to which the government's protectionist instincts arise. Dr. Rashmi Das in her book '*E-Com in India: Violations & Tax Avoidance*' pointed out that many e-commerce entities created 'name lending' companies through which they started holding stocks. In this case, the e-commerce marketplace buys goods from companies in bulk on discount, then they influence the price of goods - which affects small sellers who can't participate in fast-growing e-commerce sector.[27] Start-ups cannot work in the marketplace model because they do not have adequate investment. In a survey, it was established that people buy more electronics and accessories such as hard drives, USB drives, laptop skins, etc., on e-commerce platforms, and a study of Counter Research and E-Marketerestimated that 40% of total smart phones that have been sold in India in the past year are through e-commerce websites.[28] Hence, if these goods are kept in inventory,

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[24] Abhinna Shrestha, "Should 100% FDI be Allowed in B2C E-Commerce?" (Exchange4media, 21 May, 2015) <https://www.exchange4media.com/digital-news/should-100fdi-be-allowed-in-b2c-e-commerce-60103.html> accessed 16 February, 2019. NASSCOM said that 100% FDI be allowed in B2C model for growth of "Make in India"; Aditya Srivastava, "Foreign Direct Investment in E-Commerce Sector in India" (*iPleaders*, 18 April, 2018) <https://blog.ipleaders.in/foreign-direct-investment-e-commerce-sector-india/> accessed 16 February, 2019. FICCI said that FDI in B2C model should be allowed in phased manner to promote "Make in India" and for sourcing SMEs and MSMEs.

[25] Discussion Paper on E-Commerce in India <http://indiafdiwatch.org/wp-content/uploads/2014/01/discussionpaper.pdf> accessed 1 March, 2019.

[26] Arpita Mukherjee and Avantika Kapoor, "Trade Rules in E-Commerce: WTO and India" (2018) Indian Council for Research on International Economic Relations, Working Paper No. 354 <http://icrier.org/pdf/Working_Paper_354.pdf> accessed 19 March, 2019.

[27] Shelley Vishwajeet, "The E-Commerce Transgressions and the Cry for a Level Playing Field by Physical Retailers" (India FDI Watch, 9 October, 2018) <https://indiafdiwatch.org> accessed 20 March, 2019.

[28] Harish Patil and Rajiv Divekar, "Inventory Management Challenges for B2C E-Commerce Retailers" (2014) 11 Procedia Economics and Finance 561<https://www.researchgate.net/

they can be delivered to customersas soon as possible and as they do not take much space, inventory cost is less.[29] In the survey, it was also found that many people did not prefer buyingonlinedue to long product delivery times (this is one the touch points of consumer friction). This is another significant reason why an inventory of goods is necessary.

There may be some issueswith the B2C inventory model like demand fluctuations, stock outs, etc., but these are risks that businesses have to strategize for.A think tank has suggested that 49% FDI be allowed in B2C e-commerce for domestically produced things to help them gain worldwide recognition,[30] and to help small artisans grow and compete with leading business. The authors have attempted to formulate a clause that should form a part of the press note based on the discussion above. Asimilar formulation has been adopted for each of the issues discussed hereinafter.

Recommended clause:

*Para 5.2.15.2.1*

1. *"E-commerce entity shall have 100% FDI in Business-to-Business model and* 49% FDI be allowed in inventory-based model *of Business-to-Customer*[31] *in particular circumstances-*
   a) *The products which are manufactured in India.*
   b) *Single brand retail trading through brick and mortar or produced by Indian manufactures*[32] *is allowed to sell on e-commerce marketplace.*[33] *In case of Indian manufacturers, they*

publication/275541054_Inventory_Management_Challenges_for_B2C_E-commerce_Retailers> accessed 18 February, 2019.

29 *Ibid.*

30 Priyanka Sahay, "Government Keen on 49% FDI in B2C E-Commerce; Draft Proposal Being Discussed with Industry Today" Moneycontrol.com (New Delhi, 30 July, 2019) <https://www.moneycontrol.com/news/economy/policy/exclusivegovt-keen-on-49-fdi-in-b2c-e-commerce-draft-proposal-being-discussed-with-industry-today-2781371.html> accessed 20 March, 2019.

31 Amiti Sen, "Panel of Secretaries Reviewing E-Commerce Draft to Focus on FDI", *The Hindu Business Line* (New Delhi, 11 September, 2018) <https://www.thehindubusinessline.com/economy/panel-of-secretaries-reviewing-e-commerce-draft-to-focus-on-fdi/article24928815.ece> accessed 20 March, 2019.

32 Ministry of Commerce & Industry, Department of Industrial Policy & Promotion, Press Note No. 3 (2016 Series) < https://dipp.gov.in/sites/default/files/pn3_2016_0.pdf> accessed 7 February, 2019. Indian manufacture is one who is an Indian brand owner manufactures in India.

33 Namrota Baruwa, "India Inc Seeks Easing of FDIs in Multi-Brand Retail, E-Commerce & More" (*Plunge Daily*, 8 January, 2016) <https://mybigplunge.com/trending/india-inc-seeks-easing-of-fdis-in-multi-brand-retail-e-commerce-more/> accessed on 13 March, 2019. In pre-budget meeting, India Inc. has raised this issue to provide FDI in multi-brand retail. In February 2006, India provided single brand retail trading with 51% FDI.

*have at least 70% of its products with themselves and 30% from Indian manufactures.*[34]

2. *In case of multi-brand retail there shall be* 51% FDI be provided to boost manufacturing, export and start-ups.[35]
3. *E-commerce entity will enter into transaction with end customers through business-to-customer model for* limited products *for which entity having inventory like electronics, accessories or any other product which takes less space to store.*[36]
4. *E-commerce entity shall have an option to check the nature of quality of goods which are being delivered to customers."*

## II. Ownership of Inventory

PN3/16 and the subsequent FDI Policy of 2017[37] restricted e-commerce entities operating with the marketplace model from exercising ownership over the inventory (i.e., goods purported to be sold). It further stipulated that a single seller or its group companies should not account for more than 25% of the aggregate sales in one financial year on that marketplace, in order to ensure that the affiliated sellers did not account for most of the actual sales on these platforms.[38] What PN2/18 adds to the ownership test is the requirement of control test to be satisfied. It is now required that the marketplace entity (apart from not having ownership over the inventory) should not exercise control over the goods to be sold. The PN2/18 further provides the parameters to determine control - the threshold for which is satisfied if more than 25% of the purchases of the vendor are from the marketplace entity or

34 Ministry of Commerce & Industry, Department of Industrial Policy & Promotion, Press Note No. 3 (2016 Series) <https://dipp.gov.in/sites/default/files/pn3_2016_0.pdf> accessed 7 February, 2019.

35 Namrota Baruwa, "India Inc Seeks Easing of FDIs in Multi-Brand Retail, E-Commerce & More" (*Plunge Daily*, 8 January, 2016) <hhttps://mybigplunge.com/trending/india-inc-seeks-easing-of-fdis-in-multi-brand-retail-e-commerce-more/> accessed on 13 March, 2019. In pre-budget meeting India Inc. has raised this issue to provide FDI in multi-brand retail.

36 Harish Patil and Rajiv Divekar, "Inventory Management Challenges for B2C E-Commerce Retailers" (2014) 11 Procedia Economics and Finance 561 <https://www.researchgate.net/publication/275541054_Inventory_Management_Challenges_for_B2C_E-commerce_Retailers> accessed 18 February, 2019.

37 Ministry of Commerce and Industry, Department of Industrial Policy & Promotion, "Consolidated FDI Policy 2017" <http://www.makeinindia.com/documents/10281/0/Consolidated+FDI+Policy+2017.pdf> accessed 13 February, 2019.

38 "Review of FDI Policy in E-Commerce" (Trilegal, 7 January, 2019) <https://www.trilegal.com/index.php/publications/analysis/review-of-fdi-policy-in-e-commerce> accessed 15 February, 2019.

its group companies. The failure to comply with either of these requirements (i.e., the ownership test or the control test) will result in conversion of the business into the inventory-based model,[39] effectively attracting the prohibition on FDI. Hence, non-compliance with this condition is a death-knell for foreign entities that have invested in the e-commerce space in India. There is, however, a lack of clarity as to whether the 25% requirement is to be met annually or otherwise, as the press note is silent on the same.[40] However, it may be presumed that the requirement is to be met annually considering the same requirement was followed previously.[41] Another issue that crops up is whether the stipulation is 25% of the purchases of the seller's inventory on the e-commerce entity by the ultimate consumers, or the percentage requirement is for the purchases by the vendor from the e-commerce entity or its group companies. In the absence of any further clarification from the DPIIT, e-commerce entities may be required to comply with both possible interpretations in order to avoid falling on the wrong side of the law.

Apart from the difficulties created by the language, this change will impact marketplace entities that use one or more of their group entities to sell goods to sellers on a B2B basis with such sellers in turn listing the goods on the marketplace entity's platforms for sale to retail customers.[42] Additionally, significant disadvantages have emerged for sellers selling on marketplace platforms, most of whom are devoid of any monetary benefit in the form of FDI andare now forced to diversify their procurement channels. This may mean that each of such sellers may be required to build additional channels / relationships such that they comply with the new condition.[43] As a result, their margins will be affected which is contrary to the government's desire of ensuring the protection of seller community. The peculiarity of the clause is that its non-compliance will result in violation of the FDI laws by the

[39] Ministry of Commerce & Industry, Department of Industrial Policy & Promotion, Press Note No. 2 (2018 Series) <https://dipp.gov.in/sites/default/files/pn2_2018.pdf> accessed on 15 February, 2019.

[40] DIPP Press Note on the Consolidated FDI Policy for E-Commerce (Economic Laws Practice, 28 December 2019) <https://elplaw.in/leadership/dipp-press-note-on-the-consolidated-fdi-policy-for-e-commerce/> accessed 15 February, 2019.

[41] Ministry of Commerce & Industry, Department of Industrial Policy & Promotion, Press Note No. 3 (2016 Series) <https://dipp.gov.in/sites/default/files/pn3_2016_0.pdf> accessed 7 February, 2019.

[42] Vinay Joy, Rishabh Bharadwaj and Neil Deshpande, "India: FDI in E-Commerce Activities: Press Note No. 2 (2018 Series)" (Khaitan & Co., 2 January, 2019) <http://www.mondaq.com/india/x/768654/Fiscal+Monetary+Policy/FDI+IN+ECOMMERCE+ACTIVITIES+PRESS+NOTE+NO+2+2018+SERIES> accessed 16 February, 2019.

[43] DIPP Press Note on the Consolidated FDI Policy for E-Commerce (Economic Laws Practice, 28 December, 2019) <https://elplaw.in/leadership/dipp-press-note-on-the-consolidated-fdi-policy-for-e-commerce/> accessed 15 February, 2019.

concerned e-commerce entity[44] imposing a burdensome requirement on them without much thought as to the practicality of execution. Due to its loosely worded nature, the press note also brought into its ambit the private labels of e-commerce entities exclusively sold on its market platform. However, a later clarification introduced by the department stated that the modified policy does not ban private labels.[45]

*Recommended clause*:

> *"Para 5.2.15.2.4 (iv): E-commerce entity providing a marketplace will not exercise ownership or control over the inventory that is the goods purported to be sold. Inventory of a vendor shall be deemed to be controlled by e-commerce marketplace entity if 25% of* annual sales *of such a vendor are from the marketplace entity or its group companies."*

## III. Equity Participation

The latest DIPP diktat prohibits an entity from selling its goods on the platform of the marketplace entity if the latter has a stake in the company by means of equity participation. The prohibition is also attracted if the e-commerce marketplace entity exercises control on the inventory of the entity. The phrase "equity participation" is an ambiguous term without any inkling in the entire press note with respect to whether both direct and indirect equity participation is banned. Although keeping in mind the intention of the government, it may be safely inferred that both are prohibited. The above statement is still guesswork at best because in the succeeding clause, where the government seeks to regulate cash backs and logistical services provided by e-commerce entities or their affiliates, both direct and indirect equity participation is prohibited. Hence, it is estimation at best as to why this clause was left uncertain and ambiguous. The trouble that arises as a result of such an expansive interpretation is that in the absence of a minimum disqualification percentage even minority participation by e-commerce marketplace entities has been disallowed.

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44 Ministry of Commerce & Industry, Department of Industrial Policy & Promotion, Press Note No. 2 (2018 Series) <https://dipp.gov.in/sites/default/files/pn2_2018.pdf> accessed 15 February, 2019.

45 "No Ban on Private Labels, FDI Policy Not against Consumer: Government", *The Economic Times* (New Delhi, 4 January, 2019) <https://economictimes.indiatimes.com/news/economy/policy/no-ban-on-private-labels-fdi-policy-not-against-consumer-government/articleshow/67374862.cms?from=mdr> accessed 16 February, 2019.

This in turn could limit the prospect of e-commerce players investing significantly in the vendor ecosystem in India, leading to an undesired effect on the ability of Indian e-commerce companies to develop and sell white-label brands or provide growth-capital to small-scale artisanal brands.[46] Globally, white-label and artisanal brands have been a driver of volumes and margins for e-commerce entities, providing them with an incentive to invest in this ecosystem.[47] This is not some anticipated dystopian event whose occurrence is a remote possibility. The adverse effect of this clause has already surfaced with Amazon no longer contemplating buying a stake in Future Retail,[48] a direct causality of the PN2/18.

Prior to the absence of any such restrictions, the e-commerce entities backed by foreign players had evolved such structures where they had a stake in a substantial number of sellers on their platform which enabled them to exert influence on the price of goods and services on their platform and provide discounts. Prohibition on the same has created a lot discomfort for foreign e-commerce players who are now revamping their structures following the refusal of the government to extend the deadline of February 1, 2019[49] for compliance despite intense lobbying.

*Recommended clause:*

> *"Para 5.2.15.2.4 (v): An entity having* direct equity participation *by an e-commerce marketplace entity or its group companies or having control over its inventory* as defined in Para 5.2.15.2.4 (iv) *by an e-commerce marketplace entity or its group companies will not be permitted to sell its products on the platform run by an e-commerce company."*

## IV. NON-DISCRIMINATORY PRICING

PN2/18 Para 5.2.15.2.4 (ix) states that e-commerce marketplace entities or other entities (wherein e-commerce marketplace entity has direct or indirect equity participation or common control) providing services such as logistics,

46 Review of FDI Policy in E-Commerce (Trilegal, 7 January, 2019) <https://www.trilegal.com/index.php/publications/analysis/review-of-fdi-policy-in-e-commerce> accessed 15 February, 2019.

47 *Ibid.*

48 Ajita Shahsidhar, "Amazon-Future Retail Deal has Fallen Through, Sources Say", *Business Today* (New Delhi, 4 January, 2019) <https://www.businesstoday.in/current/corporate/kishore-biyani-may-not-sell-stake-in-future-retail-to-amazon-say-sources/story/306941.html> accessed 30 February, 2019.

49 PTI, "Government to Not Extend February 1 Deadline on Revised Norms for E-Tailers", *The Hindu* (New Delhi, 31 January, 2019) <https://www.thehindubusinessline.com/economy/policy/govt-to-not-extend-february-1-deadline-on-revised-norms-for-e-tailers/article26140099.ece> accessed on 30 February, 2019.

warehousing, advertisement/ marketing, payments, financing, etc., to vendors shall do so at arm's length basis and in a fair and non-discriminatory manner. They should not directly or indirectly influence the sale price of goods or services and they have to maintain a level playing field. In all similar circumstance, the services which are provided to one vendor will be provided to other vendors. Furthermore, cash back provided by group companies of marketplace entity to buyers shall be fair and non-discriminatory.

The model of business is that aB2Centity buys goods from a B2Bcompany at heavy discounts and sells these on thee-commerce platform attracting a lot of customers. The foreign investor holding shares in B2B companies absorbs this discount that increases the Gross Merchandise Value which is used in ascertaining the valuation of market place models. This directly influences the sale price of goods and the objective is to ensure maximum sales happen through their platform.[50] There is also indirect influence on sale price of goods when e-commerce giants like Amazon through a concept known as promotional funding recommend its sellers to offer discount and subsequent to the consent of the seller, a debit note is offered to Amazon which is then duly paid by it.[51]

The PN2/18 has been brought to solve issues between offline and online market but the clause providing for a fair and non-discriminatory treatment raises a number of issues and also prima facie seems to encroach on the jurisdiction of the Competition Commission of India (hereinafter, "CCI"). The issue relating to 'influencing the sale price of goods' is a concern of the CCI and not of the DIPP,[52] because if marketplace is directly or indirectly influencing prices, then offences and the punishment are mentioned in Competition Act, 2002. According to Competition Act, 2002 if the e-commerce marketplace is involved in predatory price (influencing the sale price of goods) then it must be in a dominant position[53] in a relevant market.[54] CCI

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50 Aakash Kamble and Dr Shubhangi Walvekar, "Policy Regulations in E-Commerce Sector – Critical Analysis of FDI Guidelines for Market Place Model", Journal of Commerce & Management Thought (2017) 8(3) International Journal of Commerce and Management 409.

51 *Ibid.*

52 Srinivas Katta, Aakash Dasgupta and Ankita Gupta, "Indus law Guidelines for Foreign Direct Investment in E-Commerce" (IndusLaw, April 2016) <http://www.manupatrafast.in/NewsletterArchives/listing/Induslaw/2016/April-2016%20--%20GUIDELINES%20FOR%20FOREIGN%20DIRECT%20INVESTMENT%20IN%20E-COMMERCE.pdf> accessed 15 March, 2019.

53 Competition Act, 2002, S. 4. Predatory price is defined in S. 4 Expln. (*b*) as when the price of goods is below the cost for the sale of goods to reduce the competition or eliminate the competitors. Dominant positionis defined in S. 4 Expln. (*a*) as position of strength enjoyed by enterprise in relevant market to work independently of leading forces and to affect the relevant market, customer or competitors in their favour.

54 *All India Online Vendors Assn.* v. *Flipkart India (P) Ltd.*, 2018 SCC OnLine CCI 97 : 2018 Comp LR 1122. Relevant market was defined as services provided by online marketplace

does not recognize e-commerce marketplace as a dominant player because it's not the only platform available in India.[55]

CCI in case of Ashish Ahuja v. Snapdeal.com[56] stated that Snapdeal is not a dominant player because it acts as a facilitator who manages a web portal so that sellers and buyers can come together to interact, and is not itself engaged in purchase or sale of storage devices. In case of *Mohit Manglani* v. *Flipkart India (P) Ltd.*,[57] CCI was of the opinion that e-commerce marketplace entity is not individually dominant whether it operates as a separate relevant product market or only as a distribution channel, because there are many online players who offer similar facilities to their customers. In yet another case of *All India Online Vendors Assn.* v. *Flipkart India (P) Ltd.*,[58] a complaint was filed against Flipkart under Section 3 and Section 4 of Competition Act, 2002 saying that it sells products from WS Retailers at discounted prices by giving preference. The CCI re-affirmed its earlier stance stating that in the present market structure, online marketplace is not in a dominant position because there are several players online and it can't be said that one player is dominating the whole marketplace.

Hence, the above cases prove that an e-commerce marketplace entity directly or indirectly influencing the prices of the goods to be sold is not liable under Competition Act, 2002.The reason to have PN2/18 is to curb the practice of influencing the sale price ofgoods but it will be very hard to prove that marketplace is doing it because CCI does not recognize e-commerce marketplace as dominant player. So, in case the DIPP really wants the established status quo to change then a new regulatory authority should be established whose only task is the regulation of the e-commerce market.

Another concern is what the government means by "influencing the sale price of goods" as there can be many interpretations to it. Doesit only refer to deep discounting or does it include predatory pricing as well? Does it cover within its ambit discounts offered for marketing and advertisement purposes? Or does the government mean that pricing algorithms[59] should be

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platforms for selling goods in India.

[55] Esha Shekhar, "Are Deep-Discounts in E-Commerce Anti-Competitive? Flipkart's Big Billion Day Sale and the Way Forward" (ipleaders, 17 October, 2014) <https://blog.ipleaders.in/are-deep-discounts-in-e-commerce-anti-competitive-flipkarts-big-billion-day-sale-and-the-way-forward/> accessed 19 March, 2019.

[56] 2014 SCC OnLine CCI 67.

[57] 2015 SCC OnLine CCI 61.

[58] Competition Commission of India, Case No. 20 of 2018.

[59] Bill Baer, Sonia Kuester Pfaffenroth and Vesselina HMusick, "United States: Pricing Algorithms: The Antitrust Implications" (Arnold & Porter, 17 April, 2018) <https://www.arnoldporter.com/en/perspectives/publications/2018/04/

stopped? Are the 'buy one get one free' offers by e-commerce entities hit by the prohibition on predatory pricing?

Moreover, there are no prohibitions on cash backs i.e., one of the methods of discounting which should be fair and non-discriminatory. The vendors have raised a hue and cry about the fact as to how the cash backs by Paytm have negatively influenced the price of goods,[60] completely obliterating any control over pricing and adversely affecting profit margins.

In Fast Track Call Cab (P) Ltd. v. ANI Technologies (P) Ltd.,[61] CCI considered the radio cab service as different relevant market on the basis of convenience, ease of availability, round of clock availability, etc. This put the e-commerce marketplace at same place as that of cab service, which makes it a different relevant product market. Therefore, offline and e-commerce market are placed on different pedestals. So if discounting is provide by e-commerce platform, then offline market can't say that it affects their market.

The issues do not end here. Common control has not been defined in press note. It is defined in neither the Consolidated FDI Policy nor the PN3/16. What does it mean? Does it mean common ownership? Does it mean the services which are being provided to e-commerce marketplace, vendors also have a common control over it?

Another important distinction is between small vendors on one hand, and medium and big vendors on the other hand, who are not in the same class. Small vendors need more support for their sustenance and growth from e-commerce marketplace.[62] If services provided are in a fair and non-discriminatory manner, then it will only impact the small vendors. The start-up business will also be affected because of this rule as to make a mark on customer there are many things which are to be done which can't be possible if services provided are fair and non-discriminatory for all the vendors. Article 14[63] also says that like should be treated alike and alike should be treated

pricing-algorithms-the-antitrust-implications> accessed 1 March, 2019. Pricing algorithm means that when different customers open the e-commerce portal, they are shown a different price for the product.

60 Shashidhar K.J., "CCI to Look into Cashbacks Models for Predatory Pricing: Report" (MediaNama, 17 May, 2016) <https://www.medianama.com/2016/05/223-cci-cashbacks-models/> accessed 12 March, 2019.

61 2015 SCC OnLine CCI 139.

62 Srinivas Katta, Aakash Dasgupta and Ankita Gupta, "Indus Law Guidelines for Foreign Direct Investment in E-Commerce" (IndusLaw, April 2016) <http://www.manupatrafast.in/NewsletterArchives/listing/Induslaw/2016/April-2016%20--%20GUIDELINES%20FOR%20FOREIGN%20DIRECT%20INVESTMENT%20IN%20E-COMMERCE.pdf> accessed 15 March, 2019.

63 Constitution of India 1950, Art. 14.

like. Therefore, small vendors and leading vendors are two different classes and for each class, there should be fair and non-discriminatory practices.

Lastly, "similar circumstances" has not been interpreted by the Government. Itcannot be interpreted as "same circumstance". Any meaning to the word will limit the growth of e-commerce.[64]

Recommended clause:

> *"Para 5.2.15.2.4 (ix) E-commerce entities shall provide discounts and cash backs for a maximum duration (sunset clause) or shall provide monthly limit to the discounts, i.e., for the month this much discount be given on the goods and shall maintain a level playing field for the same class of sellers.*
>
> *For the purposes of this clause, provision of services to vendor who fall under same class not made available to other vendors in same class in similar circumstances will be deemed unfair and discriminatory."*

## V. EXCLUSIVE SALE AGREEMENTS

PN2/18 Para 5.2.15.2.4 (xi) says that marketplace e-commerce will not mandate any seller to sell any product exclusively on its platform. There can be two interpretations to it. First, whether they are prohibiting the seller from entering into exclusive contract with e-commerce entity? Second, whether they are restricting the seller from entering into multiple platforms that are run by group companies or marketplace entity?[65]

Press note has not mentioned what would happen if sellers want to enter with e-commerce entity exclusively? How can one show that sellers entered exclusively and not the e-commerce entity?[66]

*Recommended clause:*

> *"Para 5.2.15.2.4 (xi) E-commerce entities are prohibited from mandating sellers to enter into exclusive sale agreements. In case sellers*

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[64] Review of FDI Policy in E-Commerce (Trilegal, 7 January, 2019) <https://www.trilegal.com/index.php/publications/analysis/review-of-fdi-policy-in-e-commerce> accessed 15 February 2019.

[65] Vinay Joy, Rishabh Bharadwaj and Neil Deshpande, "FDI in E-Commerce Activities: Press Note No. 2 (2018 Series)" (Khaitan & Co. 2 January, 2019) <http://www.mondaq.com/india/x/768654/Fiscal+Monetary+Policy/FDI+IN+ECOMMERCE+ACTIVITIES+PRESS+NOTE+NO+2+2018+SERIES> accessed 16 February, 2019.

[66] Anubhuti Mishra and Parth Sehan, "Press Note 2 of 2018: Reinventing E-Commerce?" (Linkedin, 3 January, 2019) <https://www.linkedin.com/pulse/press-note-2-2018-reinventing-e-commerce-anubhuti-mishra/> accessed on 23 March, 2019.

*want to enter then* 'certificate of voluntary entry' *shall be issued to them.*"

## CONCLUSION

One of the elements of Lon Fuller's principles of inner morality is that law should be constant,[67] meaning it should not change so frequently as to render obedience difficult. While the law does need to keep evolving so that the changing needs of the society are met with as little friction as possible, it cannot be a reason for the government to make substantive alternations without a discernible policy objective. The changes introduced by PN2/18 force foreign entities in the e-commerce space to completely alter their structures that were carefully built and operated over the years, within a months' notice. Request for extension or a grandfathering clause were denied. With elections around the corner, the move seemed more and more directed towards appeasement of the small sellers who along with their families form a significant voter base. The piecemeal manner in which changes are introduced is nothing more than a hindrance in the overall development of the sector. The need of the hour is a specific set of laws governing the e-commerce ecosystem and a national e-commerce regulator enforcing them. This will ensure that there are not multiple regulators each coming out with their own set of rules for the businesses to comply with.

Specifically with respect to PN2/18, the addition of the control test over the goods purported to be sold (inventory) increases compliance, and burdens and compels marketplace entities to alter their business models. The restriction on equity participation does seem to be bit stretched as it covers both direct and indirect participation in both the entity as well as its group company. The requirement of fair and non-discriminatory treatment for all vendors is especially a laudable step in view of the stake of e-commerce marketplace entities in multiple sellers on their platforms. In this manner cash backs will be within limits too.

The PN2/18 is one among the many regulations and changes that the government will keep on introducing as and when it encounters new challenges. Businesses will also respond to them. The sector being at a nascent stage, the regulations that govern it are nebulous at best and clarity will be achieved only in due course of time.

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[67] Collen Murphy, "Lon Fuller and the Moral Value of the Rule of Law" (2005) 24(3) Law and Philosophy 239 <https://www.jstor.org/stable/30040345?seq=1#metadata_info_tab_contents> accessed on 27 March, 2019.

# Impact of Social Media on the Securities Market

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The ever-evolving digital space has contributed to the enormous flow of data available on the internet today. The spread of social media platforms such as Twitter, Facebook and Instagram has contributed immensely to the volume of readily available information and opinions. The impact of social media platforms on political discourse, social issues and matters of national security has been well publicized. The recent controversies ranging such as the U.S. Presidential elections, Mark Zuckerberg's testimony to the U.S. Congress, the global #MeToo moveme~nt, issues surrounding the publication of documents on WikiLeaks and unfortunate incidents surrounding the spread of "fake news" on Whatsapp in India are well-known.

In the context of the securities market, the impact of social media has become increasingly relevant because thoughts expressed on social media platforms increasingly influence stock market behaviour. Be it episodic, the influence exerted by even a single tweet show cases the impact of social media platforms today - in that they have percolated much beyond private zones of 'tech-affection' and have moved into the larger realm of the manner in which businesses function.

Securities regulators such the U.S. Securities and Exchange Commission ("S.E.C.") and the Securities and Exchange Board of India ("SEBI") are facing the challenge of maintaining the integrity of the stock markets in the face of social media platforms which provide an unregulated source of data and opinions. The objective of this article is to identify causal links between social media and the way stock markets have reacted to it, in order to assess the growing impact of messages sent via social networks on the larger market sentiment. This article will not indulge in text mining algorithms used to identify patterns of messages over the social network and their causal links with the whole market; but based on a contextual reading of some of the recent news-making events, it seeks to find the causality between a social media sentiment and the price of specific stock titles in order to understand

and illustrate the far-reaching impact of the social media space. This article also analyzes some of the other regulatory issues that stock markets may have to grapple with in the coming times, in the context of insider trading and publishing of price sensitive information, demonstrating the effect of social media in more ways than purely cyber security centric - in ways that can very much affect already established regimes of securities laws.

A case that perfectly fits the point being made above is that of Elon Musk and his recent entertaining tryst with Twitter. The case involves a series of tweets by Elon Musk, founder and Chief Executive Officer of Tesla, Inc. ("Tesla"), on August 7, 2018, regarding taking Tesla (a listed company in the U.S.) private.[1] Musk's statements, made via Twitter, indicated that he sought to take Tesla private at a purchase price that reflected a substantial premium over Tesla's stock's then-current share price, that funding for this transaction had been secured, and that the only contingency was a shareholder vote.[2] In truth, Musk had not even discussed or finalized key deal terms, including price, with any potential funding source.[3] To quote, on August 7, 2018 at around 12:48 PM EDT, Musk tweeted to a Twitter following of over 22 million, "*Am considering taking Tesla private at $420. Funding secured.*"[4] Over the next three hours, Musk made several other materially false and misleading prospective statements via Twitter in relation to taking Tesla private with the support of shareholders and investors.[5] As a result of the hue and cry over his tweets, NASDAQ halted trading in Tesla shares for one and a half hours.[6] After NASDAQ lifted the trading halt, Tesla's stock price continued to rise, closing at $379.57, up over 6% from the time Musk first tweeted about taking Tesla private earlier in the day and up 10.98% from the previous day.[7]

In the complaint filed by the S.E.C. against Elon Musk on September 27, 2018, S.E.C. alleged that Musk knew or perhaps was reckless in not knowing that each of his tweets amounted to false and/or misleading statements because he did not have an adequate basis in fact for his assertions, and neither had he satisfied several additional contingencies when he declared that the only thing remaining between the finalization of Tesla going private was a shareholder vote.[8] Funnily enough, according to Musk, he had calculated the $420 price per share based on a 20% premium to Tesla's then market

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1 *United States Securities and Exchange Commission* v. *Elon Musk*, (2018) Unites States District Court, Southern District of New York, Civil Action No. 1:18-cv-8865 [1].
2 *Ibid* 1.
3 *Ibid.*
4 *Elon Musk*, *supra* note 1, 2.
5 *Ibid.*
6 *Ibid.*, 40, 46.
7 *Ibid.*, 4, 6.
8 *Ibid.*, 3, 68.

price because he thought 20% was a "*standard premium*" in going-private transactions.[9] But in fact, as the S.E.C. concluded, the $420 was rounded up from the actual $419 price per share because he had recently learned about the number's significance in marijuana culture and thought his girlfriend "*would find it funny, which admittedly is not a great reason to pick a price*."[10]

In assessing the market chaos andharm caused to Tesla investors by Musk's impulsive tweets, the S.E.C. noted that immediately prior to Musk's August 7 statements via Twitter, Tesla's stock was trading at $356.67.[11] Musk's first tweet about taking Tesla private set off a trading frenzy and the trading volume and price of Tesla shares immediately spiked.[12] By the end of August 7, after Musk's tweets and a post on Tesla's blog, the stock closed at $379.57, up 6.42% from just prior to the first tweet.[13] By the close of market trading on August 13, after Musk and Tesla disclosed more information about the details underlying Musk's "funding secured" statement, Tesla's stock price had declined to around pre-tweet trading levels. Moreover, by the close of trading on August 27, the first trading day after Musk announced that he was abandoning his proposal to take Tesla private, Tesla's stock had dropped to$319.44.[14] Thus, in S.E.C.'s opinion, investors who purchased Tesla stock in the period after the false and misleading statements but before accurate information was made known to the market, were harmed.[15]

On September 29, 2018, S.E.C. issued a press release indicating that Elon Muskhad agreed to settle the securities fraud charge brought by the S.E.C. against him. The settlements will result in comprehensive corporate governance and other reforms at Tesla with the appointment of two new independent directors, including Musk's removal as Chairman of the Tesla board, and the putting in place of additional controls and procedures to oversee Musk's communication and financial penalties amounting to $20 million each on Musk and Tesla, and another $40 million to the harmed investors, under a court approved process.[16]

What makes Musk-gateintriguing is that it involves one of the most prolific entrepreneurs of the 21st century, having founded PayPal, Tesla, Space X

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[9] *Ibid.*, 24.
[10] *Ibid.*
[11] *Ibid.*, 75.
[12] *Ibid.*
[13] *Ibid.*
[14] *Ibid.*, 76.
[15] *Ibid.*, 77.
[16] "Elon Musk Settles SEC Fraud Charges; Tesla Charged with and Resolves Securities Law Charge" (2018) <https://www.sec.gov/news/press-release/2018-226> accessed 10 December 2018.

and The Boring Company, a sophisticated businessman and investor whose social media commentary was a clear violation of securities law in the United States. While this was possibly a relatively easy investigation for the S.E.C., it does highlight the challenge securities regulators face globally in ensuring that no false or misleading statements are disseminated on social media.

Depicting the blurred lines between social media profiles and market consequences, Musk's example comes as an eye opener in a day and age where social networking profiles are used heavily by companies and organizations to muster investor interest and support. In the absence of much clarity on what can be or is permitted on one's social media profile to keep investors informed, it is perhaps safer to err on the side of caution when operating social media platforms especially on behalf of businesses and in capacities of CEOs and the like, on topics that concern investors and business forecasts.

In another instance of a tweet causing some ripples in stock prices, Snap Inc. (the company that owns and operates Snapchat) was at the receiving end when American reality television personality and model Kylie Jenner, who also wields extraordinary influence with a Twitter following of over 25 million, expressed disinterest in using Snapchat by tweeting, "*Sooo does anyone else not open Snapchat anymore? Or is it just me... ugh this is so sad*." The tweet was on February 22, 2018 (Thursday) and a brief review of publicly available historical data of stock prices for Snapchat on the NYSE shows that from a closing price of $18.64 per share on February 21, Snapchat closed at $17.51 per share on February 22, i.e., down by 6%. From a look at the previous week's trading prices for Snapchat, it appears that in the week leading up to February 22, the stock prices for Snapchat were on an upturn from Monday and the week before that, until the dip on Thursday, February 22. While Jenner did follow up with a Tweet declaring "*still love you tho snap ... my first love*" - with social media, much like an arrow from a bow, once let loose, the damage may have already been done.

While these are episodic correlations between one-off instances over social media and stock prices, the logic is the same - what one says over the internet is disseminated in a fashion that has all-pervading results, especially in the context of a market susceptible to volatilities like the securities market.

In a dangerously unsettling reality, in addition to Twitter, another popular social networking application with a much wider reach in terms of instant messaging has presented starkly real problems for the stock market, even closer to home. Indian-listed shares of Infibeam fell by approximately 71% on September 28, 2018, from ₹ 200.35 on the closing of September 27 to ₹ 58.45 on the closing of September 28. The Economic Times noted that this was the steepest single-day fall after Satyam Computers Services, which plunged 83% on January 7, 2009, after the accounting scam broke out.[17] What caused this plunge were WhatsApp messages, allegedly attributable to brokerage firm Equirus, raising questions about Infibeam's accounting practices.[18] With Infibeam being only one such example in recent times, the volatility of stock prices relating to social media makes one wonder how and where to draw the line, from a regulatory perspective, for information dissemination on a platform that otherwise knows no bounds.

In another curious case in India, the effect of a blog article expressing surprise at the success of Manpasand Beverages Limited (or Manpasand, a company that sells juices and drinks under the Mango Sip and Fruits Up brand) brings to light what sometimes even an opinion expressed on an online blog can result in, in the context of stock prices and the securities market. In a blog post titled "*The curious case of Manpasand Beverages*" written on December 6, 2016, Amit Mantri (former Vice President at Hornbill Capital, Mumbai, with eight years of experience across private equity and public markets) analyzed the success of Manpasand in achieving high sale volumes, in comparison with its competitors, such as Parle Agro, Coca Cola, Pepsi Cola.[19] Mantri in his blog expressed disbelief in accepting the simple success of Manpasand in attaining a higher market share than brands like Parle Agro (which sells drinks under the brand of Frooti), which being 30 years old, had a much larger advertising budget and distribution network. Mantri questioned governance aspects of the company and the low compensation of a supposedly high performing management, and concluded that something was amiss.[20] While the impact of the blog was not immediate (Manpasand's stock price corrected more than 7% in the days after the blog was published), what precipitated a freefall in the stock price was the sudden resignation of Manpasand's auditorsin late May 2018, days before the final audit for the company was to be finalized. Given the unease created by Mantri's online blog, the market assumed that something was amiss. In its resignation letter, Deloitte stated that "significant information" requested by it from the company's management at various points in time was not provided. The

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17 Rajesh Mascarenhas, "How a WhatsApp Note Triggered Crash in Infibeam Avenues" (ET Bureau, 1 October 2018) <https://economictimes.indiatimes.com/markets/stocks/news/how-a-whatsapp-note-triggers-crash-in-infibeam-avenue/articleshow/66002863.cms> accessed 10 December 2018.

18 Mascarenhas, *supra* note 17.

19 Amit Mantri, "The Curious Case of Manpasand Beverages" (2point2 capital, 6 December 2016) <https://2point2capital.com/blog/index.php/a2016/12/06/the-curious-case-of-manpasand-beverage/> accessed 10 December 2018.

20 *Ibid*; Prathamesh Mulye, "No Longer Street's Manpasand" (*Outlook Business*, 8 June 2018) <https://www.outlookbusiness.com/markets/trend/no-longer-streets-manpasand-4438> accessed 11 December 2018.

questionsraised by Mantri in his blog, coupled with Deloitte's untimely resignation, led to Manpasand's stock price plummeting by over 40% in in less than a week.

What has beenclear from the trials and tribulations of companies such as Infibeam and Manpasand is that the lack of quality information, particularly by small and mid-cap promoter-driven companies, leads to a trust deficit with investors – these companies are easy prey for short sellers waiting to pounce on information asymmetry. While the above instances demonstrate how intra-day trades have been impacted by social media, the effect of social media can also be increasingly felt in the way that SEBI is dealing with issues pertaining to insider trading and sharing of unpublished price sensitive information under the SEBI (Prohibition of Insider Trading) Regulations, 2015 (the "PIT Regulations").

On April 16, 2018, SEBI passed an order in the matter of insider trading in the scrip of Deep Industries Limited ("DIL"), establishing connection between certain persons for the purposes of the PIT Regulations, on the basis of being friends on Facebook and having liked posts of one another on Facebook. SEBI's order indicted three investors –Rupesh Savla, V-Techweb India Pvt. Ltd ("VTPIL") and Sujay Hamlai.[21] According to SEBI, DIL (a diversified oil and gas company) was awarded three contracts around July-August 2015 for hiring mobile drilling rigs from ONGC over a period of several months.[22] Considering the magnitude of the new contracts, the information relating to DIL bagging them constituted as price-sensitive information, which would affect the share price of the company, once published.[23] However, it was observed that Rupesh Savla (Managing Director and Promoter of DIL) had increased his stake in DIL to 8.62% from 8% before this information was made public.[24] SEBI found that VTPIL was owned equally by Ajay and Sujay Hamlai, and that Sujay had traded in the scrip during the investigation period.[25] Additionally, the directors of VTIPL were Facebook friends with Rupesh Savla and his wife, Sheetal. Radhika Hamlai (wife of Ajay Hamlai) was also a friend of Rupesh and Sheetal on Facebook. There were several photos posted by Sheetal Savla on Facebook that were 'liked' by Ajay

21 SEBI order for DIL, April 16, 2018 (till note 28).

22 Order in the matter of Deep Industries Limited (Order of Whole Time Member, Securities and Exchange Board of India) (2018) (SEBI/WTM/MPB/IVD/ID–6/162/2018).

23 *Ibid.*, 11.

24 *Ibid.*, 4; K.S. Badri Narayanan, "Insider Trading: Beware of Your 'Likes' on Social Media" (*The Hindu Business Line*, 20 April 2018) <https://www.thehindubusinessline.com/markets/insider-trading-beware-of-your-likes-in-social-media/article23619826.ece> accessed 11 December 2018.

25 Order in the matter of Deep Industries Limited (Order of Whole Time Member, Securities and Exchange Board of India) (2018) (SEBI/WTM/MPB/IVD/ID–6/162/2018) (17).

Hamlai and Sujay Hamlai. Similarly, Rupesh and Sheetal Savla had 'liked' several photos posted by Ajay, Sujay and Radhika Hamlai.[26] SEBI found the evidence sufficient to establish connection between these parties and DIL Managing Director Rupesh Savla for the purpose of the PIT Regulations. SEBI held that, by virtue of this association, they were reasonably expected to have access to unpublished price sensitive information of DIL at the relevant period and, therefore, as per the PIT Regulations, Sujay Hamlai and Ajay Hamlai were connected persons and insiders with respect to DIL.[27]

While social media connections may be one out of several other factors (such as trading pattern, KYC documents, etc.) being considered in totality, SEBI seems to have based its *prima facie* finding on the Facebook association to establish connection. While this conclusion may not be inappropriate, the process of relying on Facebook connections to draw links between connected persons is divisive in a time when accepting friend requests or interacting on social media can often be a very light hearted, ill thought out, casual process. Virtual connections becoming the basis of regulatory action raises questions regarding the very authenticity of these virtual connections, not to mention the prospect of online surveillance by regulators.

In a series of other recent actions in relation to social media, in February 2018, SEBI issued directions to HDFC Bank Limited ("HDFC") in respect of the leakage of its unpublished price sensitive information ("UPSI"), relating to its financials, through WhatsApp.[28] SEBI initiated a preliminary examination in the matter of the circulation of the UPSI through WhatsApp, during which it observed that messages circulated on WhatsApp since July 21, 2017[29] closely matched the quarterly financials of HDFC for the quarter ended June 30, 2017, prior to official announcement of actual results by HDFC on July 24, 2017[30]. This could not have been possible without the leakage of information from persons who were privy to the information prior to its official announcement.[31] SEBI noted that leakage of the unpublished quarterly financial results (covered under the definition of UPSI under regulation 2(n) of the PIT Regulations), which eventually led to circulation of messages on WhatsApp, was prohibited and in contravention of the PIT Regulations, which prohibit procurement or communication of UPSI.[32]

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26 *Ibid.*, 18.
27 *Ibid.*, 25.
28 Directions in the matter of HDFC Bank Limited (Order of Whole Time Member, Securities and Exchange Board of India) (2018) (WTM/MPB/ISD/142/2018).
29 *Ibid.*, 2.
30 *Ibid.*
31 *Ibid.*, 10.
32 *Ibid.*, 11.

Whatever be our views regarding regulatory surveillance of social media interactions, there is undoubtedly a role for Indian regulators in the domain of policing corporate disclosure and protecting investor interests. The incidents involving Infibeam and Manpasand demonstrate that not only facts, but also social media banter on the functioning of a company can dramatically affect stock prices, because of the information asymmetry that exists with respect to Indian listed companies. Presently in India, a company is required to make comprehensive disclosures in the form of filing an offer document for a public issue, with relatively condensed yet still detailed offer documents required to be issued at the time of private placements, rights issues, or other offerings post listing. In contrast, there is a disparity in compliance with ongoing financial disclosure obligations by Indian listed companies. While Indian law requires annual and quarterly disclosure of financial information, including related party transactions, there is no 'prospectus style' disclosure to the market by an Indian-listed company to ensure that all material aspects of a company's governance and operations are presented to the larger pool of investors. Annual reports published by listed companies in India are essentially a narration of basic facts and audited financials. Upon listing, fragmented additional disclosures are often guided by a company's own judgment of what it considers to be material developments on an 'as and when basis'. Unavailability, lack of uniformity or subjective nature of information about a company makes such a company more susceptible to stock market volatility post listing.

Regulation 35 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("Listing Regulations") is SEBI's attempt at remedying this information gap by requiring a listed entity to submit an annual information memorandum to the stock exchange(s) as may be specified by the SEBI from time to time in order to assist investors in making informed investment decisions.[33] However, as specific requirements are yet to be notified by SEBI, there is a current lacuna in operationalizing this disclosure requirement for listed companies, particularly in the face of omnipresent and ever-growing social media and given India's promoter-controlled and family-driven corporate environment. A robust corporate governance compliance framework – truly independent directors coupled with transparent and fair public disclosure norms – is becoming increasingly important.

In fact, SEBI is not alone in its concern regarding social media influences upon the market and the public. The Telecom Regulatory Authority of India ("TRAI") issued a press note on August 10, 2017, addressing issues faced

[33] Securities and Exchange Board of India, Discussion Paper on "Annual Information Memorandum" (Reports for Public Comments, 2014).

by SEBI in enforcing its regulations, in relation to misleading unsolicited bulk SMSs by unauthorized persons, relating to investments in securities market.[34] TRAI directed service providers to ensure that SMSs relating to investment advice are only from SEBI registered investment advisers/stock brokers and that necessary arrangements be made to filter and block SMSs sent by telemarketers using bulk SMS channels containing key words relating to securities.[35] This welcome collaboration between TRAI and SEBI in addressing issues faced by the securities market on account of social media is a reminder that the securities market is very susceptible to pressures from a growing digital and social media space, and that issues arising on account of this need to be addressed far more rapidly and creatively than ever before, possibly in consultation with other regulatory authorities.

While it has long been the regulatory objective to improvethe quality and parity of information available in the Indian securities market, the new paradigm that unites multiple regulators, companies, investors and other stakeholders in India is that timely and robust corporate disclosure should temper investor sentiment, whenthe pop of a single social media post may send the stock of a company, or the entire market, crashing.

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[34] Telecom Regulatory Authority of India, "TRAI Issues Direction to Service Providers Regarding Unsolicited Bulk SMSs Relating to Investment in Securities Market" (Information Note to the Press, Press Release No. 58/2017, 2017).

[35] *Ibid.*, 3.

# ANTI-TRUST ENFORCEMENT IN INDIA: EXPLORING INDIVIDUAL LIABILITY

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*This paper reviews the enforcement of individual liability under the anti-trust law in India. Section 48 of the Competition Act, 2002 recognizes an important cornerstone of corporate governance; that a company acts through its individuals. This provision allows the Competition Commission of India to hold individuals that direct the business of a company liable for anti-trust offences committed by such company. Such individuals, as in any other corporate misdoing, must be subjected to adequate penalties in appropriate cases. In such cases, the Commission and its Director-General (its investigative arm) must conduct a thorough investigation into the matter to ensure that liability is imposed based on the actual involvement of the individual, rather than based on assigned roles and designations. In this light, this paper reviews the investigative ethos, policy and procedure of the Commission in such matters. Primarily underscoring the need for meaningful investigations and fair and equitable enforcement of individual liability, this paper sets out findings and recommendations in relation to sequencing, standard of proof, procedure, and the scope of investigations under the Competition Act.*



* The views expressed in this paper are the personal views of the authors alone and do not reflect the views of any other person or organization.

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## I. Introduction

The Competition Act, 2002 (Competition Act) is the forbearer of anti-trust law in India and is intended to serve as the protector of its post-liberalisation free market economy. It was enacted to promote and sustain competition in the markets, to protect the interests of consumers and to ensure freedom of trade in India.[1] Its core focus is three-pronged: first, the Competition Act prohibits anti-competitive agreements that result in an appreciable adverse effect on competition in the Indian markets.[2] Secondly, the Competition Act prohibits a dominant enterprise[3] from abusing its position in the relevant market of its operation.[4] Thirdly, the Competition Act regulates mergers and acquisitions meeting the prescribed asset or turnover thresholds, to ensure that such combination does not cause an appreciable adverse effect on competition in India.[5] To enforce these provisions, the Competition Act grants the Competition Commission of India ("the Commission") the power to issue appropriate penalties, orders and directions.[6] Contraventions of these provisions also attract significant penalties of up to 10 per cent of the average turnover of the enterprise for the preceding three financial years in case of an anti-competitive agreement or abuse of dominance, and in case of cartels, up to three times the profit for each year that the cartel exists.[7]

The Commission also has the power to identify, hold liable and punish the individuals who direct the business of companies that contravene the Competition Act. Section 48 of the Act sets out that the persons who were in-charge of the conduct of the business of the concerned company or the directors, manager, secretary or other officers of the company may be held liable for anti-competitive acts of the company.[8] This provision is crafted in broad terms, it allows the Commission to impose penalties based on supporting evidence that the officers of the company knew of the contravention, or

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1 The Competition Act, 2002, preamble.

2 The Competition Act, 2002, S. 3; All such agreements are void.

3 The Competition Act, 2002, S. 2(*h*) for the meaning of enterprise. In general, "enterprise" includes any "person" that is engaged in the business in India and is indifferent to the how the person is organized. It includes individuals, as well as persons organized as companies, partnerships, limited liability partnerships, societies, etc.

4 The Competition Act, 2002, S. 4.

5 The Competition Act, 2002, S. 6.

6 The Competition Act, 2002, Ss. 27 and 31.

7 Or 10 per cent of the average turnover for each year that the cartel exists, whichever is higher.

8 It is worth noting that the explanation to S. 48 of the Competition Act provides that "company" means a body corporate and includes a firm or other association of individuals; and a "director", in relation to a firm, means a partner in the firm. For example, see *Kerala Cine Exhibitors Assn.* v. *Kerala Film Exhibitors Federation*, 2015 SCC OnLine CCI 98. As such, references to "companies" in this paper should be read in light of the above explanation.

if such contravention was committed with the consent or connivance or was attributable to the negligence of such officers. This is in consonance with the general corporate principle that, in appropriate cases, the individuals of the company are equally liable for the acts of the company. To impose liability on only the company, but not the individuals responsible for the acts of the company would leave such individuals to continue to damage the interests of competitive markets.[9]

The Commission can exercise this power by initiating proceedings under Section 26 under which the Commission may call upon its Director-General to investigate alleged anti-competitive practices and prepare a report of the investigation. If such report finds that there has been a contravention of the Competition Act, the Commission can make further inquiry into the matter to determine whether or not a violation of the Competition Act has been committed.[10] Unfortunately, in some cases, the Commission and the Director-General have imposed liability on officers and employees of companies without taking due consideration of the role played by such individuals. In these cases, the COMPAT has observed that the enforcement of the Competition Act must be backed by a deep understanding of the facts and circumstances that promp the anti-competitive conduct. This is because a particular conduct could be appreciated under one circumstance and deprecated under another, and two opposite conducts could invite the same outcome.[11] In view of these dichotomous possibilities, there is a duty to prevent a false negative that may result if the individuals who direct the business of a company are not allowed to explain their conduct. The cost of such a false negative is high as it may deter efficient business.[12]

In the light of these issues, this paper analyses the jurisprudence under the Competition Act relating to individual liability, to determine whether the Commission has fulfilled its mandate. Part II sets forth the relevant provisions of the Competition Act and examines key procedural and evidentiary issues in such matters. These include matters of standard of proof, due process

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[9] *Ministry of Agriculture and Farmers Welfare* v. *Mahyco Monsanto Biotech (India) Ltd.*, 2016 SCC OnLine CCI 40, ¶ 32 (*Ministry* v. *Mahyco*).

[10] Upon consideration of the Director-General's report and submissions of the parties on this report, the Commission may send the report back for further investigation. If the report does not find a contravention, the Commission may proceed to close the matter, or conduct a further inquiry, as it deems fit. If the report finds a contravention, and the Commission agrees with such finding after hearing the parties concerned, the Commission may take action including passing a cease-and-desist orders and imposing appropriate penalties.

[11] For example, the Commission does not consider an unfair or discriminatory price by an enterprise illegal if it is adopted to meet competition; see *MCX Stock Exchange Ltd.* v. *National Stock Exchange of India Ltd.*, 2011 SCC OnLine CCI 41.

[12] *Ministry of Agriculture and Farmers Welfare* v. *Mahyco Monsanto Biotech (India) Ltd.*, 2016 SCC OnLine CCI 40, (*Supra* note 9).

and the scope of such investigations. Based on this review, this paper advocates that the Commission and its Director-General must make a conscious effort to investigate the actual role of the individuals who are alleged to hide behind the corporate form in such cases.[13] Based on these investigations, the Commission must only penalize individuals who are in fact involved in anti-competitive conduct, and at the same time, should not let culpable individuals go unpunished. Part III concludes that the Commission's enforcement and investigation methodology in cases of individual liability has been inconsistent and, at times, deficient. Therefore, to ensure fair and equitable enforcement of the anti-trust law, the Commission must thoroughly investigate the actual role and involvement of individuals involved in anti-competitive offences, and only take action based on sound evidence, adequate reasoning, and whilst observing the principles of natural justice.

## II. Individual Liability under the Competition Act

Section 48 of the Competition Act deals with individual liability in cases of contraventions by companies, and reads as follows:[14]

"Contravention by companies

48. (1) Where a person committing contravention of any of the provisions of this Act or of any rule, regulation, order made or direction issued thereunder is a company, every person who, at the time the contravention was committed, was in charge of, and was responsible to the company for the conduct of the business of the company, as well as the company, shall be deemed to be guilty of the contravention and shall be liable to be proceeded against and punished accordingly:

> Provided that nothing contained in this sub-section shall render any such person liable to any punishment if he proves that the contravention was committed without his knowledge or that he had exercised all due diligence to prevent the commission of such contravention.

(2) Notwithstanding anything contained in sub-section (1), where a contravention of any of the provisions of this Act or of any rule, regulation,

[13] *Ibid.*, ¶ 32. The Commission itself stated: "*no person can be condemned unheard. This is not rhetoric. This has to be followed in substance. This means that a person, who might be ultimately condemned, must have an effective opportunity to defend himself at the appropriate stage.*"

[14] A similar provision existed in the precursor to the Competition Act, 2002 that is the Monopolies and Restrictive Trade Practices Act, 1969 (*viz.* S. 53).

order made or direction issued thereunder has been committed by a company and it is proved that the contravention has taken place with the consent or connivance of, or is attributable to any neglect on the part of, any director, manager, secretary or other officer of the company, such director, manager, secretary or other officer shall also be deemed to be guilty of that contravention and shall be liable to be proceeded against and punished accordingly."

Under Section 48(1), the Commission is required to identify the personnel in charge of, and responsible to the company for the conduct of the business of the company at the time of the contravention, and the burden lies on such person to rebut that the contravention took place without his/her knowledge or took place in spite of all due diligence to prevent such contravention. On the other hand, under Section 48(2), the burden of proof lies with the Commission and the Director-General to establish that the director, manager, secretary or other officer consented to, connived or acted in a negligent manner in respect of the contravention. As such, while Section 48(1) of the Competition Act imposes individual liability on the basis of the position of responsibility held by an official(s), Section 48(2) of the Competition Act requires evidence of active participation of such director, officer, secretary or manager in relation to the anti-competitive conduct.

This provision has been in effect since May 20, 2009.[15] Despite this, individual liability only started to take shape in 2013. In *Santuka Associates (P) Ltd.* v. *All India Organization of Chemists and Druggists Assn.*,[16] the Commission attributed individual liability to the office bearers of trade associations in the pharmaceutical industry. Thereafter, in *Prasar Bharati* v. *TAM Media Research (P) Ltd.*[17], the Commission ordered that if the Director-General finds a contravention against the respondent company, the Director-General shall also investigate the role of the individuals behind such contravention under §48. Despite this, the first instance of penalties being imposed on officers arose in 2014 in *Bengal Chemist & Druggists Assn.* v. *Competition Commission of India*.[18] In this case, the Commission imposed a penalty of INR 18.38 crores, the majority of which was borne by the office

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[15] This provision was in the Competition Act, as enacted. However, the provisions relating to anti-competitive agreements and abuse of dominance only came into effect on 20 May 2009; *See* MCA Notification No. S.O. 1241(E) dated 15 May 2009 (w.e.f. 20 May 2009) and MCA Notification No. S.O. 1242(E) dated 15 May 2009 (w.e.f. 20 May 2009)

[16] 2013 SCC OnLine CCI 16.

[17] 2016 SCC OnLine CCI 15.

[18] 2016 SCC OnLine Comp AT 421; See also *Indian Sugar Mills Assn.* v. *Indian Jute Mills Assn.*, 2014 SCC OnLine CCI 141; *Rohit Medical Store* v. *Macleods Pharmaceutical Ltd.*, 2013 SCC OnLine CCI 29; *P.K. Krishnan* v. *Paul Madavana*, 2015 SCC OnLine CCI 186; Piyush Gupta *et al.*, "India: Individual Culpability: Liability of Directors & Officers under the Indian Competition Regime" (Mondaq, 15 September 2016) <http://www.mondaq.com/india/x/525380/

bearers and executive committee members.[19] Notably, the Commission levied individual penalties at differential rates based on the extent of their roles in the anti-competitive conduct. The office bearers were subjected to a fine of 10 per cent of their average income for the three preceding years, while the executive committee members were subjected to a penalty at a lesser rate of 7 per cent.

## III. Sequencing of Identification of Liability

In the course of this jurisprudential development, the Commission and appellate bodies were grappled with a procedural question, i.e., whether officers can be held guilty before (or concurrently) with the company? If not, was it necessary to first find the company guilty before proceeding against its officers? A plain reading of the relevant provisions of the Competition Act suggests that the Commission must find a contravention against a company before it can go on to attributing personal liability to its officers or employees. However, the Delhi High Court in *Pran Mehra* v. *Competition Commission of India*[20] ("*Pran Mehra* v. *Commission*") held that there cannot be two separate proceedings in respect of the company and its officers. Following the inquiry made under Section 26, a finding of contravention has to be recorded against the company and its officers are to be probed, however not necessarily in a particular order.[21] The Court found that the scheme of the Competition Act did not contemplate such separate proceedings, which would be both '*inefficacious and inexpedient*'.

This decision was rendered in February 2015. Notwithstanding the decision of Delhi High Court, the erstwhile Competition Appellate Tribunal (COMPAT) in two decisions delivered in April-May 2016 viz., *A.N. Mohana Kurup* v. *Competition Commission of India*.[22] ("*Mohana* v. *Commission*")

Directors+Officers/Individual+Culpability+Liability+Of+Directors+Officers+Under+The+Indian+Competition+Regime> accessed 5 February 2018.

[19] On account of entering into anti-competitive agreements with pharmaceutical companies.

[20] 2015 SCC OnLine Del 7929.

[21] In *Aneeta Hada* v. *Godfather Travels and Tours (P) Ltd.*, (2012) 5 SCC 661, the Supreme Court did hold that the company has to also be prosecuted along with its officers, to the effect that its prosecution becomes a condition precedent to vicarious liability of the officers. (Furthermore, there was no ground to establish that there was a sequence to the prosecution, with the company being held liable first, and the Court then proceeding against the officer-in-charge responsible for the conduct of the company).

[22] 2016 SCC OnLine Comp AT 33, ¶ 29; *cf.* Prasar Bharati v. TAM Media Research (P) Ltd., 2016 SCC OnLine CCI 15 (The Commission holding in 2012 that if the Director-General finds a contravention against a company, the Director-General shall also investigate the role of the individuals behind such contraventions under Section 48).

and *Alkem Laboratories Ltd.* v. *Competition Commission of India*[23] ("*Alkem* v. *Commission*"), has held that finding contravention by the company is a pre-requisite before commencing proceedings against individuals.[24]

The COMPAT held that Section 48 is an *ex post* clause which can be invoked only after it has been found that the company has contravened the provisions of the Competition Act. No director, manager, secretary or other officer of the company can be penalized under these sections unless the company has itself been found in contravention of the provisions of the Competition Act. The COMPAT in *Alkem* v. *Commission* relied on the Supreme Court decision in *Aneeta Hada* v. *Godfather Travels and Tours (P) Ltd.*,[25] where the Court had held that liability can attach to persons in charge of the company only after a charge is framed and a finding of contravention is made against such charge under the *pari materia* provision in the Negotiable Instruments Act, 1881.[26]

In July 2016, the Commission, in *Ministry of Agriculture and Farmers Welfare* v. *Mahyco Monsanto Biotech (India) Ltd.*[27] ("*Ministry* v. *Mahyco*"), held that *Mohana* v. *Commission* and *Alkem* v. *Commission* could not be taken as binding precedents. The applicants in *Ministry* v. *Mahyco* had relied heavily on these orders to argue that the Commission must find that a contravention has been committed by a company before it could issue directions to the Director-General to investigate the role of the officers of the company. Instead, the Commission applied the reasoning of *Pran Mehra* v. *Commission* and other similar decisions under *pari materia* provisions[28]

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23 2016 SCC OnLine Comp AT 101, ¶ 65.

24 In *Alkem Laboratories Ltd.* v. *Competition Commission of India*, 2016 SCC OnLine Comp AT 101, the COMPAT held that S. 48 requires strict construction and more importantly, that the deeming provisions in S. 48 can only be invoked after the Commission finds that a company has committed a contravention. It noted that the legislature had used the term "committed" in these sub-sections, necessarily implying that some competent authority must make an affirmative finding against the company before its officers can be proceeded against and punished; the scheme of the Competition Act only permits the Commission (and not the Director-General) to make such a finding; *ibid.*, ¶ 64.

25 (2012) 5 SCC 661, ¶ 34.

26 The Negotiable Instruments Act, 1881, S. 141.

27 2016 SCC OnLine CCI 40; In this case, the Commission received information from various informants such as Ministry of Agriculture and Farmers Welfare, National Seeds Association of India, Department of Agriculture and Cooperation, and the State of Telangana, alleging anti-competitive practices by the respondents. The Commission passed a *prima facie* order against Monsanto under S. 26(1) directing the Director-General to investigate the matter and the individuals responsible for the alleged anti-competitive conduct. The opposite parties filed an interim application challenging this order and contended that the investigation against the individuals could not be undertaken at a preliminary stage, prior to finding a contravention against the company.

28 *Ministry of Agriculture and Farmers Welfare* v. *Mahyco Monsanto Biotech (India) Ltd.*, 2016 SCC OnLine CCI 40, ¶¶ 31, 32; the Commission also referred to a significant number of judgments under different statutes where the Courts have proceeded against

to hold that a company and its officers can be investigated simultaneously. However, the Commission did clarify that even in such simultaneous proceedings, a finding has to be recorded against the company before investigating individual liability though both findings can be in one single order. In sum, the Commission held that the Director-General must investigate the entire matter, which necessarily includes investigating the role of all persons behind the conduct of the company.[29]

The Kerala High Court in a recent decision also endorsed this position of law. In *Unnikrishnan* v. *Competition Commission of India*,[30] it held that the scheme of the Competition Act does not contemplate two separate proceedings against the opposite parties and its office bearers. A proceeding under Section 48 is a "*composite one*" and "as such, the guilt, if any, of the persons who come under Section 48 of the Act also needs to be examined simultaneous to the guilt of the company". Therefore, there is divergence of judicial opinion between the COMPAT and High Courts. However, the decisions of the Delhi and Kerala High Court are more pragmatic. Aside from procedural benefits to the individual, there is no prejudice caused to such person. An investigation by itself does not adversely affect the person being investigated, and no consequences flow from simply from an order to investigate the involvement of an individual.[31] In fact, this would allow such individuals to plead and demonstrate that the company was not liable in the first place.[32] Further, this decision is aligned with *Mohana* v. *Commission* and *Alkem* v. *Commission* in recognizing the principle that an individual cannot be held severally liable, or liable prior to making a similar finding against the company, and *Pran Mehra* v. *Commission* simply allows this to happen simultaneously and streamlines the existing procedure.

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the company and the officers-in-charge simultaneously; See *Vasu Tech Ltd.* v. *Ratna Commercial Enterprises Ltd.,* 2008 SCC OnLine Del 524: (2009) 160 DLT 591; *Dilip S. Dhanukar* v. *Air Force Group Insurance Society,* 2007 SCC OnIine Del 12: ILR (2007) 1 Del 234; *Satyapal Talwar* v. *State (Govt. of NCT of Delhi),* 2011 SCC OnLine Del 1559; *Sushila Devi* v. *SEBI,* 2007 SCC OnLine Del 1081 : (2008) 1 Comp LJ 155; *Shailendra Swarup* v. *Enforcement Directorate,* 2009 SCC OnLine Del 3724: (2011) 162 Comp Cas 346; *Aneeta Hada* v. *Godfather Travels and Tours (P) Ltd.*, (2012) 5 SCC 661.

29 *Ministry of Agriculture and Farmers Welfare* v. *Mahyco Monsanto Biotech (India) Ltd.*, 2016 SCC OnLine CCI 40 , ¶ 35; This order was challenged before the High Court of Delhi in *Monsanto* Co. v. *Competition Commission of India*, Writ Petition (Civil) No. 7578 of 2016, decided on 12-10-2018 (Del) and *Mahyco Monsanto Biotech (India) (P) Ltd.* v. *Competition Commission of India*, Writ Petition (Civil) No. 7583 of 2016, decided on 12-10-2018 (Del).

30 (2016) 4 KLT 395.

31 *Bhoruka Financial Services Ltd.* v. *SEBI*, 2006 SCC OnLine SAT 163.

32 *Ministry of Agriculture and Farmers Welfare* v. *Mahyco Monsanto Biotech (India) Ltd.*, 2016 SCC OnLine CCI 40 , ¶ 34.

In view of the above, the Commission may direct the Director-General to concurrently investigate anti-trust contraventions and determine the extent of individual liability of the officers and employees concerned if it is of the opinion that a *prima facie* case exists.[33] Acting on such order, the Director-General shall investigate the matter and prepare its report.[34] In such cases, the Director-General must issue action-oriented notices to the individuals under investigation, and these notices should clearly put the individual on notice to demonstrate why such individual should not be found liable under Section 48 of the Competition Act.[35] After considering the submissions of such individuals (if any), the Director-General may identify whether such individuals were in charge of or responsible for conducting the affairs of the company being investigated. Based on this report, the Commission issues show cause notices to such persons requiring them to make their submissions against the Director-General's report.[36]

## IV. STANDARD OF PROOF

The Commission seems to rely solely (or at least heavily) on the assigned roles or designations of individuals under Section 48. It does not appear to consider, or rather side-steps the question of whether the individuals consented to or connived in the contravention, or whether the contravention is attributable to their neglect. Ostensibly, the Commission proceeds on the wide language of sub-section (1) of Section 48. In this regard, the Director-General and the Commission has not duly investigated the involvement of these individuals. They have also not appreciated that the intent of such 'Offence/ Contravention by companies' clauses, is to punish only those individuals that had a role to play in the incriminating act, or those who had knowledge of the act; in other words, persons who had nothing to do with

[33] The Competition Act 2002, S. 26(1); It can do so suo motu, or on the receipt of a reference from a governmental or statutory authority or based on information received from an informant under Section 19:

Provided that if the subject-matter of information received is, in the opinion of the Commission, substantially the same as or has been covered by any previous information received, then the new information may be clubbed with the previous information.

[34] The Competition Act, 2002, S. 26(3).

[35] See *BCCI* v. *Competition Commission of India,* 2014 SCC OnLine Comp AT 103 and *Interglobe Aviation Ltd*. v. *Competition Commission of India*, 2016 SCC OnLine Comp AT 87 for judicial precedent on "action-oriented notices".

[36] In these show-cause notices, the Director-General also calls for the income tax returns of the relevant individuals for the three financial years preceding the contravention. Similar to the provisions on penalty on enterprises having regard to their average turnover, in case of individuals, the CCI determines the penalty on individuals on the basis of their average annual income.

the matter need not be roped in.[37] In such cases, clear and cogent evidence is required to establish an offence.[38] A person cannot be said to be in charge of the business of the company merely because he is a director or manager of the company; it is possible that such officers may be in charge of one part of the business but not the other part from which the contravention arises. In other words, persons who are considered under corporate law to conduct the business of a company, for example, directors, must also *de facto* have charge of the business of the company and should be held liable.[39] Therefore, individual liability should be linked to the *de facto* role played by the individual in question in the affairs of a company and not his designation or status. If being a director, manager or secretary was enough by itself to cast liability, the Competition Act would (or should) have said so.[40]

These principles should apply to investigations under Section 48 of the Competition Act.[41] This was noted by the COMPAT in *Alkem* v.

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[37] See *S.M.S. Pharmaceutical Ltd.* v. *Neeta Bhalla,* (2005) 8 SCC 89, ¶ 5 (With regard to S. 141 r/w the Negotiable Instruments Act, 1881, S. 138 stating "*The proviso to the sub-section contains an escape route for persons who are able to prove that the offence was committed without their knowledge or that they had exercised all due diligence to prevent commission of the offence.*")

[38] See *K.K. Ahuja* v. *V.K. Vora,* (2009) 10 SCC 48, ¶ 11 (referring to *K. Srikanth Singh* v. *North East Securities Ltd.*, (2007) 12 SCC 788, ¶ 5) (The mere fact that at some point of time, an officer of a company had played some role in the financial affairs of the company, will not be sufficient to attract the constructive liability under S. 141 of the Negotiable Instruments Act).

[39] See *Girdhari Lal Gupta* v. *D.N. Mehta,* (1971) 3 SCC 189 : (1971) 3 SCR 748; *State of Karnataka* v. *Pratap Chand,* (1981) 2 SCC 335 : 1981 Cri LJ 595; *Katta Sujatha* v, *Fertilizers & Chemicals Travancore Ltd.,* (2002) 7 SCC 655; *Swapan Kumar Karak* v. *Competition Commission of India,* 2015 SCC OnLine Comp AT 939 (The person must actually be associated with the contravention, for the Commission to hold such person liable).

[40] *See S.M.S. Pharmaceutical Ltd.* v. *Neeta Bhalla,* (2005) 8 SCC 89 (The Supreme Court stated that if being a director, manager or secretary was enough to cast criminal liability, S. 141 of the Negotiable Instruments Act, 1881 would have said so. The Court also stated that the legislature is aware that it is a case of criminal liability, which means serious consequences so far as the person sought to be made liable is concerned. Therefore, only persons who can be said to be connected with the commission of a crime at the relevant time have been subjected to action.) S. 48(2) institutes a two-pronged test to attribute liability. The first is to identify the designation of a director, manager, secretary or officer, and the second is to link the contravention committed by the company to the consent, connivance or negligence of such person.

[41] These principles have evolved in the context of other *pari materia* provisions. In this regard, the Commission and the COMPAT have consistently relied on judgements under such provisions; *for example, Alkem Laboratories Ltd.* v. *Competition Commission of India*, 2016 SCC OnLine Comp AT 101, ¶ 68 (holding that the decision of the Supreme Court in *T.N. Electricity Board* v. *Rasipuram Textile (P) Ltd.*, (2008) 17 SCC 285 squarely applied to *Alkem Laboratories Ltd.* v. *Competition Commission of India*, 2016 SCC OnLine Comp AT 101).

*Commission*.[42] In this case, the Commission initiated investigation into the officers of the Company at the threshold, that is, under Section 26(1) of the Competition Act. The Joint Director-General framed issues which did not contain any indication that the appellants were also to be investigated. The informant[43] in this case did not aver, allege or lead evidence to prove that the officers of the Company were in-charge of, and were responsible to Alkem Laboratories Limited (Alkem) for the conduct of its business. The Joint Director-General recorded a finding that Alkem had engaged in anti-competitive practices, but did not return a similar finding against the officers of Alkem. Nevertheless, Alkem officers were held liable under Section 48.

None of these facts supported the Commission's finding against the officers of the Company. Therefore, and specifically since no evidence was collected by the Joint Director-General against the officers of Alkem, the COMPAT found that the Commission had casually held them guilty under Section 48(1) of the Competition Act. This was found to be *ex facie* contrary to the law laid down by the Supreme Court in *T.N. Electricity Board* v. *Rasipuram Textile (P) Ltd*.[44] In this case, the Supreme Court interpreted a *pari materia* provision to hold that the burden of proof lies on the complainant; this burden only shifts to the officers if the complainant establishes by evidence that such officers were, in fact,[45] in-charge of, and responsible for the company's business.[46] Therefore, up to this point, there was no need to refer to the proviso to such provisions that allows such individuals to prove that the offence was not committed with their knowledge or that they

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42 *Alkem Laboratories Ltd*. v. *Competition Commission of India*, 2016 SCC OnLine Comp AT 101, ¶ 65.

43 *See* Information filed by P.K. Krishnan, Proprietor, Vinayaka Pharma dated 31 March 2014 under Section 19(1)(*a*) of the Competition Act.

44 (2008) 17 SCC 285; *Alkem Laboratories Ltd*. v. *Competition Commission of India*, 2016 SCC OnLine Comp AT 101, ¶ 67.

45 *Cf. Girdhari Lal Gupta* v. *D.H. Mehta,* (1971) 3 SCC 189: (1971) 3 SCR 748; *State of Karnataka* v. *Pratap Chand*, (1981) 2 SCC 335: 1981 Cri LJ 595; *Katta Sujatha* v. *Fertilisers & Chemicals Travancore Ltd*., (2002) 7 SCC 655 (holding that being a person *de jure* in charge of, and responsible for, the business of a company under corporate law is not sufficient and must be backed by *de facto* proof); *Alkem Laboratories Ltd*. v. *Competition Commission of India*, 2016 SCC OnLine Comp AT 101 goes slightly beyond these cases, in that there is no need to present a defense at all, unless the Commission discharges its burden to prove that individuals were in *de facto* control of the company, similar to criminal procedure. If however, the Commission discharges this burden, such individuals always have the escape carve-outs in contained in S. 48 to prove that they did not know or consent to the offending act, or took due-diligence to prevent it. To this extent, S. 48 r/w S. 26 provides an in-built multi-tiered defense to individuals to escape liability under the Competition Act.

46 In cases initiated on the basis of information provided by an informant, the informant does not play the role of a "complainant" *per se*. Therefore, the burden of proof in such cases lies with the Commission.

undertook due-diligence to prevent it.[47] In view of the above, the COMPAT held that the Commission had gravely erred in passing an order without any valid grounds or evidence in its support. The error was patent to the point where even a person of ordinary prudence would not have recorded such a finding.[48]

Further, it is also important to note the Haryana Cartel case.[49] Despite the Commission finding evidence of the involvement of officers[50] and primarily using this evidence to implicate the companies involved, the Commission did not proceed against such officers under Section 48 merely on the ground that the Director General had not undertaken a specific investigation into the actual role played by such individuals (except recording the designation of such individuals and noting briefly their work profile based on their respective statements). The Commission ought to have exercised its powers under Section 26(7) of the Competition Act and should have directed the Director General to conduct a further investigation in the matter.

## V. Procedural Irregularities

In conducting investigations under the Competition Act, the Director-General possesses wide powers of a Civil Court in respect of matters such as summoning and enforcing the attendance of any person, examining him on oath, receiving evidence on affidavit, etc. These are commensurate with the powers bestowed upon the Commission in Section 36(2) of the Competition Act.[51] Despite possessing such wide powers, there have been instances where the Director-General has not provided an opportunity to the officers of the company to present their case. The Commission's practice of granting such opportunities in earlier cases[52] confirms this right, though this amounts

47 *Alkem Laboratories Ltd.* v. *Competition Commission of India*, 2016 SCC OnLine Comp AT 101, ¶¶ 66-67.

48 *Ibid.* at ¶ 29.

49 *Director, Supplies & Disposals* v. *Shree Cement Ltd.*, 2017 SCC OnLine CCI 2.

50 The officers in question were regional heads of the various cement companies, who allegedly had the decision-making power to submit the bids in response to the tender invited by the Haryana Government. These officers allegedly coordinated with each other before submitting the bids of their respective companies, by way of a series of calls. This was noted by the Director-General in his investigation report based on their call detail records.

51 The Competition Act, 2002, S. 41(2) r/w S. 36(2).

52 See *Chemists & Druggists Assn.* v. *Competition Commission of India*, 2015 SCC OnLine Comp AT 1022; In this case, the Commission directed the Director-General to issue notices in terms of S. 48(2) of the Competition Act, and give the office-bearers an opportunity to explain their role in the decision-making in respect of the practices which were found anti-competitive; *Swapan Kumar Karak* v. *Competition Commission of India,* 2015 SCC OnLine Comp AT 939; In this case, the Director-General was directed by the Commission

to a denial of the natural justice on first principles alone.[53] In support, the COMPAT in *Alkem* v. *Commission* noted two key mistakes:

> *first*, the Jt. Director-General failed to grant the right to present a defense to the individuals being investigated, though the complainant was given an opportunity to present his case;
>
> *secondly*, such individuals were not given an opportunity to cross-examine the complainant who was found to have made false and unfounded statements in his complaint.[54]

It should be noted that the Commission did provide a technical right to the individuals being investigated to present their case, in that such officers were provided copies of the Jt. Director-General report and were given the right to make submissions against the report. However, the meeting of the Commission in which it ordered that such copies were to be provided and the Jt. Director-General's report gave these individuals "*not even a whisper*" that they were being probed under Section 48(1) of the Competition Act. This resulted in a violation of the principle of natural justice, i.e., *audi alteram partem*, which rendered the penalty null.[55] The Commission itself in *Ministry* v. *Mahyco* categorically endorsed this principle; it stated that the principle that '*no person can be condemned unheard*' is not a mere rhetoric; it has to be followed in substance by providing an effective opportunity to

to issue notices to the office-bearers of Bengal Chemist and Druggist Association (BCDA) giving them an opportunity to prove that the contravention by BCDA was committed without his knowledge or that he exercised all due-diligence to prevent the commission of such contravention. Further, the COMPAT in this case had observed that "*if the appellant was not associated with the offending decision, then the Commission could not have penalized him under Section 27 read with Section 48(1) of the Act*".

53 *See* The Competition Act 2002, S. 36(1) ["*36(1) In the discharge of its functions, the Commission shall be guided by the principles of natural justice and, subject to the other provisions of this Act and of any rules made by the Central Government, the Commission shall have the powers to regulate its own procedure.*"]; See also *Interglobe Aviation Ltd.* v. *Competition Commission of India*, 2016 SCC OnLine Comp AT 87, ¶ 33. The Commission was duty bound to comply within view of the mandate of S. 36(1) of the Act.

54 *Alkem Laboratories Ltd.* v. *Competition Commission of India*, 2016 SCC OnLine Comp AT 101, ¶ 70.

55 *Ibid.*, ¶ 71; Even otherwise, the appellant company was absolved by COMPAT in this appeal and on this ground alone, the officers would have been discharged; See also *State of Orissa* v. *Binapani Dei,* AIR 1967 SC 1269, ¶ 13 (rules of natural justice apply alike to judicial tribunals and bodies of persons invested with authority to adjudicate upon matters involving civil consequences.); *A.K. Kraipak* v. *Union of India,* (1969) 2 SCC 262, ¶ 21(rules of natural justice apply to both quasi-judicial enquiries as well as administrative enquiries.)

present a defense.[56] Furthermore, this defense is to be provided at the very threshold.[57]

In the same vein, a Division Bench of the Delhi High Court in *Google Inc.* v. *Competition Commission of India*[58] pointed out that the Director-General's powers of investigation are sweeping and wider than the powers conferred upon the police under the Code of Criminal Procedure, for example, the police does not have the power to record evidence on oath. Further, the Director-General can allow cross-examination of witnesses, which forms evidence recorded in Director-General's report, and which consequently forms the basis of further proceedings before the Commission. Therefore, due to the nature of these powers, the *audi alteram partem* rule must apply to these proceedings (though it may not apply to police investigations). Further, if a person is not given this right and the Director-General report is adverse, such person has been unfairly prejudiced and then it cannot be argued that no prejudice was caused by such procedure merely because the person has an opportunity to defend himself before the Commission.[59]

The Director-General must also provide the concerned individuals with an action-oriented notice, per *Mohana* v. *Commission*,[60] in this case the Commission passed on order imposing penalties on individuals allegedly involved in anti-trust offences (including an order not to associate the appellants with its affairs, including administration, management and governance for a period of two years albeit) without issuing an action-oriented notice and giving them opportunity of hearing. The counsel for the individuals submitted before the COMPAT that this order was vitiated on account of a breach of principles of natural justice. One of the breaches cited by the counsel was that the Commission did not provide adequate notice to the relevant individuals to show cause against imposition of penalties as the

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[56] *Ministry of Agriculture and Farmers Welfare* v. *Mahyco Monsanto Biotech (India) Ltd.*, 2016 SCC OnLine CCI 40 , ¶ 33.

[57] *Ibid.*, ¶ 34.

[58] 2015 SCC OnLine Del 8992.

[59] See also *Blaze and Central (P) Ltd.* v. *Union of India*, 1980 SCC OnLine Kar 99 : AIR 1980 Kar 186 ["*…if the right to be heard is to be a real right which is worth anything, it must carry with it a right to know the evidence of the opposite side. The (petitioner) must therefore be told what evidence has been given or what statements have been made by the opposite side. In other words, to put it shortly, the (petitioner) must be given a fair opportunity to correct or contradict the statements recorded or the evidence collected in his presence or absence.*"]

[60] See also *Kerala Film Exhibitors Federation* v. *Competition Commission of India*, 2016 SCC OnLine Comp AT 298, ¶ 25; *Shib Shankar Nag Sarkar* v. *Competition Commission of India*, 2016 SCC OnLine Comp AT 275, ¶ 19 (In this case, the COMPAT set aside a penalty on the ground that the Commission did not provide the appellants with a copy of the main investigation report; this caused the appellants serious prejudice by depriving them of an effective opportunity to contest the findings).

Commission only directed electronic copies to be supplied to the opposite parties and the relevant individuals to enable them to "file their suggestions/ objections". The counsel for the Commission resisted this submission, and requested the Tribunal to refuse to interfere with the order on a "hyper-technical ground of violation of the principles of natural justice" since the Jt. Director-General had given ample opportunity to the appellants to defend themselves and which the appellants did not avail of.[61] The COMPAT held that the Commission did not give any notice or opportunity of hearing to the appellants.[62]

The COMPAT also applied a similar line of reasoning in *Interglobe Aviation Ltd.* v. *Competition Commission of India*.[63] It noted the decision of the Supreme Court in *Gorkha Security Services* v. *State (NCT of Delhi)*[64] which had stated:

> "21. ... The fundamental purpose behind the serving of show-cause Notice is to make the individual understand the precise case set up against him which he has to meet. This would require the statement of imputations detailing out the alleged breaches and defaults he has committed, so that he gets an opportunity to rebut the same. Another requirement, according to us, is the nature of action which is proposed to be taken for such a breach. That should also be stated so that the noticee is able to point out that proposed action is not warranted in the given case, even if the defaults/breaches complained of are not satisfactorily explained.
>
> 22. ... [I]t is equally important to mention as to what would be the consequence if the noticee does not satisfactorily meet the grounds on which an action is proposed. To put it otherwise, we are of the opinion that in order to fulfil the requirements of principles of natural justice, a show-cause notice should meet the following two requirements viz:
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> (i) The material/grounds to be stated which according to the department necessitates an action;
>
> (ii) Particular penalty/action which is proposed to be taken. It is this second requirement which the High Court has failed to omit.

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[61] *Ibid.*, ¶¶ 20-21.

[62] *Ibid.*, ¶¶ 38-41.

[63] 2016 SCC OnLine Comp AT 87, 2016; See also *BCCI* v. *Competition Commission of India,* 2015 SCC OnLine Comp AT 238.

[64] (2014) 9 SCC 105, ¶ 21.

> We may hasten to add that even if it is not specifically mentioned in the show-cause notice but it can be clearly and safely be discerned from the reading thereof, that would be sufficient to meet this requirement."

Against the backdrop of this decision, the COMPAT found that the Commission ought to have indicated to the appellants that the Commission had disagreed with the clean chit given by the Director-General. Having considered the Director-General's report, the Commission passed a 'usual order' directing the supply of copies of the report to enable them to file their replies/objections; it did not contain any indication that the Commission had disagreed with the report. Even at the stage of oral hearing, the Commission did not give any such indication, or call upon the appellants to show cause against a finding of contravention. Therefore, no opportunity was given to show that the reasons for disagreement were untenable, which was a clear breach of the principles of natural justice.[65]

The position of the COMPAT on these issues is well summarized in *Sunil Bansal* v. *Jaiprakash Associates Ltd.*[66] as follows:

> "In [the] last few years, this Tribunal has noticed that the Commission has passed several orders in complete disregard to the law laid down by the Supreme Court that while exercising adjudicatory functions, the Commission acts as a quasi-judicial body and it is bound to act in consonance with different dimensions of the principles of natural justice. The Commission has also not realised that as a quasi-judicial body, it is subordinate to the Tribunal established under Section 53A and is bound to follow the law laid down by the Tribunal on the interpretation of the provisions of the Act and the Regulations. It is high time for the Commission to realise that by enacting Section 36(1), Parliament has unequivocally declared that in the discharge of its functions, the Commission shall be guided by the principles of natural justice. The Commission should also take cognizance of the law laid down by the Tribunal, the High Courts and the Supreme Court. Any delay in this regard will only add to unnecessary litigations in the form of appeal under Section 53B(2) of the Act and further appeals under Section 53T of the Act and also petitions under Articles 226 and 227 of the Constitution."

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[65] *Interglobe* (*supra* note 63), ¶¶ 32-34.
[66] 2016 SCC OnLine Comp AT 391, ¶ 46.

## VI. SCOPE OF INVESTIGATION

The Commission has held that the investigation caused to be made under Section 26, is an investigation into the 'matter'. There is no suffix, no prefix, no *proviso*, no explanation, and no caveats of any form attached to the word 'matter', which *ipso facto* means that the Director-General needs to investigate into the matter comprehensively in all its dimensions. The Commission has also in certain cases specifically directed the Director-General to investigate the role of the officers of the company.[67]

Given the unique nature of anti-trust offences, especially in the case of cartels, it may not be easy to identify individual liability. The Commission also recognized that conduct that may be considered anti-competitive in one case may not be so in another case. As such, the Director-General and the Commission must carefully and consciously examine the facts, circumstances and evidence on record, in addition to providing an effective opportunity for defense. In this regard, reports of the Director-General commonly impute liability merely because a certain person was marked a copy of incriminating e-mails. Such a person may be marked on e-mails simply as a matter of practice, and may not actually be involved in the commission of the offence.[68] Similarly, in *Alkem* v. *Commission*, individuals were held liable simply due to them holding "*key positions*" in a company. Eventually, the COMPAT rejected the order and held that simply because the appellants wrote a letter to the pharmaceutical company to appoint the complainant as stockist is not sufficient proof.

In this regard, it should be noted that section 48 provides two lines of defense; first, the individual must be de jure in charge of, or responsible for, the conduct of the business of the company. The second line of defense is added by judicial precedent i.e., liability cannot be imputed unless such

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[67] *Ministry of Agriculture and Farmers Welfare* v. *Mahyco Monsanto Biotech (India) Ltd.*, 2016 SCC OnLine CCI 40 , ¶ 35; This had been stated by the Commission in Prasar Bharati v. TAM Media Research (P) Ltd., 2016 SCC OnLine CCI 15, though it was not assertive and did not express this requirement as a mandatory duty.

[68] It is worth noting that S. 48(2) of the Competition Act provides that where a contravention is attributable to any neglect on the part of, any director, manager, secretary or other officer of the company, such person may be found liable with the company. Therefore, even if any such person is casually marked on e-mails, he/she should be careful where these e-mails demonstrate ex facie contraventions of the Competition Act. In such cases, even being casually marked on e-mails may be sufficient to demonstrate neglect on the part of such persons. In such cases, it is advisable for such persons to expressly record dissent with such practices, by responding to such e-mails stating that the same is against company anti-trust policy or escalating the matter to the relevant compliance teams. Also, in *Fx Enterprise Solutions India (P) Ltd.* v. *Hyundai Motor India Ltd.,* 2017 SCC OnLine CCI 26, the Commission considered the plea that the respondent had a competition law compliance programme in quantifying penalties.

persons are proved to be de facto in charge of the business of the company.[69] However, this does not mean that the de jure nature of such individuals should be disregarded for the purposes of the Competition Act. For example, while any director may be relieved from liability under Section 463 of the Companies Act, 2013 (Companies Act),[70] independent directors and non-executive directors can only be held liable if acts or omissions by a company occur with their knowledge and with their consent or connivance or where they have not acted diligently.[71] Further, in most cases, executive directors will probably be more culpable than non-executive directors who do not participate in the day-to-day functioning of the company. To this extent, all directors cannot be painted with the same brush.[72] Typically, directors are categorized as follows:

[69] It is worth noting in this behalf that S. 166 of the Companies Act, 2013 requires directors to ensure the best interests of the company and its stakeholders', which could include anti-competitive practices, if viewed solely from the perspective of economic benefits. However, these interests must be balanced in a manner which ensures compliance with the Competition Act, in order to avoid individual liability under S. 48 of the Competition Act.

[70] This section provides that the Court may, in its discretion, relieve a director of liability arising from breaches of Companies Act, if the Court is satisfied that he has acted honestly and reasonably, having regard to all the circumstances of the case.

[71] The Companies Act, 2013, S. 149(12); and (in case of listed companies) the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations 2015, S. 25(5); This recognizes that independent directors and non-executive directors do not participate in the execution of the business of the company. Therefore, the liability of such directors for acts of the company is diluted on this count, in relation to the Companies Act, 2013. However, S. 149 r/w Sch. IV of the Companies Act presents a unique dichotomy in relation to anti-trust offences; this provides for certain additional duties for such directors, including reporting concerns with the running of the Company to the board, ensuring that such concerns are addressed, ascertaining and ensuring that the Company has an adequate and functional vigil mechanism and most importantly, to report concerns about unethical behaviour, actual or suspected fraud or violation of the Company's code of conduct or ethics policy. To this extent, such directors are made to act as a system of checks and balances and play a more supervisory role in the functioning of the company. This includes ensuring that the company does not engage in anti-competitive practices. As such, such directors may be derelict in their duties if they fail to take steps to prevent the company from committing cartelization offences.

[72] The Gujarat High Court adopted the same rationale in a case dealing with banking policy of the Reserve Bank of India and struck down a subordinate legislation that sought to impose liability on all directors equally, without considering if the director is involved in the day-to-day functioning of the company as an executive director or not (e.g. independent or nominee directors) and whether the act in question was within the control of such directors. In this case, a policy of the Reserve Bank of India specifically applied to all kinds of directors, regardless of the nature of their role or duties. In this regard, the Court undertook a detailed analysis of the various kinds of directors under the Companies Act, including shadow directors (who is not appointed to the Board, but on whose directions the Board is accustomed to act), de facto directors (who is not actually appointed as a Director, but acts as a Director and is held out by the company as such) and nominee directors. The Court also took into account the classification of directions under the Securities Contracts (Regulation) Act, 1956 and the listing agreements executed by listed companies with stock exchanges, thereunder. On the basis of these classifications, the Court held that all directors of a company cannot be held liable for a default in repayment of a loan by a company,

(i) Managing Director: The Managing Director is entrusted with substantial powers of management of affairs of the company and is in charge of and responsible for the management of the company.

(ii) Executive Directors: The executive directors are full-time directors of the company and are in charge of the affairs of the company under the supervision of the Managing Director.

(iii) Non-executive Directors: The non-executive directors attend and participate in board meetings and carry out other functions, but are not full-time directors. They are not responsible for the day-to-day business operations of the company.

(iv) Nominee directors: Nominee directors are appointed to the board of a company to represent the interests of the person making the nomination. The nominator may be given the right to nominate directors, for instance, by virtue of shareholder arrangements or lending arrangements with a shareholder or creditor.

(v) Independent Directors: Independent directors are apart from the Managing Director or executive and nominee directors. Such directors are usually appointed to bring relevant expertise and experience in relation to the business of the company, and are required to bring a level of impartiality and independence in decision-making in the board of directors.

Often, shareholders' agreements declare that nominee directors will not be identified (to the extent permitted by law) to be in-charge of and responsible for the business of the company. Further, directors may record objections with corporate actions and demonstrate that they were not involved in or consented to illegal acts of the company. For instance, in *Re Zylog Systems Limited*, two independent directors disclaimed liability arising out of a breach of law by Zylog Systems Limited (ZSL). These directors convinced the SEBI that they were not associated with the day-to-day operations of ZSL, and that the default occurred without their knowledge and consent. To do so, they brought board minutes on record before the SEBI where they promptly and diligently recorded their concerns with the breach. Soon thereafter, they resigned. The SEBI noted the importance of the role played by independent directors in guiding the management of companies

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which might be for varied reasons beyond the control of such directors. It does not distinguish between a director who is involved in the day-to-day functioning of a company as against those who are not. The circular paints all directors with the same brush. On this basis, the Court found that the policy, so far as it is sought to be made applicable to all the directors of the company, is arbitrary and unreasonable; See *Ionic Metalliks* v. *Union of India*, 2014 SCC OnLine Guj 10066.

and ensuring compliance with law, and found that these directors had performed this role with diligence. When the non-compliance came to their notice, they took "*strong stands*" to convince the board to comply with statutory obligations and when ZSL failed to do so, they resigned. On this basis, the SEBI did not take any action against these directors.[73]

In view of the above, the mere fact that a person was a director when the offence was committed by the company should not be enough to hold such person liable under Section 48. The Supreme Court clarified this in *National Small Industries Corpn. Ltd* v. *Harmeet Singh Paintal*[74] under the *pari materia* provision in the NI Act, holding:

> "...every person who is a Director or employee of the company is not liable. Only such person would be held liable if at the time when offence is committed he was in charge and was responsible to the company for the conduct of the business of the company, as well as the company. Merely being a director of the company in the absence of above factors will not make him liable..."[75]

In *S.M.S. Pharmaceutical Ltd.* v. *Neeta Bhalla*,[76] the Supreme Court took notice that there is a whole chapter in the Companies Act, 1956 on directors, of which sections 291 to 293 deal with the powers of the board. On a review of these provisions, the Court made some pertinent observations with respect to officers of a company: it found that the powers of directors depend upon the role and functions assigned to Directors under the memorandum and articles of association of the company. More importantly, it noticed that there is nothing which suggests that simply by being a director, a person is supposed to discharge particular functions or has knowledge of the day-to-day functioning of the company. Further, a director may attend only meetings of the board on policy matters and guide the course of business of a company. However, sub-committees or designates may be appointed to take on the day-to-day operations of the Company. Therefore, the role of a director in a company is a question of fact depending on the peculiar facts in each case. There are no universal rules in this regard, and it is the role of

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73 *S. Rajagopal, In re,* 2017 SCC OnLine SEBI 40.

74 (2010) 3 SCC 330.

75 See also *S.M.S. Pharmaceuticals* v. *Neeta Bhalla,* (2005) 8 SCC 89 ("... liability depends on the role one plays in the affairs of a Company and not on designation or status. If being a Director or Manager or Secretary was enough to cast criminal liability, the section would have said so. Instead of "every person" the section would have said "every Director, Manager or Secretary in a Company is liable", etc. The legislature is aware that it is a case of criminal liability which means serious consequences so far as the person sought to be made liable is concerned. Therefore, only persons who can be said to be connected with the commission of a crime at the relevant time have been subjected to action.")

76 *S.M.S. Pharmaceuticals Ltd.* v. *Neeta Bhalla,* (2005) 8 SCC 89.

the person that matters and there are no magic designations like directors, managers, etc. which make a person liable. Further, the complaint[77] must disclose the necessary facts which make a person liable.[78]

These principles must be applied to anti-trust enforcement as well, especially with jurisprudence under the Competition Act already recognizing that liability depends on the role played by a person in the company and not merely on his designation or status. This also makes the converse possible i.e., a non-executive director (not ordinarily involved in the management of the company, but who was complicit in the anti-trust violation) may be proved to be actually liable. Consequently, a nuanced consideration of the *de jure* and *de facto* roles and functions should be considered by the Commission and the COMPAT. Differential standards ought to be adopted for different kinds of directors and employees, based on the true involvement and nature of functions performed by such persons. Furthermore, it must be recognized that culpability may not be evenly distributed even between employees at the same level; one officer may have committed a flagrant violation whereas another may have tacitly supported such person. For example, in *Kerala Cine Exhibitors Assn.* v. *Kerala Film Exhibitors Federation*,[79] the Commission penalized the Kerala Film Exhibitors Federation (KFEF) and the Film Distributors Association (Kerala) (FDA) for anti-competitive conduct in violation of Section 3(3)(b) of the Act for limiting the release of new movies to only 70 approved release centres in Kerala. It held that KFEF was the '*main perpetrator*' and that FDA "*had no option but to succumb to the diktats of KFEF to protect the commercial interest of its members*". Further, it noted that while FDA did succumb to the influence of KFEF, the fact that this was required to protect the commercial interests of its members was considered to be a mitigating factor, justifying a lesser penalty on FDA. Similarly, the officers of FDA were fined with a proportionately lesser amount than the officers of KFEF.

It is also important to note that the Commission in *Mohana* v. *Commission* directed office-bearers of a trade association, found to have engaged in the anti-competitive activity, to refrain from participating in the administration, management or governance of the association for a period of two years. The COMPAT held that the residuary clause in Section 27, i.e., Section 27(g)

[77] *See* (*supra* note 10) on the nature of proceedings under the Competition Act.

[78] This stems from cheque-dishonour proceedings under the Negotiable Instruments Act, 1881 being adversarial, with a complainant and respondent on either side. Proceedings before the Commission and the Director-General can be initiated suo motu and therefore, this cannot apply verbatim. Nevertheless, there is principled rationale to apply this to suo motu initiated proceedings as well, to the end that the Director-General's report must be based on and present evidence against the individual under investigation.

[79] 2015 SCC OnLine CCI 98.

must be interpreted contextually and found that the Commission's direction was an unbridled exercise of power. It held that the Commission cannot issue an order or direction which would directly or indirectly impinge upon the provisions of other statutes. As such, while the Commission may impose a penalty on officers found to have engaged in anti-competitive activity, it cannot pass any direction asking them to refrain from holding their posts or from continuing to engage in the management of the enterprise.

## VII. CONCLUSION

The Act casts strict obligations for anti-trust offences on corporates, as well as individuals, who direct the mind and will of these companies. These obligations, and the penalties that follow the contravention of these obligations, are intended to deter anti-trust practices. The deterrent value depends on the certainty of successful enforcement which has not been consistent, as demonstrated in this paper. The shortcomings in investigations conducted by the Commission and its Director-General, highlighted in this paper above, have resulted in several cases being overturned by the COMPAT. The Commission must therefore thoroughly investigate the actual role and involvement of the individuals, and enforce provisions of the Competition Act based only on sound evidence and adequate reasoning; critically, fundamental principles of natural justice and thorough investigative procedures must be observed. This will ensure fair and equitable enforcement of anti-trust law, failing which battles against cartels and abusive dominant enterprises may prove futile.

# Unmasking the Asset tracing tools under the Indian Insolvency Laws

*Atotyma Gupta*

*"Asset tracing" is not a novel concept. This practice has been in existence since ages. It attaches itself with the phenomenon of lending as well as varied forms of transfer of property – such as by creation of a trust, bailment, pledging, mortgaging or sale of the property. It has an intriguing convergence with the insolvency laws. As the legal framework pertaining to insolvency has recently been overhauled in India, the author wishes to indulge in a detailed and metamorphic analysis of the divergent roads towards asset tracing in primarily three jurisdictions: - United States, United Kingdom and India.*

## Testing the Waters for Asset tracing

Since ages, credit has been playing a significant role in the effective and efficient operations of any economy[1] as it enables the goods and services to be traded on a much broader level than otherwise would be the case. "Credit" is derived from a Latin term 'credere' which essentially implies the confidence and trust reposed by the lender in the debtor[2]. However, in the modern day corporate scenario, it is imperative that the risks assumed by the lender while financing are reduced to a negligible extent[3]. Such risk reduction is normally effected by importing terms and conditions relating to security and guarantee in the lending agreement[4].

Moreover, in this backdrop it is condign to appreciate that for almost as long as there have been credit transactions and dealings there have been debtor who have been unable to fulfil their debt obligations either due to uncontrollable factors, mismanagement or deviousness. In such a dilemma, triggering of the collective nature of the insolvency procedures against the debtor assumes utmost importance. The procedures for insolvency resolution and bankruptcy are collective in nature so as to ensure that the assets owned by the debtor are distributed amongst the creditors in the fairest manner possible in a given scenario[5].

The statutory obligation of the insolvent entity to consign its assets for distribution to the creditors coupled with the inability of those assets to sufficiently address the claims has often led to a varied range of pursuits by the insolvent entity to escape the legal shackles of distribution. It consequently attempts to carve out the most efficient route for its asset employment[6]. As a noticeable trend, the assets of the company may be dissipated through gifts or transactions for which the company does not get full value[7]. This may capacitate a "phoenix company" to rise from the ashes with a similar

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1 Gail Pierson, "The Role of Money in Economic Growth" (1972) 86(3) The Quarterly Journal of Economics.

2 Charles A. Conant, "The Development of Credit" (1899) 7(2) Journal of Political Economy.

3 Rowena Olegario, *A Culture of Credit: Embedding Trust and Transparency in American Business* (2006).

4 D. Levhari and D. Patinkin, "The Role of Money in a Simple Growth Model" (1968) 45 American Economic Review.

5 V.S. Datey, *Taxmann's Guide to Insolvency and Bankruptcy Code* (7th edn., 2019).

6 Rebecca Parry et al., *Transaction Avoidance in Insolvencies* (3rd edn., OUP 2018) 3; *Sykes Butchers Ltd., In re* 1998 BCC 484:— It encapsulates the incentives for the directors of the insolvent entity to repay the bank overdraft for which they have personally guaranteed prior to the distribution of the assets of such entity to avoid any personal attribution of liability.

7 *Continental Assurance Co. of London Plc., In re*, (1997) 1 BCLC 48; *Brian D. Pierson (Contractors) Ltd., In re*, 1999 BCC 26.

business but it contradicts the ground objective of protecting the creditors of the insolvent entity[8].

The legislative problem to the above discussed issue has been to expressly encompass specific provisions which enable the avoidance of such abusive transactions[9]. These legal fetters are tabled to enable the entity in the management and control of the assets of the debtor to avoid certain agreements which showcase preferential behaviour of the debtor to excessively guard the investments of certain creditors. Additionally, it also enshrouds the transactions wherein certain creditors highlight the insufficiency of debtor's assets by claiming security on extortionate terms to procure an undue advantage over other creditors.

In this context, the revelation and optimum conservancy of concealed assets (which may also be termed as '**fructus sceleri**' or the '**fruits of fraud**') allied to debtor's estate turns into a focal point for any insolvency office-holder. The rate of recovery of these assets and the accumulated costs for the same have also been analyzed as factors to initiate the process of asset tracing (the cost-benefit analysis of the entire process). Moreover, there are various other considerations for the party contemplating to initiate and conduct the process of asset tracing[10]. Whilst the author would have desired to address all the concerns identified in this respect, the limited scope of this article only allows a high level analysis of a few select issues.

## ASSET TRACING IN UNITED STATES – THE TRINITARIAN CONTRIVANCE

This section of the Article critically examines the key elements which exist in the US Bankruptcy regime for the effective redressal of the issues concerning asset concealment. As has been succinctly observed, asset concealment has a contagion effect which undermines the trust and confidence in the

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8 Neil Hannan, *Cross-Border Insolvency* (1st edn., 2017).

9 D. Brown and T.G.W. Telfer, "The 'New Australasian' Voidable Preference Law: Plus Ca Change?", (2007) 13 New Zealand Business Law Quarterly 160; J.S.U. Bodoff, "Bankruptcy Reform Study Project: The ABI Performance Survey" (1997); A. Duggan and T. Tefler, "Canadian Preference Law Reform" (2006-07) 42 Texas International Law Journal 661; I. Fletcher, "Voidable Transactions in Bankruptcy: British Law Perspectives", as cited in J. Ziegel, *Current Developments in International and Comparative Corporate Insolvency Law*, (Oxford University Press 1994); R. Goode, *Principles of Corporate Insolvency Law* (4th edn., 2011).

10 For example: "The Existence and Impact of a Commercial Crime Insurance Policy"; Nathan Wadlinger, et al., "Domestic Asset Tracing and Recovery of Hidden Assets and the Spoils of Financial Crime", (2018) 49 St. Mary's Law Journal 609, 614.

capital markets and consequently shakes the well-being of the entire world economy[11]. The triggering of the Bankruptcy process under the U.S. Laws has twin-fold ramifications. Firstly, it leads to the crystallization of the bankruptcy estate[12]. Although the Congress intended to delineate the broadest possible amplification of the estate, it is apposite to observe that the estate only succeeds to limited rights which are possessed by the debtor and no greater interests in that property[13].

The legal apparatus for asset recovery in the United States can be examined in three forms:

(A) **Operation of automatic stay**[14] on the initiation of a novel litigation, enforcement of a judgment or a lien against the debtor, recovery of any pre-petition claim against the debtor etc. It aims to guard the bankruptcy estate from disintegrating.

(B) **Preference and Fraudulent transfer avoidance actions** which facilitate the estate succession to whole of the assets of the debtor and endorses the obliteration from the resultant contractual obligations.

(C) **Discovery** powers of the bankruptcy participants to unearth the whereabouts of the hidden assets.

Trustees and debtors-in-possession (as the United States' Bankruptcy Law endorses allegiance to the Debtor-in-possession model of insolvency resolution[15]) have been adequately empowered under the U.S. Bankruptcy Code to facilitate the recovery of assets for the well-being of the creditors. A detailed analysis of the above outlined three legal mechanisms is indispensable to appropriately appreciate the asset tracing framework under the U.S. Bankruptcy laws. As a cherry on the cake, the potential criminal liabilities

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[11] Martin S. Kenney, "Serious Fraud" in Bernd H. Klose (ed.) *Asset Tracing & Recovery: The Fraudnet World Compendium* 19, (2009).

[12] The "property of the estate" is defined as inclusive of all legal and equitable interests of the company: 11 USC § 541(*a*)(1).

[13] 11 USC § 541(*d*) narrates: —"*Property in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest, such as a mortgage secured by real property, or an interest in such a mortgage, sold by the debtor but as to which the debtor retains legal title to service or supervise the servicing of such mortgage or interest, becomes property of the estate under sub-section (a)(1) or (2) of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest in such property that the debtor does not hold.*"; further illustrated in Felicity Toube (ed.), *International Asset Tracing in Insolvency* (77, 2009).

[14] 11 USC § 362(*a*).

[15] Baker McKenzie, Global Restructuring & Insolvency Guide, <http://restructuring.Bakermckenzie.com/wp-content/uploads/sites/23/2016/12/Global-Restructuring-Insolvency-Guide-New-Logo-United-States.pdf> accessed March 20 2019; Gerard McCormack, "Control and Corporate Rescue — An Anglo-American Evaluation", (2007) 56 Int'l & Comp. L.Q. 515.

and the risks of equitable subordination or re-characterization of the claims of the creditors ensures that the whole exercise augments the betterment of the creditors.

## Cushioning the bankruptcy estate – The Automatic Stay

The initiation of a Bankruptcy proceeding leads to the creation of an automatic stay[16]. It operates analogous to an injunction for the creditors from resorting to any judicial or private means for enforcement of their rights against the estate except via the prescribed procedures under the Bankruptcy Code[17]. In this manner, it fulfills twin objectives – Firstly, it cushions the estate from any pre-petition claim and secondly it benefits the entire class of creditors by assuring an orderly distribution of estate and avoids the race to other authorities.

Notably, despite the wider breadth of the stay, it excludes suits against debtor's guarantors or corporate affiliates[18], shareholders[19], partners (only when they, in their individual capacity, have not been subjected to Bankruptcy[20]). However, notwithstanding these exceptions to the automatic stay, the bankruptcy court has been empowered to enjoin any actions when their independent assessment would lead to the development of hurdles in the debtor's capacity to re-organize[21].

The safe harbor provisions in respect of the operation of automatic stay are provided in section 362(b) of the code. It contains 28 exceptions in its entirety. One of the pertinent exceptions among them is crucial to be analyzed. This exception is designed to permit a non-debtor party to close-out the derivative contracts notwithstanding the automatic stay.

The raison d'être for exempting these contracts from the applicability of the automatic stay is to prevent any resultant impairment of the liquidity of the concerned underlying agreement and of the counter-party. Such concerns have been acknowledged to be extremely prescient[22] in the context of the devastating effect of the bankruptcy of Lehman Brothers Holdings Inc. In that scenario, the counterparties were permitted to enter into agreements

16 11 USC § 362(*a*); *Credit Alliance Corpn.* v. *Garry L. Williams*, 851 F 2d 119 (4th Cir 1988).

17 *Patterson* v. *Shumate*, 1992 SCC OnLine US SC 74 : 119 L Ed 2d 519 : 504 US 753 (1992).

18 *Otoe County National Bank* v. *W & P Trucking Inc.*, 754 F 2d 881 (10th Cir 1985).

19 *Spaulding Composites Co. Inc., In re*, 207 BR 899 (1997).

20 *Patton* v. *Bearden*, 8 F 3d 343 (6th Cir 1993).

21 *Wedgeworth* v. *Fibreboard Corpn. Fontenot,* 706 F 2d 541 (5th Cir 1983).

22 Felicity Toube (ed.), *International Asset Tracing in Insolvency* (2009).

with other entities which would fully or partially offset any over-the-counter derivatives existing with the Lehman Brothers.

The amendments floated in 2005 to the Bankruptcy Code further reinforced varied safe harbor protections. It significantly expanded the definition of "re-purchase agreements" by including mortgage related securities, mortgage loans and interests in mortgage securities[23]. It also created a space for cross-product netting under a "master netting agreement"[24].

If the automatic stay imposed as per the legal framework as discussed is violated, the courts have held the actions to be void[25] or voidable at the option of the debtor[26]. The effect of this nullification of the action of the creditor is to convert the secured creditors' claim into an unsecured claim. When the stay is knowingly breached by any of the party, the court may punish that party for contempt because an automatic stay is treated to be equivalent to a court order[27].

## Avoidance Actions – Invalidating the "transfers" and restoration to the "original position"

The U.S. Bankruptcy Code consists of a double set of avoiding powers consisting of fraudulent conveyances (section 548) and unlawful preferences (section 547). The Avoidance Powers (also termed as "**claw back actions**") are mechanisms for recovery of the property of the debtor when the circumstances shrouding the transactions fall within the element prescribed by the relevant statute[28]. It is extremely pertinent to comprehend the benefits reaped by enforcing these powers with the managing trustee or the debtor in possession.

The prominent advantage is the ex-ante amelioration or ex-post reversal of opportunistic, value destructive attitudes (which includes but is not limited to asset dilution, asset substitution, debt dilution) potentially encountered by bankrupt debtor entities[29]. Hence, it ensures maximization of the value of the firm as it demotivates the market players to conclusively enter into agreements with a bankrupt entity.

23 11 USC § 101(47) (2009).
24 *Ibid.*, § 561 (2009).
25 *Soares* v. *Brockton Credit Union*, 107 F 3d 969 (1st Cir 1997).
26 *Jones* v. *A. Garcia*, 63 F 3d 411 (5th Cir 1995).
27 *Vahlsing* v. *Commercial Union Insurance Co. Inc.*, 928 F 2d 486 (1st Cir 1991).
28 Robert Clark, "The Duties of the Corporate Debtor to its Creditors" (1977) 90 Harvard Law Review 505.
29 Aurelio Gurrea-Martínez, "The Avoidance of Pre-Bankruptcy Transactions: An Economic and Comparative Approach", (2018) 93 Chicago-Kent Law Review.

Additionally, it also prevents the invigorated rat race to debtor's assets when bankruptcy is predicted and resultantly abridges the "common pool"[30] concern of the Bankruptcy Law. The "common pool" (as applied within this framework) indicates the scarce assets of the Bankrupt entities which is essentially mandated to be collectively managed to avoid the narrative of "tragedy of the commons"[31]. This necessitates a collective and coordinated decision making[32].

The retrospective implication of the "avoidance powers" for validly executed transactions may prove to be disastrous for the want of legal certainty and clarity. Therefore, the legal design for avoidance transactions shall harmonize the concerns of the common pool objective and the bona fide investment by the non-bankrupt counterparty to the contested transactions. One of the routes to achieve this is to statutorily prescribe a time period for the transactions to be scrutinized under the avoidance powers of the trustee (which is commonly referred to as the "twilight period", "suspect period", and "look-back period").

The "**Twilight Period**" – Minimizing the risk of ambivalence vis-à-vis Counterparty's investment

Twilight zone or period has not been statutorily explicated, however, in common terms, this period is accredited as the maximum period antecedent to the initiation of the Bankruptcy procedure whose transactions can be assailed and put to scrutiny pursuant to avoidance powers[33]. It implies the time duration between the realization of absence of any prospects of avoiding the "trigger event" for bankruptcy and its real initiation[34].

While deciding the duration of this period, several policy considerations are required to be analyzed in detail. A very long period might inflate the value of the estate but it will not be enabled to eliminate the costs affiliated with legal uncertainty. On the contrary, a shorter period may lead to predictability but will surely erode the underlying design of the avoidance powers. The decision in relation to this period may also digress due to the

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30 Agasha Mugasha, "Solutions for Developing-Country External Debt: Insolvency of Forgiveness", (2007) 13 Law and Business Review of the Americas 859.

31 Garrett Hardin, "The Tragedy of the Commons", (1968) 162 Science 1243.

32 Jodie A. Kirshner, "Design Flaws in the Bankruptcy Regime: Lessons from the UK for Preventing a Resurgent Creditors' Race in the U.S.", <https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1482&context=jbl> accessed 20 April, 2018.

33 Douglas Baird and Robert K. Rasmussen, "Chapter 11 at Twilight", (2003) 56 Stanford Law Review 673; *Grafton Partners, In re,* 321 BR 527 (2005); Dennis Faber, *Commencement of Insolvency Proceedings* [Niels Vermunt , Jason Kilborn, Tomas Richter, (eds.), 2012].

34 D. Milman, "Strategies for Regulating Managerial Performance in the 'Twilight Zone' – Familiar Dilemmas: New Considerations", (2004) 4 Journal of Business Law 493.

nature of the concerned transaction or the counterparty[35]. Furthermore, the imposition of certain temporal limits within these avoidance powers in the bounds of the legal procedure might also facilitate to avoid any haziness in the administration of the Bankruptcy procedure to debtors.

## Preferential transactions – An ex-ante tool for asset tracing

The avoidance of preferential transactions is addressed under Section 547 of the Bankruptcy Code. Sub-section (b) envelops five stipulations for testing the transfer of debtor's property on the touchstone of avoidance powers[36]. Firstly, the transfer must be to or for the benefit of the creditor. Secondly, it shall account for an antecedent debt owed by the bankrupt entity. Thirdly, the transfer shall be effected by the debtor while it is insolvent. Fourthly, the transfer shall have been effectuated during 90 days preceding the onset of the bankruptcy case, or if the transfer is made to an insider[37], during the period beginning one year prior to initiation of bankruptcy and ending 90 days before the filing of bankruptcy (further, it is to be noted that the condition precedent for the elongated twilight period to apply attaches itself to the factum of the existence of a reasonable cause with the insider to believe that the debtor was insolvent at the time of the agreement[38]). Fifthly and lastly, such transfer shall have elevated the circumstances of the counterparty in comparison to its position under the Bankruptcy Code.

Moreover, this rigid statutory design for avoidance of preferential transactions may have an adverse effect on the willingness to deal with entities encountering financial difficulties[39]. To address this concern, and to reduce the risk of potential disgorgement of payments received for value by the counterparties, the Bankruptcy Code also enumerates certain exceptions.

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35 For instance, the period is longer for the related parties as counterparties as they are expected to be well-apprised of the circumstances of the debtor while shorter for the non-related parties.

36 11 USC § 547(*b*) (2009).

37 An "insider" has been marked as having sufficiently close relationship with the debtor and therefore are mandatorily subjected to stricter scrutiny and checks; S Rep No. 95-989, at 25 (1978).

38 *Holloway Browning Interests* v. *W. Allisonl*, 955 F 2d 1008 (1992); It has also been held that any transfer made to a non-insider that benefits the insiders shall be tested on the touchstones of the reach-back period as prescribed for the insiders and not non-insiders – *Levit Vn* v. *Ingersoll Rand Financial Corpn.*, 874 F 2d 1186 (7th Cir 1989).

39 *Jones Truck Lines Inc.* v. *Central States, Southeast and Southwest Areas Pension Fund*, 130 F 3d 323 (8th Cir 1997).

It excludes contemporaneous exchanges[40] as it is not on account of an antecedent debt in its real sense[41]. However, to ensure that this exception does not become the escape route to allow preferential transactions, its applicability has been limited to only those cases wherein no action has been effectuated by the counterparty-creditor (such as demanding security etc.) on being apprised of the lack of requisite intent of the debtor to pay for the value/or about its factual insolvent state of affairs[42].

Secondly, to ensure that when an entity slides into bankruptcy, its normal operations are not impaired and it continues as a going concern with the hope to resume and resolve sooner or later, section 547(c) also drives out the transactions materialized in the ordinary course of business[43].

Thirdly, the Code also nets out transactions leading to the creation of new security interest for new value pursuant to a valid security agreement to empower the debtor to acquire the property[44] (also termed as the "new value defense") It is imperative that it is perfected on or before the expiry of 30 days post receipt of possession by the debtor.

The creditor must corroborate that (a) the new value is bequeathed post preferential transfer, (b) the "new value" is of an unsecured nature, and (c) the "new value" remains unpaid[45]. A lion's share in the U.S. judicial system believes that even if the new value is paid with the alleged transaction[46] , it will qualify as "new value".[47]

## Judicial shield accorded to Earmarked Secured Loans

Adjoining the statutorily prescribed exceptions to avoidance of preferential agreements, the U.S. Judiciary has also espoused the doctrine of "Earmarking". This doctrine propagates that if a third party has advanced a loan to the bankrupt debtor entity to pay off a specific creditor, it cannot be frowned upon by the trustee as a preferential transaction[48]. This doctrine derives its prominence from the fact that the debtor never had actual control

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40 11 USC § 547(*c*)(1) (2009).

41 HR Rep No. 95-595 (1977).

42 *National City Bank of New York* v. *Henry D. Hotchkiss*, 1913 SCC OnLine US SC 254 : 58 L Ed 115 : 231 US 50 (1913).

43 11 USC § 547(*c*)(2) (2009).

44 11 USC § 547(*c*)(3) (2009).

45 *IRFM Inc.* v. *Ever-Fresh Food Co.*, 52 F 3d 228 (9th Cir 1995).

46 The transfer of debtor's assets which is being tested for preferential avoidance.

47 *Toyota of Jefferson Inc.* v. *Vallette*, 14 F 3d 1088 (1994); *Jones Truck Lines Inc.* v. *Central States, Southeast and Southwest Areas Pension Fund*, 130 F 3d 323 (8th Cir 1997); *Check Reporting Services, Inc., In re*, 140 BR 425 (1992).

48 *Bohlen Enterprises Ltd.* v. *National Bank of Waterloo*, 859 F 2d 561 (1988).

over the funds lent by the third party and further, the payment of the same to the creditor does not tear down the bankruptcy estate[49].

Although this principle was applicable primitively when a guarantor discharged his obligations under a contract of guarantee, it was extended to any third party as well due to the same objective[50]. It is also crucial to note that the doctrine is applicable when a security interest is created on the assets of the debtor for payment of another secured loan and not unsecured debt[51].

## Fraudulent transfers running afoul of the Pari-Passu rule

Section 544 and 548 of the Bankruptcy Code largely embodies the legal framework for fraudulent transfers. Section 548 enshrines the elements of a fraudulent transfer while section 544 is the strong arm clause which encapsulates the special powers of the trustee to avoid any transaction which is avoidable under the state fraudulent conveyance laws[52]. The point of difference arises when the expiry of the twilight period acts as a hurdle for the trustee to effectively enforce its powers of avoidance[53]. Fraud is type casted as Actual Fraud (defined as a transfer of an interest in the property made by the debtor within two years of bankruptcy commencement) with an actual intent of hindering, delaying or defrauding the other creditors[54]) and Constructive Fraud (wherein the insolvent debtor has received less than a reasonably equivalent value effecting to under-capitalize the debtor[55]).

The aim and objective of these provisions is to generally cushion all the creditors from the adverse impact of those transactions which impair their right to payment or which deplete the estate or maximize the obligations of the debtor. It is validated further by the application of the principle of equitable subordination (which allows one person's claim to be subordinated to its class of claims in the interests of substantial justice[56]).

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49 *Bruening* v. *M. Fulkerson*, 113 F 3d 838 (8th Cir 1997); *Kemp Pacific Fisheries Inc.* v. *MacDonald Meat Co.*, 16 F 3d 313 (9th Cir 1994).

50 *Kemp Pacific Fisheries Inc.* v. *MacDonald Meat Co.*, 16 F 3d 313 (9th Cir 1994).

51 *Muncrief* v. *Mt Prospect State Bank*, 900 F 2d 1220 (8th Cir 1990).

52 Uniform Fraudulent Conveyance Act, 1918 and Uniform Fraudulent Transfer Act, 1984.

53 For Instance — New York Civil Practice Law and Rules provides for a longer reach back period of six years than the two year period prescribed under S. 548 of the Bankruptcy Code.

54 11 USC § 548 (2009).

55 11 USC § 548 (*a*)(1) (2009).

56 *Pepper* v. *Litton*, 1939 SCC OnLine US SC 146 : 84 L Ed 281 : 308 US 295 (1939).

## "Discovery" as a means to uncover the concealed assets

Amidst the mechanisms explored above for asset tracing, the discovery and the conservation of concealed assets assumes utmost prominence. "Discovery" has been agreed to be an iterative process[57] pursuant to which the creditors or any other interested parties can access material information in relation to the whereabouts and value of the debtor's assets.

The Federal Rules of Bankruptcy Procedure (FRBP) ('Bankruptcy Rule 2004') are the primitive means for discovery as they expedite the process and insist upon the preservation of confidential information[58]. The rule leads the interested party to knock on court's doors to order the examination of any entity. The nature of information in a case Chapter 11 may, inter alia, include any matter which is material to the formulation of a plan. The bounds of this Rules are wider in comparison to the Federal Rules of Civil Procedure as in these Rules, the party seeking information need not provide exact details about it (it is symmetrical to a fishing expedition[59]). However to ensure that the interests of the creditors and the debtor are attuned, the Rules also stipulate that the party seeking the motion shall also depict sufficient cause[60].

## The Burgeoning effect of Bankruptcy Rule 2004 – Issuance of Subpoenas

The Bankruptcy Rule of 2004 is only curtailed to legalize debtor's investigation and it unmistakably recapitulates that a subpoena is not prescribed for debtor to honor the order of the court[61]. Moreover, for securing the attendance of a non-debtor party, issuance of subpoenas gains prominence. Therefore, the Bankruptcy Rule 2004 ascribes to Bankruptcy Rule 9016 and the Federal Rules of Civil Procedure. They govern the variety of unfolds of obtaining and issuing subpoenas for three-pronged objective:- To secure attendance of a person, to produce documents and to permit the inspection of the property.

For the purposes of safeguarding the interests of the witness, and to ensure that the creditor/issuing party does not inflict unjust hardships or expenses on the witnesses, they are warranted for the mileage costs and witness' fees

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[57] Phyllis Atkinson, *Introduction*, as cited in *Tracing Stolen Assets: A Practitioner's Handbook* 19 (2009) (it also approximates the frequency at which criminal moneys are traded through financial centers to escape tracing by the law enforcement agencies).

[58] Federal Rules of Bankruptcy Procedure 2004(*a*) (2009).

[59] *Duratech Industries, Inc., In re*, 241 BR 283 (EDNY 1999).

[60] *Bennett Funding Group, Inc. In re,* 203 BR 24 (Bankr. NDNY 1996).

[61] Federal Rules of Bankruptcy Procedure 2004(*d*) (2009).

for one day[62]. It is an instance of the assurance that these discovery mechanisms are not intended to veil collusive activities among the creditors.

### The Tracing Formulas

The Low Intermediate Balance Test (LIBT) formula states that if any payments are made from the commingled funds, it is presumed to have been made from the unencumbered part of the funds[63]. Under this rule, the funds are guarded only to the bounds of the lowest balance in the commingled account[64]. The First-In First-Out (FIFO) rule which formerly played a remarkable role in inventory valuation, generates the assumption that any funds wrongfully diverted into an account shortly preceding the bankruptcy survives in that account until the originally deposited funds of that account are employed[65]. This rule further fortifies the legislative intent to avoid any eleventh hour transfers of funds and then prodigalize them to the benefit of certain creditors. Conversely, the Last-In First-Out (LIFO) rule postulates that lately added funds are to be subtracted at the first instance[66]. However, the court is also capacitated to impose "reasonable assumptions doctrine" where an inapposite outcome is delivered due to the application of these rules[67].

## Asset tracing in United Kingdom:- Fortifying the Substantial Collectivity

The prime beneficiary in the insolvency proceeding shall be the general body of creditors. The Cork Committee discouraged the provision of separate remedies to the creditors and emphasized a consistent and collective redressal of their grievances arising out of a common disaster[68]. This section of the Article scrutinizes the English law for asset-tracing and the orders which may be given by an English court to further the recovery of assets of the bankrupt company. It primarily focuses on the doctrine of creation of

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62 Federal Rules of Civil Procedure 45(*c*)(3) (2009).

63 *Mahan & Rowsey Inc.*, *In re*, 817 F 2d 682 (10th Cir 1987).

64 Jean-Pierre Brun, et al., *Asset Recovery Handbook: A Guide for Practitioners* (2011).

65 *California Trade Technical Schools Inc.* v. *United States of America*, 923 F 2d 641 (9th Cir 1991).

66 *Chase Manhattan Bank* v. *Traditional Investment Corpn.*, 92 Civ 2774 (1995).

67 *Begier* v. *Internal Revenue Service*, 1990 SCC OnLine US SC 96 : 110 L Ed 2d 46 : 496 US 53 (1990) – The tracing rules were found to be inapplicable for the payment of taxes to the IRS; *Megafoods Stores Inc.*, *In re*,163 F 3d 1063 (9th Cir 1998) – The court applied LIBT rule to trace tax funds in a commingled account.

68 Report of the Review Committee on Insolvency Law and Practice (Cm 8558, 1982) 232.

constructive trusts, piercing of the corporate veil, sham, civil and criminal orders along with the requisite disclosures.

An office holder will be entitled to acquire and manage the "property" of the company. Although lacking a precise definition the term ''property'' has been characterized in section 436 of the Insolvency Act, 1986 to be inclusive of money, goods, things in action, land and every description of property wherever situated and obligations and every description of interest, whether present, future, vested or contingent arising out of or incidental to the property[69].

## Moratorium imposition – The most powerful tool

One of the significant tools in the arsenal of the office holder is the imposition of moratorium as against any action of proceeding against the company or its property[70]. It resultantly forestalls any individual creditor actions and halts the invigorated race to the assets of the company. Hence, it amounts to the provision of a "breathing space" to arrive at a comprehensive reorganization plan.

This statutory framework further reflects cognizance of the "absolute priority rule" (which connotes an equal treatment to the creditors of the same priority class and according hierarchies to the existing creditors)[71]. On the same lines, it is apposite to acknowledge that the secured creditors have been bestowed with the right to petition for lifting the moratorium against individual creditor actions and then seek allegiance to the assets of the company having security interest[72]provided that the claimant may prove that lifting of the moratorium is not prejudicial to the process of insolvency resolution and on the contrary if the moratorium is not lifted it will prejudice the interests of the claimant[73].

## Misfeasance claims against the office holder

Section 212 of the Insolvency Act, 1986 provides for the remedy in cases of misapplication, retention of the money or any other property of the

[69] Insolvency Act, 1986, S. 436.
[70] Insolvency Act,1986, S. 130.
[71] Insolvency Act, 1986, Ss. 40 and 175.
[72] *Insolvency Act, 1986*, c.45, Sch. B1; Abeyratne et al., "Corporate Rescues — A Comparative Study of the Law and Procedure in Australia, Canada and England", (DPhil thesis, University of London 1995); Alan Meek and John Reid, "UK: Lifting the Moratorium in Administration" <http://www.mondaq.com/ uk/x/208956/Insolvency+Bankruptcy/Lifting+The+Moratorium+In+Administration> accessed 20 April 2018.
[73] *Lazari GP Ltd.* v. *Jervis*, 2012 EWHC 1466 (Ch).

company[74] by the incumbent or previous 'officers'[75] of the company or a person who has acted as the receiver, liquidator or administrative receiver of the company[76] or any other person who has been concerned in the promotion, formation and management of the company[77]. Thereafter it also extends its applicability to any act of 'misfeasance' or breach of any fiduciary duty **in relation to the company.**

The England and Wales Court of Appeal, as late as in 2003, ruled in this context. Oldham v. Kyrris[78] was a dispute concerning the administration procedure of Mr. Jack Kyrris' partnership wherein Mr. Michael Oldham was given charge as an administrator. The dispute was initiated by one Mario Royle (employee) seeking remedies against Mr. Oldham for breach of duty of care. The claim was vehemently denied by the court. The court endorsed a strong reference to Section 212 of the Insolvency Act, 1986 and drew an inference that the administrator, liquidator, voluntary liquidator or receiver ("insolvency officials") owes no direct duty of care to the creditors, absent any special factual relationship. Such duties are solely directed and owed to the concerned company.

In this context, the immediate concern shall be to identify various possible ways to develop these "**special relationships**" with the administrator/liquidator of the company. These potential probabilities were discussed in brief in a recently decided matter by the Chancery Division of the England and Wales High Court[79]. The court, in para 63, held that if any claimant desires to seek special guards for themselves from the insolvency officials, they shall request for undertakings or specific assurances from such officials. In this case, the court placed heavy reliance on the ratio laid down by Honorable Lord Justice Sir Jonathan Frederic Parker in the Oldham's case. It held that as there were no specific representations made by the joint administrators which had been relied upon by the claimants, or specific reference to the fact that he will re-direct his efforts in any other way than as the administrator, the claim of misfeasance under section 212 cannot be sustained.

## Public Examinations, Subpoenas and Restraint Orders

Section 133 of the Insolvency Act, 1986 bestows enormous authority to the court to order public examinations at the behest of the Official Receiver for

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74 Insolvency Act, 1986, S. 212(1).
75 Insolvency Act, 1986, S. 212(1)(*a*).
76 Insolvency Act, 1986, S. 212(1)(*b*).
77 Insolvency Act, 1986, S. 212(1)(*c*).
78 *Oldham* v. *Kyrris*, 2003 EWCA Civ 1506.
79 *Fraser Turner Ltd*. v. *PricewaterhouseCoopers LLP*, 2018 EWHC 1743 (Ch).

any incumbent or past officer of the company, any person concerned with the promotion, formation or management of the company or for anyone who has functioned as Liquidator, administrator or receiver for the company.

An office holder may also apply to the court to order the furnishing of any property or records to which the company "appears to be entitled"[80]. Whenever any property or asset is acquired by or is devolved upon the bankrupt, it is notifiable to the trustee or the office holder[81]. To further add to the fuel, the law has attached no liability with the office holder for any wrongful seizure or disposal of asset (unless it is on account of negligent actions or omissions).

These orders are not vitiated by the rules against self-incrimination[82], however, this information cannot be put to use in any criminal proceedings at a later point of time[83]. If the bankrupt is not willing to cooperate, then there are other remedies as well such as the issuance of orders for private examinations, redirection of post etc.

## Constructive Trust- Static or circumstantial?

Constructive trust is a concept which replicates the creation of security interest in an asset, with the only difference that it emerges by legal operation wherein it is not conscionable for a person to deny other's beneficial interest[84]. The courts generally assign proprietary remedies for restoration of the property or assets wrongfully deprived by the claimant or unjustly acquired by the defendant.

It includes instances of recession or avoidance of contracts due to fraudulent misrepresentation[85], payments effected under a mistake irrespective of the knowledge or negligence on the part of the person who made such mistaken payment[86], and breach of fiduciary duties (when the fiduciary is insolvent the court deems it fit to grant proprietary claims over the profits earned by the fiduciary in breach of its duties)[87].

The noteworthy facet of this asset tracing tool is two pronged – firstly, the relevance associated with the circumstances of each case. There is no general

80 *London Iron and Steel Co. Ltd., In re,* 1990 BCC 159.
81 *Insolvency Act, 1986*, S. 333(2).
82 *Bishopsgate Investment Management Ltd.* v. *Homan*, 1993 Ch 1.
83 *Suanders* v. *United Kingdom,* 1997 BCC 872.
84 *Paragon Finance Plc* v. *D.B. Thakerar & Co.*, (1999) 1 All ER 400.
85 *Banque Belge Pour L'etranger* v. *Hambrouck*, (1921) 1 KB 321.
86 *Chase Manhattan Bank NA* v. *Israel-British Bank (London) Ltd.*, 1981 Ch 105.
87 *Bristol & West Building Society* v. *Mothew*, 1998 Ch 1: (1997) 2 WLR 436.

classification of unconscionable conduct which escorts the imposition of constructive trust. Secondly, the judicial disbelief in allowing the imposition of a remedial constructive trust over a property or asset of the insolvent company[88]. These trusts are different from institutional constructive trusts as remedial trusts totally lie within the equitable discretion of the courts and do not operate by law, unlike institutional trusts[89]. The reasoning of the courts has consistently been stationed on the doctrine of separation of powers as it results in varying the proprietary rights of the parties and an Act of Parliament is required for the same[90].

## Durant International Case – Turning the tables towards "Backward Tracing"

Tracing has been catalogued as a **process** of identifying the location of the property and justifying one's claim over that property[91]. As opposed to the general connotation of tracing, i.e. when a substitute asset ('traced asset') has been attained by employing the assets from the estate ("**trust asset**" when a constructive trust has been imposed over such assets by the court), backward tracing is the process which is applied when a debt is taken in exchange of an asset (traced asset) and thereupon, the trust assets are used to discharge that debt[92].

The point of difference is associated with the acquisition of the traced asset pre-misappropriation of the trust assets in backward tracing cases. As in United Kingdom, one of the major purposes of asset tracing is the identification of the property of the estate. Backward tracing has been denied in the obiter observations[93] and since then lacking a formal recognition in law, it has been lying in obscurity.

The inclination of the judicial authorities to disallow claims based on backward tracing was substantially diluted by the Durant International judgment delivered by the Privy Council in 2015[94]. This case involved pay-

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[88] *Polly Peck International Plc* v. *The Marangos Hotel Co. Ltd.*, 1998 EWCA Civ 789 : (1998) 3 All ER 812 and *Foskett* v. *McKeown*, (2001) 1 AC 102 : 2000 UKHL 29.

[89] Michael Fiddy, "Fighting the Flab: UK Supreme Court Seeks to Limit the Scope for Remedial Constructive Trusts", <https://www.dlapiper.com/sv/uk/insights/publications/2016/11/global-insight-18/fighting-the-flab/> accessed 21 April 2018.

[90] *Westdeutsche Landesbank Girozentrale* v. *Islington London Borough Council*, 1996 AC 669 : (1996) 2 WLR 802.

[91] *Foskett* v. *McKeown*, (2001) 1 AC 102 : 2000 UKHL 29.

[92] Alexandra Clarke, "The Future after Durant: Is Backwards Tracing the Way Forward?" 91 Oxford University Journal <https://www.law.ox.ac.uk/sites/files/oxlaw/field/field_document/7_0.pdf> accessed 25 April 2018.

[93] *Bishopsgate Investment Management Ltd.* v. *Homan*, 1995 Ch 211, 221.

[94] *Federal Republic of Brazil* v. *Durant International Corpn.*, 2016 AC 297 : 2015 UKPC 35.

ment of bribe proceeds in installments and the proceedings revolved around the issue-whether three of such installments can be labelled as "traced assets/ substitute assets". The chronological orientation suggested it possible only by the application of backward tracing[95] which does not have a sound application in this jurisdiction.

The council despite agreeing to the conceptual coherence and soundness of this argument[96], refuted the same, dismissed the appeal and projected the application of the test of **co-ordination between the depletion of the trust fund and acquisition of the traced asset**[97]. The Board did not doubt the correctness of the previously decided judgments[98] wherein backward or equitable tracing was held to be undeveloped for a full-fledged application. These cases were distinguished as in none of these factual scenarios was there a concerted and coordinated effect of inward and outward movement of the assets in the overall transaction.

## Insolvency Specific Court orders (Civil)

If there exists a course of action justifiable in England and a prima facie case on merits coupled with the "real risk" that the defendant will attempt to dissipate the assets, the court will grant a freezing order against the assets of the defendant. These orders can also bite any third party if in that party's name, the defendant is holding beneficial assets (regardless of any specific claim against that third party)[99]. If the third party is foreign based, the order, by the application of **"Babnaft proviso"** will not be applicable unless it is given effect to by that local foreign court[100]. This order can also be accompanied by a **search order**, a **writ ne exeat regno order** (proscribing the defendant from leaving the jurisdiction of England or giving up his passport) or a **gagging order** (which precludes the defendant from informing third parties of the existence of the proceedings and the delivery of any order).

A **Norwich Pharmacal order** seeks to bind institutions such as banks, accountants or financial advisers (which are voluntarily or involuntarily mixed up in the wrongdoing to the claimant) to a full and frank disclosure

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[95] *Ibid.*, 10 – "*The three payments which were made after the transfer of the bribe moneys into Durant Account cannot be traced to the appellants because there is no sound doctrinal basis for 'backwards tracing'.*"

[96] *Ibid.*, 18.

[97] *Ibid.*, 40.

[98] See *James Roscoe (Bolton) Ltd.* v. *Winder*, (1915) 1 Ch 62 and *Goldcorp Exchange Ltd., In re*, (1995) 1 AC 74.

[99] *T.S.B. Private Bank International SA* v. *Chabra*, (1992) 1 WLR 231.

[100] *Babanaft International Co. SA* v. *Bassatne*, 1990 Ch 13.

of the information sought by the order[101]. The involvement of the respondent in the wrongdoing shall be undoubtedly established by the claimant to seek this order and the involvement shall not be merely of a witness to the wrongful act by the company[102]. A **Bankers Trust order** shares similar features to the **Norwich Pharmacal order** but is limited to the delineation of the location of the assets[103].

## ASSET TRACING IN INDIA – THE STRATEGICALLY EMERGENT CONSIDERATIONS

The Insolvency law in India has been stationed upon the doctrines widely acclaimed in common law jurisdictions[104]. It is not a novel idea, but has gained prominence since the advent of urbanization in India. An augmented insolvency resolution regime in a jurisdiction is an indicator of the gradual drift from a centrally planned economy to a market controlled economy[105]. Hence, a rationalized and streamlined insolvency resolution mechanism assumes paramount significance to sustain in this extensively globalized universe.

Considering the anecdotal evidence on the saddening state of affairs in the courts and tribunals during the insolvency resolution proceedings, it is imperative to state that the World Bank's Ease of Doing Business Index in 2015 ranked India 137 out of the 187 jurisdictions[106]. Prior to the enactment of the Code, there existed a colossal variety of adjudicatory forums for matters relating to insolvency resolution[107]. This resulted in extreme chaos. The prepotency of corporate debtors over the creditors led to credit scarcity and hence, adversely affected the integral economy. The Supreme Court while deciding its first case under the newly enacted Insolvency and Bankruptcy

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101 *Norwich Pharmacal Co.* v. *CCE*, 1974 AC 133 (HL).

102 *Ashworth Hospital Authority* v. *MGN Ltd.*, (2002) 1 WLR 2033.

103 *Bankers Trust Co.* v. *Shapira*, (1980) 1 WLR 1274.

104 Bankruptcy Law Reform Committee, The Report of the Bankruptcy Law Reforms Committee Volume I Rationale and Design, F. No. 7/02/2014-FSLRC (2015); Gerard McCormack, "Universalism in Insolvency Proceedings and the Common Law" (2012) 2 Oxford Journal of Legal Studies 32.

105 Evan D. Flaschen and Timothy B. DeSieno, "The Development of Insolvency Law as Part of the Transition from a Centrally Planned to a Market Economy", (1992) 26 The International Law 3, 667-694 (1992).

106 World Bank, Ease of Doing Business, (May, 2018), <http://www.doingbusiness.org/en/data/exploretopics/resolving-insolvency> accessed 19 May 2018

107 Aparna Ravi, "Indian Insolvency Regime in Practice: An Analysis of Insolvency and Debt Recovery Proceedings", (19 December 2015), <https://www.epw.in/journal/2015/51/special-articles/indian-insolvency-regime-practice.ht ml?0=ip_ login_nocache%3De8f-217853e54428113c6d8723fb15724> accessed 19 May 2018.

Code, 2016 noted that the Code has brought a paradigm shift in the law and has introduced the concept of creditor in control in India, wherein the management of the corporate debtor and its assets are deprived of their control after the Code is triggered[108].

In this backdrop, it becomes indispensable for the purpose of this research to address the statutorily granted mechanisms for asset tracing in India. The extant statutory framework in respect of asset tracing in India consists of a collective understanding of the Insolvency and Bankruptcy Code, 2016 along with the allied rules and regulations, the Indian Contract Act, 1872, the Companies Act, 2013, the Transfer of Property Act, 1882, the Indian Trusts Act, 1882, the Code of Civil Procedure, 1908, the Code of Criminal Procedure, 1973, the Indian Penal Code, 1860 and any other sector specific law relating to the facts at hand. Considering the common law orientation of India, the law based on precedents also needs to be conjunctively appreciated with the statutory apparatus.

## Judicial Apperception to creation of "constructive trusts"

The idea of creating a constructive trust was impliedly recognized in India in the case of RBI v. Bank of Credit and Commerce International (Overseas) Ltd.[109] This was a case where the "**margin money**" deposited by the applicant in a separate margin account of the bank was sought to be included in the general assets of the bank for the purposes of a ratable distribution of assets. The court held that the relationship between the bank and the applicant was that of a trustee and a beneficiary and hence, on the commencement of insolvency of the bank, (trustee) the moneys due to the applicant shall be fully recoverable and it will not form part of the insolvency estate.

The court further held that if the bank mixes the trust money into its funds and assets and puts it into use, the doctrine of tracing shall find its applicability to guard the interests of the beneficiaries. The court placed a heavy reliance on the Supreme Court's judgment in 1961 in the case of New Bank of India Ltd. v. Pearey Lal wherein it was categorically held that the when money is held by the bank with special standing instructions and is being earmarked to be put to use only for some specific purposes, the bank will be considered to be entrusted with it and it cannot form part of the settlement scheme for the bank[110]. Similarly, it has also been held that when

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108 *Innoventive Industries Ltd*. v. *ICICI Bank,* (2018) 1 SCC 407.

109 *RBI* v. *Bank of Credit and Commerce International (Overseas) Ltd*., 1992 SCC OnLine Bom 528 : (1993) 78 Comp Cas 207, 34.

110 *New Bank of India Ltd*. v. *Pearey Lal*, AIR 1962 SC 1003.

an amount is being credited to the suspense account in the bank's books of accounts, (awaiting specific instructions for the application of that money) it is to be refunded in full to the depositors in the event of insolvency as the relation in such cases is of fiduciary nature[111].

In cases where a bank or financial service provider is not involved in the transaction, the Supreme Court has held that a constructive trust can only be created by placing a specific reference to the terms of the agreement between the parties[112]. The court held that a contractually agreed security deposit will not be treated as a trust unless the intention of the parties is made express by the agreement that a trust condition shall be created for repayment of the deposit.

Thus, it is unclouded that the Indian judiciary has been repeatedly applying the doctrine of creation of constructive trusts (although without clearly mentioning and referring to this doctrine) for tracing the assets which have either been misappropriated by the insolvent entity or mixed with its own assets and put to its own use[113].

## Tracing defaulter and its assets – Improvisations in Banks' recovery

The Indian situation post the banking scams (such as the Nirav Modi scam, Kingfisher's fiasco, Satyam scandal etc.) is not unknown. The skyrocketed NPAs and bad debt in the banks formed one of the considerations for a speedier enactment of the Insolvency code in India[114]. The Code was introduced in Lok Sabha on December 21, 2015[115] and it was enacted on May 28, 2016[116]. The short span of time in which the Code was enacted evidences the exigency to reshape the obsolete and ineffective laws relating to insolvency resolution mechanisms.

The manner and extent of involvement by the banks in tracing the assets of the defaulters has depicted a radical turnaround in the past few years. As opposed to the traditional setting wherein the banks used to accept the blow

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111 *Official Assignee* v. *Natesam Pillai*, 1939 SCC OnLine Mad 366 : AIR 1940 Mad 441.

112 *Rai Bahadur Seth Jessa Ram Fatehchand* v. *Om Narain Tankha*, AIR 1967 SC 1162.

113 *Monie Ardeshir Baria* v. *Controller of Estate Duty*, 1975 SCC OnLine Bom 166 : (1977) 106 ITR 203, 20 Trusts Act, 1882, S. 63.

114 Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design <ttps://ibbi.gov.in/BLRCReportVol1_04112015.pdf> accessed 20 April 2018.

115 PRS Legislative Research, The Insolvency and Bankruptcy Code, 2015, <http://www.prsindia.org/billtrack/ the-insolvency-and-bankruptcy-bill-2015-4100/> accessed 18 April 2018.

116 Act No. 31 of 2016, The Insolvency and Bankruptcy Code (28 May 2016).

to their balance sheets on defaults, they have now begun to employ private detectives to trail the moneys and trace the assets even if they are hidden abroad[117]. This neoteric fierceness can be seen as an instance of the effect of public anger against crony capitalism. A precedent can be the tracing of the personal assets of Mr. Sunil Kakkad, head of the Ahmedabad based information technology company Sai Info System (India) Ltd (SIS). The company had impending loans of approximately 1.41 crores with the State Bank of India and Mr. Kakkad absconded[118]. The SBI hired investigators only to unfold that Mr. Kakkad had transferred the assets belonging to the company to his own personal accounts and his companies' accounts and had also purchased properties in Liberia.

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI Act) has been amended to arrange for a faster recovery with a provision for three months' imprisonment if the borrower fails to make due provision of the asset details and for the lender to get possession of mortgaged property within 30 days[119]. Further, the enactment of a detailed circular to facilitate the effective use of section 35AA of the Banking Regulation Act, 1949 allows the central bank to initiate insolvency for the defaulters to deal with the issue of stressed assets.

## Asset tracing – Picture painted by the IBC

The Insolvency and Bankruptcy Code assimilates numerous provisions for preventing the conclusion of such defrauding transactions as well as facilitating the unraveling of the assets of the corporate debtor or its equivalent proceeds to assure the betterment of the general body of creditors. In consonance with the internationally accepted practices, the Indian code also contemplates the imposition of a moratorium period. This period has also been termed as the 'pacifying/calm period' wherein the proceedings or executions **against** the corporate debtor and its assets are stayed. Section 14(1) of the Code provides that on the commencement of insolvency, the Adjudicating

117 ET Bureau, "More Banks Hiring Financial Detectives to Trace Personal Assets of Defaulters" *The Economic Times* (Mumbai, 20 February 2015), <https://economictimes.indiatimes.com/industry/banking/finance/banking/more-banks-hiring-financial-detectives-to-trace-personal-assets-of-defaulters/articleshow/46306251.cms> accessed 4 April 2019.

118 Virendra Pandit, "Sai Info CMD 'Siphoned Off Rs 40 Cr' before He Went 'Missing', Say Staff in Plaint" *The Hindu Business Line* (Ahmedabad 19 September 2013) <https://www.thehindubusinessline.com/info-tech/sai-info-cmd-siphoned-off-rs-40-cr-before-he-went-missing-say-staff-in-plaint/article23114693.ece>.

119 PIB Delhi, Measures to Recover Loan Amount from NPAs, (July 2018) <http://www.pibregional.nic.in/PressReleaseIframePage.aspx?PRID=1539834> accessed 1 April 2019).

Authority shall declare the moratorium[120]. Insolvency commencement date is the date of admission of the application for initiating the insolvency resolution process and the appointment of interim resolution professional[121].

The moratorium precludes a variety of actions against a corporate debtor including creating a charge or encumbering the assets of the corporate debtor[122] except the supply of essential goods or services to the corporate debtor[123]. It also extends to the preclusion of any transfer, encumbrance, alienation or disposal of assets or any beneficial interest by the corporate debtor[124]. The horizon of section 14(1)(b) is narrowed to extend its coverage to the property and assets of the corporate debtor and not those owned by its promoters[125]. This provision in the Code confirms that the corporate debtor does not strip off its value during the process and if it does so, it shall attract the punishment prescribed under section 74 of the Code.

Additionally, the Code also mandates the collection of asset details and taking control and custody of the assets of the corporate debtor by the interim resolution professional ('IRP')[126]. However, if the asset is owned by a third party and merely possessed by the corporate debtor under a contractual arrangement or a trust, (which can be by an agreement or by the operation of law) it shall not form part of these obligations of the IRP[127].

Furthermore, to guarantee a consented variation of the creditor's rights and interests in the corporate debtor post commencement of the process under the Code, section 28 places a mandatory condition of seeking an express approval by the committee of creditors for undertaking certain specified actions by the RP[128]. Creation of any security interest over the assets of the corporate debtor and recording any change in the ownership of the assets are two of the specified actions under section 28. It enables the committee to keep an eye on the transactions being undertaken by the RP concerning the assets of the corporate debtor. It acts as a deterrent for the RP. If any action contravening this section is undertaken, it shall be considered void and the

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120 Insolvency and Bankruptcy Code, S. 14(1).

121 Insolvency and Bankruptcy Code, S. 5(12).

122 Insolvency and Bankruptcy Code, S. 14(1).

123 Insolvency and Bankruptcy Code, S. 14(2).

124 Insolvency and Bankruptcy Code, S. 14(1)(*b*).

125 *Alpha & Omega Diagnostics (India) Ltd.* v. *Asset Reconstruction Co. of India Ltd.*, 2017 SCC OnLine NCLAT 394; *Schweitzer Systemtek India (P) Ltd.* v. *Phoenix ARC (P) Ltd.*, 2017 SCC OnLine NCLAT 235 .

126 *Ibid.*, Ss. 18(*a*) and (*f*).

127 *Ibid.*, Expln. (*a*).

128 V.S. Wahi, *Treatise on Insolvency & Bankruptcy Code* (Bharat Law House 2018).

committee shall also have the right to report such actions of the RP to the Adjudicating Authority for taking necessary actions against him[129].

The liquidator has been granted wide powers for taking any measures he considers necessary for the effective protection and preservation of the assets of the corporate debtor[130]. He acts in a fiduciary capacity for the benefit of the creditors[131]. It is worth noting that the liquidator holds the liquidation estate for the benefit of the creditors only and not for any other stakeholders such as contributories in the process.

## Exposition of Asset tracing in Preferential, Undervalued, Fraudulent and Extortionate Transactions

The transaction avoidance power of the resolution professional is one of the most discussed concepts amongst insolvency resolution ideas. However, the nature and the consequent ramifications of the orders which are permitted to be passed by the Adjudicating Authority under the Code are a little less explored. This article seeks to achieve a clarity on the same by engaging in a high-level analysis of the nature of these orders and its implications for the parties.

Section 36(3)(f) of the Code includes assets or any value recovered as a consequence of avoidance of transactions in the meaning of "**liquidation estate**". Section 44 of the Code enumerates the list of orders which can be promulgated by the Adjudicating Authority in the cases of preferential transactions. It includes a direction to any persons to pay an equivalent sum accounting for the benefits received by him from the corporate debtor[132].

This is illustrated as one of the explicitly stated mirror images of the doctrine of constructive trusts as prevalent in the United Kingdom which facilitates asset tracing under the Code[133]. The Bankruptcy Law Reforms Committee clearly acknowledged the necessity of a stricter scrutiny of these transactions and the grant of certain enabling powers to the Adjudicating Authority for reversing the effect of such transactions. It was perceived in the discussions that this property shall be held by a third party as trustee and is required to be distributed through the waterfall as prescribed under section 53 of the Code.

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129 *Ibid.*, Ss. 28(4) and 28(5).
130 *Ibid.*, S. 35(1)(*d*).
131 *Ibid.*, S. 36(2).
132 *Ibid.*, S. 44(1)(*c*).
133 Report of the Bankruptcy Law Reforms Committee Volume I: Rationale and Design <ttps://ibbi.gov.in/BLRCReportVol1_04112015.pdf> accessed 20 April 2018.

## Recommendations and Concluding Comments

A remarkable amount of advancement can be witnessed in the theory and practice of the insolvency framework. A comparative understanding of these laws in various jurisdictions has been entailed due to the current transformation in favor of globalization and integration taking effect across the globe. It is imperative to apprise oneself of the differing legal and judicial apparatus for insolvency resolution while contemplatingthe setting up of any business. As it is believed, one should be optimistic but not to the extent of becoming a rabbit to be defeated by the slowly approaching tortoise of financial difficulties and finally, insolvency.

Insolvency might not only knock at a company's door due to its own faults or negligent handling of its business. There may be a myriad of reasons. For instance, as Fin-Techs are developing, (such as the online payment platforms like Paytm, PhonePe etc.) if in future the traditional banking system fails or banks get insolvent, it shall be on account of their displacement by technological superiority of the Fin-Tech entities (it is not always the company's fault, it might just get unfortunate).

One of the elementary rationales for the enactment of any insolvency law in any jurisdiction shall always be to satisfy the creditors on account of the incapacitated state of affairs of the debtor and concurrently expedite an effective resolution for the debtor. Henceforth, the legal avenues and vacuums placed for "asset tracing" assumes significance. This article has attempted to kick-start a high level discussion about the differing ramifications of the tools provided for asset tracing in India, United Kingdom and United States.

On a prima facie stratum, Indian insolvency framework is wholly different from the U.S framework. In United States, the debtor-in-possession regime is applied while, on the contrary, in India, we have recently shifted the focus on the creditor-in-control model from the erstwhile debtor management set up under the Companies Act, 2013 and 1956. The contrasting base line of entitlements in India and U.S is the reason for this difference.

In India, as it is not unknown, one of the underlying objectives of the Code was to address the issue of piled up NPAs and bad debt with the banks and financial lenders. Therefore, the new law had to be titled in favor of creditors (specifically the financial creditors). Henceforth, we have a committee of secured creditors unlike in U.S where it is agreed that secured creditors are already empowered enough to resume with their actions against the company after the automatic stay is lifted and hence, a committee of unsecured creditors shall be a viable option to balance the dichotomy of rights and entitlements between both the classes of creditors. In U.S., the problem of NPA was addressed long back. They believe that the debtor is the best entity to resolve its own insolvent state and it is best apprised of all the nitty-gritties of its own functioning and operations. However to avoid any conflicting situations, the Bankruptcy Code also makes due provisions for replacing the debtor-in-possession with a managing trustee (where there is any claim of fraudulent behaviour or the debtor is incompetent to deal with the issue).

In due course of this article, the author analyzed that the Bankruptcy Code contains numerous provisions to assist the creditors and debtors to trace their assets or an equivalent benefit and to consolidate and accumulate the bankruptcy estate such as the imposition of automatic stay to prevent any dissipation of assets, avoidance actions to reclaim the assets for the benefit of the estate and discovery mechanisms to trace the location, nature and value of the assets. Similarly in the United Kingdom, the Insolvency Act empowers the office holders to take appropriate actions for the recovery of assets. Moreover, there are other mechanisms as well outside the Act to seek orders form the civil courts. Indian situation can be rightly concluded to be at a nascent stage, as under the Insolvency Code, we do not have express provisions recognizing the concept of "asset tracing" as of now. However, practically, the Code promotes efficient measures to be undertaken for recovering the assets.

One of the stark differences marked by the author is in respect of the tripartite relationship between the office holder, the company (or the corporate debtor) and the creditors (individually as well as a general body of creditors) in India and the United Kingdom. Indian law attaches a fiduciary relation between the liquidator and the creditors of the corporate debtor, however, in UK, (as it is pointed while analyzing the case law pertaining to misfeasance claims) the relation is seen to be established between the company and the office holder.

The Indian code provides that the liquidator shall be a fiduciary for the "**benefit of the creditors**". This phrase has not been raised for interpretation of the judicial authorities as of now. However, a literal and coherent understanding of the same is the establishment of a fiduciary relationship between the creditors and the liquidator. Therefore, this issue is still unaddressed and requires a legislative clarity.

Moreover, as noted earlier as well, there is a dire need of incorporating specific provisions in the Code with respect to asset-tracing such as the discovery mechanisms or a reference to the Civil Courts for claiming injunctions etc. Although in the banking sector, continuous amendments are being deliberated to strengthen the recovery process as well as to create a deterrent effect for the defaulters.

Besides appreciating the ramifications of the recent amendment to the Code and to the allied regulations, it is worth noting that guarantors to the corporate debtor have been ousted from the scope of section 14. In most of the situations, a guarantor to the corporate debtor is a person from the Board of the company or a promoter and willat least bea related party to the company. In this scenario, one of the appalling implications can be the dissipation/disposal of the property owned in the name of the guarantor but a beneficial interest is held by the debtor. Therefore, this amendment leads to the creation of a loophole for the stricter scrutiny of prevention of asset disposal.

The argument that guarantors and the corporate debtor shall stand and be treated as separate entities seems to be contradicted by section 44(1)(e) of the Code. This provision states that the Adjudicating Authority shall have the power to direct any guarantor in case of a preferential discharge of obligations to be a guarantor under the new or revived debts. Where the orders under this provision can stand applicable to a guarantor, it raises concerns as to why should moratorium not apply to guarantors.

The position in the United States should be considered by the Indian law making agencies in this respect. In the United States, the automatic stay shields the debtor and its property only and excludes any guarantors to the debtor or its affiliates. This position stands similar to the ruling position in India as well but it exists with a pinch of discretion with the bankruptcy courts. If it appears that sidelining the guarantors or affiliates of the corporate debtor from the operation of the automatic stay interferes with the ability of the debtor to reorganize successfully, it may enjoin them as well.

This position seems more secured. However, a contrary opinion against the same can be the risk vis-à-vis the capacity of the Indian judicial system to exercise this discretion wisely and ensuring that this exception does not become a rule, especially when the Adjudicating Authorities have been recently constituted and have not dealt with a plethora of cases.

# Book Review
# Gigged by Sarah Kessler

*Sreyan Chatterjee*



## Introduction

The gig economy represents that section of the economy characterised by temporary work contracts between parties. Gigged, a book with a hat tip to the gig economy's early ambition in its subtitle, "The Future of Jobs", is the culmination of a decade's work by journalist Sarah Kessler. Kessler's day job has been on the startup beat in New York during this decade: rotating through various desks but always with a ring side view of the nascent gig economy. In this book, she explores the rise of both new jobs and jobs-in-transition which do not share the character of traditional employment in various ways: temporal in nature, less control by the 'employer', reduced wages and benefits offered and more flexibility in choosing the type, timing and quantum of work by the 'employee'. Historically, relationships of this nature have been termed variously as freelancing or independent contracting but the rising trend, especially by startup companies has necessitated a new term: the gig. Kessler's approach does justice to the emerging literature, exploring broad labor issues in the gig economy through the personal experiences of a wide variety of stakeholders in the gig economy. From hyper-productive Mechanical Turk workers, motivated Uber drivers, gifted Gigster programmers to startup founders with interests in both the bottom line and positive community impact, it is an impressive range of perspectives that this book offers. Kessler's personal investment in their lives as well as her political opinions come through but never threaten to skew or stifle the narrative that the book sets out for itself. Kessler's approach is structured enough to ensure that this book will find mention as a worthy literary effort in documenting the labour issues of this era.

## Misrepresentation and Marketing

When discussing the rise of the venture capital backed gig economy startups, Kessler's narrative highlights one particular regulatory gap. This is the tendency of new business models to proclaim themselves as the panacea to the historic clash between labor and capital. In the period from 2012 to 2015, a time marked by the rise of Uber in the transportation industry, Uber's (and other gig economy companies') marketing pitch consistently harped on the fact that the traditional job was failing most job seekers. This failure was manifested in a number of ways: lack of jobs, stagnancy of wages for most jobs, a lack of meaning and purpose in one's function and a lack of control over one's working conditions. Uber's continually referenced the flexibility for its driver-entrepreneurs, control over the work day and the narrative of business partnership in the pitch to get drivers signed up. The marketing to investors would suggest that this was a new paradigm of work where all stakeholders would have unprecedented leeway to define their actions. The final part of the pitch, to the consumer focused on convenience and pricing. However, the narrative of control and flexibility ended up being a hollow promise to most of Kessler's protagonists: the flexibility seeming to have accrued only to the gig economy corporations and none of it to gig economy workers. Kessler highlights multiple times in this book that the well-known axiom of contract law still holds true: that equality of contract terms can only come with equality of bargaining power. There is a critical example that Kessler highlights to make this point. While Uber is extra careful not to use traditional methods of control (such as explicit instructions and training) over drivers (to avoid an expensive court mandated classification as employees), the problem for Uber was to maintain a consistent level of service without instruction or control. To solve this problem, Uber's management made extensive use of the expertise of social scientists. They helped in devising opaque social engineering tools to manage and channel the behavior of the driver entrepreneurs on Uber's platform while being able to maintain a facade of being only a gig-aggregator company. When one party in a contract has all the bargaining power and the contract is largely unregulated, an unequal outcome is the inevitable conclusion. This misrepresentation in the marketing effort has been at the root of the dissatisfaction of many stakeholders in the gig economy.

## The Gig Economy Pays Off

There are notable exceptions to the tale of false advertising, and to Kessler's credit, she devotes equal attention to these even at the risk of veering away from her main narrative. One of the main examples in this bucket is the computer programmer who quits his highly remunerative but largely unchallenging traditional job. When he finds himself on a work aggregator platform like Gigster, he is skilled enough to understand the terms of his service and mobile enough to exit when he wants to re-enter traditional employment again. Kessler documents how for the period he was engaged with Gigster, his hourly compensation was higher as well his flexibility to perform the given services. Eventually, he moves on from Gigster to re-enter traditional employment but with his skill set and options considerably enhanced.

The other exception can be found at the lower end of the spectrum, where the identifiers of a good job have more to do with how long personal insolvency is avoided. When compared to widespread unemployment outcomes such as a major employment providing factory shutting down in a town, the gig economy can provide enough of a parachute to many and soften the blow of sudden unemployment. The idea that comes through from Kessler's book is that the gig economy can shine as a stop gap solution to prevent the worst outcomes for many workers. This conclusion again remains to be tested over the long term.

## The Gig Story in India

In most Indian cities, the advent of Uber (along with the locally started up Ola) has opened up new market segments in the transportation industry hitherto unfulfilled by the public or the private sector. In a country where public transport is cheap but overburdened and private transport stays reserved for only the economically privileged, cab aggregator applications have captured the critical market for consumers looking for convenience at a bargain price. At the same time, it has attracted large number of small business owners and drivers with the lure of high earnings, control and flexibility.[1] This is where Uber's marketing approach has graver consequences than in developed countries. Cab aggregator applications like Uber and Ola have faced nearly 35 major and minor strikes/protests from drivers in India in the last couple of years. There has been one common grievance among almost all the various drivers who went on strike: the large and ever widening difference between the initially advertised take home pay and the actual earnings per month.[2] This outcome is similar to what Kessler's work in other countries have shown, for most workers in the gig economy, stability has more value than flexibility. For the period while the heady times lasted, most new drivers

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1 Sundeep Khanna, "Striking Workers a Consequence of Failed Business Models" (*Livemint*, 31 October 2018) <https://www.livemint.com/Opinion/qirJJuwxZ4ug7UF97FmsZO/Ola-Uber-strike-in-Mumbai-Delhi-bus-strike-DTC-strike.html>.

2 Karan Choudhary, "Ola, Uber Strike in Mumbai May Have Ended, But Drivers' Woes Everywhere Continue" (The Wire, 4 November 2018) <https://thewire.in/labour/ola-uber-strike-mumbai>.

had financed cars at exorbitant interest rates which they hoped would be offset by their assured earnings over a long period of time. As per anecdotal evidence, without turning a profit, Uber managed to live up to their earning assurances for a while no doubt burning through the venture capital war chest it had built up (it would not be entirely unsurprising as Uber considers India to be its single biggest and most important market).[3]

However, as elsewhere in the wider economy, in a clash of interests between the shareholders and workers, the workers tend to lose. While on the consumer side, the market niche for Uber/Ola's services have been well established, the drivers are increasingly finding themselves on the road not to earn a better living but to be able to pay-off the vehicle debt burden. It will be interesting to see how this plays out in India and whether Kessler's vision of the gig economy as a low cost temporary employment security net is realised. For now, what the gig economy predominantly has achieved is creating and fulfilling a critical market niche on the consumer side by locking a large number of workers in a vicious debt trap.

## Where now?

From the experiences outlined above, there has to be some political will to go about the regulation of the gig economy. Kessler draws from historical context when discussing the take-aways for policy and regulation. When the Industrial Revolution started to sweep around the world, drawing in workers from their traditional self-employed vocations, many captains of industry lobbied against the first protective legislations that would govern their factories. The claim in these lobbying efforts was that protective legislation for workers would stifle the bottom line and hence innovation. It is helpful to remember that this was happening in a time when work hours were dawn to dusk in life threatening conditions, wages were near to starvation wages and child labour was used as a matter of course. Led by a few pioneers, the status quo changed slowly and steadily and the 8 hour workday, minimum wages, paid break times and prohibition of child labour came to be as standard as it is today. It is not unreasonable, so Kessler's conclusion goes, to expect hard work for all stakeholders to ensure minimum standards in the gig economy as in the rest of the organised economy. Leaving open the question of how and when this change comes to pass, what is clear is that Kessler's work will remain a relevant literary landmark to anyone willing to document that journey in the future.

3 "Uber to Focus on High-Potential Markets Like India" (*The Economic Times*, 17 August 2018) <https://economictimes.indiatimes.com/small-biz/startups/newsbuzz/deliberately-investing-in-uber-eats-high-potential-markets-like-middle-east-india-uber-ceo/articleshow/65423860.cms>.

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Submissions may be made in electronic form (strongly recommended) or in hard copy. All submissions must be word processed, and formatted in Times New Roman, point 12, 1.5 line spacing. All word limits are inclusive of footnotes.

References and citations must be in the form of footnotes (not endnotes) and must conform to the latest edition of Bluebook. Footnotes must be formatted in Times New Roman, point 10, 1.0 line spacing.

All submissions must contain the name of the author, academic qualifications, professional information (including institutions to which they are affiliated), the title of the manuscript, and contact information. Joint authorship of papers by individuals of the same or different institutions is welcomed.

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